Fiat lux – Shedding new light on derivatives markets

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Not so long ago, we policymakers thought we knew just what challenges we were facing for Europe to better take advantage of globalisation through a more sustainable model: these were climate change and a rapidly ageing society. However, since 2007 we have also learnt that there was another area requiring a deep sustainability check: the financial system. What started in 2007 as a credit crisis in the US market for subprime mortgages turned into a full-blown global financial crisis in 2008, following Lehman’s default and has taken us near to a sovereign debt crisis as countries face the fiscal consequences of financial instability, on top of large public indebtedness.

This highlights the importance of the financial system for society as a whole and, therefore, the political imperative of mending it so that finance serves the real economy – not the other way around. We therefore need to put in place a new set of rules and principles ensuring a stable and sustainable financial system. Without this our whole economy will be impeded from prospering again and we will not be able to address the challenges outlined above.
This issue of the Financial Stability Review is therefore timely and welcome, as it puts the focus on one financial instrument that has played an important role during the crisis – over-the-counter (OTC) derivatives – thus allowing me to highlight the significant changes our approach to regulation in this area has to take.

1| **OTC DERIVATIVES: USEFUL, POPULAR AND RISKY**

Derivatives are financial contracts that trade and redistribute risks generated in the real economy, and as such are important risk management tools for economic agents. There are many types of derivatives. Some are standard products (e.g. futures) while others are not, as each contract is tailored to the specific needs of the user (e.g. swaps). Derivatives therefore play a useful economic role and it is not surprising that their use has grown tremendously over the last decade.

However, derivatives still give rise to risks. As risks are hedged on OTC markets, it is hard, in the absence of reliable public information about those markets, for market participants and supervisors to determine, for each such contract, whether risks have been effectively hedged and where the risk resides. The Commission Communication of July 2009 has highlighted how these risks played out during the financial crisis:

"Derivatives in general and CDS in particular created a web of mutual dependence that was difficult to understand, disentangle and contain in the immediate aftermath of a default. Therefore, the crisis has clearly shown that the characteristics of OTC derivative markets – the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks – increases uncertainty in times of market stress and accordingly poses risks to financial stability."1

2| **ADDRESSING OTC DERIVATIVES**

The Commission believes that a paradigm shift must take place, with legislation allowing markets to price risks properly, away from the traditional view that derivatives are financial instruments for professional use and, as such, would only need, light-handed regulation. Europe cannot afford another situation where the risks of the financial sector are ultimately borne by the taxpayer.

It is therefore necessary to significantly improve the way risks are managed on OTC derivative markets. The G20 has succinctly defined the actions that needed to be taken: "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."2

On the basis of its prior analysis, the Commission in October 2009 announced a set of actions for 2010 structured around four headings: reduce counterparty credit risk, reduce operational risk, increase transparency and strengthen market integrity and oversight. These actions will implement the G20 commitment in Europe.

- **Counterparty credit risk**: The risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter, has been brought to the forefront of attention by the crisis, which highlighted that market participants did not necessarily price counterparty credit risk adequately. 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 projected actions will therefore strengthen the clearing of derivatives both at central and bilateral level. This will be done by new Community legislation on CCPs that will (i) establish common

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2 G20 meeting of 25 September 2009
safety, regulatory and operational standards; and (ii) mandate the use of CCPs for standardised contracts, in line with G20 conclusions. In addition, the Commission will amend the Capital Requirements Directive (CRD) to (i) mandate the supply of initial and variation margins; and (ii) substantially differentiate capital treatment of bilateral and CCP cleared transactions.

- **Operational risk**: Operational risk arises from inadequate legal documentation and internal processes for managing OTC derivatives contracts. Steps have been taken by industry to reduce operational risk. For example, legal documentation is now standardised for a considerable part of the derivatives market. Moreover, market participants are gradually moving to electronic processing of trades. These ongoing efforts are likely to be boosted by the mandatory use of trade repositories and CCPs. These efforts 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. Even so, as not all trades will be sufficiently standardised to go onto CCPs, the Commission will carefully assess whether legislation will also need to strengthen the way operational risk is addressed for non-CCP cleared transactions.

- **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 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. A third set of proposals will therefore focus on increasing transparency. First, the Commission will propose (i) mandating that positions be recorded in trade repositories, but also (ii) regulating and supervising such repositories. Second, trading of derivatives should become more transparent. Changes to the Markets in Financial Instruments Directive (MiFID) to this effect are needed and ways to ensure that standardised derivatives are traded on organised trading venues should be examined.

- **Market integrity and oversight** must be enhanced. Accordingly, the Commission will propose to clarify and extend the scope of market manipulation as set out in the Market Abuse Directive (MAD) to cover all OTC derivatives. Moreover, regulators should be given the possibility to set position limits to counter disproportionate price movements or concentrations of speculative positions.

These actions will be delivered in the course of this year and beginning of next year: I launched a consultation on 10 June to fine-tune the technical details of the measures to come on CCP clearing and trade repositories, and I intend to bring forward proposals on these issues in September; proposals relating to the transparency of trading, market integrity and oversight will follow by the end of 2010 or early 2011.

Once implemented, these reforms will bring much needed transparency to OTC derivatives markets and will significantly improve the way the market deals with the risks associated with derivatives contracts. They will also increase the upfront cost of engaging in speculation. Last but not least, they will strengthen our instruments to ensure market integrity.

Even so, recent events involving a particular type of derivative (sovereign credit default swaps) merit a renewed assessment to see whether additional actions are needed in this particular field. The Commission is currently assessing the facts and has included this dimension as part of another consultation launched on 10 June relative to short-selling. I do not exclude proposing further measures on the basis of the ongoing assessment and consultation.

**These challenging times have taught us that finance has too great a social and economic impact to be left in the dark, and that no sector, no instrument, no place must escape the light of law. We now need to strengthen the governance and regulation of OTC derivatives markets as a part of mending the financial system and ensuring that it provides a sustainable contribution to the European economy. It is imperative that we succeed.**