DERIVATIVES REGULATION

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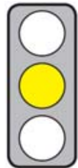
cep Centrum für Europäische Politik

MAIN ISSUES

Objectives: The Commission examines the shortcomings in the organisation of the current derivatives market and outlines the policy actions it intends to take in 2010 to increase the stability and transparency of these markets.

Parties affected: Banks; all other companies that use derivatives; stock exchanges; central counterparties.



Pros: (1) Clearing through central counterparties (CCP) reduces the default risks involved in derivatives and increases the stability of financial markets.
(2) In view of the systemic relevance of CCP, it is necessary to regulate them.
(3) Data warehouses ("trade repositories") improve supervision.

Cons: (1) For the time being, only credit default swaps (CDS) are to be subject to clearing over a central counterparty (CCP).
(2) The increase in bilateral clearing costs hampers risk management for both financial service providers and non-financial institutions.

CONTENT

Title

Communication COM(2009) 332 of 3 July 2009: **Ensuring efficient, safe and sound derivatives markets** and **Communication COM(2009) 563** of 21 October 2009: **Ensuring efficient, safe and sound derivatives markets: Future policy actions**

Brief Summary

- **Function, relevance and types of derivatives**
  - Derivates are financial contracts whose value is derived from an underlying value (e.g. stock price, commodity price, exchange rate or interest level). Should a predefined event occur in the underlying, contract partners are entitled to payment or the right to purchase or sell .
  - Derivates are used by financial institutions or other companies ("non-financial institutions") for risk hedging or speculative purposes. Certificates, options, futures and credit default swaps (CDS) are common derivatives. CDS provide for compensation payments in the case of credit defaults.
  - The volume of outstanding derivatives has grown tremendously in recent years, and at the end of 2008, it was estimated by the Bank for International Settlement to amount to USD 600 Trillion.
  - Less than 20% of derivatives – only standardised types – are traded in organised trading venues (e.g. stock exchanges). More than 80% of derivatives – mainly non-standardised, but also standardised types – are concluded and traded directly between parties ("over-the-counter", OTC). Interest rate derivatives play the crucial role here. CDS make up 7% of the entire OTC derivatives.
- **Need for action**
  According to the Commission, derivatives traded not in organised trading venues but directly between parties ("OTC derivatives") pose a significant threat to the stability of the financial market. The lack of transparency in OTC transactions and the extensive cross-linking of financial markets means that problems can spread easily and quickly throughout the entire global economy. This knock-on effect occurs in particular where a trader fails to comply with the obligations from a derivative transaction (counterparty default risk).
- **Standardisation**
  - The Commission wishes to enhance the comparability of derivatives. Both the contractual parameters of derivatives and the electronic settlement of contracts are to be standardised as far as possible.
  - In order to expedite standardisation initiatives of the private sector, the Commission is considering revising the concept of "operational risk" in the Capital Requirement Directive (2006/48/EC). Thus banks would be obliged to deposit more own funds for OTC derivatives than before.
- **Central counterparty (CCP) clearing of standardised derivatives**
  - In future, all standardised derivatives must be cleared centrally through a central counterparty (CCP). As this means the CCP will become a neutral counterparty between the contract parties in all derivatives transactions, the Commission hopes that this will help to reduce the counterparty default risk.
  - Due to "regulatory, supervisory and monetary" policy concerns the Commission insists that clearing takes place through CCPs located inside the EU. Thus CCPs would be subject to supervision by European supervisory authorities which have an "undisputed and unfettered" access to information held by CCP. Furthermore, if it were located in the European currency area, it would be "easier" to intervene should a CCP get into difficulties.

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– The Commission has announced that it wishes to regulate the activities of CCP at EU level. More specifically, it wishes to:
  - establish conduct of business rules to avoid interest conflicts and to introduce minimum standards of expertise;
  - prescribe a high-quality risk management for CCP including minimum capital requirements;
  - establish legal protection of collaterals deposited at CCP by a contract party;
  - to grant the new European Securities and Markets Authority (ESMA) the exclusive power to give CCPs authorisation to operate in the EU;
  - enable authorised CCPs to offer their services throughout the entire EU by way of an EU passport;
  - regulate the recognition of CCPs from third countries wishing to offer their services within the EU.

► **Clearing and collateralisation of non-standardised derivatives**
– The Commission concedes that tailor-made derivatives cannot be standardised and therefore are not suitable for central counterparty (CCP) clearing. Such OTC derivatives will continue to be cleared bilaterally between contract parties.
– However, the Commission intends to amend the rules for bilateral clearing as follows:
  - In future, financial institutions will have to deposit more collateral for OTC derivatives – both initial margin against the default risk and variation margins against the change in the value of a contract – and to deposit more own funds.
  - Non-financial institutions will also have to deposit more collateral in general; however, the Commission will introduce exceptions for companies which only use derivatives to a limited extent.

► **Trading on regulated and transparent trade markets**
– Like the G20, the Commission is also striving for standardised derivatives in future only being traded on regulated trade venues (e.g. stock exchanges or multilateral trading systems).
– The Commission wishes to increase the transparency of trading venues for derivatives. As part of the review of the MiFID Directive (2004/39/EC) scheduled for 2010, it will introduce harmonised transparency requirements for the public display of prices and volumes in OTC derivatives trading.

► **Central data collection ("trade repositories")**
– In future, all standardised and non-standardised derivatives transactions must be reported to trade repositories. For this purpose, the Commission intends to introduce new reporting obligations for all market players.
– In order to supervise the systemic risks inherent in derivatives, the financial supervisory authorities are to obtain access to information collected in trade repositories even if these are located outside the EU. The new European Securities and Markets Authority (ESMA) is to co-ordinate this procedure.

► **Position Limits for speculative commodity derivatives**
– The Commission intends to authorise supervisory authorities to set position limits on speculative contracts of commodity derivatives in order to counter "disproportionate price movements" and "concentrations of speculative positions".

Changes Compared to the Status Quo

See content.

Statement on Subsidiarity

The EU Commission does not address the question of subsidiarity.

Political Context

The question of how derivatives markets can be designed to be more transparent and crisis-proof finds itself not only in the EU under serious discussion. The new rules to which the US government aspires also provide for the improved collateralisation of derivatives and would like to see OTC transactions being standardised and cleared by a CCP seated in the USA. Although the EU Commission says that it wishes to guarantee "global consistency of political approaches" through a cooperation with US authorities, it actually promotes clearing through European CCPs.
It is against this background that the pressure developed by the EU Commission on the most important European derivative traders has to be seen, who in Spring 2009 finally agreed as of 31 July 2009 to clear all CDS through European CCPs.. Now, the Commission is pushing traders to clear not only CDS through CCPs, but also all other OTC derivatives.
Since the onset of the financial crisis, the EU has made substantial changes to the regulatory framework for financial service providers. This has had an impact on the trading of derivatives and on CDS in particular.
For instance, in October 2008 the Commission proposed revising the Capital Requirements Directive (Basel II, 2006/48/EC) so as to ensure that issuers of securitisations must always retain at least 5% of the credit volume in their own books (Proposal COM (2008) 602; cp. CEP Policy Brief). Moreover, in July 2009 the Commission

proposed raising the capital requirements for securitisations in the trading books of banks (Proposal COM (2009) 362; cp. CEP Policy Brief).

Rating agencies – which underestimated the risks of securitised credits from CDS – are meanwhile also regulated in a much stricter manner. On 27. July 2009, a regulation was adopted which imposed strict quality and transparency requirements on rating agencies as well as their constant supervision through supervisory authorities (COM(2008) 704; cp. CEP Policy Brief).

The Commission wishes to restrict the speculative use of derivatives through hedge funds by way of position limits to the level of leverage employed. Therefore, it has submitted a Regulation Proposal (COM (2009) 207; cp. CEP Policy Brief) which is currently subject of an intense debate in the European Parliament.

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Consultation Procedure:	Along with its Communication COM(2009) 332 of 3. July 2009 the Commission initiated a consultation (cp. Statements). On 25. September 2009 a public hearing was held.

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

Even though derivatives are an extremely important instrument for hedging risks, at the same time they can also pose risks to the stability of financial markets. As the Bank for International Settlement states, 85 to 90% of derivative contracts are concluded between financial institutions (cp. http://www.bis.org/statistics/derstats.htm). Hence, the default of one financial institution can have severe consequences for other institutions.

There is no doubt that **the use of central counterparties (CCP) is a reasonable instrument to reduce default risks**. Unlike bilateral clearing between two contract parties, CCPs can clear a multitude of mutual exposures "netting") and thus reduce the degree of residual risk. **However, there are three problems related to the use of CCPs:**

First, it is premature to prescribe CCPs not only for standardised credit default swaps (CDS) but also for as many derivatives as possible. **As long as the systemic risks posed by interest rate derivatives or foreign exchange derivatives are not demonstrated, only CDS should be subject to CCP clearing**. There is a risk potential inherent in CDS which interest rate and foreign exchange derivatives – which after all represent 80% of the OTC derivative volume – do not possess.

This is so since the CDS market is very speculative: CDS insurance buyers must not have granted the credits concerned themselves. Also, estimating the default risk – related to both underlying credit and the insurance seller – is often difficult for the contract parties. Moreover, the discontinuity of CDS cash flows can cause disruption, since in the case of a credit event – and only then – a large payment is suddenly due. Finally, the CDS market is very concentrated: 10 traders dominate 65% of the market. The default of only one of those brokers can cause severe disruption to the entire market.

Secondly, though CCP reduce the outstanding risk, they also represent a concentration of risk. Hence, **CCP are system-relevant** as their insolvency affects all its participants directly. **To this end, the Commission's plan to introduce an ambitious regulation of the authorisation, activity and risk management of CCP is to be welcomed**.

In doing so, distortions of competition resulting from Member States imposing different requirements (e.g. regarding the necessity of a bank license) for the trading of CCPs, should be removed. Moreover, global cooperation in the regulating of CCPs is indispensable. Otherwise even a very strict European regulation could not prevent weak regulations in third countries causing problems for European CCPs, since CCPs are (logically) globally tied.

Thirdly, CCPs are no "universal remedy": They can be used for standardised derivatives only. **The Commission should abstain from overly restricting the free design of derivatives by a de-facto-compulsion to standardise them**. This would undermine efficient risk management. In order to collateralise specific risks, tailor-made derivatives are necessary.

The central data collection in trade repositories is absolutely crucial. For an adequate level of risk estimation it is also necessary for European supervisory authorities to gain insight into trade repositories of third countries.

"Position limits" against "disproportionate price movements" imply the risk of unnecessarily intervening into pricing. A public authority cannot be absolutely sure if prices are fluctuating "disproportionately". Stock exchange trading with derivatives can increase price transparency, but should not be prescribed statutorily. Any disadvantages to OTC trading will be accepted only as long as derivatives generate higher returns and benefits than other financial products.

Impact on Efficiency and Individual Freedom of Choice

The substantial increase in bilateral trading costs with non-standardised derivatives caused by the Commission's plans **is not acceptable in its current form**. The Capital Requirements Directive (2006/48/EC) already – and rightly so – promotes CCP clearing by releasing financial institutions from the deposit obligation

of own funds for CCP derivatives. **Imposing additional across-the-board penalties on this trade, for instance by requiring that more own funds and collateral be kept ready, makes risk management more difficult**.
This is all the more true since both financial and non-financial institutions naturally switch to non-standardised derivatives, if only these represent their company-specific risks correctly. Often they are neither particularly risky nor speculative, but simply mirror risks inherent in real business transactions. Moreover, standardised derivatives are expensive for non-financial institutions: Since they do not exactly mirror existing risks, the benefits of hedge-accounting – the accounting rules for derivatives – do not apply to them.
Therefore, **the Commission should be generous when designing the announced exceptions for non-financial institutions**.

Impact on Growth and Employment

The project makes risk management more expensive and forces companies to collateralise derivatives with more funds. Subsequently, these funds will then not be available for investments. However, CCP clearing increases the stability of the financial market, which makes recessions resulting from financial crises less probable.

Impact on Europe as a Business Location

On the one hand, stable financial markets increase the attractiveness of Europe as a business location. On the other hand, the Commission's plans make the collateralisation of risks more expensive which, as a result, weakens the quality of Europe as a business location. As the regulation of derivatives markets is currently also being revised in the USA, a balancing comparison of the impact of both is not possible at present.

Legal Assessment

Legislative Competence

The announced measures serve to foster the sound functioning of the single market for financial services. The legal competence is laid down in Art. 95 TEC. Regarding the requirements for CCPs, Art. 47 TEC is applicable, which authorises the adoption of rules regarding the pursuit of activities as self-employed persons.

Subsidiarity

Unproblematic.

Proportionality

The presented measures are not concrete enough to allow an assessment of proportionality.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

Unproblematic.

Alternative Policy Options

The further increase of bilateral clearing costs – through the raising of capital requirements and the requirements regarding the deposit of collaterals – should be waived.

Possible Future EU Action

The Commission wishes to revise the Capital Requirements Directive (2006/48/EC) again by the end of 2010: Banks are to deposit more own funds and collaterals for the bilateral clearing of derivatives. In this way, the Commission wishes to take away "commercial hesitation to take up CCP clearing wherever possible".
By mid 2010 the Commission wishes to draw up proposals for a statutory regulation of CCPs and trade repositories.
In its revision of the MiFID Directive (2004/39/EC) planned for 2010, the Commission wishes to propose transparency requirements for the display of prices and volumes in derivative trading.
The Commission is also assessing whether or not the operational requirements, reporting duties and rules of conduct of the MiFID Directive should in future be applied equally to non-financial institutions trading with derivatives.
Also in 2010 the Commission wishes to revise the Directive on insider dealing and market manipulation (2003/6//EC) to include all derivatives. In particular, the Commission wishes to enhance the transparency of the cash market for electricity, gas and emission permits and thus reduce market manipulation and insider dealing.

Conclusion

Clearing through central counterparties (CCP) reduces the default risk of derivatives and increases the stability of financial markets. However, only credit default swaps (CDS) should be cleared through a central counterparty (CCP) until the systemic danger of interest rate derivatives and foreign exchange derivatives has been demonstrated. The regulation of the authorisation, activities and risk management of CCPs, as well as the establishment of trade repositories at EU level, is to be welcomed. The increase of bilateral clearing costs will lead to the degradation of risk management.