

EPFSF Briefing

“The role and regulation of OTC Derivatives”

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....”

“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.”

“The Commission does not want to limit the economic terms of derivatives contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for 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.”

- The European Commission Communication “Ensuring efficient, safe and sound derivative markets: Future policy actions” (COM(2009) 563/4)

These Commission statements summarise the balance that must be achieved in developing the agenda for regulatory reform of the OTC markets.

The global derivatives markets are a main pillar of the international financial system and the economy as a whole. They enable commercial and institutional users to manage risk across a whole range of money rates (e.g. interest and exchange rates) and asset classes (e.g. equities and commodities). One key advantage of an OTC derivative is that its economic terms can be tailored to meet the individual needs of the parties and so reduce “basis risk” i.e. the risk of a hedging instrument not being precisely matched to the underlying risk that is sought to be protected. Nevertheless, there is a trade off between full risk hedging and the complexity of required product design. A reasonable (but as yet unquantifiable) percentage of full risk hedging can be secured through standardised exchange-traded and standard OTC derivatives.

A further advantage is that exchange traded derivatives and OTC derivatives which are eligible for central clearing are supported by a clearing house guarantee whereby, once the trade is matched, the central counterparty becomes the counterparty to both the buyer and the seller, assuming thereby the counterparty risk of each of them. A direct market participant therefore no longer needs to look at the credit counterparty risk of other market participants insofar as the participant is only exposed to the CCP itself.

It is essential therefore that wholesale counterparties can continue to access a broad range of financial instruments in order to manage their business and transactional risks – which can be complex and highly individualised – effectively, cost-efficiently and without incurring undue basis risk.

Regulatory objectives

Derivatives need to be differentiated from securities, e.g. equities, bonds or structured securities (ABS, CDOs, CLOs etc.). While it is acknowledged that the use of some derivatives, particularly credit derivatives, had a part to play in the crisis, it is generally accepted that this is not true of the exchange-traded and mainstream OTC markets, which performed well. Nevertheless, reflecting its view that there are concerns over leverage and interconnection and the OTC markets need to be strengthened, the

Commission has developed a set of regulatory objectives which are designed to ensure efficient, safe and sound derivatives markets. More particularly, this includes:

- (a) establishing closer supervision and oversight of CCPs;
- (b) requiring eligible OTC transactions to be cleared by a central counterparty (CCP) to reduce credit risk;
- (c) ensuring and require all OTC transactions to be reported to an appropriate repository to enhance regulatory oversight of macro- and micro-risk;
- (d) delivering greater operational efficiency into the back office processing of OTC transactions;
- (e) enhancing OTC derivatives transparency as part of the forthcoming MiFID review;
- (f) ensuring that, where appropriate, OTC transactions eligible for exchange-trading take place on organised trading venues, as defined in MiFID as comprising regulated markets, multilateral trading facilities (MTFs) and systematic internalisers; and
- (g) enhancing the prudential rules, collateral and applicable margin of OTC transactions, particularly in relation to non-CCP cleared trades.

In general terms, there is widespread support for (a), (b) (c) and (d). So far as (b) is concerned, infrastructure providers already provide central clearing solutions for a number of OTC asset classes including CDS indices and for single name products; and are developing solutions for further OTC derivatives. With regard to (d), ISDA has increased the level of electronic processing of eligible trades, enhanced the efficiency of trade confirmation processing and reduced operational risk through portfolio compression.

On the other hand, concerns have been expressed over the scope and scale of (e) and (f). With regard to (g), while the proposals of the Commission are in line with the G20's objective that non-centrally cleared contracts should be subject to higher capital requirements because of higher credit risk, some end users are becoming increasingly concerned over the cumulative impact of the Commission's proposed prudential requirements. The strength of OTC markets is their capability to meet the needs of corporate and institutional end users. It is important that regulatory loopholes are avoided and that derivatives are accurately priced in terms of risk, but this should not result in the imposition of punitive capital requirements for bilaterally cleared products insofar as this is likely to have a very negative impact on the competitiveness of European firms. While there is support generally for the collateralisation of OTC trades, caution should be taken when extending margin rules to end user who, if required to fully collateralise, would have to choose between increasing their liquidity risk or their financial risk. Additionally, increasing capital requirements on non-OTC trades may have the unintended consequence of forcing end users to choose products which would not meet their risk management needs, but which have lower capital requirements.

The need for a globally-agreed approach as to how the OTC markets should be regulated is self-evident, but the bar should be set at an appropriate level which provides appropriate market liquidity and sustains the capability of markets to meet the risk-management needs of corporate Europe. Additionally, each derivatives asset class (credit derivatives, commodities, equity derivatives, foreign exchange and interest rates) has its own unique set of market practices and risks, which should be recognised by policymakers as they look to legislate in this area. A balanced approach will strengthen market safety, but without undermining market functionality or diversity. Much will depend, however, upon how "eligibility" or "standardisation" is to be defined for the purpose of determining which OTC contracts are suitable for CCP clearing. Full standardisation of all existing derivatives contracts is unlikely to be achievable and innovation and developments in financial markets to meet end-user needs are likely to continue to result in non-standard tailored structures. While these may not be eligible for CCP-clearing, this does not imply that the related counterparty risks cannot be successfully mitigated through bilateral clearing arrangements (e.g. tri-party collateral management solutions). The EC Communication, while recognising this fact, argues for the strengthening of such bilateral clearing arrangements.

Impact on CCPs

Well-managed and well-capitalised CCPs with robust risk and default processes offer a highly effective means of managing counterparty credit risk, enhance transparency of risk positions and help to ensure the operational efficiency of the market. They also have the advantage of a clear focus and expertise on risk management. They have demonstrated their financial robustness at times of stress (most recently evidenced by CCP management of the Lehman's default) and can, therefore, play a key role in the new OTC financial architecture.

On the other hand, because of the increasing systemic importance of clearing houses, the European Commission will be bringing forward market infrastructure legislation which will set standards and new requirements for CCPs. These are expected to include new business conduct, governance, risk management requirements and the legal protection of collateral positions. The legislation should also address insolvency concerns arising in respect of CCPs. However, CCPs must, as the infrastructure providers and risk takers, continue to be able to determine which OTC contracts are appropriate to be cleared by them, albeit under regulatory oversight.

Another question is which authority will be responsible for regulating clearing houses – will it be national supervisors, central banks such as the ECB or the new European Securities and Markets Authority (ESMA)? The European Commission is proposing that ESMA will be the licensing authority with an appropriate allocation of representatives between ESMA and the national authorities. While it is helpful to have confirmation that CCPs will continue to be regulated by their home state supervisors, it is not clear why the Commission believes an ESMA licence is necessary to authorise a CCP to operate on a cross-border basis in the EU. Given systemic risk, what would be the role of central banks? Other systemically important organisations are able to carry on significant cross-border business based solely on their national home-state license. This requirement, taken together with the proposal that ESMA will be responsible for licensing and regulating trade repositories, suggests that there may be an eventual and progressive transfer of regulatory responsibility from the home-state supervisor of clearing houses to ESMA.

The Communication foreshadows a review of the basis upon which the EU authorities might be able to “recognise” non-EU clearing houses. This is to be welcomed, but a level-playing field is a pre-requisite so non-discriminatory market access must also be granted by overseas authorities for EU clearing houses.

Central data repositories

There is broad support for the use of central data repositories. Providing EU regulatory authorities have full rights of access to data and are satisfied as to the level and quality of regulatory oversight there appears to be no reason why non-EU repositories could not be made available for use by market participants on grounds of reciprocal recognition.

Position limits

The last paragraph in the Commission's Communication recommends empowering member state authorities to have the “possibility” of imposing position limits. This suggests a cautious approach which takes into account the intensity of the debate in other jurisdictions, particularly in the US as well as the current situation in the EU.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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