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COMMISSION OF THE EUROPEAN COMMUNITIES

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**COMMISSION STAFF WORKING PAPER**

**Consultation Document:  
Possible initiatives to enhance the resilience of OTC Derivatives Markets**

{COM(2009) 332 final}  
{SEC(2009) 905 final}

## 1. INTRODUCTION

The Commission's Communication<sup>1</sup> on ensuring the efficiency, safety and soundness of derivatives markets (herein after the Commission Communication) and the accompanying Staff Working Paper<sup>2</sup> (herein after the Staff Working Paper) concluded that the way derivatives markets work needs to be improved in order to safeguard financial stability.

Overall, the end-goal of financial stability can be achieved by targeting two intermediate objectives, namely by (i) strengthening counterparty credit risk mitigation and (ii) increasing transparency. In order to achieve these objectives, a number of tools are available that can be applied depending on each market segment's level of maturity:

- (1) promoting further standardisation;
- (2) strengthening the bilateral collateral management for non-CCP eligible contracts
- (3) enhancing the use of central data repositories;
- (4) moving clearing of standardised OTC derivatives to CCPs;
- (5) increasing transparency of prices, transactions and positions; and
- (6) moving (part or all of) trading to public trading venues<sup>3</sup>.

While the Communication briefly outlined the main rationale for each tool as well as the general issues that will guide the consultation, this paper provides a more detailed outline of each of the tools as well as detailed questions to stakeholders. In this context it has to be noted that the Basel Committee on Banking Supervision is currently reviewing the treatment of counterparty credit risk, which might have an impact on several issues touched upon in this document and might result in further actions of the Commission in this field.

This consultation is open till 31 August 2009. Responses can be addressed to [markt-g2-consultations@ec.europa.eu](mailto:markt-g2-consultations@ec.europa.eu). The Commission services will publish all responses received on the Commission website unless confidentiality is specifically requested.

The issues addressed in this document will also be discussed at a high-level conference in Brussels, on 25 September.

## 2. PROMOTING FURTHER STANDARDISATION

Standardisation has two dimensions: standardisation of the contractual parameters and standardisation of the contracts themselves to support market infrastructure. The nature of the OTC market so to be tailored made to fit the exact risk faced by users is not compromised by a contractual standardisation that facilitate the use of electronic means<sup>4</sup>. On the other end, if the parameters of the contracts are standardised (e.g. coupons, strike prices, maturities, etc.), the flexibility toward users' need may be impacted.

By facilitating automatic processing, standardisation would increase efficiency and reduce operational risks by e.g. encouraging electronic affirmation and confirmation services, central

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<sup>1</sup> C(2009) XXX final

<sup>2</sup> SEC(2009) XXX final

<sup>3</sup> The term "public trading venues" generally refers to regulated markets and multilateral trading facilities subject to public disclosure requirements.

<sup>4</sup> Interest Rates Swaps and Credit Default Swaps represents good examples where electronic systems have been developed to reduce the operational risks in these markets, without impacting on the contracts flexibility.

storage, automation of payments and collateral management processes. In this regard, standardisation is a necessary prerequisite for the other policy options. However, standardisation requires costly investments and, therefore, additional measures might be considered necessary to provide the adequate incentives to promote it, in the spirit of G20 declaration<sup>5</sup>.

Depending on the level of standardisation and on the risk mitigation tools employed, the operational risks a market participant faces might be higher or lower. More specifically, a contract, which is electronically affirmed, confirmed, recorded in a central data repository and where payments arising from it are settled in an automated manner, incurs less operational risks than a contract that does not employ these systems.

Operational risks are specifically dealt with in the Capital Requirements Directive (CRD) and they also include legal risks, which may e.g. arise in case of disputes toward the terms of a contract if electronic systems are not used. Considerations might be given on whether specific requirements pertaining to operational risk provide adequate incentives toward standardisation of contracts and use of market infrastructures (e.g. use of electronic systems and central repositories).

#### *Questions*

- (1) What would be a valid reason not to use electronic means as a tool for contracts standardisation?
- (2) Should contracts standardisation be measured by the level of process automation? What other indicators can be used?
- (3) Should non-standardised contracts face higher capital charges for operational risk?
- (4) What other incentives toward standardisation could be used, especially for non-credit institutions?

### **3. STRENGTHENING BILATERAL COLLATERAL MANAGEMENT FOR NON-CCP ELIGIBLE OTC DERIVATIVES**

For those OTC derivative contracts that remain beyond the reach of CCP clearing irrespective of further standardisation, it is important to strengthen the bilateral clearing model. The following actions might be foreseen:

- Improve timeliness: ensure more timely mark-to-market of positions (daily valuation should be the end goal);
- Improve coverage: the share of credit exposure covered by collateral has stagnated in recent years. According to the latest issue of the ISDA Margin Survey<sup>6</sup>, one third of overall credit exposures remain uncollateralized. Improve the coverage rate by encouraging market participants to enter into appropriate collateral arrangements and by encouraging second tier institutions and non-financial firms to provide collateral.
- Strengthen the collateral management process, by further promoting more frequent portfolio reconciliation (possibly on a multilateral basis) and ensure more timely exchange of collateral (daily portfolio reconciliation and daily exchange of collateral should be the goal).

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<sup>5</sup> G20 (2009). *Declaration on strengthening the financial system – London summit*, 2 April 2009, <http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm>

<sup>6</sup> ISDA (2009b). *Margin Survey 2009*, [http://www.isda.org/c\\_and\\_a/pdf/ISDA-Margin-Survey-2009.pdf](http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2009.pdf)

- Reduce the size of outstanding derivatives positions and facilitate the management of a potential default by promoting increased recourse to multilateral portfolio compression (i.e. multilateral netting of positions). This would also increase the operational efficiency (less contracts to process) even in a CCP environment.

#### *Questions*

- (5) How could the coverage of collateralised credit exposures be improved?
- (6) Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.
- (7) How frequently should multilateral netting be used?
- (8) Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?

#### **4. CENTRAL DATA REPOSITORIES**

As mentioned above and detailed in the Staff Working Paper, central data repositories improve operational efficiency of OTC markets by facilitating payment and settlement instructions and by central processing of corporate events.

By their nature, central data repositories are also essential sources of information and therefore substantially contribute to improving market transparency, especially for the market segments not covered by CCPs. The contribution to transparency is both toward regulators and to the public. The former should be granted full and unimpeded access to central data repositories to perform their supervisory functions. The latter can access aggregate market information.

In view of the broad interest for central data repositories, their usage could be extended to market segments other than credit default swaps (CDS) and specific regulatory requirements (including transparency requirements) may be foreseen. It is the Commission services' understanding that CESR is currently analysing this issue with the respect to the establishment of a central data repository in the EU.

#### *Questions*

- (9) Are there market segments for which a central data repository is not necessary or desirable?
- (10) Which regulatory requirements should central data repositories be subject to?
- (11) What information should be disclosed to the public?

#### **5. MOVE CLEARING OF STANDARDIZED OTC DERIVATIVES TO CCPs**

In view of the broad desirability of CCP clearing for OTC derivatives, it is necessary to ensure that it is used to the greatest extent possible. This section looks at the different tools that might be considered.

##### **5.1. Defining CCP eligible contracts**

The first prerequisite for CCP clearing concerns clarity about eligibility of contracts. Whether a contract is CCP eligible should ultimately be decided by the CCP that is assuming the risk associated with the contract.

There may be a trade-off, however. Requiring a product to be cleared by a CCP might alter the margin calculations in comparison with that product being cleared bilaterally. Under

bilateral clearing, margins are applied to the portfolio of all products with a particular counterparty. In contrast, the CCP applies margin multilaterally per product range cleared. Moving to a CCP may thus imply higher margins. This margin difference may be especially pronounced for illiquid products. However, this increase in required margin needs is there to pay for the benefits that the introduction of a CCP brings in terms of systemic risk reduction.

Some have argued that this may prompt the CCP to clear all products (including the illiquid ones), benefiting from clearing fees but not considering the cost due to the increase in margin described above.

However, CCPs do not have an incentive to clear illiquid products that they cannot manage. In addition, the users of a CCP can affect the decisions concerning which products a CCP will clear given that they are members of the risk committees (i.e. the bodies in charge of such decisions). Therefore, leaving the CCP to decide on the eligibility criteria appear to be appropriate, and hence if a contract is cleared by at least one authorised CCP it should be considered eligible for policy purposes.

#### *Questions*

- (12) Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?

### **5.2. Incentives to use CCP clearing**

The considerable reduction of counterparty risk associated with CCP clearing already provides an incentive to use it. Using a CCP becomes more valuable for each participant as the number of participants increases, since this maximises the potential for multilateral netting of claims and obligations. Because of this network externality and in view of the systemic risk reduction provided by CCPs, providing incentives to market participants is economically viable and justified from a public policy perspective.

#### *5.2.1. Business incentives*

The presence of a CCP in a market brings with it a number of benefits to its participants. First, and most obviously, a CCP allows for risk mutualisation thus providing a vital function in preventing contagion in case of failure of a market participant. Second, from a day-to-day business point of view, it facilitates risk management and position valuation of its users. Next, it reduces operational risk through, for example, process standardisation and legal risk reduction. Finally, a CCP may facilitate reporting of specific information to public authorities. As a CCP is a natural data repository of the contracts it clears, regulators may be able to obtain participant-specific information directly from it without having to go to the individual participants, thus exempting the latter from the burden of reporting.

#### *Questions*

- (13) What additional benefits should the CCP provide to secure a broader use of its services?

#### *5.2.2. Regulatory capital incentives - zero-risk weighting*

Under Directive 2006/48/EC (Capital Requirement Directive, CRD), a zero-risk weighting is attributed to counterparty credit risk exposures on derivatives contracts that are outstanding with a CCP, provided that the CCP fully collateralises its exposures with all participants on a

daily basis<sup>7</sup>. Although beneficial for certain market segments, e.g. interest rates swaps, this incentive has proved to be insufficient to grant the necessary shift toward a broad use of CCP clearing in OTC derivatives markets. Therefore, consideration might be given for further regulatory capital incentives (see section 5.2.3.). The provisions related to the zero-risk weighting capital treatment are currently under revision in the context of the Basel Committee of Banking Supervision and duly consideration is to be given to this work.

Furthermore, the regulatory capital relief may not be available for all market participants, as not all users of derivatives are able or willing to meet the requirements to become a direct participant in a CCP. This is particularly the case for insurance companies, investment and hedge funds and smaller banks. Such users will get CCP access indirectly through a direct participant (general clearing member). Depending on how the indirect access is granted, the indirect participant of a CCP is more or less exposed to the default of its general clearing member. This issue may be addressed by appropriately segregating the collateral of the indirect participant at CCP level.

#### *Questions*

- (14) Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?
- (15) Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?

#### *5.2.3. Further regulatory capital incentives*

When a product is CCP-eligible, it could become a general principle for it to be cleared through a CCP. Therefore, dealers and other market participants might be subject to an additional regulatory cost if they continue to clear CCP-eligible contracts on a bilateral basis. However, in some cases, there may be legitimate reasons for not following this principle. In that case, an approval mechanism would need to be introduced.

The rules on credit risk mitigation under the CRD might offer a possible avenue of doing this for credit derivatives. According to the CRD, credit default swaps are recognised as credit risk mitigation instruments only if certain conditions are met. Consideration might be given on whether different degree of recognition might be given to CCP-eligible CDS that are not cleared through an authorised CCP. The overall impact of all the above capital requirements should duly be taken into account.

#### *Questions*

- (16) Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?
- (17) Under which conditions should exemptions be granted and by whom?

#### *5.2.4. Monitoring*

In order to verify that CCP-eligible contracts are indeed cleared by a CCP, continuous monitoring becomes necessary. Market infrastructures, and in particular trade repositories, will play an important role in this respect. Central data repositories may, in principle, contain information on all outstanding contracts and their characteristics (including whether they have been cleared by a CCP or not). This should enable supervisors to obtain all necessary data on

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<sup>7</sup> Annex III, part 2, point 6 Directive 2006/48/EC

the number of total, eligible and CCP-cleared contracts (the latter should be cross-checked with the information on the open interest present in the CCP for consistency purposes). It is also important to ensure that contracts are not defined in such a way so as to become non-CCP-eligible.

For the CDS market, as outlined in the Commission Communication, the Derivatives Working Group established by the European Commission has proved to be effective in addressing the issues related to the standardisation of European CDS contracts for the purpose of facilitating CCP clearing, though some technical issues still need to be solved. Therefore, once these new standards will be in place, a large portion of European CDS will likely become eligible for CCP clearing. How much of the eligible contracts will actually be cleared is too early to say. The ten dealers having signed the letter of commitment to the European Commission<sup>8</sup> cover roughly 80 per cent of the market, the rest being essentially covered by other credit institutions associated with banking federations, which also share the same objective.

#### *Questions*

- (18) What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?
- (19) What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

### **5.3. Ensuring the safety and soundness of CCPs**

The use of a CCP *per se* does not guarantee any increase in safety if the CCP is not properly structured, organised, supervised and ensures even with its eventual outsourcing arrangements easy accessibility, timely execution, redundancy, business continuity and effective risk management.

The ESCB and CESR are in the process of adopting common recommendations for central counterparties, which take into account the specific risks related to OTC derivatives. These recommendations, although not binding, may form the basis for such set of requirements. However, common harmonised rules need to be enforceable and therefore non-binding recommendations may be insufficient. Furthermore, i) to ensure that CCPs continue to be considered a zero risk counterparty even when dealing with much complex instruments; ii) to grant the necessary level of transparency and access to regulatory information; iii) to guarantee that even indirect participants may benefit from the enhanced safety granted by CCPs; and iv) to establish common authorisation regimes, these requirements may be further developed.

#### *Questions*

- (20) How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

## **6. INCREASE TRANSPARENCY OF PRICES, TRANSACTIONS AND POSITIONS**

This section considers transparency of trading, transaction as well as position reporting of derivatives and other complex products. These issues will be further developed in the context of the upcoming MiFID review with more specific questions.

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<sup>8</sup> Letter of commitment from major dealer banks to clear European-referenced credit default swaps on one or more European CCPs, signed on 17 February 2009.



## 6.1. Transparency of trading

Extensive analysis and consultation have been carried out in recent years on whether more transparency of trading activity in non-equity markets is required. Market participants, infrastructure providers and regulators agree that an adequate picture of ongoing and past-trading activity is necessary but disagree on the adequacy of existing arrangements and the need for regulatory intervention.

In the present environment there are nevertheless valid reasons to re-examine the need for more transparency. First, more transparency of trading activity could help instil better due diligence, and ultimately more efficiency in these markets. Second, a growing number of regulators, policy-makers, and market participants, mainly from the buy-side, have pointed to recent experience as being symptomatic of a market failure which more transparency could partially help undo. Finally, MiFID favours the development of a harmonised regulatory framework for trading in financial instruments. It can be argued that the present patchwork of national transparency regimes for EU non-equity markets is hindering efficiency and the development of a pan-European level of service provision and access in these instruments. A more harmonised transparency approach beyond equities may therefore be necessary in order to strengthen investor protection and supervision.

### *Questions*

- (21) Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

## 6.2. Transaction reporting of OTC derivatives

Article 25 of MiFID requires investment firms to report all transactions in any financial instruments admitted to trading on a regulated market to the competent authority (including exchange-traded derivatives and listed structured products), wherever these transactions take place (regulated market, MTF or OTC). This means that transactions in OTC derivatives and other complex products if these are not admitted to trading on a regulated market are exempt from these requirements.

CESR has recently mandated a Task Force to analyse the possibility to both collect and exchange reports in some OTC derivatives (e.g. options, warrants, contract for difference and CDS) with the objective to help detect cases of market abuse. Based on the preliminary analysis carried out<sup>9</sup>, there may be a need to extend the scope of Article 25 to include OTC derivative instruments whose underlying financial instrument is admitted to trading on a regulated market (including corresponding depositary receipts) to ensure that the collection of transaction reports in these OTC derivative instruments is made mandatory.<sup>10</sup> Most Member States appear to support this.

### *Questions*

- (22) How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

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<sup>9</sup> Call for Evidence on the Technical Standards to Identify and Classify OTC Derivative Instruments for TREM, CESR's Transaction Reporting Exchange Mechanism, 2 February 2009.

<sup>10</sup> Currently, recital 45 of MiFID allows (but does not require) Member States to apply transaction reporting obligations to financial instruments that are not admitted to trading on a regulated market.

### **6.3. Position reporting to Competent Authorities**

A periodic position reporting obligation to supervisors could complement the transaction reporting obligation. The benefits of such a measure might be twofold. From a prudential perspective, it would make Competent Authorities aware about firms' exposures, and from a market surveillance perspective it could improve market oversight and assist in the detection of potentially abusive positions.

The scope of such a reporting obligation would have to be carefully defined taking into account the specificities of each market (OTC versus exchange-traded derivatives, structured credit products, etc) and the risk that a lack of transparency in such a market could pose. Consideration will also need to be given to the level of granularity and costs for firms associated with reporting. In this respect the greater use of CCPs and of central data repositories can actually reduce the burden on single reporting institutions and achieve the same level of regulatory information.

Market regulators would need to put in place arrangements to be able to easily exchange information. The positions reported to the national Competent Authorities might have to be aggregated at the level of CESR in order to have an overview of the European market at all times.

#### *Questions*

- (23) How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

## **7. MOVE TRADING TO MORE PUBLIC TRADING VENUES**

In principle, for standardised derivatives that are cleared by a CCP, the next logical step would be for trading of these contracts to take place on an organised trading venue where prices and other trade-related information are publicly displayed, such as a regulated market (i.e. derivatives exchange) or a multilateral trading facility (MTF) subject to transparency requirements. This would improve price transparency and strengthen risk management.

However, the type of standardised contracts that are typically traded on public venues may not cater for the full range of derivative users' risk management needs. Most market participants have a commercial preference for trading OTC. However, the importance for financial stability of the existence of transparent and operationally efficient markets must be the main consideration. There is a societal preference for transparent trading venues, as public and standardised as possible for the purpose of risk assessment and price determination.

A system based on competition between different trading venues (OTC, exchanges and MTFs), is also advantageous in terms of market efficiency as long as it subjects all venues to adequate transparency and organisational requirements that ensure fair competition. This choice for transparent and organised trading is something not unknown for other financial markets. The Markets in Financial Instruments Directive (MiFID) abolished the rule whereby trades should be carried out on regulated markets (the so-called "concentration rule"), but subjected other trading venues (MTFs, systematic internalisers) to appropriate transparency requirements. Accordingly, for cash equities, competition between trading venues takes place under the umbrella of common transparency and organisational rules. However, MiFID's transparency regime currently does not cover derivatives and transaction reporting does not apply to financial instruments that are not admitted to trading on a regulated market.

The US administration has recently announced legislative measures that may encourage the greater use of public trading venues for the execution of derivatives transactions.<sup>11</sup>

### *Questions*

- (24) How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

## **8. NEXT STEPS**

This document marks the beginning of a nine-week consultation period ending on August XX during which the Commission services invites comments on this communication from all interested parties. Responses can be addressed to [markt-g2-consultations@ec.europa.eu](mailto:markt-g2-consultations@ec.europa.eu). The Commission services will publish all responses received on the Commission website unless confidentiality is specifically requested.

The issues addressed in this document will also be discussed at a high-level conference in Brussels, on 25 September.

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<sup>11</sup> The US intends to encourage trade execution on "regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives" (US Treasury Financial Regulatory Reform, 17 June 2009).

## ANNEX – LIST OF QUESTIONS

### **Standardisation**

- (1) What would be a valid reason not to use electronic means as a tool for contracts standardisation?
- (2) Should contracts standardisation be measured by the level of process automation? What other indicators can be used?
- (3) Should non-standardised contracts face higher capital charges for operational risk?
- (4) What other incentives toward standardisation could be used, especially for non-credit institutions?

### **Strengthening bilateral collateral management**

- (5) How could the coverage of collateralised credit exposures be improved?
- (6) Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.
- (7) How frequently should multilateral netting be used?
- (8) Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?

### **Central data repository**

- (9) Are there market segments for which a central data repository is not necessary or desirable?
- (10) Which regulatory requirements should central data repositories be subject to?
- (11) What information should be disclosed to the public?

### **CCP clearing**

- (12) Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?
- (13) What additional benefits should the CCP provide to secure a broader use of its services?
- (14) Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?
- (15) Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?
- (16) Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?
- (17) Under which conditions should exemptions be granted and by whom?
- (18) What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?
- (19) What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

- (20) How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

### **Transparency requirements**

- (21) Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?
- (22) How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?
- (23) How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

### **Public trading venues**

- (24) How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?