

# Derivatives: What are we dealing with ?



*The financial crisis has put **derivatives** in the spotlight, a class of financial instruments that can play a beneficial role for the economy but could also entail significant risks to financial stability.*

*Future policy measures to enhance the safety of derivative markets were therefore outlined in a Commission Communication on 20 October 2009 as a response to President Barroso's call for 'ambitious legislation on the regulation of derivatives in 2010'. These measures follow a stakeholder consultation in July and a public hearing in September.*

## What are derivatives ?

Derivatives are financial contracts, whose value is 'derived' from an 'underlying', which can be a financial instrument, a commodity, a market price, like the interest or an exchange rate, or a credit risk. These contracts are concluded between two parties in order to trade risks inherent to an economic activity. Economic agents who are not willing to bear risks sign them over to those who are. 'Trading away a risk' is usually called 'hedging'. Conversely, 'taking on risk' is often referred to as 'speculation'. Derivatives are zero-sum contracts: The gain to one party equals the loss of the counterparty.

## How can derivative contracts threaten financial stability ?

There are three ingredients to this: leverage, lack of transparency and interconnectedness. Derivatives allow for increasing leverage: Few own funds are sufficient to take up a large position in the market – and magnify possible gains and losses. Currently, most derivatives are traded over-the-counter (OTC). Contracts are concluded bilaterally, but currently neither the public nor the supervisors have much available knowledge about the market. The spectacular growth of the derivatives market over the last decades has therefore created an opaque web of mutual dependence, where huge uncertainty exists when a participant is in distress.



## Commission proposal: safety first

The Commission believes that a paradigm shift must take place, away from the traditional view that derivatives are financial instruments for professional use towards an approach that puts the safety of the financial system first. Europe cannot afford another situation where financial sector risks are ultimately borne by the taxpayer.

The market for derivatives is global. To ensure an ambitious and convergent international regulatory outcome, the Commission proposals are in line with the objectives agreed at the G20 meeting of 25 September 2009. Technical details will be further developed in cooperation with the G20 partners to ensure a coherent implementation of these policies across the globe. Cooperation with the US, who are also in the process of designing a new approach to derivatives markets, will continue to be very close.

## Reducing counterparty risk

The first set of the Commission's proposals focuses on reducing counterparty risk, i.e. the risk that a counterparty will default on its obligations. Currently, this risk is high in OTC markets, where organisations using derivatives are exposed to many different counterparties. The Commission proposes to change this by requiring the use of so-called central counterparties (CCPs) – a central market infrastructure that interposes itself between buyers and sellers, thereby becoming the single counterparty to all market participants – for those OTC derivatives that are sufficiently standardised. The Commission will therefore propose legislation on CCPs to ensure that they are safe and sound.

Not all derivatives are suitable for central clearing. For those derivative trades that remain outside CCPs, stricter collateral requirements should apply. In addition, to better reflect the risk when not using CCPs, the Commission will also propose to increase the capital that credit institutions will have to set aside for such derivative trades.

## Increasing transparency

A second set of proposals focuses on increasing transparency. A key problem during the financial crisis was that supervisors did not have sufficient information about what was happening in OTC derivatives markets. To correct that, market participants are currently setting up so-called trade repositories, where they will report all transactions they engage in and which supervisors can access. The Commission will propose legislation on repositories to ensure that all transactions are indeed reported and to ensure that they are well-managed. Trading derivatives on organised venues increases the transparency of prices and positions to the market.

The Commission will propose mandating trading of standardised derivatives on exchanges and other organised trading venues, as pre- and post-trade transparency will be part of the upcoming review of the Markets in Financial Instruments Directive (MiFID) for all derivatives.

The Commission has started the process of working out these proposals and drafting impact assessments, in order to come forward with ambitious legislation to regulate derivatives in 2010.

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