

EPFSF Briefing

“The role and regulation of OTC Derivatives”

Introduction

As a result of the recent financial crisis, reform of the over-the-counter (“OTC”) derivatives markets has become a priority on the global regulatory reform agendas. In the European Union, the European Commission will be implementing the G20 conclusions on OTC derivatives¹ through a new market infrastructure Regulation and amendments to existing legislation, with a public consultation on derivatives and market infrastructures now underway. There is broad support for reforms to mitigate systemic risk, increase operational efficiency and provide enhanced transparency to regulators. Achieving the proper balance between crafting robust regulations, preserving the competitiveness of derivatives business (and the wider European economy) and ensuring adherence to the principles of better and proportionate regulation will be necessary. The Commission, in its Communication of 20 October 2009, recognised the “useful role” that derivatives play in the economy, while understanding the need to “strike the right balance” between financial and non-financial counterparties, to consider the risk characteristics of certain products, and to recognise the importance of international cooperation to mitigate regulatory arbitrage.² Werner Langen’s draft “Own Initiative” report highlighted similar objectives.

Role of Derivatives

According to the Bank for International Settlements (BIS), the notional amount of outstanding OTC derivatives stood at \$615 trillion in December 2009, up from \$605 trillion six months earlier. That is however below June 2008’s figure of \$684 trillion, which was the highest figure since the BIS began to collect such data in 1998. Notional amounts are useful as a measure of cumulative market activity. However, gross market values which provide a measure of the amounts that are actually at risk shows a decrease of 15% in the six months to December 2009, to \$21.6 trillion (\$3.5 trillion, after netting and before collateral).

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). Alongside standardised derivative products, economic terms of OTC derivative can be tailored to meet the individual needs of the parties, allowing hedging instruments to more precisely match the underlying risk. This means that there is a trade off between full risk hedging and the complexity of the required product design.

Exchange traded derivatives and OTC derivatives which are eligible for central counterparty (“CCP”) clearing are supported by a clearing-house guarantee. Once the trade is matched, the central counterparty becomes the counterparty to both the buying clearing member and the selling clearing member, assuming thereby the counterparty risk of each of them. The CCP ensures collateralization, through a combination of up-front (‘initial’) margin and daily (‘variation’) margin calls. Counterparty credit risk, complexity in counterparty relations and monitoring costs are thus substantially reduced. The CCP is further protected against default by limiting its risk to instruments that can easily be closed out; and by its multiple lines of defence (including a ‘default fund’). Additionally, the CCP nets all offsetting open derivatives contracts of each trading party across all other trading parties. Such ‘multilateral’ netting decreases the gross risk exposure even more than the 85% reduction achieved by bilateral netting. However, not all products will be suitable for central counterparty clearing. Therefore, it will be important that market participants are able to 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.

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 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,

¹ In September 2009, the G20 leaders agreed that “*all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at latest. OTC derivatives should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.*”

² *Ensuring efficient, safe and sound derivatives markets: future policy options*
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which performed well. Nevertheless, reflecting concerns over leverage and interconnection and the need for strengthening OTC derivatives markets, the Commission has developed a set of regulatory objectives which are designed to ensure efficient, safe and sound derivatives markets. More particularly, these objectives include:

- (a) establishing closer supervision and oversight of CCPs;
- (b) reducing counterparty exposure by requiring eligible OTC transactions to be cleared by a CCP;
- (c) requiring all OTC transactions to be reported to an appropriate trade repository to enhance regulatory oversight of macro- and micro-risk; information on trades made on-exchange or cleared through a CCP can be provided to regulators directly by these entities;
- (d) increasing operational efficiency for 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, collateral and margin rules for OTC derivative transactions, particularly in relation to non-CCP cleared trades.

In general terms, there is broad support for (a), (b), (c) and (d), although in respect of (b), there are divergences of views across the industry regarding whether clearing OTC derivatives through CCPs should be mandated. In the absence of a legal mandate to centrally clear, some infrastructure providers already provide central clearing solutions for a number of OTC derivative classes, including CDS indices and some single name products; interest rates, equities and commodities; and, owing to user demand and beneficial regulatory capital treatment, are developing solutions for further classes. In respect of (c), some have noted that trade repositories should be able to gather and report back to supervisors relevant information on all OTC trades, irrespective of the modality used to clear such trades. With regard to (d), the level of electronic processing of eligible trades has already been increased, the efficiency of trade confirmation processing enhanced, and portfolio compression has reduced operational risk. Much will depend, however, upon how “eligibility” or standardisation are to be defined to determine which OTC contracts are suitable for CCP clearing, and to which categories of firms the rules should apply. There is support for the Commission’s preference for “eligibility” since this recognises that while a very illiquid contract could be standardised in operational and legal terms, it may be quite illiquid and not easily valued and therefore, not suitable for clearing. Full standardisation of all existing derivatives contracts is unlikely to be achievable, and developments in financial markets to meet end-user needs are likely to continue to result in non-standard tailored structures. Finally, it will be important that non-financial institutions/corporate end-users which do not create systemic risk are not harmed by a clearing requirement. The Commission’s suggestion is that, as a starting point, such firms would be exempt from such an obligation subject to position/activity thresholds where they could be seen as systemic.

On the other hand, concerns have been expressed over the scope and scale of (e) and (f). These have centred primarily on the need to consider potential impacts on hedging, liquidity and market volatility. For example, it is important to recognise that not all eligible contracts will be suitable for trading on organised venues as -- due to their customised nature -- they would trade very infrequently. Also, the price information that is disclosed could be misleading, particularly in shallow or illiquid markets and lead to unnecessary and unwarranted volatility. While enhanced transparency may be appropriate for certain classes of instruments, it should be remembered that excessive transparency rules could reveal to the market the risks and positions that hedgers are trying to manage.

With regard to (g), there is a general recognition that the existing capital incentives to use CCPs to clear derivatives contracts should be maintained³ and that CCP-cleared derivatives should continue to attract a zero exposure charge on collateral and mark-to-market exposures provided they adhere to internationally agreed standards of robustness. However, not all OTC derivatives will be eligible for central clearing, particularly those that are more structured. In such circumstances, the related counterparty risks can be mitigated through bilateral close-out netting and collateralisation arrangements (as also successfully

³ Some parties argue that the maintenance of these incentives render the proposed regulatory mandate to centrally clear CCP-eligible instruments unnecessary, particularly as tightening capital and liquidity standards elsewhere make market-driven use of CCPs an increasingly appealing option.

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operated in the Lehman's default, preventing knock-on defaults). While it is recognised that bi-laterally 'cleared' trades nonetheless are likely to attract higher capital charges under CRD4, it is important that such charges are proportionate and risk sensitive. The European Commission acknowledges that there will remain a need for bi-laterally "cleared" OTC derivatives, but stresses the importance of robust procedures and arrangements for mitigating associated credit and operational risks.

While it is important to avoid regulatory loopholes and ensure that derivatives are accurately priced for risk, it is essential the requirements are proportionate to risk, enabling the OTC markets to continue to meet the needs of market participants. While there is support generally for the collateralisation of OTC derivative trades, corporate end-users suggest caution should be taken when extending margin rules to those end-users who, if required to fully collateralise, would have to choose between increasing their liquidity risk or their financial risk. 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.

Role of CCPs

Well-managed and well-capitalised CCPs with robust risk and default processes offer a highly effective means of managing counterparty credit risk, enhancing transparency of risk positions and helping to ensure the operational efficiency of the market. 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.

Clearing houses need uniform and robust CCP standards to promote a level playing field and ensure adequate risk management. Transparency of CCP rules is key for indirect users (non-clearing members) whose interests should be protected and represented in the CCP's corporate governance structure. The EC's market infrastructure legislation is expected to include standards and requirements for CCPs in a number of critical areas including business conduct, governance, risk management and prudential standards, and to provide for a CCP 'passport'.

Segregation of client assets/positions and their portability to another clearing member are also key issues that legislative proposals need to resolve in order to provide legal certainty and a real reduction of counterparty risk.

Still, in determining a supervisory regime for CCPs, it will be important to seek a solution that provides a coordination role for European Securities and Markets Authority in ensuring robust and consistent standards across the European Union, to ensure level playing field and safety.

Trade Repositories

The industry has been an advocate for the use of central trade repositories ("TRs") to provide regulators with access to trade data for help them monitor the build-up of systemic risk. Discussions about the level and quality of access to data by regulators are currently ongoing, in particular with regards to access to repositories in different jurisdictions. Any new regime for reporting to TRs non-cleared (i.e., bilateral) trades should avoid unnecessary reporting duplication, overlapping requirements, and fragmentation of risk view. It will also be essential to address statutory client-confidentiality obstacles to releasing data to or by TRs.

Position limits

Debate continues on this topic. It is also recognised that supervisors should have access to detailed transaction information (time, price, volume), to enable them to enforce market abuse rules effectively.

Conclusion

The need for a global approach as to how the OTC derivatives markets should be regulated is self-evident, but the bar should be set at a level which provides appropriate market liquidity and sustains the capability of markets to meet the needs of derivative users in 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.

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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