ROADMAP

Title of the initiative: **Legislative proposal to improve transparency and stability in Derivatives markets Central Counter Party Clearing (CCP)**
Type of initiative (CWP/Catalogue/Comitology): CWP (Strategic)
Lead DG/contact person/details: DG MARKT
Expected date of adoption of the initiative (month/year): June 2010
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Initial IA screening & planning of further work

A. Context and problem definition

(i) What is the political context of the initiative? (ii) How does this initiative relate to past and possible future initiatives, and to other EU policies?

The financial crisis has brought derivatives to the forefront of regulatory attention. The near-collapse of Bear Sterns in March 2008, the default of Lehman Brothers on 15 September 2008 and the bail-out of AIG on 16 September highlighted the significant role played by derivatives. As a result there is agreement at the EU and international level on the need to tackle some of the issues raised by the current regulation of derivative instruments:

- In the Conclusions of the European Council of 18/19 June 2009 the European Council called for "*further progress to be made in the regulation of financial markets, notably on (…) transparency and stability of derivatives markets.*"
- G-20 leaders at their meeting on 25 September 2009 called on Finance Ministers and Central Bank Governors to reach agreement on an international framework of reform i.e. in the area of OTC derivatives. Specifically, the G20 leaders agreed that "*all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.*"
- The ECOFIN roadmap adopted by the Council (ECOFIN) on 20 October as an annex to its *conclusions* on strengthening EU financial stability arrangements sets out two strands of work in the area of OTC derivatives, the first one on increasing the safety of OTC derivatives markets and the second one on improving transparency in use of derivatives.

As outlined in the Commission communication of 20 October 2009 on "Ensuring efficient, safe and sound derivatives markets: future policy actions", this proposal is only the first of a number of initiatives dealing with derivatives. Further initiatives include a legislative initiative on short selling and Credit Default Swaps (CDS) in October, a revision of the Capital Requirements Directive (CRD IV) in December, a revision of the Market Abuse Directive (MAD) in December, and a revision of the Markets in Financial Instruments Directive (MiFID) in the first quarter of 2011.

The Commission since 2008 has been actively involved in improving the safety and stability of derivatives market (ref. McCreevy, C. "Time for regulators to get a better view of derivatives", 17 October 2008,SPEECH/08/538) and in working together with the industry for the shifting to CCP clearing of European referenced credit default swaps. On 3 July 2009 the Commission has published it first Communication in this field, together with a detailed staff working paper analysing the different market characteristics and policy tool to improve the resilience of the market. That Communication opened a market consultation which was concluded with a high level conference on 25 September 2009.

What are the main problems identified?

While derivatives did not cause the crisis, they contributed to make it worse. The crisis has clearly shown that the characteristics of over-the-counter (OTC) derivatives markets – the private nature of contracting with limited public information (i.e. lack of transparency), the complex web of mutual dependence and the difficulties of understanding the nature and level of risks (especially counterparty risk) – increases uncertainty in times of market stress and accordingly poses risks to financial stability.

Who is affected?

The proposed legislative initiative targets and will therefore have a direct impact on regulated entities active on financial markets (such as banks, investment firms and central counterparties). Indirectly, it will have an impact on all economic agents that buy financial products.

(i) Is EU action justified on grounds of subsidiarity? (ii) Why can the objectives of the proposed action not be achieved sufficiently by Member States (necessity test)? (iii) As a result of this, can objectives be better achieved by action by the Community (test of EU Value Added)?

Given the cross-border nature of the identified problems and the importance of the financial system for the proper functioning of the real economy a common set of binding rules needs to be developed at Community level in order to avoid divergent solutions at Member States' level and thus avoid the possibility that regulated entities engage in regulatory arbitrage.

B. Objectives of EU initiative

What are the main policy objectives?

The main goal is to increase the safety of (decrease the systemic risk inherent in) derivatives markets through increased transparency and decreased counterparty risk. While achieving this, another goal is to ensure global consistency in order to avoid unwanted regulatory arbitrage.

Do the objectives imply developing EU policy in new areas or in areas of strategic importance?

For the most part achieving the abovementioned objectives will require the development of new EU policy (especially concerning central counterparties and trade repositories). Given that the proposals are aimed at the financial sector, and in particular to market infrastructure, they touch upon issues of strategic importance.

C. Options

(i) What are the policy options? (ii) What legislative or 'soft law' instruments could be considered?
(iii) Would any legislative initiatives go beyond routine up-date of existing legislation?

Prior to the financial crisis, the industry was already working together with some regulators in order to address the issues highlighted above. These efforts led, inter alia, to the creation of a trade data repository for CDS and various commitments on the use of central counterparties (CCPs) for clearing OTC derivatives. Since the onset of the crisis, these efforts have been redoubled with new commitments added to existing ones (e.g. using CCPs located in the EU for clearing European-referenced CDS).

While the above initiatives have already borne some fruit, the question arises of whether they would be sufficient in themselves or would need to be complemented by legislative action to achieve the overall objectives of safer, sounder and more efficient derivatives markets. Legislation could be necessary in part to support these initiatives and in part because some of the issues cannot be tackled by the industry.

The two main policy options are to introduce legislative measures and complement them by self-regulatory efforts or simply rely on industry initiatives. Within the former different sub-options can be imagined and are being examined.

Does the action proposed in the options cut across several policy areas or impact on action taken/planned by other Commission departments?

The proposal is part of a bigger package that will also include amendments to existing legislation, most notably Markets in Financial Instruments Directive (MiFID), Market Abuse Directive and Capital Requirements Directive.

Agriculture and Rural Development DG, Environment DG, Energy DG and Mobility and Transport DG are conducting separate initiatives that are related to derivatives markets, such as analysis and possible measures to reduce volatility of food prices, the auction mechanisms for carbon emission allowances.

Explain how the options respect the proportionality principle.

The options will be targeted specifically at the most critical shortcomings of the OTC derivatives market that were highlighted by the financial crisis. Where obligations will be introduced they will be carefully defined in terms of their scope (while keeping in mind the necessity to maintain a level playing field among the parties involved).

D. Initial assessment of impacts

What are the significant impacts likely to result from each policy option (cf. list of impacts in the Impact Assessment Guidelines pages 32-37), even if these impacts would materialise only after subsequent Commission initiatives?

The impacts of the initiatives are in the process of being analysed. They will be examined in detail in the impact assessment that will be published together with the legislative proposal.

Could the options have impacts on the EU-Budget (above 5 Mio €) and/or should the IA also serve as the ex-ante evaluation, required by the Financial Regulation?

No impact on the EU budget is foreseen.

Could the options have significant impacts on (i) simplification, (ii) administrative burden or on (iii) relations with third countries?

Since the intended proposals include the establishment of a common regulatory framework for central counterparties and trade repositories, an element of simplification will be included (e.g. a central counterparty will need to comply with a single set of requirements when operating in multiple Member States). While the latter is likely to bring about some reduction in the administrative burdens, the introduction of reporting obligations will, almost certainly lead to an increase of the administrative burden. The net impact will therefore have to be examined. Finally, given the global nature of OTC derivatives market, the proposals will without a doubt have an important impact on relations with third countries. [*The future legislation may assume the form of a regulation which will be directly implemented in all MS, therefore a risk-based implementation plan does not seem to be appropriate*]

E. Planning of further impact assessment work

When will the impact assessment work start?

Work on the IA has been started.

(i) What information and data are already available? (ii) Will this impact assessment build on already existing impact assessment work or evaluations carried out? (iii) What further information needs to be gathered? (iv) How will this be done (e.g. internally or by an

external contractor) and by when?
(v) What type and level of analysis will be carried out (cf. principle of proportionate analysis)?

There are a number of official sources and publicly available publications that can be used to obtain the necessary data and other information on the OTC derivatives markets. These include data and publications published by the Bank of International Settlements, the European Central Bank, the International Swaps and Derivatives Association and Markit [*please note that Markit is a widely used data provider in the filed of derivatives*] to name but a few.

In addition further information has been obtained from CCPs, financial and non-financial institutions operating in the OTC derivatives market. Part of it was already used in the two Commission Communications and the fact finding report that have been published on the topic of OTC derivatives. In addition further information will be sought from individual entities and associations, Member States and relevant authorities. This information includes / will include both information on the status quo and information on the potential impacts of the proposed initiatives.

Which stakeholders & experts have been/will be consulted, how and at what stage?

The Commission has already held a public consultation and a public conference to gather views on the steps that need to be taken to improve the functioning of the OTC derivatives market. In addition, a large number of bilateral and multilateral meetings have been held with representatives of all major stakeholders. This practice will continue during the preparatory phase of the proposals.