Regulation on Over-the-Counter Derivatives and Market infrastructures – Frequently Asked Questions

What are derivatives?
A derivative is a financial contract linked to the future value or status of the underlying to which it refers (e.g. the development of interest rates or of a currency value, or the possible bankruptcy of a debtor).

Over-the-Counter (OTC) derivative contracts are not traded on an exchange (for example the London Stock Exchange) but instead privately negotiated between two counterparts (for example a bank and a manufacturer). The definition of OTC derivatives in EMIR refers to all derivatives contracts which are not "executed on a regulated market". As a result all derivatives contracts executed on a venue of execution which is not a regulated market (e.g. a Multilateral trading facility), is considered as an OTC derivative contract under EMIR.

What is the size of the market? What kinds of products are comprised?
OTC derivatives account for almost 95% of the derivatives markets. In June 2011, the notional value of outstanding OTC derivatives was around $707 trillion or €540 trillion. The OTC derivatives market comprises a wide variety of product types across several asset classes (interest rates, credit, equity, foreign exchange (FX) and commodities) with widely differing characteristics and levels of standardisation. OTC derivatives are used in a variety of ways, including for purposes of hedging, investing, and speculating. Contrary to derivatives traded on exchanges, OTC derivatives are not automatically cleared through Central Clearing Parties (cf next question) or subject to reporting rules.

What are market infrastructures?

Central Counterparties (CCP)
A CCP is an entity that interposes itself between the two counterparties to a transaction, becoming the buyer to every seller and the seller to every buyer. A CCP's main purpose is to manage the risk that could arise if one counterparty is not able to make the required payments when they are due –i.e. defaults on the deal.

CCPs are commercial firms. There are currently about a dozen CCPs, all but one located in Europe or the USA, clearing interest rates, credit, equity and commodities OTC derivatives. There is currently no CCP clearing FX OTC derivatives.
**Trade repositories**
A trade repository is a central data centre where details of derivatives transactions are reported.

Trade repositories are commercial firms. There are global trade repositories for credit, interest rate and equity OTC derivatives, and soon for commodities and FX.

**Why did the Commission propose legislation on OTC derivatives?**
Derivatives play an important role in the economy. But they are also associated with certain risks. The financial crisis, including the default of Lehman Brothers and the bail out of AIG, highlighted that these risks were not sufficiently mitigated, particularly in the OTC market where almost 95% of derivatives are traded. The European Commission committed to deliver, in its Communication on Driving European Recovery of March 2009, appropriate initiatives to increase transparency in the derivatives market and to address financial stability concerns.

In September 2009, at the G-20 Pittsburgh Summit, the leaders of the 19 biggest economies in the world and the European Union agreed that "all standard 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." Furthermore, they acknowledged that "OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements."

The Commission’s proposal meets the G20 commitments on OTC derivatives markets.

**What are the objectives of the new rules?**
The new rules objectives are to increase transparency in the OTC derivatives market and to make it safer by reducing counterparty credit risk and operational risk.

- To increase transparency, the new rules requires that i) detailed information on OTC derivative contracts entered into by EU financial and non-financial firms are reported to trade repositories and made accessible to supervisory authorities, and that ii) trade repositories publish aggregate positions by class of derivatives accessible to all market participants. In the course of the negotiations the scope of the proposal has been widened to cover the reporting of both listed (i.e. non-OTC) and OTC derivatives.

- To reduce counterparty credit risk, the new rules introduce (i) stringent rules on prudential (e.g. how much capital they need hold), organisational (e.g. role of risk committees) and conduct of business standards (e.g. disclosure of prices) for CCPs, (ii) mandatory CCP-clearing for contracts that have been standardised (i.e. they have met predefined eligibility criteria), (iii) risk mitigation standards for contracts not cleared by a CCP (e.g. exchange of collateral)

- To reduce operational risk. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The proposal requires the use of electronic means for the timely confirmation of the terms of OTC derivatives contracts. This allows counterparties to net the confirmed transaction against other transactions and ensure accurate book keeping.
How does the proposal make the derivatives market more transparent?

Currently, there is little reliable information on what is going on in the OTC derivatives market. There are no public prices available, no public information as to who is entering deals with whom, over what period of time, relating to what underlying asset or for which amounts.

Under the final text agreed in the negotiation process, detailed information on each derivatives contract traded by a financial or a non-financial firm will have to be reported to trade repositories. The data in these trade repositories will then be available to regulators, giving them a much better overview of who owes what to whom so they can spot any potential problems early and be in a position to take action if need be. In addition, trade repositories will have to publish aggregate positions by class of derivatives, providing market participants with a clearer view of the derivatives market. However, trade repositories will not publish data at trade level as the type of information is commercially sensitive.

To whom will the clearing and reporting obligations apply to?

The obligation to clear OTC derivatives contracts through a CCP and report derivatives to trade repositories will apply to financial firms (banks – both universal banks and investment banks, insurance companies, funds etc.) and to non-financial firms (energy companies, airlines, manufacturers etc.) that have large positions in OTC derivatives.

Are any exemptions foreseen from the clearing and reporting obligations?

The proposal provides for some limited exemptions from clearing and reporting requirements for non-financial firms.

- contracts by non-financial firms:

Contracts by non-financial firms below a 'clearing threshold' will not have to be cleared through a CCP. "Commercial and Treasury hedging activities", i.e. when these firms use OTC derivatives to hedge risks related to their activities, will be subtracted from the firm's overall position which means that they will not count towards the threshold set for the clearing obligation. These activities do not need to be cleared. For example, commercial hedging could be when airlines using OTC derivatives to secure the price at which they buy fuel, or when exporters who use OTC derivatives to shield themselves from fluctuations of exchange rates.

These thresholds are not set out in the proposal. ESMA, the European Securities and Markets Authority, together with ESRB, the European Systemic Risk Board and other relevant authorities will draft technical standards on what these thresholds should be.
When setting these thresholds, ESMA will have to take into account the systemic relevance of the sum of net position and exposures by counterparty per class of derivatives (i.e. looking at how much overall risk they pose to the system).

A hypothetical example of hedging: a plane manufacturer has a contract to build 6 planes in the next 6 months and will need 10 tonnes of steel per plane. He may want to guarantee that whatever the fluctuations in the market of the price of steel, he gets steel at a certain fixed price for the next 6 months so as to be able to deliver the planes on budget. To cover for the risk of steel rising, the plane manufacturer could enter into an OTC contract with a bank for example. They could agree on a set price for a set quantity of steel for 6 months. If, after 6 months, when the contract matures, the market price turned out to be lower, the bank would make a profit; but if the market price turned out to be higher, then the plane manufacturer would be able to purchase the steel a price lower than the market price and thus save money.

- financial institutions involved in the management of public debt

Members of the European System of Central Banks (ESCB), public bodies charged with or intervening in the management of the public debt, and the Bank for International Settlements will not be subject to the clearing, reporting or bilateral risk mitigation obligations in order to avoid limiting their powers to intervene to stabilise the market, if and when required.

- pension funds

Besides, a temporary exemption from central clearing for pension funds has been introduced in the course of the negotiations. This is aimed at ensuring that pension funds do not incur disproportionate costs that could ultimately impact EU pensioners. Once the industry has developed the appropriate technical solutions for the provision of non-cash collateral as variation margins by pension funds they will be subject to central clearing. In the interim pension funds will have to exchange collateral for their OTC derivatives.

- intra-group transactions

In addition, an exemption from the clearing obligation for transactions entered within a group of financial firms, non-financial firms or a mix of financial and non-financial firms has been introduced (‘intra-group exemption’). This exemption is necessary because requiring clearing of intra-group transactions could substantially increase the capital and liquidity required by firms that centralise risk management in certain entities as well as increase operational complexity. However, to ensure that the exemption does not increase systemic risk, EMIR will require that intra-group exempted transactions will be subject to bilateral collateralisation unless two conditions are met: there is no current or foreseen practical or legal impediment to the prompt transfer of own funds and repayment of liabilities between the counterparties, and the risk management procedures of the counterparties are adequately sound, robust, and consistent with the level of complexity of the derivative transactions.
Which OTC derivatives contracts will be eligible for mandatory clearing?

To have as many OTC contracts as possible cleared through a CCP, the Regulation introduces two approaches to determine which contracts must be cleared:

- **a 'bottom-up' approach** - Where a competent authority has authorised a CCP to clear a class of derivatives, it will inform ESMA who will assess whether a clearing obligation should apply to that class of derivatives in the EU, and develop draft Regulatory technical standards which will have to be adopted by the Commission. The procedure originally proposed by the Commission which gave power to ESMA to decide on the application of a clearing obligation to a specific class of derivatives has been modified, in order to take into account the jurisprudence of the Court of Justice (MERONI case law 9/56 of 13 June 1958) which strictly frames the ability of agencies to adopt individual decisions.

- **a 'top-down' approach** - ESMA, on its own initiative and in consultation with the European Systemic Risk Board, will identify contracts that should be subject to the clearing obligation but for which no CCP has yet received authorisation.

The 'top down' approach will ensure that if no CCP clears a product that should be subject to the clearing obligation, there are tools available to regulators to get this product cleared through a CCP. It will also ensure that new products will not fall through the net.

ESMA will use the following criteria when determining eligibility for the clearing obligation: the degree of standardisation of the contract and operational processes, liquidity and the volume of contracts, availability of fair, reliable and generally accepted pricing information.

Why does the proposal not envisage mandating clearing for all OTC derivatives?

Because they are customised to meet particular counterparty or end-user needs, some bespoke OTC derivatives products will not have the level of standardisation required for central clearing.

How will the proposal reduce counterparty credit risk in OTC derivatives trading?

Currently, participants in the OTC derivatives market do not collect sufficient collateral (i.e. guarantees; usually they are in the form of cash or securities) to mitigate counterparty credit risk, which refers to the risk of loss arising from one party not making the required payments when they are due.

The Commission's proposal requires that OTC derivatives that are standardised will have to be cleared through central counterparties (CCPs). Since an OTC derivative contract cleared by a CCP usually involves the posting of higher amounts of collateral than an equivalent contract that is not cleared by a CCP, this will increase the amount of collateral held in the system.

As collateral will be held in a few places, there is an argument that risk will be concentrated there. To avoid CCPs becoming a source of risk to the financial system in themselves, the proposal introduces stringent conduct of business, organisational and prudential requirements so that CCPs manage risk properly and are therefore safe to use.
The final text defines stringent requirements on CCPs liquidity risk management, which will be specified in technical standards. CCPs’ access to liquidity could result from access to central bank or to creditworthy and reliable commercial bank liquidity, or a combination of both.

If a contract is not deemed eligible (e.g. prices are not available or the contract is not liquid), or if one of the parties to an eligible contract is not subject to the clearing obligation, then that contract will in all likelihood not be cleared by a CCP. For such contracts, the proposal will require the institutions subject to the clearing obligation to apply robust bilateral risk management technique, including marked-to-market on a daily basis of outstanding contracts and holding of additional capital.

Are commodity derivatives and foreign exchange included in the proposal?
The proposal covers all segments of the OTC derivatives market (interest rate, credit, equity, foreign exchange and commodities). At this stage, while the segments differ in their characteristics, the Commission considers that there is no strong evidence to exclude any of them from the scope of the proposal.

There is, on the contrary, a strong incentive to adopt a comprehensive policy on OTC derivatives, as the failures uncovered by the financial crisis are present in all segments of the OTC derivatives market. Furthermore, there is a risk that excluding any segment from the outset would create a loophole that could be exploited by market participants. This is because any derivative contract can be partitioned and reconstructed into different but economically equivalent contracts. For example, if a specific contract is eligible for clearing but can be reconstructed into two other types of derivatives that are not covered by the Regulation and do not have to be cleared through a CCP, market participants would be able to avoid clearing requirements by modifying the original contract.

However, there will be a need to look at what other G20 jurisdictions do and ensure consistency at a global level.

What will be the role of European Securities and Markets Authority (ESMA)? What will be the role of national financial supervisors?
The proposal gives ESMA a key role. ESMA will be responsible for the identification of contracts that will be subject to the clearing obligation, i.e. those that are standardised and must then go through CCPs. It will also be responsible for the supervision of trade repositories and will be a member of the colleges supporting national authorities supervising CCPs operating in several member states. Finally, it will be required to draft a large number of specific binding technical standards for the application of the Regulation, for example with respect to the clearing thresholds.

The members of those CCPs, who bear the financial risk for the contracts cleared, are largely major internationally operating financial firms such as banks and investment firms. In view of its cross-border activities and the involvement of large international financial firms, the continued health and viability of a CCP is therefore not only of interest to the authorities of the Member State of its establishment, but also to authorities from other Member States.

Therefore the proposal from the Commission envisaged that during the authorisation process of a CCP, there would be strong cooperation between all of the public authorities concerned (supervisory authorities, central banks, etc) from all of the Member States involved. This principle has been retained in the final agreement.
It has been agreed that in the event that the public authorities have legitimate concerns about the authorisation of a CCP, the Regulation will include a mechanism that allows those authorities to raise their concerns and, if necessary, to request ESMA to take a final decision using a procedure of binding mediation.

The mechanism to request binding mediation by ESMA is balanced and takes into account the interests and concerns of both the home authorities (authorities of the Members States in which the CCP is established) and the host authorities (authorities of the Member States in which the CCP provides its services).

Host authorities cannot request binding mediation by ESMA against the opinion of a home country authority unless the host authorities agree to do so unanimously, or if a significant number (two-thirds) of the host authorities are concerned with the proposed authorisation and agree to request binding mediation.

**What about data protection for trade repositories?**

The proposal will require those trade repositories that wish to be used for the purpose of the reporting obligation to register with ESMA. In order to obtain registration, a trade repository will have to comply, among other things, with strict requirements aimed at ensuring the confidentiality, integrity and protection of the information it receives and maintains.

**How will the regulation interact with third countries?**

Recognition of a third country CCP by ESMA will first require that the European Commission has ascertained the legal and supervisory framework of that third country as equivalent to the EU's, that the CCP is authorised and subject to effective supervision in that third country and that ESMA has established co-operation arrangements with the third country competent authorities. A CCP of a third country will not be allowed to perform activities and services in the EU if these conditions are not met.

Recognition of a third country trade repository will be subject to similar conditions as for CCPs in terms of equivalent legal regime and supervision. In addition, it will be subject to an international agreement being in place between the European Commission and that third country with regard to mutual access to data and exchange of information on OTC derivatives contracts held in trade repositories.

The final text also introduces important tools to manage the risks of market participants being subject to two sets of potentially conflicting requirement on OTC derivatives (EMIR and the rules of a third-country). The text also contains an anti-avoidance clause: if market participants deliberately structure a contract outside of the EU to avoid EMIR then EMIR rules still apply.

**What does the proposal say with respect to interoperability of CCPs?**

Interoperability is an essential tool to achieve an effective integration of the post-trading market in Europe. However, interoperability may expose CCPs to additional risks. For this reason, regulatory approval is required before entering into an interoperable arrangement. CCPs should carefully consider and manage the extra risks that interoperability entails and satisfy the competent authorities about the soundness of the systems and procedures adopted. In view of the complexity of derivatives markets and the early stage of development of CCP clearing for OTC derivatives, the proposal does not extend the provisions on interoperability to instruments other than cash securities.
A new article on the access of CCPs to venues of executions opens an access right of CCPs to the transactions traded on a venue of execution. This provision may result in a venue of execution being cleared by several CCPs but this does not imply the implementation of interoperability arrangements between those CCPs.

**What has been done at the global level on OTC derivatives?**

In line with the EU's G20 commitments there have been a number of initiatives both by individual jurisdiction and international bodies. At national level, both the US (Dodd-Frank Act) and Japan have passed OTC derivatives legislation in 2010. The Commission's proposal uses different approaches at times, but is very much in line with the legislation being adopted in other parts of the world. This is essential to ensure no regulatory arbitrage.

At international level, the Financial Stability Board set up a work stream, co-chaired by the Commission, in order to address the challenges related to the implementation of the G20 commitments. In addition, the OTC Derivatives Regulators' Forum was established to promote cooperation between regulators. Finally, CPSS/IOSCO has published guidance on the application of its 2004 recommendations for CCPs to OTC derivatives, and is currently in the process of reviewing these recommendations and preparing recommendations for trade repositories.

The Commission has also regular bilateral discussion with the US authorities in order to identify the possible issues raised by the cross-border effects of Dodd-Frank act's provisions on derivatives and EMIR.

**What additional proposals are foreseen in the OTC derivatives space?**

Other measures relevant to OTC derivatives have been taken, notably the revision of the Capital Requirements Directive (e.g. differentiation of capital charges between CCP cleared and non-CCP cleared contracts), the Market in Financial Instruments Directive (e.g. ensuring trading of standardised contracts on organised trading venues, enhancing trade and price transparency across venues and OTC markets as appropriate) and the Market Abuse Directive (extending the scope of the Directive to OTC derivatives).

**When will EMIR be implemented?**

Before the EMIR rules are implemented, the European Supervisory Authorities (ESAs) first need to develop technical standards. The ESAs must submit these standards to the Commission by 30 September 2012. In line with G20 commitments, these new standards should be fully adopted by the Commission by the end of 2012.

Central counterparties will have to apply for authorisation under the new European regime at the latest six months after the adoption of the technical standards by the Commission. In the meantime, CCPs must continue to comply with national rules on authorisation.

The date of application of the reporting obligation and clearing obligations will be determined in the new technical standards to be developed by 30 September 2012.