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COMMUNICATION FROM THE COMMISSION

Ensuring efficient, safe and sound derivatives markets

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Ensuring efficient, safe and sound derivatives markets

(Text with EEA relevance)

1. INTRODUCTION

The ongoing 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 in general and Credit Default Swaps (CDS) in particular.

There is broad agreement about the benefits and risks of derivatives markets as exposed by the financial crisis. The report of the High Level Group chaired by Jacques de Larosière demonstrated the risks associated with the rapid explosion of the use of credit derivatives and stressed the need to address the lack of transparency in the market. To this end, the report recommended action to simplify and standardise over the counter (OTC) derivatives and to introduce central counter party (CCP) clearing. The G20 Summit in London in April committed to promoting the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision. The European Council on 19 June 2009 also called for further progress to be made to ensure the transparency and stability of derivatives markets.

Since October 2008 the Commission has been working actively on an in-depth review of derivatives markets. As announced in the Communication "Driving European Recovery", this Communication presents the findings of that review and prepares the ground for forthcoming measures to address the problems identified. In parallel the Commission will continue to work constructively with industry to ensure the implementation of its commitment to introduce EU-based central clearing by end-July 2009. The Commission will take full account of the measures taken by industry in designing the follow-up.

This Communication is accompanied by a Commission Staff Working Paper, which contains an overview of (i) derivatives markets, (ii) OTC derivative market segments, and (iii) an assessment of the effectiveness of current measures to reduce risks, notably as regards Credit Default Swaps (CDS).

The Commission welcomes the feedback of stakeholders on the orientations presented in this Communication and in particular on the specific questions set out in more detail in the accompanying Consultation Document. Responses should be sent to the Commission by 31 August 2009.

2. DERIVATIVES AND DERIVATIVES MARKETS

This chapter explains what derivatives are, the benefits they have for the economy and the risks they may entail. The latter have been at the centre of the financial crisis.

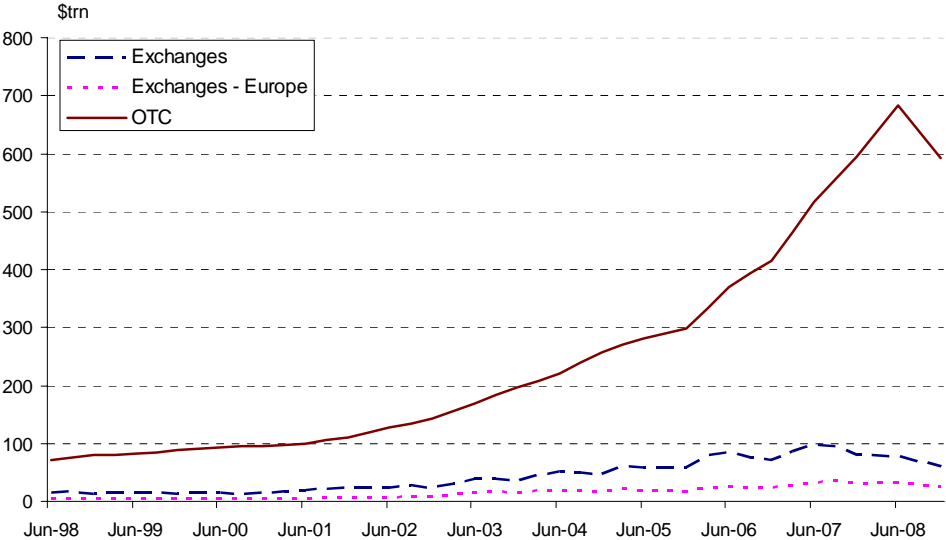
2.1. What are derivatives?

Derivatives are financial contracts that trade and redistribute risks generated in the real economy, and are accordingly important tools for economic agents to transfer risk. They can be used both for hedging risk and to acquire risk with the aim of making profit. They are called derivatives, as their value is "derived" from an "underlying", e.g. a financial instrument, a commodity, a market variable or even a service.

There are many types of derivatives. Some are standard products (e.g. futures) while others are not, as each contract is tailored to the specific needs of the user (e.g. swaps). The standardised derivatives are typically traded in organised trading venues where prices are publicly displayed (e.g. derivatives exchanges) while the non-standardised derivatives are traded off-exchange or, as commonly called, over-the-counter (OTC) where prices remain private.

Their use has grown tremendously over the last decade. This growth has materialised in OTC transactions, as illustrated by the graph below.

The size of derivatives markets: on- and off-exchange

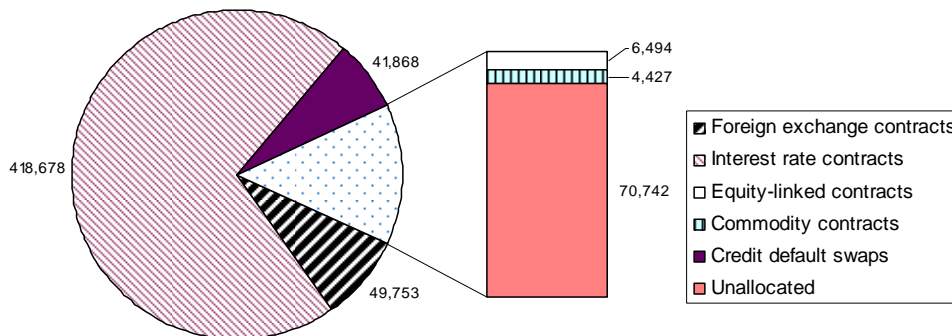


Note: The figure shows the notional amounts outstanding in on- vs. off-exchange market segments in USD trillions in 1998-2008. The trends show outstanding amounts worldwide, where European exchanges' market share is shown separately (no similar geographic breakdown exists in OTC data). Source: Bank for International Settlements (BIS).

OTC derivatives are generally divided into five broad segments: foreign exchange derivatives, interest rate derivatives, equity derivatives, commodity derivatives and credit derivatives, of which credit default swaps is the most important. The graph below depicts the relative weight of these segments. Chapter 3 of the Staff Working Paper presents these segments in further detail and describes the different characteristics and risks involved in the different types of OTC derivatives.

OTC derivative market segments

Notional amounts outstanding, USD trillion, December 2008



Source: BIS (2009)

2.2. Derivatives benefit the economy...

No economy can flourish if no-one is willing to take risk. An entrepreneur setting up a business is taking the risk that the business may fail. A bank that is lending money to that business risks not receiving the full repayment of its loan. Without the entrepreneur setting up the business, however, the saver that has deposited his funds with the bank would have one opportunity less to earn a decent return on his or her savings. The saver knows that the higher the return, the higher the risk of the project he is funding. The funding of investment projects therefore depends on whether somebody is willing to bear the associated risk. Nobody likes taking too much risk and it is therefore beneficial if risks can be shared.

This is what derivatives can do. They share or redistribute risks and they can be used as protection against a particular risk ("hedge") or, as a tool to take speculative positions. In particular, commercial entities, such as airline companies, manufacturers, etc. use derivatives to cover the risk of a price increase in the basic materials they use to run their business and to better plan their future needs.

2.3. ...but can put it at risk...

Institutions participating in derivatives markets can cover, or 'hedge', the risks they face by using derivatives. However, if risks are hedged on OTC markets, it is hard, in the absence of reliable public information about those markets, for market participants and supervisors to determine whether those risks have been effectively hedged.

When traders in derivatives are neither market makers nor do they have any interest in the underlying they facilitate speculation, volatility and the building up of risks in the system. Derivatives can then be used as a means of leveraging the balance sheet of those who intervene in derivatives markets as they allow market participants to take positions with less capital than the one required for investing in cash markets.

Moreover, if a counterparty defaults it may be difficult to find other counterparties to replace a hedge. These may either be in distress themselves or reluctant to enter into a trade in view of wider uncertainty. In markets with few participants this problem is amplified.

In sum, when concluding an OTC contract, it is difficult to *assess* the risk that a counterparty may default. In highly interconnected financial markets, such an assessment would in principle require any market participant to have good knowledge about all other market participants. As OTC markets have little public information, such knowledge is incomplete.

CDS are particularly vulnerable in all these respects. While most derivatives depend on observable market prices (e.g. interest or the exchange rates), CDS are different. The risk they cover – credit risk – is not immediately observable but requires specific information about the borrower, which typically only banks have had. However, over the last decades credit risk has become more tradable, e.g. through securitisation. Assessing the risk remains difficult, which may lead to situations where the market all of a sudden faces a significant default event. Moreover, the risks associated with CDS are further amplified by the fact that the potential obligations that come with them are extreme.¹ These risks are not unique to CDS: they apply to derivatives generally, although to a less dramatic extent.

2.4. ...as highlighted by the financial crisis

The financial crisis has illustrated that these risks are not theoretical but real. Bear Sterns, Lehman Brothers and AIG were important players in the OTC derivatives market, either as dealers or users of OTC derivatives, or both. The trouble they experienced originated outside the OTC derivatives markets, it entered the derivatives market via the CDS written by these three institutions and, because of these institutions' central role in all OTC derivatives markets, it spread beyond CDSs and affected the world economy. The opaqueness of the market prevented, on the one hand, other market participants from knowing exactly what the exposures of their counterparties were to these three entities, which resulted in mistrust and in the sudden drying up of liquidity. On the other hand, it also prevented regulators from being able to identify early the risks building up in the system, the extent to which risks were being concentrated and consequently the effects that their default would have for financial stability. The light regulatory coverage of the market exacerbated this problem as supervisors did not have sufficient information.

In sum, the crisis has highlighted how derivatives in general and CDS in particular created a web of mutual dependence that was difficult to understand, disentangle and contain in the immediate aftermath of a default. Therefore, the crisis has clearly shown that the characteristics of OTC derivative markets – the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks – increases uncertainty in times of market stress and accordingly poses risks to financial stability.

¹ The cash flows related to a CDS are 'discontinuous', i.e. while in normal times the seller of a CDS earns a steady flow of fees he nevertheless face the risk that the entity on which the CDS is written defaults, which will force him to pay out the full principal amount minus the value of the defaulted obligation. That has made some to misuse CDS as financing instruments.

3. MANAGING COUNTERPARTY RISKS

These risks can be mitigated by the way trade and post-trade functions are structured. At trading level, risks can be reduced by improving operational efficiency, e.g. ensuring electronic trade execution, affirmation and confirmation.² This would have the effect of making OTC trade execution more similar to the way transactions are handled on-exchange. Improving operational efficiency has been the focus of regulatory attention prior to the financial crisis and has contributed to e.g. ensuring that CDS are today increasingly affirmed and confirmed electronically.

However, while operational efficiency is necessary it is in itself insufficient. To effectively address the risks outlined above, it is important to strengthen post-trade functions as well, notably clearing. Clearing is the way by which the risks outlined above are mitigated. It accordingly plays an essential role in derivative markets. Clearing can either occur bilaterally between the two counterparties to a particular trade or at central market level, by means of a Central Counter-party (CCP). On-exchange, clearing is almost exclusively done by CCPs. Off-exchange, bilateral clearing remains the norm, even though some market segments have CCP clearing as well (most notably interest rate swaps).

- **Bilateral clearing:** the two counterparties most often have collateral agreements in place that provide for regular monitoring of how the value of the contract evolves so as to manage their respective credit exposures to each other. Should the value evolve so that one party has built up a claim on the counterparty it is then entitled to ask for collateral. While collateral is important to mitigate credit risk, it requires managing clearing relationships with numerous counterparties. The very nature of this complex bilateral network makes it difficult for an institution to understand its own credit exposure in view of its counterparties' exposures to each-other, let alone assessing the cascading implications of a counterparty defaulting.
- **CCP clearing:** the CCP steps into each trade by acting as a counterparty to each side of a transaction. The obligations of each of the two trading partners are now vis-à-vis the CCP, hence each party's exposure in this market is now with one and the same party. There are numerous advantages of using a CCP. A CCP is effectively a mutual insurance with mutual defences. It makes collateral management simpler, as it is the CCP that collects and manages collateral. It is also safer, as the CCP is the central guarantor and is an institution solely focused on managing risks with several layers of protection. This sole focus on risk management makes the CCP a neutral party. Being in the centre, it is easier for the CCP to understand and manage risk. Moreover, the central information contained in the CCP also makes it easier for regulators to supervise risks. In view of the systemic role of the CCP it is essential that it is professionally run, amply capitalised and well regulated so as to be safe and sound.³

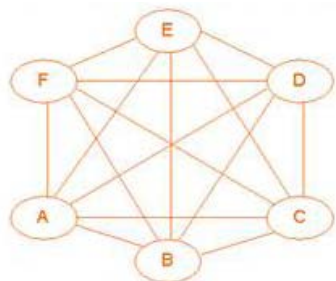
² See accompanying Staff Working Paper, section 2.2 for further description of these concepts.

³ See accompanying Staff Working Paper, section 2.4.2 for a more detailed description of CCP clearing.

Bilateral vs. CCP clearing

Bilateral clearing

- Web of counterparty exposure
- Complex collateral movements
- Potential domino effect of one dealer default



CCP clearing

- Hub and spoke with central guarantor
- All collateral moves to/from CCP
- CCP capitalised to withstand dealer default



Given these benefits, one might wonder why market participants do not universally use CCP clearing. The first, and obvious, reason is that safety comes at a cost for its participants, as they have to contribute to the CCP's layers of protection. Second, a CCP improves transparency, which redistributes informational advantages among market participants, to the disadvantage of those currently enjoying an information advantage (i.e. major OTC derivatives dealers). It is also true, however, that a CCP cannot always be used. There are a number of prerequisites, broadly related to liquidity and standardisation, which need to be satisfied before a CCP can be used. In this sense, given that not all OTC derivatives fulfil the necessary characteristics to be cleared via a CCP, the Commission will also work to strengthen counterparty risk management in bilateral trades.

In sum, the risks associated with derivatives vary depending on the market structure. Overall, OTC markets are much riskier than regulated trading venues, as the former are more opaque and counterparty relations more complex. The effectiveness of bilateral counterparty risk mitigation tools therefore leave a lot to be desired and the way counterparty risk is mitigated needs to be substantially improved.

4. ACTIONS ALREADY TAKEN BY THE COMMISSION TO IMPROVE FINANCIAL STABILITY IN DERIVATIVES MARKETS

Whilst derivatives are not outside EU financial services regulation, the huge growth of OTC derivatives markets, the increased volume of speculative positions built through derivatives and the greater participation in derivatives markets of non-regulated entities are issues which justify a review of our regulatory framework. Since the outbreak of the financial crisis, the Commission has acted swiftly and taken steps to address some of the most urgent and acute risks associated with derivatives.

First, as regards CDS, in October 2008, Commissioner McCreevy called for (i) a systematic look at derivatives markets in the aftermath of the lessons learned from the financial crisis, and (ii) concrete proposals as to how the risks from credit derivatives can be mitigated.⁴ As a

⁴ McCreevy, C. (2008). "Time for regulators to get a better view of derivatives", 17 October 2008, SPEECH/08/538.

result, CDS dealers committed to start clearing eligible CDS on European reference entities and indices on these entities through one or more European CCPs by 31 July 2009.⁵

Second, some of the problems related to securitisation and to the excessive risk transfer and risk mispricing have been addressed by the review of the Capital Requirement Directive (CRD).⁶ This proposal notably states that firms (known as 'originators') that re-package loans into tradable securities will be required to retain some risk exposure to these securities, while firms that invest in the securities will be allowed to make their decisions only after conducting comprehensive due diligence. If they fail to do so, they will be subject to heavy capital penalties.

Third, as regards the systemic risk related to speculative trading, the Commission will soon adopt a proposal on the capital requirements applied to the trading book of financial institutions and to securitisation and re-securitisation positions. The increased levels of capital foreseen in this proposal will very likely avoid excessive short term risk taking by financial institutions.

Fourth, the Commission is in the process of reviewing its approach to the supervision of financial markets. In proposing the creation of a European macro-financial supervisor Europe will give itself the capacity to identify excessive risks building in the system and act to contain those risks. The European Systemic Risk Board will be instrumental in avoiding that the risks associated with derivatives markets pose a problem to the whole financial and economic system.

Fifth, as Credit Rating Agencies (CRAs) failed to adequately assess the risks posed by complex instruments, in particular due to the conflicts of interests inherent to the "issuer pays model", it became evident that they could not be left unregulated. In April 2009, the Council and the European Parliament approved a regulation proposed by the Commission according to which CRAs will have to comply with strict standards of integrity, quality and transparency and be subject to ongoing supervision of public authorities.⁷

Finally, the European Commission has proposed a directive on hedge fund and other alternative investment fund managers (AIFM) that will create a comprehensive and effective regulatory and supervisory framework at European level. The proposed Directive will enable Member States to improve the macro-prudential oversight of the sector and the micro level

⁵ On 17 February 2009, nine global dealers (Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, UBS) have committed to use one or more central counterparties (CCPs) in the European Union once they are established as systems under the Settlement Finality Directive (98/26/EC) to (i) clear CCP-eligible Credit Default Swaps (CDS) on European reference entities and indices based on these entities, and (ii) back-load outstanding eligible contracts. The commitment has been then endorsed by one more dealer (Nomura) and support for this initiative has been provided by the European Banking Federation, by the European Public Banks Board and by other European banks associations

⁶ COM/2008/0602 final - COD 2008/0191 amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.

⁷ European Commission (2008), "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies", COM(2008) 704, as approved by the European Parliament and Council on 23 April 2009.

supervision, to impose limits to the level of leverage of these entities and to take coordinated action as necessary to ensure the proper functioning of financial markets.⁸

5. THE WAY FORWARD: NEW INITIATIVES TO IMPROVE FINANCIAL STABILITY

The current crisis has highlighted the need to deal with OTC derivatives markets to allow them to fulfil their economic role in a way which does not endanger the stability of the system. To this end the Commission considers that actions should be undertaken in order to: a) allow regulators and supervisors to have full knowledge about the transactions that take place in OTC derivatives markets as well as the positions that are building in those markets, b) increase the transparency of OTC derivatives markets vis-à-vis their users; in particular more and better information about prices and volumes should be available; c) strengthen the operational efficiency of derivatives markets so as to ensure that OTC derivatives do not harm financial stability and d) mitigate counterparty risks and promote centralised structures. The main tools for achieving these objectives are (i) promoting further standardisation, (ii) using central data repositories, (iii) moving to CCP clearing, and (iv) moving trading to more public trading venues.⁹ This section analyses these tools and suggests orientations for future work.

5.1. Standardisation

For CCP eligible OTC derivatives, standardisation is a prerequisite for the other tools outlined below. For non-CCP eligible OTC derivatives, operational efficiency would be strengthened, and operational risks reduced, by further standardisation, e.g. by encouraging broader take up of standard contracts and electronic affirmation and confirmation services, central storage, automation of payments and collateral management processes. As standardisation is a prerequisite for further actions, it will form a core building block in the Commission endeavour to make derivatives markets efficient, safe and sound.

But standardisation requires investments. The Commission intends to take forward work to incentivise industry's on-going efforts to make these investments so as to promote standardisation in the areas of all OTC derivatives that are unlikely to be eligible either for CCP clearing and unsuited to on-exchange trading.

5.2. Central data repository

A central data repository collects data – such as number of transactions, size of outstanding positions – for all trades (both CCP eligible and CCP non-eligible) with the purpose of increasing transparency and knowledge.¹⁰ This not only contributes to transparency, but also improves the operational efficiency of the market. A repository could also provide other services (e.g. facilitate settlement and payment instructions).

⁸ European Commission (2009), "Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers", COM(2009) 207.

⁹ The applicability of these tools varies somewhat depending on market segment. There is marked difference of complexity in implementing these tools. A more detailed analysis of the effectiveness of current risk mitigation methods and the associated need for additional measures in each OTC market segment are further outlined in the accompanying Staff Working Paper's chapter 4.

¹⁰ Such a data warehouse exists for CDS in the form of the Trade Information Warehouse, operated by the US Depository Trust and Clearing Corporation (DTCC).

The Commission sees the merits in terms of increased transparency and knowledge which central data repositories can bring for supervisors. This is particularly relevant given the fact that CCP clearing cannot easily apply to all derivatives as the necessary prerequisites are not always in place and not easily applicable. For reasons of legal protection, supervision and business continuity, the Committee of European Securities Regulators (CESR) will study the usefulness of such a facility. The Commission will therefore, in the light of the forthcoming CESR report, take appropriate actions to that effect.

5.3. CCP clearing

Of the four tools considered, the one that has been subject to most attention so far is CCP clearing. CCPs have proven their worth during the financial crisis, as illustrated by their role in managing the consequences of Lehman Brothers' default. The Commission has already pushed industry to expand the use of CCP clearing and intends to implement the relevant recommendation of the de Larosière Group as a matter of priority.

There are strong reasons for CCP clearing being located in Europe, relating to regulatory, supervisory and monetary policy concerns. If a CCP is located in Europe, it is subject to European rules and supervision. Supervisors accordingly have undisputed and unfettered access to the information held by CCPs. It is also easier for European authorities to intervene in case of a problem at a European CCP. For example, central banks do not provide direct access to their liquidity facilities to financial institutions located outside their currency areas.¹¹

In the area of CDS, the major derivatives dealers have signed a commitment with the European Commission to move clearing of European CDS onto one or more European CCPs by 31 July 2009 and are currently working on the necessary standardisation of European CDS contracts to make CCP clearing possible. Two European CCPs are expected to be ready to offer their services on CDS by 31 July 2009, a third one is expected to be ready in December 2009 and a fourth one has not committed to a firm date. Overall, the Commission welcomes the industry's efforts in trying to meet the deadline stated in their commitment. Indeed, industry initiatives have so far proved to be effective on both sides of the Atlantic as far as the standardisation of CDS is concerned. However, the implementation of the solutions for certain technical aspects, such as those related to the restructuring credit event, has not yet been finalised. Therefore, if industry is unable to deliver on its commitment, the Commission will have to consider other ways, as outlined further below. The Commission welcomes the industry initiatives and will take full account of their delivery and implementation in considering whether any further initiatives are necessary to ensure as broad a usage of CCP clearing as possible.

Incentives to use CCPs already exist. Market participants have a natural incentive to use CCP clearing, as it reduces their counterparty credit risk and allows regulatory capital savings. However, these incentives have not been sufficient in overcoming commercial incentives favouring bilateral clearing. Therefore, the Commission is considering ways to significantly

¹¹ Currencies swaps agreements may exist between central banks, but because of the absence of direct access to liquidity facilities, the ECB has expressed its strong preference for the CCP to be located in the euro area, as illustrated in a statement by its Governing Council on 18 December 2008, which confirmed that "*there was a need for at least one European CCP for credit derivatives and that, given the potential systemic importance of securities clearing and settlement systems, this infrastructure should be located within the euro area.*" ECB (2008), Decisions taken by the Governing Council, 18 December 2008, <http://www.ecb.europa.eu/press/govcdec/otherdec/2008/html/gc081219.en.html>

strengthen the incentives to use CCP clearing so as to dismantle any commercial hesitation to take up CCP clearing wherever possible. This could be done by (i) amending the rules on regulatory capital contained in the CRD, and (ii) providing further regulatory and supervisory assurances that CCPs are safe and sound by means of future European legislation where justified and possibly common supervision.¹² Naturally, this further work does not in any way affect the deadline associated with the ongoing efforts to move clearing of European CDS onto one or more European CCPs, i.e. 31 July 2009.

5.4. Trade execution

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 Commission will examine, taking into account the bespoke and flexible nature of OTC derivatives markets and the regime applicable to cash equities, how to arrive at a more transparent and efficient trading process for OTC derivatives. In this respect the Commission will further assess (i) the channelling of further trade flow through transparent and efficient trading venues and (ii) the appropriate level of transparency (price, transaction, position) for the variety of derivative markets trading venues.

6. CONCLUSION

Derivatives play an important role in the economy but are associated with certain risks. The crisis has highlighted that these risks are not sufficiently mitigated in the OTC part of the

¹² European Commission (2009). Communication from the European Commission, *European Financial Supervision*, COM(2009)252.

market, especially as regards CDS. Since the beginning of the financial crisis, the Commission has been working to address the most urgent of these risks.

But beyond this the Commission will consider further measures to move ahead with increased standardisation and transparency of transactions, to consolidate the move to CCP clearing and ensure that it becomes the norm for OTC derivatives markets as a whole, and to channel further trade flow through transparent and efficient trading venues, wherever possible.

Following the public consultation which this Communication launches, the Commission will host a public hearing on 25 September 2009. The views and evidence presented by stakeholders will feed into a detailed impact assessment exercise which will help the Commission to shape its approach. Taking into account the outcome of the consultation, the Commission will draw operational conclusions before the end of its current mandate and present appropriate initiatives, including legislative proposals as justified, before the end of the year.

The Commission will take full account of industry efforts, as well as developments in the EU's key partners and in particular, the comprehensive regulatory framework for OTC derivatives announced by the US Treasury. This notably translates into an obligation to clear all standardised OTC derivative contracts on CCPs and an encouragement of executing trades on "regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives".¹³ The Commission will continue to work on these issues with US authorities, *inter alia* in the context of the financial services regulatory dialogue, in order to ensure global consistency of policy approaches and avoid any risk of regulatory arbitrage.

¹³ See US Treasury Financial Regulatory Reform, 17 June 2009.