EC proposals for increased transparency and risk mitigation in derivatives markets

On July 3, 2009, the European Commission released a Communication entitled "*Ensuring efficient, safe and sound derivatives markets*" (the "Communication").[1] The proposal is largely based upon the recommendations of the February 25, 2009 report by the High Level Group on Financial Supervision, chaired by Jacques de Larosière, which received the Commission's support in its Communication entitled "Driving European Recovery" of March 4, 2009.[2]

The Communication analyses the risks associated with derivatives markets and their role in the financial crisis. It is accompanied by a Staff Working Paper, which provides an overview of derivatives markets, with a particular focus on over-the-counter ("OTC") trading, and an assessment of the effectiveness of current measures to reduce risk. The Communication and Staff Working Paper focus in particular on the risk profile of credit default swaps ("CDS").

The Communication and Staff Working Paper propose the following measures to safeguard financial stability:

1. increased use of central counterparties ("CCPs") to manage counterparty risk;
2. promotion of standardization for OTC derivatives;
3. execution of trades in cleared standardized derivatives on an organized trading venue to provide increased price transparency and strengthened risk management; and
4. review of the potential benefits of using central data repositories for non-CCP cleared trades.

It is expected that, before the end of the year, the Commission will present legislative proposals in line with the recommendations in the Communication.

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[1] COM (2009) 332.

[2] COM (2009) 114.

I. INCREASED USE OF CCPS

The economic positions of the counterparties to a derivative contract change as the value or price of the underlying asset fluctuates. Settlement (through which parties to open derivative contracts settle their obligations under the derivative contracts as against each other) can occur either at a bilateral level directly between the two counterparties (non-cleared OTC trading) or at a multilateral level (cleared trading). With cleared trading, a CCP becomes the counterparty to each of the initial parties though a novation.

The Communication recommends the increased use of CCP clearing, particularly in relation to standardized OTC products. It is argued that individual market participants will benefit from the expansion of CCP clearing of OTC trades, as CCP clearing mitigates their exposure to counterparty risk and systemic risk. Although market participants may have only a partial perspective on risk, the CCP is in a position to assess risk across the market. Moreover, the CCP values at least daily each open position in accordance with the movement in the market price of the derivative or underlying asset to understand the exposure or potential loss/gain of each market participant if the derivative contract were to be closed out at that point.

A CCP may also call for funds from a market participant whose exposure has increased and who would be making a loss if the derivative contract were to be closed out. Depending on the type of product being traded, the CCP will either retain those funds as margin to protect it against a default by such market participant. Alternatively, it may pay those funds to the market participant holding the back-to-back contract for the same derivative with the CCP whose exposure will have decreased by an identical amount, and who would make a profit if the derivative contract were to be closed out.

CCPs generally net all the obligations of each market participant across all products and markets cleared by the CCP, thereby ensuring the efficient use of resources by such market participant. In addition, by holding significant resources to protect against a default, the CCP reduces systemic risk for all market participants, significantly reducing the likelihood that the insolvency of one or more market participants will create a domino effect of defaults across the market, as could be the case with bilateral non-cleared trading where a failure to pay by one market participant prevents another market participant from paying.

The Communication's endorsement of CCP trading is of particular importance to CDS trading. Although CDS make up a small section of the derivatives markets, they give rise to disproportional risk. This heightened risk arises at least in part out of the fact that information to value the risk underlying the CDS is not readily available to market participants, and, as a result, it has not been possible to apply to the CDS market the level of due diligence customary in other markets.

Major derivatives dealers have made a commitment to the European Commission to move clearing of European-referenced CDS to European CCPs by July 31, 2009. The commitment is likely to be met by banks, but it is unlikely that CDS contracts with respect to companies will follow suit. The Commission is therefore considering further ways to encourage the use of CCP clearing. Currently, the incentives are the reduction in counterparty risk and the zero weighting afforded to amounts held as margin with a CCP. The adoption of a general principle that all CCP-eligible products should be cleared through a CCP is a further possible measure. To this end, dealers and other market participants might be subjected to an additional regulatory cost if they continued to clear CCP-eligible contracts on a bilateral basis.

Whilst the Commission has advocated the expansion of CCP clearing, CCP clearing is not regarded, in and of itself, as a cure-all. The Communication recognizes the importance of using CCP clearing in conjunction with strengthened bilateral collateral management as well as the improved standardization and central storage of contract details.

II. PROMOTING STANDARDIZATION

The Communication regards standardization as essential to delivering efficient and safe derivatives markets. Conducting trades using standardized contractual terms promotes the fungibility of products and the transparency of markets, increases legal certainty and reduces legal risk. It also increases operational efficiency by enabling electronic affirmation and confirmation services and more standardized collateral management processes. Standardization concentrates on the "legal" terms of the contracts (*e.g.*, applicable law, dispute resolution procedure), the "economic" terms of the contracts and any delivery processes specified in the contract (of most relevance to commodity derivatives)

III. TRADE EXECUTION

The Communication advocates standardized cleared derivatives being traded on an organized trading venue to improve price transparency and improve market participants' ability to manage risk effectively. In addition, trading on organized markets assists the regulatory authorities in detecting market abuse (through transaction reporting) and additionally reduces friction costs.

IV. CENTRAL DATA REPOSITORIES

Where CCPs cannot be used, the Communication proposes the use of central data repositories to improve transparency: CCPs naturally collect position data on their respective market on at least a daily basis. The repositories would hold information on the number of outstanding contracts and the size of outstanding positions in a particular contract. Currently, a data repository exists for CDS; namely, *the Trade Information Warehouse* operated by the US Depository Trust and Clearing Corporation.

V. OUTLOOK

The Communication's recommendations are aligned with parallel regulatory developments in the United States. On May 13, 2009, the U.S. Treasury proposed regulatory reforms requiring all standardized OTC derivatives to be regulated through CCPs. These reforms will be implemented through ICE Trust and the Chicago Mercantile Exchange. The Communication also echoes the U.S. Treasury's white paper, "*Financial Regulatory Reform: A New Foundation*" published on June 17, 2009, which also calls for increased standardization and the use of public trading venues in the OTC derivatives markets.

The recommendations also complement the extension, announced by the Committee of European Securities Regulators ("CESR") on July 22, 2009, of the Transaction Reporting Exchange Mechanism ("TREM") from financial instruments traded on European regulated markets to OTC derivatives whose underlying instruments are traded on such markets. The TREM is a system through which European regulators exchange transaction reports, in accordance with the framework created by the Markets in Financial Instruments Directive ("MiFID").

Simultaneously, the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organisation of Securities Commissions ("IOSCO") announced on July 20, 2009 that they are in the process of reviewing the manner in which their 2004 Recommendations for Central Counterparties (Recommendations) are applied to clearing arrangements. The review will focus on the conduct of clearing by CCPs - including those that clear CDS and other OTC derivative transactions - and the management of risk by those CCP. It is proposed that the IOSCO-CPSS committee will "promote consistent interpretation, understanding and application of the recommendations across CCPs for OTC derivatives".

The Communication has generally received a warm response. NASDAQ OMX has commented that it particularly welcomes the move towards widespread CCP clearing and more public trading venues. Some concern has been expressed by market user groups that too many CCPs could add to the effective cost of trading for market participants and could worsen the position of market participants on the (unlikely) insolvency of a CCP. The argument is that where a CCP is created to clear a small number of products or a single market, on an insolvency of that CCP, a market participant would be unable to net off obligations owed to it by other CCPs against the obligations of the insolvent company, thereby potentially increasing the market participant's exposure. On the basis that large banks and CCPs are at risk of default, greater regulation of CCPs themselves may, therefore, be desirable.

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