

Derivatives markets: future policy actions

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PURPOSE: to set out future actions to strengthen the safety of derivatives markets.

BACKGROUND: 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. However, they also contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants, a fact which went unnoticed because of the lack of market transparency, resulting from the predominant over-the-counter (OTC) market structure.

Already in July this year, the Commission identified four complementary tools to reduce the negative impact of OTC derivatives markets on financial stability: (i) increase standardisation, (ii) use trade repositories, (iii) strengthen the use of Central Counter-party clearing houses (CCPs), and (iv) increase the use of organised trading venues (see [COM\(2009\)0332](#)). The proposed tools have been the subject of a stakeholder consultation and were debated at a high-level conference on 25 September 2009.

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.

CONTENT: this Communication examines the main shortcomings of the current derivatives market organisation as concerns both OTC and derivatives traded on organised trading venues. It outlines the policy actions the Commission intends to take in 2010 to address these problems and thus meet the need for greater stability and transparency in these markets as recognised by the De Larosière report, the June 2009 European Council conclusions and the G20. All legislative and other proposals to give effect to the policy orientations will be subject to appropriate impact assessment. The proposed measures will shift derivative markets from predominantly OTC bilateral to more centralised clearing and trading.

The Communication notes that the various derivatives market segments differ in their characteristics, namely in terms of risk, operational arrangements and market participants. In principle, the Commission believes that a **comprehensive policy on derivatives is necessary in order to avoid market participants exploiting differences in rules, i.e. regulatory arbitrage**. However, where justified, the policy proposals take into account the specificities of the asset class and contracts involved as well the specificities of the market participants, also striking the right balance between financial and non-financial institutions. At the same time the Commission will take into account the specificities of certain commodity markets, e.g. electricity and gas markets, which are particular in their underlying physical market structure.

The future policy actions set out in the Communication aim to do the following:

Reduce counterparty risk: the crisis has shown, inter alia, that market participants did not price counterparty credit risk correctly. Clearing is the way by which this risk is mitigated. Clearing can either occur bilaterally between the two counterparties or at central market level, by means of a central counterparty (CCP), thus involving appropriate collateralisation. The Commission aims to strengthen the clearing of derivatives both at central and bilateral level. It will reduce counterparty risk by proposing legislation on CCP requirements, governing: (a) safety requirements (e.g. conduct of business, governance, risk management, legal protection of collateral and positions); (b) authorisation/withdrawal of authorisation and supervision of CCP; (c) mandating of CCP clearing of standardised derivatives. It will also amend Directive 2006/48/EC (the [Capital Requirements Directive](#) (CRD)) in order to: (a) mandate

financial firms supplying initial and variation margin; (b) substantially differentiate capital charges between CCP cleared and non-CCP cleared contracts in CRD.

Reduce operational risk: operational risk relates to losses resulting from inadequate or failed internal processes, or from external events, and includes legal risk. The market has been making efforts to reduce operational risk. For example, market practice has generated standard legal documentation for a considerable part of the derivatives market. Moreover, market participants have gradually moved to electronic processing of trades. These efforts are likely to be boosted by the mandatory use of data repositories and the widening use of central clearing. They will result in more standardisation of contracts in terms of electronic processing and standard legal terms (without affecting the economic terms of the contracts), which will also facilitate central clearing. However, the Commission considers that ongoing industry efforts to reduce operational risks should be reinforced. It proposes to assess whether to re-shape the operational risk approach in the CRD to prompt standardisation of contracts and electronic processing, and to work with industry to increase standardisation of legal regimes and processes.

Increase transparency: OTC derivatives markets have clearly suffered from a lack of transparency of prices, transactions and positions. The lack of transparency to regulators and the market has varied with time and across products, but has overall hindered regulators from efficiently supervising derivatives markets in terms of systemic risk and market abuse. For market participants, it has created difficulties in accessing reliable prices, assessing risks, valuing positions, and checking best execution. Accordingly the Commission will propose legislation on trade repositories: (a) to regulate trade repositories; (b) to mandate reporting of OTC derivatives transactions to trade repositories. With regard to trading on organised markets, it will (a) amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories; and (b) ensure trading of standardised contracts on organised trading venues under MiFID.

Enhance market integrity and oversight: the review of the [Market Abuse Directive in 2010](#) will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion. In the context of efforts to align the rules applicable to physical and financial energy markets, a tailor-made proposal for the EU level oversight of electricity and gas spot markets is envisaged ensuring transparency and market integrity. Similarly, the Commission is to examine by end-2010 whether the market for emission allowances is sufficiently protected from insider dealing and market manipulation and, if appropriate, bring forward proposals to ensure it. Lastly, the Commission intends to propose rules to give regulators the possibility of setting position limits to counter disproportionate price movements or concentrations of speculative positions.

The Commission concludes that its general approach will limit the potential for loopholes and regulatory arbitrage. It will begin the process of drafting legislation, notably by launching impact assessments, in order to come forward with ambitious legislation to regulate derivatives in 2010. When finalising these proposals, the Commission will work closely with all stakeholders in the EU as well as with its global partners.