

# Derivatives markets: future policy actions

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The European Parliament adopted a resolution on derivatives markets (future policy actions) in response to the Commission's communication on the same subject.

Parliament welcomes the Commission's initiative for better regulation of derivatives, and in particular OTC derivatives with a view to reducing the impact of the risks in the OTC derivatives markets for the stability of financial markets as a whole, and backs the calls for legal standardisation of derivatives contracts (inter alia through regulatory incentives in the Capital Requirements Directive (CRD) regarding operational risk), the use of trade repositories and centralised data storage, the use and strengthening of central clearing houses and the use of organised trading venues.

**Increasing transparency:** Parliament welcomes the Commission's paradigm shift towards greater regulation of OTC derivatives markets, abandoning the prevailing view that derivatives need no further regulation, chiefly because they are used by experts and specialists. It calls, therefore, for future legislation to secure not only transparency in the derivatives markets but also sound regulation. The resolution calls for more transparency on pre-trade transactions for all instruments that qualify for the extensive use of organised trading venues as well as for increased post-trade trade transparency through reporting of all transactions to repositories, to the benefit of both regulators and investors.

**Strengthening CCPs (central counterparty clearing facilities):** Members back the call for the **compulsory introduction of CCP clearing between financial institutions for all eligible derivative products** with a view to ensuring better assessment of counterparty credit risk, and support the objective that as many eligible derivative products as possible should be traded on organised markets. They call for provision of incentives that encourage the trading of eligible derivative products on trading venues regulated by the Markets in Financial Instruments Directive (MiFID), i.e. on regulated markets and multilateral trading facilities (MTFs). They note that one criterion for clearing eligibility must be liquidity.

Members insist that, in future, **derivative prices** must better reflect risk and that the costs of the future market infrastructure must be borne by market participants and not by taxpayers.

They consider that individually negotiated derivatives are required to hedge special risks and therefore **oppose the compulsory standardisation of all derivatives.**

The resolution calls on the Commission to look into ways of significantly reducing the overall volume of derivatives so that the volume is proportionate to the underlying securities in order to avoid a distortion of price signals, to reduce the risk to market integrity and to cut down systemic risk. The Commission is called upon to give a **strong role in the authorisation of European clearing houses to the European Securities and Markets Authority (ESMA).**

**Reducing counterparty risk:** Parliament considers that, through clearing, collateral by adjusting capital requirements and through other regulatory tools counterparty **credit risk can be reduced.** It supports the Commission in proposing **higher capital requirements for financial institutions in the case of bilateral derivative contracts** that are ineligible for central clearing, based on a risk-proportionate approach and taking into account the effects of netting, collateral, initial margin, daily portfolio reconciliations, daily margining, automated collateral movements and other bilateral counterparty risk management techniques in counterparty risk reduction.

Members insist that **CCPs must not be organised wholly by users, that their risk management systems must not be in competition** with each other, and that regulatory arrangements for clearing costs must be envisaged. They call on the Commission to address these concerns in its legislative proposal and to set **governance and ownership rules for clearing houses**, with regard inter alia to the independence of directors, membership and close supervision by regulators. The Commission must pay close attention to the possible development of technological differences, discriminatory practices and work-flow barriers which are harmful to competition.

Members calls for conduct-of-business and access rules governing CCPs to ensure non-discriminatory access by trading venues, with the issues to be addressed including discriminatory pricing practices.

**Repositories:** Parliament backs the **introduction of repositories for all derivatives positions**, ideally distinguished by asset class and regulated and supervised under ESMA direction. It calls for binding procedural rules to be established to prevent distortions of competition and to ensure equal interpretation in the Member States and, furthermore, for ESMA to have supreme decision-making authority in disputes. It calls for the Commission to ensure that national supervisory authorities have real-time access to granular data in repositories that relate to market participants based within their jurisdiction and to data that relate to potential systemic risk that might be built up in their jurisdiction, as well as access to aggregate data from all repositories including those held in repositories based in third countries.

The Commission is called upon to draw up **reporting standards for all derivative products consistent with standards being elaborated at an international level**. Measures should also be developed to ensure that regulators are able to set position limits to counter disproportionate price movements and speculative bubbles. Parliament asks the Commission to ensure in particular that the valuation of all derivatives that are not traded on exchange is conducted in an independent and transparent way, avoiding conflicts of interest.

The resolution considers careful clarification of all technical details to be necessary, in close cooperation with national regulators, in particular as regards standards and the distinction between financial-market products and non-financial-market products.

The Commission is backed in its plan to **establish CCPs under agreed European standards, overseen by ESMA**. Members demand that key market participants should not have a controlling influence on the governance and risk management of the CCPs but should be included in the risk management board. They insist on the need to have regulatory standards to ensure that CCPs remain resilient to a broader set of risks, including multiple participant failures, sudden sales of financial resources and rapid reduction in market liquidity.

The resolution calls, therefore, for clear rules of conduct and the necessary compulsory standards as regards the setting-up of CCPs (involvement of users) and the decision-making procedures and risk management systems used by them.

**Credit default swaps:** Members recall that the recent events involving sovereign credit default swaps used by financial speculators led to unjustified high levels of several national spreads. Those events and practices highlighted the need for further market transparency and for enhanced European regulation vis-à-vis trading of credit default swaps, in particular those connected to sovereign debts.

Parliament calls, as a matter of priority, for **credit default swaps (CDS) to be made subject to independent central clearing** and for as many derivatives as possible to be settled centrally by CCPs. It believes that individual types of derivative with cumulative risks should, if necessary, be authorised only conditionally or even, on a case-by-case basis, prohibited. The Commission should come forward with appropriate **legislative proposals** to regulate **financial transactions involving naked selling** of

derivatives in order to ensure financial stability and transparency of prices. It takes the view that, pending that, credit-default swaps (CDSs) should be processed through a **European CCP** in order to mitigate counterparty risks, increase transparency and reduce the overall risks. Parliament demands that CDS protection should be payable only upon production and proof of an underlying bond exposure and be limited to the amount of this exposure.

Members are of the opinion that all financial derivatives that concern public finances in the EU (including sovereign debt of Members States and local administration balance sheets) must be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public.

They call for a **ban on CDS transactions** with no underlying credit which are **purely speculative** transactions involving bets on credit defaults, thereby leading to an artificial rise in the cost of credit default insurance and, consequently, to increased systemic risks through actual credit defaults. They call on the Commission to consider **upper risk limits for derivatives**, particularly CDSs, and to agree on them with international partners.

The resolution calls for the planned regulation of derivatives to include rules relating to the banning of purely speculative trading in **commodities and agricultural products**, and the imposition of strict position limits especially with regard to their possible impact on the price of essential food commodities in developing countries and greenhouse gas emission allowances.

Lastly, Members welcome the Commission's intention to submit legislative proposals on clearing houses and trade repositories as early as mid-2010 and to submit legislative proposals on CDSs.