Consultation on possible measures to strengthen bank capital requirements for counterparty credit risk

Response by

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Friends of the Earth Europe (FoEE) campaigns for environmental and economic justice, including the principle of food sovereignty and global sustainable and just use of natural resources. FoEE unites more than 30 national organisations with thousands of local groups and is part of the world's largest grassroots environmental network, Friends of the Earth International. FoEE is united by a common belief in strong grassroots activism and effective national and international advocacy. FoEE is the European branch of Friends of the Earth International, the world's largest grassroots environmental network uniting 77 national member organisations and some 5,000 local activist groups on every continent.

We have based our contribution to this consultation on the response of SOMO and on our response to the consultation on capital requirements in April 2010.

General response to questions 1 and 29

The proposals about qualifying and non-qualifying CCPs and treatment of incurred credit valuation adjustments (CVA) focuses on assessing only the financial risks of exposure to CCPs. However, not all derivatives -OTC or on exchanges- have the same functions and effects. Some derivatives have particular social, environmental and economic risks, especially commodity derivatives, credit derivatives and emission allowance derivatives. By not measuring social and environmental risks of such derivatives, the CCP risk is underestimated. Not only do speculating parties in the derivative trade and the clearing houses have no or little information on, or interest in, the social and environmental risks of underlying assets or markets etc. on which the derivatives are based. More importantly, derivatives trading itself creates social and environmental risks.
The following are examples of social and environmental risks for CCPs exposed to the following derivatives, OTC and on exchanges, and their trading:

- **Credit derivatives**
  The social and economic and even monetary impacts of credit default swaps (CDS) have become clear during the sub-prime mortgage crisis. The offering of non-transparent ('OTC') CDS resulted in more sub-prime mortgages to be sold in an unfair way to low-income people. When interest rates went up, default followed and many people lost their homes. When the CDS issuers could no longer fulfil all the due payments, a total mistrust lead to a stop in interbank lending. During the Greek budget crisis, the role attributed to CDS against Greek bonds resulted in making credits to Greece and Greek sovereign bonds more expensive, aggravating the Greek crisis and its social consequences (e.g. cuts in public services).

- **Agricultural commodity derivatives**
  The increased speculative investment and trading in agricultural commodity futures, and the related services by banks (e.g. index funds), have played a role in the significant increases in food and agricultural prices during 2008[1]. Price increases then resulted in riots by low-income groups in poor and food importing countries. Indeed, too high food prices breach poor people's right to food as defined in the Universal Declaration of Human Rights. The influence of increasing and excessive financial speculation in agricultural commodity derivative trading continues to risk disruption of these markets and to risk volatile and higher food prices – a risk that could affect again food

[1] For the role of financial speculation in agricultural commodity derivatives plaid in the food price hikes in 2007-2008, see for instance: J. Baffes and T. Hanniotis (2010), "Placing the 2006/08 commodity price boom into perspective", World Bank Policy Research Working Paper 5371, July 2010.

consumption and production after prises peaked again in 2011, and could influence inflation and the economy as a whole. This could lead to social, economic, political and financial instability. Moreover, none of the derivatives trading assesses whether the commodities of the underlying contracts are being sustainably produced and transported.

Box 2: At the European Parliament hearing, before his appointed as the new Commissioner for the EU's Internal Market and Services, Michel Barnier said in January 2010: "Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world".[2]

- **Energy and metal derivatives markets**
  Financial speculation on energy (oil, gas) and metal derivatives markets can also contribute to volatility and increases in prices of energy and metals.[3] This can have important economic consequences such as impacting on inflation. Social consequences can follow when high energy prices make energy inaccessible to the poor, fertilisers too expensive to poor farmers and inflation too high an impact on the economy. Also, metal prices driven up by speculation can encourage more socially and environmentally harmful activities for mining, such as driving communities off their land for swift production increases.

- **Foreign exchange derivatives**
  Foreign exchange derivatives can be used to speculate against currencies from developing countries, and are currently playing a role in the increasing value of emerging countries' currencies. Speculation against a country's currency can have enormous economic and financial - and consequently social and environmental – impacts in a country. In addition, banks selling foreign exchange derivatives can have harmful effects (see box).

Box 3: Banks are selling foreign exchange derivatives to small exporters in developing countries, often without explaining all the risks. After unexpected movements in foreign exchange, exporters in developing countries like Brazil and India (Tirupur[4]) lost huge sums and some (near) bankruptcies made many workers unemployed.

- **Emission allowance derivatives**
  Derivatives that are based on carbon trading and offsetting projects are called emission allowance derivatives and often categorised with commodity derivatives. There are so far no regulations in place to avoid that emission allowance derivatives, and their incorporation in commodity indexes, might increase and potentially lead to a bubble in carbon trading, which would undermine the functioning of carbon trading. Moreover, the environmental benefits of carbon trading and carbon offsetting projects are being disputed, let alone when speculators would become important beneficiaries.

The underestimated and undesirable potential social, environmental and economic impacts of derivatives and their trading mentioned above might eventually undermine the value of the underlying commodity asset or index, and increase the CCP exposure to credit risk of the counterparties of these derivatives.

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[2] European Parliament, "News", European Parliament, 12 January 2010.

[3] J. Chevalier, "Rapport du groupe de travail sur la volatilité des prix du pétrole", Ministry of Economic, Industrial and Employment Affairs, February 2010: . The report pointed out that derivate speculation caused volatility and systemic risks in oil markets in 2008.

[4] K. Singh, Fixing Global Finance, 2010, p 72-73.

→ Banks that engage in the above mentioned derivatives trade and are exposed to CCPs that do not take social and environmental risks into account, should be required to hold higher capital reserves. When CCPs do not assess social and environmental sustainability risks of these derivatives (e.g. impact of trading, impact on counterparties), and in particular their potential social and environmental impacts on the underlying assets, banks should make such assessments themselves, leading to appropriate high capital reserves.
→ Supervisors should be entrusted to do their own thorough sustainability impact assessments of the above mentioned derivatives. They should require sustainability risk assessments to be conducted by CCPs as well as originators of the above mentioned derivatives, with according consequences for capital requirements by those exposed to CCPs clearing above mentioned derivatives (OTC or on exchanges) and margins requested by CCPs. In other words, new legislation on CCPs and bank exposure to CCPs should ensure that higher margins are required by qualifying CCPs for all commodity derivatives, credit derivatives, foreign exchange derivatives and emission allowance trading derivatives. Margins by CCPs and capital requirements for banks exposed to CCPs (especially if those CCPS that do not make social and environmental risks assessments) should be prohibitively higher for OTC traded derivatives as well as derivatives traded for pure financial speculation (see above), compared to derivatives for hedging purposes in which one party is a producer or an end-user (e.g. of commodities), especially in times of high volatility of prices and price spikes.

Sustainability criteria are indicators and standards on specific sustainability issues, such as biodiversity, climate change, labour rights, human rights and social justice. Many are already clearly defines so that they can give clear direction on how to make social and environmental sustainability assessments. The Ten Principles of the UN Global Compact provide a first starting point, but they can be further detailed and expanded with a large body of internationally agreed conventions, covenants and declarations of UN- and other international bodies, as well as multi-stakeholder initiatives. Examples are the Principles of Responsible Investment, the Universal Declaration on Human Rights, the ILO-conventions on labour rights, the principles and criteria of the Forest Stewardship Council, the Convention on Biodiversity, the UN Framework Convention on Climate Change and the International Code of Conduct on the Distribution and Use of Pesticides (related to agricultural commodities) and the 1995 ILO Safety and Health in Mines Convention (related to energy and metals commodities). [5]

[5] For an extensive discussion of standards for the most crucial sectors and important issues, see: BankTrack, “Close the Gap - Benchmarking investment policies of international banks”, BankTrack, April 2010.