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SUMMARY OF THE IMPACT ASSESSMENT

Accompanying document to the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on OTC derivatives, central counterparties and trade repositories

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Derivatives are an important building block of modern finance. In essence they are financial contracts that facilitate the trading and redistribution of risks. They owe their name to the fact that their value is derived from an underlying, such as the price of a financial instrument (e.g. a share of a publicly traded company) or a commodity (e.g. oil). Since they redistribute risk, they can be used either to insure (hedge) oneself against a particular risk or, conversely, to take on risk (invest or speculate). They can also be used to arbitrage between different markets.

Derivatives can range from those (e.g. futures) that have fully standardised parameters, such as notional value or maturity, to those (e.g. swaps) that are fully tailored to the specific needs of a particular user. The type of derivative usually also determines how a derivative is traded: fully standardised derivatives are typically traded on organised trading venues, i.e. derivatives exchanges, while customised (or bespoke) derivatives are traded bilaterally, i.e. off-exchange or, as commonly called, over-the-counter (OTC).

The financial crisis has brought the OTC derivatives market 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 the following day highlighted the shortcomings in the functioning of this market. Within this context, regulators devoted particular attention to the role that credit default swaps (CDS) played during the crisis.

Since October 2008 the Commission has been working actively to tackle the shortcomings that the crisis brought to light. In the short term the Commission focused on the CDS market and obtained a commitment from the major dealers in the market to start clearing European-referenced CDS transactions on a central counterparty (CCP). In the medium term it focused on an in-depth review of derivatives markets that resulted in the publication of two Communications on derivatives markets, respectively in July and October 2009.

The first Communication examined the role played by derivatives in the financial crisis, looked at the benefits and risks associated with derivatives markets and assessed how the identified risks could be reduced. The second Communication set out the future policy actions the Commission intends to propose to increase transparency of the derivatives market, reduce counterparty credit risk and operational risk in trading and enhance market integrity and oversight.

This impact assessment report accompanies part of the proposals announced by the Commission, namely those that look at increasing transparency, and reducing counterparty credit risk and operational risk through the use of post-trading market infrastructure.

Transparency

By its very nature, the OTC derivatives market is opaque. This is because OTC derivatives are privately negotiated contracts and consequently any information concerning any one of them is usually only available to the contracting parties.

The financial crisis highlighted a lack of information on positions and exposures of individual firms in OTC derivatives. On the one hand, this lack of information prevents regulators from a timely detection of risks building up at individual institutions and in the system as a whole. It also prevents them from accurately assessing the consequences of a default of a market participant and therefore from responding in an appropriate manner should such a default

occur (Lehman's case was a clear demonstration of this). On the other hand, it helps fuelling suspicion and uncertainty among market participants during a crisis.

Counterparty credit risk

Derivative contracts bind counterparties together for the duration of an OTC derivatives contract. Throughout the lifetime of a contract, counterparties build up claims against each other, as the rights and obligations contained in the contract evolve with the underlying that the contract is derived from. This gives rise to counterparty credit risk, i.e. the risk that a counterparty may not honour its obligations under the contract when they become due. Clearing is the function by which these risks are managed over time. It can be carried out centrally, through a CCP, or bilaterally. Although both types of clearing are used in the OTC derivatives market, bilateral clearing is the most used form of the two.

The crisis highlighted that the level of counterparty credit risk related to OTC derivatives was much higher than both market participants and regulators had previously thought. To put it differently, the amount of collateral used to mitigate counterparty credit risk was insufficient. The main reason for this lies in inadequate collateralisation in the part of the market that is cleared bilaterally, either because some market participants are not required to provide collateral to secure their OTC derivatives trades or because of issues related to the risk management processes of those market participants that do provide collateral.

Operational risk

An OTC derivatives trade goes through several processing steps from the point at which two parties agree to a trade to the point where the transaction has been confirmed. Furthermore, during the lifetime of an OTC derivatives contract several events (e.g. collateral management and settlement of cash payments), stemming from the rights and obligations of the contract, need to be managed.

Given that the OTC derivatives market allows for a high degree of flexibility in defining the economic and legal terms of derivatives contracts, there are a number of highly bespoke and complex contracts. Such contracts still require significant manual intervention in many stages of the processing. This increases operational risk, and may lead to legal risk, may limit transparency and may even lead to an increase of counterparty credit risk.

The objectives

The goal of this impact assessment is to investigate the possibility of finding Community-level solutions to the problems outlined above. The general objective is to reduce systemic risk increasing the safety and efficiency of the OTC derivatives market. As mentioned earlier, reaching this general objective requires the realisation of three specific policy objectives, namely i) increasing transparency, ii) reducing counterparty credit risk, and iii) reducing operational risk associated with OTC derivatives. As these objectives are still rather broad, more operational objectives need to be defined:

1. obtain complete and comprehensive information on OTC derivatives positions;
2. increase the use of CCP clearing;
3. improve bilateral clearing practices;

4. increase the standardisation of OTC derivatives contracts.

Preferred policy option(s) and policy instrument(s)

The IA then analyses the impacts of each possible policy option associated with the above operational objectives and compares them with a baseline scenario to determine the most appropriate course of action. Following this analysis, the IA concludes that the largest net benefits would be achieved through the adoption of measures that would:

1. require market participants to report all the necessary information on their OTC derivatives portfolios to a trade repository or, if that would not be possible, directly to regulators; require the publication of aggregate position information;
2. require the use of CCP clearing for OTC derivatives that meet predefined eligibility criteria;
3. set specific targets for the bilateral clearing of OTC derivatives transactions; and
4. set specific targets for legal and process standardisation.

In view of the preferred options and of the need to ensure that the legislative framework is applied throughout the EU with exactly the same scope, without any gold-plating and without allowing residual powers to national legislators, a Regulation is deemed as the most suitable policy instrument to achieve the desired objectives.

Post-trading market infrastructure

The decision to require the use of CCPs and trade repositories will further increase the systemic importance of the former and will provide a systemic role to the latter (to the extent they did not already have one). This imposes an obligation to ensure that this infrastructure is safe and sound, in order to prevent the situation in which its use would actually increase systemic risk instead of decreasing it. In order to achieve this goal, the IA recognises that the outstanding issues that have been identified in relation to the functioning of CCPs and trade repositories need to be addressed.

Central counterparties

A CCP is defined as an entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer. Due to its central role in the market, a CCP normally bears no market risk (the latter is still borne by the original parties to the trade). However, as counterparty to every position, the CCP bears credit risk in the event that one of its counterparties fails. Similarly, the CCP's counterparties bear the credit risk that the CCP might fail. A CCP mitigates its counterparty credit risk exposure through a number of reinforcing mechanisms, typically including access restrictions, risk-management tools (such as collateralisation), and loss mutualisation. These mechanisms are jointly known as the "risk waterfall" of the CCP.

By virtue of the risk-mitigation role they play, CCPs are a critical component of the market they serve. Consequently, their failure becomes a potential systemic event. In view of their systemically important role, CCPs are subject to strict regulation. In the EU, CCPs are regulated at the national level. Since rules for regulating CCPs differ from one Member State to another, the resulting lack of playing field makes the cross-border provision of CCP

services more costly and potentially less safe than would be desirable and represents a barrier to the integration of the EU financial market.

In view of this, the Commission considered the possibility of introducing EU legislation for CCPs in 2006, but decided against it and opted instead for a combination of industry self-regulation (it invited the industry to agree on a Code of Conduct) and Member States cooperation (it called for the completion of the ESCB-CESR recommendations for CCPs) to ensure a safer and more efficient provision of CCP services in the EU.

Since then, it became apparent that the approach chosen by the Commission would not be sufficient to eliminate the problems related to CCPs, partly because of the shortcomings of the approach itself and partly because of the emergence of new problems. The former refer mainly to the realisation that recommendations cannot achieve the same results in terms of harmonising regulation as legislation at EU level. The latter include obstacles to the establishment of links, the emergence of the danger of competition on risk between CCPs, and the problem of the portability of collateral in the CCP environment.

In view of the problems highlighted above, the IA investigates possible ways of increasing the safety and efficiency of the EU post-trading infrastructure and of investor protection. To this end it sets out four specific objectives, namely i) increasing the safety of CCPs, ii) establishing a level playing field for the provision of CCP services; iii) facilitating the establishment of links between CCPs; and iv) providing additional safeguards for market participants accessing CCPs indirectly. The specific objectives listed above require the attainment of the following operational objectives:

1. remove obstacles to cross-border provision of CCP services;
2. remove obstacles to the establishment of links between CCPs;
3. prevent CCPs from competing on risk; and
4. facilitate the portability of client positions and associated margins.

The IA then analyses the impacts of each possible policy option associated with the above operational objectives and compares them with a baseline scenario to determine the most appropriate course of action. Following this analysis, the IA concludes that the largest net benefits would be achieved through the adoption of measures that would:

1. introduce a passport for CCP services, relying on national authorisation and supervision of CCPs, with a strengthened role for the college of supervisors;
2. introduce common requirements and procedures for establishing a right for CCPs to become interoperable provided that risks are addressed and competent authorities approve the link;
3. introduce common, strict risk standards for CCPs; and
4. require CCPs to offer indirect participants the possibility of having their margins placed in segregated (omnibus or nominal) accounts, while leaving indirect participants the choice of whether or not to take advantage of the offer.

Regulation is deemed as the most suitable policy instrument to achieve the desired objectives in this case as well.

Trade repositories

A trade repository is a centralised registry that maintains an electronic database of open OTC derivative transaction records (contracts). In addition to this primary activity, a trade repository may also engage in other services, such as contract events management and trade processing services. They are a very recent addition to the family of market infrastructures (the first one was launched at the end of 2006) and were, up until very recently, not regulated. The primary public policy benefit of a trade repository is the increased transparency allowed by its record-keeping function and the integrity of information it maintains.

The main problem that arose during the crisis concerned the speed with which regulators could access the information stored in the credit derivatives trade repository (the only trade repository that existed at the time). With the systemic role that trade repositories will gain because of the reporting requirement, the question of access to information by regulators will become even more important. In addition, several other aspects of a trade repository's business will need to be addressed because of the reporting requirement.

The IA explores ways to provide safe, sound and efficient trade repositories that will provide the necessary support for the reporting requirement, and ensure that competent authorities have the necessary information to perform their duties. In order to reach this general objective, the IA sets out three more specific policy objectives, namely i) ensuring the safety and integrity of data stored in a trade repository; ii) establish a level playing field for the provision of trade repository services; and iii) ensuring that competent authorities have unfettered access to the information stored in trade repositories. The IA then specifies a single operational objective, namely the introduction of common rules governing the activities of trade repositories.

The IA then analyses the impacts of each possible policy option associated with the above operational objectives and compares them with a baseline scenario to determine the most appropriate course of action. Following this analysis, the IA concludes that the largest net benefits would be achieved through the adoption of legislation governing the activities of trade repositories with registration and surveillance done at EU level by ESMA.

Regulation is deemed as the most suitable policy instrument to achieve the desired objectives in this case as well.