

## OICV-IOSCO CONSULTATION REPORT

### Unregulated Financial Markets and Products

#### Comments by AMAFI

1. *Association française des marchés financiers* (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of the members are subsidiaries or branches of non-French institutions.

2. AMAFI welcomes the opportunity to comment on the Consultation Report (hereafter referred as to the "Report" on "Unregulated Financial Markets and Products" issued by the Technical Committee of the International Organization of Securities Commissions.

3. Before answering the specific questions raised by the "Report", AMAFI would like to emphasise some general comments.

#### I) GENERAL COMMENTS

##### ➤ *ISOCO's initiative is a very important one*

4. AMAFI strongly supports IOSCO's initiatives to put in place regulatory measures in order to restore confidence in the field of unregulated financial markets and products. The Report which tends to provide regulators with interim recommendations that could be implemented rapidly is particularly welcome.

##### ➤ *The future regulation should take into account the main lesson of the crisis: there are very different kinds of markets, that require very different treatments*

5. AMAFI considers that a sound regulation should be based on a sound analysis of the functioning and the role of the various unregulated financial markets and products. As AMAFI pointed it out in November 2008 (Reforming the Global Financial System – AMAFI / 08-51 EN), one of the main lessons of the crisis is that **there are markets and markets**.

6. For AMAFI, one appropriate reference for a well-functioning market is the organised market model. Here, orders for products subject to regular, regulated disclosures and numerous competing financial analyses are matched actively and continuously, offering a substantial level of liquidity. Equity markets, for instance meet the criteria of the organised market model. Such markets never lost their essential role, or their liquidity, during the crisis and are currently regulated by IOSCO's members. This

does not mean that their security and stability cannot be increased, nor that all markets should be built on the basis of that model.

7. In fact, the concept of OTC markets includes a wide variety of situations. Some of them are sufficiently homogenous (commoditised), liquid and active to provide a level of reliability that comes close to regulated markets. This is the case of Government bonds, foreign exchange, or most commodities. Again this does not mean that they cannot be improved. But any change should be carefully designed so as not to lose what exists.

8. Some other markets have remained pretty active and liquid in the crisis but may contribute to create a systemic risk, mainly because they tend to incorporate a high degree of counterparty risk that is not eliminated after completion of the transaction. This is currently the case for CDSs - and swaps in general. The systematic reduction and possibly elimination of that risk would considerably reduce the possible danger raised not only by the markets but also by so-called 'too big to fail' institutions (AIG is a case in point).

It is a high priority then to bring them closer to the optimum market model (organised market and commoditised market), in any case for clearing and probably also in many cases for trading. CDSs markets suffer from the lack of standardisation of contracts. Room should be left for specific customised products but the regulations governing the markets and prudential regulation should treat this case as a more risky side-case, which implies tougher equity levels. The reference should be a standardised, cleared, and liquid market.

9. Some markets and products are very different from those two types. Securitisation is a case in point. In this case, the secondary markets have suffered from a complete loss of liquidity. This is partially due to the opaqueness of the underlying assets and the complexity of many products. But in fact most of those products were not actively traded even before the crisis. Initiatives to standardise them and significantly increase their liquidity on the secondary market, notably through better information (the industry has made an excellent work in that direction) but also more commitment by originators (and others) to act as reliable market makers, are very welcome. If some of those markets do revive, which means an actively traded secondary market, they will be closer to the optimum model. If not, to be blunt, they should not be considered, from a regulatory, prudential and management point of view, as real securities, and managed for all practical purposes as loans in the banking book.

➤ ***Market regulation versus prudential regulation.***

10. As mentioned above, there is a large spectrum of financial markets and products. The future regulation to enhance these markets should not only rely on market regulation but also on prudential regulation. Future market regulation should focus on the markets which are close to the optimum market model but not yet regulated. Future prudential regulation should take into account the liquidity of the market and impose more capital requirement only to not liquid products: for the liquid ones, the crisis has not demonstrated a need for such an increase. This means that the definition of the trading book versus banking book should be revised. In other words, the more a product can be traded in a way close to the optimum market model, the less capital requirement should be charged for an investment firm or bank which trades in this product.

➤ ***Market initiative versus market regulation.***

11. AMAFI believes that industry led initiatives to enhance the markets are useful and necessary, but like IOSCO, AMAFI considers that industry initiatives may not be sufficient to achieve overall responses to the various issues raised by the functioning of the markets. AMAFI has always proposed both regulatory and industry led initiatives to enhance the markets. AMAFI also recommends a significantly more proactive action by regulators to help organise the markets and bring them closer to the optimum model.

12. In addition, given the complexity of the issues raised by the different types of markets and products and the challenge for regulators to have internal resources with a deep knowledge of all the markets and products, AMAFI encourages IOSCO to set up working groups with the industry, at an international level, in order to collaboratively examine whether, where and in what form further regulation should be necessary.

➤ ***Cooperation between regulators***

13. AMAFI strongly supports the emphasis given in the Report on the need for coordination and integration of regulatory measures. Indeed, markets work on an international basis and a lack of cooperation makes it impossible to prevent and manage crisis situations. Hence we consider that the Report should be more explicit in proposing requirements urging regulators to cooperate and to exchange applicable information and data, and harmonise the answers they give, notably their regulations.

➤ ***The first interim recommendations are generally acceptable but there is a need to go further for the CDS markets.***

14. Generally speaking, AMAFI agrees with the interim recommendations (see detail response below). Nevertheless, AMAFI would like to point it out one important issue concerning the localisation of the Central Counterparty House for the CDS. By favouring CCPs the danger is thereby to accumulate risk in them.

15. To prevent that risk, for AMAFI each CCP must have intraday/overnight access to central bank money in the currency it operates in and a CCP should not be allowed to take credit risk and liquidity risk. A CCP should always be in a position to rapidly and securely obtain the necessary liquidity for it to limit systemic risks. In the event of a major financial crisis in, the central banks had a major role to play in order to solve the crisis. In case of default of one of its participants, a systemic CCP needs to be able to have access to the liquidity provided by a central bank as rapidly as possible (on an intraday or overnight basis). In this context, the CCP should have a direct link with the central bank and should be in some respect under its supervision.

## II) IOSCO QUESTIONS

### Securitisation

#### ***TC interim recommendation #1:***

*IOSCO encourages industry responses in the securitisation market and recommends the following regulatory responses:*

- 1. Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation;*
- 2. Enhance transparency through disclosure by issuers of all checks, assessments and duties that have been performed or risk practices that have been undertaken by the underwriter, sponsor, and/or originator*
- 3. Require independence of expert used by issuers; and require experts to revisit and maintain reports over the life of the product*

**16.** AMAFI believes the question of whether originators and/or sponsors should be required to retain a long-term economic exposure to securitised products needs to be carefully considered. While we understand the appeal of a retention requirement we see that there are many questions in relation to the practical effectiveness of such measures. Specifically, we would suggest that the imposition of retention requirements would need to take account of developments regarding regulatory capital, as well as accounting and legal treatments. In addition, the calculation of any retention requirements would need to be appropriately flexible in order to take into account differences between various asset classes.

**17.** Further reflection on market making in those securities and on any ways of ensuring that those securities are real securities, actively traded on a secondary market, would also be necessary. In the absence of any secondary market they should be managed as loan portfolios and/or private placements held to maturity, with the appropriate prudential consequences.

**18.** AMAFI fully supports the recommendation to “enhance transparency through disclosure by issuers of all checks, assessments and duties that have been performed or risk practices that have been undertaken by the underwriter, sponsor, and/or originator. We consider that, improved information disclosure and the dissemination of that information to investors is fundamental to the soundness of the securitisation market (while not sufficient – see above). Efforts to standardise disclosure by issuers, pre- and post- issuance, is an important contributor to improved market confidence. We believe that here the focus of regulators and market participants should be on the quality and meaningfulness of the disclosure. The development of standardised risk measurement metrics for these products would also add to comparability and provide investors with alternative means to evaluate risk. These are precisely the kind of issues that industry initiatives seek to address and we encourage IOSCO to work with the industry towards adoption of these or similar standards.

**19.** AMAFI considers that the scope of what expert should do is not clear and should be specified by IOSCO.

**TC interim recommendation #2:**

*IOSCO encourages industry responses in the securitisation market and recommends the following regulatory responses:*

*1. Mandate improvements in disclosure by issuers including initial and ongoing information about underlying asset pool performance and the review practices of underwriters, sponsors and/or originators including all checks, assessments and duties that have been performed or risk practices that have been undertaken. Disclosure should also include details of the creditworthiness of the person(s) with direct or indirect liability to the issuer*

*2. Strengthen investor suitability requirements as well as the definition of sophisticated investor in this market.*

*3. Encourage the development of alternative means to evaluate risk with the support of the 'buy-side'.*

**20.** AMAFI supports efforts to improve disclosure that help investors to assess securitized products. IOSCO's acknowledgement of Industry work already under way is welcome, in the areas not only of enhanced disclosures but also of greater standardization where possible, e.g. with regard to definitions and calculation methodologies. We believe that originators and issuers need to bear legal responsibility for the accuracy and quality of information produced by them in relation to securitised products.

**21.** AMAFI also agrees that a sound definition of "sophisticated investor" is of great importance in complex markets, especially to induce these investors not to show overreliance of ratings given by the Credit Rating Agencies but to perform their own risk assessment. However, a review of the "sophisticated investor" standards should be based on the assumption that the concept as such is correct and important, i.e. the review should be one of specifics rather than of principle. AMAFI believes that relevant authorities determine the application of "sophisticated investor" in each jurisdiction, but that these regional specificities should not lead to undermine the principle of a maximum international consistency.

**22.** The development of alternative risk evaluation standards can be a good complement to these measures. This should be done bearing in mind the need for diversity of assessments and opinions, rather than increased alignment of investor expectations.

**TC interim recommendation #3**

*IOSCO recommends that jurisdictions should assess the scope of their regulatory reach and consider which enhancements to regulatory powers to support TC interim recommendation #1 and #2 in a manner promoting international coordination of regulation are needed.*

**23.** AMAFI agrees with the assessment made in the Report that each jurisdiction will need to assess the scope of existing regulatory parameters and expand that scope to the extent necessary to take measures identified to restore confidence in the securitisation market.

**TC interim recommendation #4:**

*IOSCO encourages industry responses in the CDS market and recommends the following regulatory responses:*

- 1. Provide sufficient regulatory structure for the establishment of CCPs to clear standardised CDS, including requirements to ensure:
  - a) appropriate financial resources and risk management practices to minimise risk of CCP failure;*
  - b) CCPs make available transaction and market information that would inform the market and regulators; and*
  - c) cooperation with regulators;**
- 2. Encourage financial institutions and market participants to work on standardising CDS contracts to facilitate CCP clearing.*
- 3. CPSS-IOSCO Recommendations for CCPs should take into account issues arising from the central clearing of CDS.*
- 4. Facilitate appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data*

**24.** AMAFI strongly **supports** these recommendations. Standardization of CDS contracts is a key issue. In addition, as mentioned above, AMAFI considers that each CCP must have intraday/overnight access to central bank money in the currency it operates in and a CCP should not be allowed to take credit risk and liquidity risk.

**25.** With regard to transparency, the Report does not make an important distinction between disclosure to regulatory authorities, which lies at the core of addressing concerns about systemic risk, and public market transparency. Clearly, it is essential for market participants to provide regulators with the appropriate information so that regulators are able to analyse systemic risk and supervise the conduct of markets. Our concern is that national data reporting requirements should be globally consistent with one another, aligned with the technical capabilities of existing IT systems, and should not place excessive demands on compliance staff by requiring them to produce complex manual reports on a regular basis.

**26.** We believe that necessary public reporting will develop as an integral by-product of central clearing. Therefore, we consider that for public reporting the focus of the authorities should be to ensure that relevant information, which is available from CCPs, is appropriately delivered to the public.

**27.** AMAFI also considers that the question of the localisation of the data warehouses for CDS should also be raised by the regulators.



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