

EPFSF Lunch Discussion

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“Derivatives”

**Speech from Thomas Book
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Dear Madame Chair, dear Members of Parliament, dear ladies and gentlemen,

I would like to thank EPFSF for organizing this luncheon and your kind invitation to speak. It is a great pleasure to be here today and to share some thoughts with you on “What do our financial markets in Europe need?” – a question that turns more and more into “What will our financial markets get?” considering the current tide of events in the political and regulatory debate.

About one year ago, financial markets have experienced an event that has been widely considered as hardly imaginable – the default of one large market participant. During 2008 and 2009 we have then been confronted with a sequence of events which probably none of us had ever experienced before. As the times of rapid fire fighting are hopefully over now, our focus naturally shifts towards the lessons learned and towards restoring markets and confidence on a sustainable basis – **the need for reform is evident**. The current political and regulatory debate in both the U.S. and Europe especially on OTC derivatives markets is an intensive discussion on how to better safeguard financial market stability as the primary consequence of the financial crisis. And I feel an increasingly common understanding across politics, regulators and the industry on what went wrong.

Given all the discussions on derivatives over the past months, I feel it is important to emphasize one aspect at the very beginning: **derivatives are useful**. The global derivatives market is a major pillar of the international financial system and the economy as a whole. Derivatives play a useful role in the economy owing to their fundamental principle: They can be used to hedge against adverse developments in the underlying instruments, especially in periods of high uncertainty. This function of the derivatives market, if properly used, is most important and **indispensable for economic growth and employment**.

Derivatives are traded in one of two ways, either “over the counter”, OTC, or on regulated markets, i.e. on exchanges. In total, the global derivatives market has an estimated size of close to 500 trillion euros in terms of notional amount outstanding, 90 percent is OTC, 10 percent on-exchange. Registration is not mandatory for OTC derivatives in most jurisdictions. Moreover, there is no comprehensive reporting of trading volumes and market prices. In practical terms, this means a **lack of market transparency in most OTC segments**. Market information is only provided on a larger scale by regulated markets, by CCPs and by so-called trade repositories. Combined, they account for approximately 37 percent of the market. In other words: there is no transparency in two thirds of the market.

Talking about “What do our financial markets need?” in order to function well, I regard four imperatives as indispensable: **safety, integrity, efficiency and innovation**. Let me stick to the derivatives market as the area of my personal expertise. While efficiency and innovation have been at the centre stage of regulation for many years now, safety and integrity have been taken for granted. This assumption has turned out to be wrong with the financial crisis. Market safety and integrity do not fall like manna from heaven. They are the necessary prerequisites for the smooth functioning of our financial markets and need to be ensured first and foremost.

With regard to the derivatives market, it is important to note that derivatives did not cause the financial crisis. But some derivatives have contributed to the problems of large banks. On the other hand, some parts of the market and its institutions have proven to be robust and resilient during the financial crisis, **particularly derivatives traded on exchanges as well as central counterparty-cleared derivatives**. And so, some simple principles can be derived for any endeavor to reform and strengthen current market structure:

- The individual responsibility for risk taking needs to be assured again;
- Excessive risk exposure needs to be avoided;
- Risk taking should be separated from risk management to avoid conflicts of interest and to ensure the accurate pricing of risks;
- An increased level of market transparency is necessary and market complexity needs to be reduced to a manageable degree.

But merely **introducing stricter regulatory or supervisory requirements may not suffice** from my perspective. Having in mind that some 90 percent of the derivatives market is taking place OTC, we need to strengthen the risk management capabilities and market transparency in the area of OTC derivatives. I regard four elements as essential for this purpose – some of you will know because we have stated them in our recent White Paper on “The Global Derivatives Market. A Blueprint for Safety and Integrity”:

1. The **maximum use of derivatives trading on organized markets** for derivatives trading as the first best option;
2. The **maximum use of central counterparties (CCPs)** where trading on organized markets is not feasible as the second best option;
3. The **bilateral collateralization of derivatives exposure**, preferably handled by a neutral third party, where organized trading or use of CCPs is not suitable;
4. The **mandatory registration of open risk positions**, establishing reporting standards for all derivative contracts.

“What needs to be done” appears to be well recognized and hopefully on a good way too – the crystal ball for the future regulatory framework becomes clearer. From my perspective, the implementation of necessary market reforms is not only the task of regulators alone but requires a joint effort between the derivatives industry and regulators. This effort should follow the principles of:

1. **Market driven solutions:** In general, market-driven solutions are preferable as a default option.
2. **Neutrality of risk management:** Providers of critical functions in the derivatives market should be neutral and independent, particularly in risk management, which needs to be independent from risk taking to avoid conflicts of interest.
3. **European solutions:** European markets should be independent in their functioning, meaning critical infrastructure should be located, operated and regulated in Europe.
4. **As few exemptions as possible:** every exemption for users and products will hamper the aim to achieve a stringent regulatory framework as it inherits a systemic weakness.

Let me be clear here: regulators and supervisors must lay the foundation. However, any **excessive regulatory burden should be avoided**, market participants and infrastructure providers should still have explicit incentives to trade products freely and continue to innovate. In addition, it is important that both regulatory and supervisory changes are coordinated internationally to ensure a level playing field, in order to avoid loopholes and regulatory arbitrage in a global market environment. The close and target-oriented collaboration of market

participants, regulators, supervisors as well as infrastructure providers is the best basis for a joint implementation effort of necessary market reforms. Processes and products (e.g. for CCP clearing) should be developed in close cooperation with all market participants, explicitly including smaller sell-side and buy-side market participants as well as non-financial corporate firms.

Ladies and gentlemen,

The need for reform is clear and it appears evident what is necessary to make the financial system less crisis-prone. Regulation plays an important role to set a framework for market participants that allows overcoming the revealed deficiencies and financial markets to function well again, even without central bank or government intervention. In the best case, regulatory reforms provide the market with proper economic incentives that align the individual rationality of market participants again with the collective rationality of a well functioning market, to the benefit of the financial industry as such and probably more importantly to the benefit of growth and employment in the real economy.

I believe that a prudent regulation of the OTC derivatives market is an essential and critical component to achieve the overarching goal of lower systemic market risk and higher transparency.

Ladies and gentlemen, thank you very much for your attention.