
Ensuring efficient, safe and sound derivatives markets: Future policy actions
Ensuring efficient, safe and sound derivatives markets: Future policy actions

(Text with EEA relevance)

1. INTRODUCTION

Derivatives play a useful role in the economy: they can be used to transfer (all or part of) the risks inherent to economic activity from economic agents who are not willing to bear them to those who are. However, they also contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants, a fact which went unnoticed because of the lack of market transparency, resulting from the predominant over-the-counter (OTC) market structure. Already in July this year, the Commission identified four complementary tools to reduce the negative impact of OTC derivatives markets on financial stability: (i) increase standardisation, (ii) use trade repositories, (iii) strengthen the use of Central Counterparty clearing houses (CCPs), and (iv) increase the use of organised trading venues. The proposed tools have been the subject of a stakeholder consultation and were debated at a high-level conference on 25 September 2009.

This Communication examines one by one the main shortcomings of the current derivatives market organisation as concerns both OTC and derivatives traded on organised trading venues. It outlines the policy actions the Commission intends to take in 2010 to address these problems and thus meet the need for greater stability and transparency in these markets as recognised by the De Larosière report, the June 2009 European Council conclusions and the G20. All legislative and other proposals to give effect to the policy orientations set out below will be subject to appropriate impact assessment.

2. GENERAL APPROACH

The Commission believes that a paradigm shift must take place away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly. As a result, the proposed measures will shift derivative markets from predominantly OTC bilateral to more centralised clearing and trading.

The various derivatives market segments differ in their characteristics, namely in terms of risk, operational arrangements and market participants. In principle, the Commission believes

2 The replies to the consultation, the summary of stakeholder views as well as a summary of the conference and presentations can be found on the Commission's webpage:
that a comprehensive policy on derivatives is necessary in order to avoid market participants exploiting differences in rules, i.e. regulatory arbitrage. However, where justified, the policy proposals will duly take into account the specificities of the asset class and contracts involved as well the specificities of the market participants, also striking the right balance between financial and non-financial institutions. At the same time the Commission will take into account the specificities of certain commodity markets, e.g. electricity and gas markets, which are particular in their underlying physical market structure. Considering the risk characteristics of the different market segments, for example, the Commission tackled credit default swaps first.

2.1. **International cooperation**

The market for derivatives is global, and regulatory arbitrage must be excluded. To ensure a robust and convergent international regulatory outcome, the proposals below are in line with the objective outlined in the G20 meeting of 25 September 2009, calling for the improvement of OTC derivatives markets. In order to ensure a coherent implementation of these policies across the globe, the Commission intends to further develop the technical details in cooperation with its G20 partners, the Financial Stability Board, and in particular with the US, which is also in the process of designing a new approach to derivatives markets.

2.2. **Non-financial institutions**

The task of the financial system is to channel funds from savers to investment projects, also by allowing for wider risk sharing. Non-financial institutions therefore have a vital interest in financial stability. Inasmuch as non-financial firms have bought protection from a financial firm and in so doing have transferred their risks into the financial system, they have generally benefited from the underpricing of risk in the build-up phase of the crisis. Through the severe decline in economic activity, they have also fallen victim of the financial crisis. Thus, non-financial institutions are part of the web of mutual dependence created by derivatives contracts and, as such, they would benefit from the policies aiming at reducing counterparty credit risk and increasing transparency outlined below.

The Commission recognises the vital role of derivatives in hedging the risks that result from normal business operations. While most hedging should, in principle, be achieved through non-customised/standard derivatives, tailor-made derivatives will still be necessary. Accordingly, the Commission does not want to limit the economic terms of derivative contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for non-financial institutions. However, the function of prices to allocate resources must be restored: derivatives should be appropriately priced in relation to the systemic risk they entail, in order to avoid those risks being ultimately passed on to taxpayers. Strengthening financial stability in this way will make severe economic crises less likely in the future and put Europe on a more sustainable growth path.

---

4 "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 cost of strengthening the market infrastructure for OTC derivatives should not be carried by the taxpayer but by those who directly enjoy the economic benefit from using derivatives. The larger part of that cost will be borne by financial firms, but some of it can be expected to fall on non-financial institutions. However, it is expected that the costs will decrease over time: the more widely central market infrastructures are used, the lower the costs per user will become, as network effects come into play. Moreover, the non-financial corporate sector is likely to be the main beneficiary of the proposals on transparency made in section 5.

The Commission will carry out impact assessments before finalising its proposals. These will take into account all stakeholders' evidence about the costs and benefits of the policy orientations set out below, in order to set them in proportion to the risks to taxpayers, recognising that most non-financial institutions are not of systemic importance.

In order to promote competitiveness and growth of the European industry, the Commission will strive to ensure that any future policy option allows non-financial institutions to manage the risks inherent to their business.

The overall objectives of safer derivatives markets should nevertheless not be undermined by loopholes.

### 3. **Counterparty Credit Risk**

The crisis has shown, inter alia, that market participants did not price counterparty credit risk correctly. Clearing is the way by which this risk is mitigated. Clearing can either occur bilaterally between the two counterparties or at central market level, by means of a central counterparty (CCP), thus involving appropriate collateralisation. The following proposals therefore aim to strengthen the clearing of derivatives both at central and bilateral level.

#### 3.1. **Central clearing: safety and soundness**

The Commission has identified CCP-clearing as the main tool to manage counterparty risks and the G20 shares this view. Currently, CCPs provide services on a European basis but remain regulated at national level, as there is no Community legislation covering CCPs. While the ESCB-CESR recommendations have started a process of converging national approaches, they are not binding. In view of the CCPs systemic importance, the Commission intends to propose legislation governing their activities so as to eliminate any discrepancies among national legislations and ensure safety, soundness and proper governance. In its Communication of 3 July 2009, the Commission also noted that there are strong reasons for CCP clearing being located in Europe, relating to regulatory, supervisory and monetary policy concerns. Today many CCPs are located in the EU but the setting-up of a clear regulatory and supervisory framework will significantly contribute to this.

CCPs provide services for several asset classes, be it cash equities, fixed income or derivatives (listed or OTC). It would accordingly be incoherent to draft legislation governing

---

5. So far, the only piece of Community legislation covering the safety and soundness of CCPs is the Settlement Finality Directive (SFD). While essential, as it covers the effects of a default of a CCP participant from spreading to other participants, the SFD is a crisis management instrument, not a broad instrument covering all aspects of CCPs' activities and it is accordingly insufficient to ensure their safety and soundness.

6. European System of Central Banks and Committee of European Securities Regulators, respectively.
their activities in one asset class only. Instead, the forthcoming legislative proposal on CCPs will cover the same range of financial instruments as MiFID, so as to achieve consistency across the value chain and avoid loopholes. The Commission will therefore propose legislation governing CCP activity covering the following key requirements:

(1) **Conduct of business and governance** (e.g. measures to address conflicts of interest, access, transparency of risks and procedures, business continuity, and minimum standards of expertise).

(2) Rules to ensure that CCPs do not employ low risk-management standards. This may require the European Securities Markets Authority (ESMA), in applying the rules provided in the basic legislative act, to develop technical standards, so as to ensure that CCP participants will benefit from the lowest possible regulatory capital charge for counterparty credit risk of centrally-cleared contracts, following the regime currently being finalised by the Basel Committee. In view of their key role in managing risks, CCPs should be subject to adequate capital requirements.

(3) **Legal protection to collateral and positions** provided by clearing members' customers, so as to encourage a wide range of market participants to use central clearing. The rules should ensure segregation of assets and portability of client assets and positions.

(4) **Authorisation** granted, under this proposal will allow CCPs to provide their services in all Member States. In order to avoid double scrutiny and to foster mutual trust between authorities, the Commission believes the European Securities and Markets Authority (ESMA) should give CCPs authorisation to operate in the EU. With a view to ensure adequate on-going supervision at European level, the Commission will seek an appropriate allocation of responsibilities between ESMA and national supervisory authorities. This may include the possibility to grant ESMA direct supervisory powers in view of the specific nature and in particular the pan-European reach of CCPs. Alternatively, recognizing the potential or contingent liabilities that may be involved, it might be appropriate for on-going supervision to be entrusted within ESMA to a college of supervisors from the Member States most directly affected.

(5) ESMA should also assist the Commission in preparing decisions for **recognising third country CCPs** that are subject to comparable, comprehensive supervision and regulation, in order to assess requests for market access from third country providers on the basis of prudential concerns.

3.2. **Collateralisation in bilateral clearing**

While in an ideal world all derivatives should be centrally cleared, in reality not all of them are suitable for this. Some products may be too customised, whereas other products may not be liquid enough for central clearing. Such contracts will continue to be cleared bilaterally with counterparties exchanging collateral to cover their exposure. However, current collateral levels are too low and do not reflect the risk that bilaterally-cleared derivatives trades pose to the financial system when they reach a certain critical mass. Financial firms need to hold a larger amount of collateral to cover their credit exposure.

The Commission will propose legislation requiring financial firms (e.g. credit institutions, investment firms, investment management companies) to post initial margin (specific to counterparty characteristics) and variation margin (the change in the value of a contract).
These requirements would also provide an incentive to use central clearing, as it would reduce the economic advantage of providing too little collateral compared with the strict collateral demands made by CCPs.

Except in the event of default, exchanging collateral does not impact on the net income of an entity. Non-financial corporate users of derivatives, however, may not want to provide cash collateral for variation margin, as it might constrain their liquidity. This would expose their financial counterparty to credit risk, which it will have to manage with its client. Variation-margin requirements, if needed for non-financial firms, should be tailored in such a way that they do not undermine the corporate sector's ability to use derivatives for transferring risk, especially in the case of companies whose use of derivatives is below a given threshold. On the other hand, awarding special treatment for non-financial firms could create loopholes which would enable financial firms to engage in regulatory arbitrage. Any possible exemptions should be designed in such a way that eliminates any potential for abuse.

3.3. Capital charges on bilateral clearing

In its July Communication, the Commission explored the idea that non-centrally cleared contracts be subject to higher capital requirements. Following the G20 meeting in Pittsburgh, this has now become an internationally accepted principle. Higher capital requirements would reflect the higher risk that such contracts pose to the financial system. Since these capital charges apply after bilateral collateral exchange and netting of exposures, this approach would further strengthen the incentive for market participants to put a wider range of products onto central clearing. The Commission will therefore ensure that the rules properly distinguish between, on the one hand, the lower counterparty credit risk of contracts that are cleared on a CCP, and the higher counterparty credit risk of those where clearing is done bilaterally. The primary way by which this can be done is to widen the difference of the capital charges between centrally-cleared and bilaterally-cleared contracts contained in the Capital Requirements Directive (CRD)\(^7\).

These changes should be consistent with the approach outlined by the Basel Committee on Banking Supervision, the global forum for international capital rules for banks, so as not to distort competition and to limit the potential for regulatory arbitrage. The Commission will work with its partners to ensure that an agreement is reached and will do its utmost to be able to propose amendments to the CRD, along the above lines, in 2010.

3.4. Mandating central clearing

On top of capital charges for non-centrally cleared products, the Commission intends to propose making it mandatory to clear standardised derivatives through CCPs, in line with the G20 declaration. When developing its detailed proposals, the Commission will work with its partners in the G20, and notably the US, to achieve ambitious solutions to the practical issues related to making the requirement operational. This involves, in particular, defining which contracts can be regarded as standardised for central clearing. While standardised contracts should become the norm, non-standardised contracts should also be subject to more in-depth oversight by supervisors.

---

4. **Operational risk**

Operational risk relates to losses resulting from inadequate or failed internal processes, or from external events, and includes legal risk. The market has been making efforts to reduce operational risk. For example, market practice has generated standard legal documentation for a considerable part of the derivatives market. Moreover, market participants have gradually moved to electronic processing of trades. These ongoing efforts are likely to be boosted by the mandatory use of data repositories and the widening use of central clearing. These efforts will result in more standardisation of contracts in terms of electronic processing and standard legal terms (without affecting the economic terms of the contracts), which will also facilitate central clearing.

However, the Commission considers that ongoing industry efforts to reduce operational risks should be reinforced. Therefore the Commission intends to assess whether to re-shape the operational risk approach in the CRD in order to prompt standardisation of contracts and electronic processing.

In addition, more collective action is needed by market participants. Therefore, the Commission will further build on the success of the Derivatives Working Group and set ambitious European targets, with strict deadlines, for legal- and process-standardisation, while ensuring that global efforts take due account of European specificities so as to deliver full benefits also in Europe.

5. **Transparency**

OTC derivatives markets have clearly suffered from a lack of transparency of prices, transactions and positions. The lack of transparency to regulators and the market has varied with time and across products, but has overall hindered regulators from efficiently supervising derivatives markets in terms of systemic risk and market abuse. For market participants, it has created difficulties in accessing reliable prices, assessing risks, valuing positions, and checking best execution.

5.1. **Trade repositories**

Systemic risk and financial regulators need to have a complete overview of the derivatives market. It should therefore become mandatory to report all transactions to trade repositories. Information on trades made on-exchange or cleared through a CCP can be provided to regulators directly by these entities. The Commission will propose legislation governing trade repositories as well as new reporting obligations on market participants.

Repositories will play a central role in the new market structure. They should therefore be regulated in order to ensure that they are operated in a safe, sound and efficient manner. Legislation should provide a common legal framework for the operation of trade repositories and should cover, inter alia, authorisation/registration requirements, access and participation to a repository, disclosure of data, data quality and timeliness, access to data, safeguarding of data, legal certainty of registered contracts, governance and operational reliability.

---

8 An initiative aiming for this goal has been launched by the OTC Derivatives Regulators Forum.
The Commission believes that ESMA should be responsible for authorising and supervising trade repositories, as repositories provide their services on a European, if not global, basis. ESMA should also be responsible for authorising the operation of third-country repositories in the EU on the basis of a Commission decision on the equivalence of the regulatory framework in question, based on prudential concerns. On a reciprocal basis, ESMA should ensure that European regulators have unfettered access to complete global information. In the absence of such access, the Commission would encourage the creation and operation of European-based trade repositories. Ultimately, therefore, ESMA will act as a gateway for disseminating information on derivatives to national financial services regulators as well as sectoral regulators.\(^9\)

5.2. Trading on organised markets

The G20 agreed that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate." In the EU, this implies ensuring that eligible trades for exchange-trading take place on organised trading venues, as defined by MiFID\(^{10}\). Almost all derivatives exchanges use a central counterparty. Adding exchange-trading to central clearing would eliminate the bilateral nature of concluding trades, resulting in highly visible prices, volumes and open interest, and facilitate market access.

5.3. Pre- and post-trade transparency

Trading on organised venues will need to be accompanied by a strengthening of the provisions applicable to such venues, notably as regards transparency of trading. Harmonising pre- and post-trade transparency requirements for the publication of trades and associated prices and volumes across the various organised venues needs to be carefully considered, also in the case of OTC markets. It will be key to avoid loopholes in the framework of trading venues, and to ensure derivatives are fully covered. This will be addressed within the review of MiFID in 2010.

The increased transparency obligations will need to be measured so as to mitigate any excessive negative side-effects on liquidity and disproportionate administrative costs.

In addition, in Pittsburgh the G20 leaders have agreed "to improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility." Financial regulation will be amended, as part of efforts to ensure that EU agriculture derivatives markets keep their initial purpose of price discovery and hedging as tools to cope with price volatility\(^{11}\). These measures will be introduced in parallel with transparency requirements for all derivative (and possibly also other non-equity) markets, namely as part of the MiFID review.

---

\(^9\) In certain commodity derivatives markets (e.g. electricity and gas) there are particular needs to look at the interdependence between spot and derivatives markets. ESMA's ultimate function as a gateway will ensure that repositories have one main regulator, which is important for efficiency. This will also ensure that sectoral regulators will have a convenient access point to information they need. Since the prime purpose of mandating trade repositories is financial stability, oversight structures for commodity spot markets may be designed differently.

\(^{10}\) Regulated Market, Multilateral Trading Facility, or Systematic Internaliser.

\(^{11}\) The Commission intends to further address these issues in the forthcoming Communication on a better functioning food supply chain in Europe.
In EU electricity and gas markets, in 2010 the Commission will, as a component of a comprehensive market integrity package, bring forth proposals to ensure the publication of wholesale trades also in spot markets, in order to improve price discovery, market access and overall public confidence\textsuperscript{12}.

6. **Market integrity and oversight**

In line with the G20 conclusions, various measures are already underway in the EU towards enhancing market integrity in derivatives markets.

The review of the Market Abuse Directive in 2010 will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion. European securities regulators are advancing with requiring transaction reports in OTC derivatives. In the context of efforts to align the rules applicable to physical and financial energy markets, a tailor-made proposal for the EU level oversight of electricity and gas spot markets is foreseen ensuring transparency and market integrity. Similarly, the Commission is to examine by end-2010 whether the market for emission allowances is sufficiently protected from insider dealing and market manipulation and, if appropriate, bring forward proposals to ensure it\textsuperscript{13}. Moreover, in the field of agriculture, more complete transaction and position reporting to financial regulators of derivatives trading activity is foreseen.

The MiFID review will also conclude the work on exemptions for certain commercial firms dealing in commodity derivatives. MiFID provisions including authorisation and operational requirements, reporting and conduct of business rules do not apply to such firms. Findings from consultations\textsuperscript{14}, and recent developments calling for financial markets regulation to cover all relevant participants, will be taken into account when reaching conclusions.

Finally, the Commission intends to propose rules to give regulators the possibility to set position limits to counter disproportionate price movements or concentrations of speculative positions\textsuperscript{15}.

\textsuperscript{12} In January 2009, the Committee of European Securities Regulators (CESR) and the European Regulators' Group for Electricity and Gas (ERGEG) recommended to the Commission to develop specific trade transparency arrangements for electricity and gas trading as part of efforts to improve market access and price discovery.

\textsuperscript{13} Article 12(1a) of Directive 2003/87/EC as amended.

\textsuperscript{14} See for example, advice of the Committee of European Banking Supervisors and Committee of European Securities Regulators (http://www.cesr.eu/index.php?docid=5306) and the European Securities Markets Expert Group (http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf)

\textsuperscript{15} This is particularly relevant for commodity markets. See e.g. footnote 11.
7. **SUMMARY**

The Commission believes that these actions will achieve a paradigm shift away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where risks are priced properly. The general approach will limit the potential for loopholes and regulatory arbitrage.

The table below summarises the concrete policy actions outlined above. The Commission will now start the process of drafting legislation, notably by launching impact assessments, in order to come forward with ambitious legislation to regulate derivatives in 2010. When finalising these proposals, the Commission will work closely with all stakeholders in the EU as well as with its global partners. It is only by acting together that we lay the foundation for truly efficient, safe and sound derivatives markets.

**Future policy actions for ensuring efficient, safe and sound derivatives markets**

<table>
<thead>
<tr>
<th>Objective</th>
<th>Proposed actions</th>
<th>Time line</th>
</tr>
</thead>
</table>
| Reduce counterparty credit risk - strengthen clearing | **(1)** Propose legislation on CCP requirements, governing:  
(a) safety requirements (e.g. conduct of business, governance, risk management, legal protection of collateral and positions)  
(b) authorisation/withdrawal of authorisation and supervision of CCP  
(c) mandating of CCP clearing of standardised derivatives | Mid 2010 |
| | **(2)** Amend CRD in order to:  
(a) Mandate financial firms supplying initial and variation margin;  
(b) Substantially differentiate capital charges between CCP-cleared and non-CCP cleared contracts in CRD; | End-2010 |
| Reduce operational risks - standardisation | **(3)** Assess whether to re-shape the operational risk approach in the CRD to prompt standardisation of contracts and electronic processing.  
**(4)** Work with industry to increase standardisation of legal regimes and processes; | End 2010 |
| Increase transparency - trade repositories | **(5)** Propose legislation on trade repositories:  
(a) Regulate trade repositories  
(b) Mandate reporting of OTC derivatives transactions to trade repositories; | Mid-2010 |
| Increase transparency – trading | **(6)** Amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories;  
**(7)** Ensure trading of standardised contracts on organised trading venues under MiFID; | End-2010 |
<table>
<thead>
<tr>
<th></th>
<th>(8) Enhanced trade and price transparency across venues and OTC markets, as appropriate, in MiFID;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(9) Conclude review of exemptions from MiFID for commodity firms.</td>
</tr>
<tr>
<td></td>
<td><strong>Improve market integrity</strong></td>
</tr>
<tr>
<td></td>
<td>(10) Extend MAD to OTC derivatives;</td>
</tr>
<tr>
<td></td>
<td>(11) Give regulators the power to set position limits in MiFID.</td>
</tr>
<tr>
<td></td>
<td><strong>End-2010</strong></td>
</tr>
</tbody>
</table>