

Opinion of the European Economic and Social Committee on the 'Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories'

COM(2010) 484 final — 2010/0250 (COD)

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Rapporteur-general: **Mr IOZIA**

On 13 October 2010, the Council and, on 7 October 2010, the European Parliament decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union (TFEU), on the

Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories

COM((2010) 484 fin – 2010/0250 (COD).

On 20 October 2010, the Committee Bureau instructed the Section for the Single Market, Production and Consumption to prepare the Committee's work on the subject.

In view of the urgency of the matter, the European Economic and Social Committee, at its 467th plenary session, held on 8-9 December 2010 (meeting of 8 December), appointed Mr Iozia as rapporteur-general and adopted the following opinion by 144 votes to four with six abstentions.

1. Observations and recommendations

1.1 At the end of 2009, the Bank for International Settlements (BIS) put the notional value of derivatives at around USD 615 trillion (615 000 000 000 000), more than ten times global GDP. In 2010, banks are set to net USD 150 billion from these derivatives, 40 % of this turnover coming from unregulated (OTC) markets. A recent study conducted by a large global banking group showed that the OTC reforms to be adopted in Europe and the US will cut revenues by at least fifteen billion dollars.

1.2 The EESC welcomes the proposal for a regulation on derivatives, unregulated markets, central counterparties and trade repositories and concurs with Commissioner Barnier's remarks: 'No financial market can afford to remain a Wild West territory. OTC derivatives have a big impact on the real economy: from mortgages to food prices. The absence of any regulatory framework for OTC derivatives contributed to the financial crisis and the tremendous consequences we are all suffering from'.

1.3 The choice of a regulation to regulate the area is sound and meets the need to bring in general, uniform requirements for all operators in the sector.

1.4 The EESC agrees with the Commission's proposal to trade standard derivatives through central counterparties (CCPs) and to ensure that the CCPs, which will take on increasing risks, are subject to uniform prudential standards. In fact, the idea has already been expressed in an earlier EESC opinion: 'OTC markets should

not be open to bilateral transactions, but limited to central counterparty transactions, which by monitoring the overall level of risk can limit access to transactions for over-exposed parties. Such transactions should take place either on a single platform, or at least on a defined set of platforms, in order to increase market transparency'.

1.5 The EESC warmly welcomes the decision to make the national authorities and ESMA jointly responsible for overseeing OTC (over-the-counter) derivatives markets, for identifying the various forms of derivatives that must be dealt with centrally, for granting, revoking or modifying authorisation for CCPs and for performing a similar role with regard to trade repositories.

1.6 It is vital, the EESC believes, to improve cooperation between ESMA and national authorities, which will undoubtedly be called upon to contribute their experience and knowledge of local markets and will have to ease the process of gradually increasing the interoperability of CCPs and improving their level of expertise, internal organisation and capacity to shoulder risks. The decision to restrict interoperability to cash financial instruments would appear to be the right one for the time being.

1.7 The proposal for a regulation implements, in fact, the suggestions made by the Financial Stability Board to extend CCP services to standardised OTC derivatives. The G-20 has determined that by the end of 2012 these contracts must be traded on exchanges or electronic trading platforms and cleared through central counterparties (CCPs). Furthermore, OTC derivative contracts will have to be reported to trade repositories.

1.8 At international level, in February 2010 a joint CPSS-IOSCO task force launched a comprehensive review of standards for market infrastructures: payment systems, securities settlement systems and central counterparties. The aim is to set about updating and bolstering the present principles and recommendations in the light of the lessons drawn from the recent financial crisis. One important result was the May 2010 report on Considerations for trade repositories in OTC derivatives market. When it comes to the role of CCPs, on the other hand, some useful recommendations made by the technical committee as far back as March 2004 have been ignored.

1.9 The Commission proposal makes no mention of a specific standard for credit default swaps (CDSs). The EESC hopes that measures will soon be adopted on these, which will be tightened up, together with short selling, from 1 July 2012, while derivatives will be covered by the end of 2012.

1.10 In October 2009, the Commission issued a Communication on future action to be taken to regulate the derivatives market. The aim is to boost transparency, reduce operational risks through standardisation and develop standardised contract exchanges, amending the MiFID as required.

1.11 The EESC firmly believes that the measures proposed will a) boost market transparency by giving an increasingly important role to trade repositories, b) reduce counterparty risk as progressively more operations are regulated via CCPs, which in turn will be subject to more stringent standards in terms of governance, internal organisation and capital requirements, and c) reduce operational risk through the use of electronic procedures to validate the terms of OTC derivatives contracts.

1.12 The EESC agrees with both the proposal for central counterparties and the restrictions on short selling. Making transactions transparent, holding operators and counterparties accountable and avoiding excessive speculation: these are the necessary goals that the Commission is tackling effectively, putting in place measures to offset, at least in part, the absence of regulation that contributed to the financial crisis.

1.13 The EESC points out, however, that there are risks that must not be underestimated. They include the risk of overstressing the benefits that CCPs can bring to CDS markets in the short term. The competitive nature of the various CCPs in clearing and in the fragmentation of the entire process is another factor not to be taken lightly, as is the risk of limiting the array of instruments available and pushing up the transaction costs involved in financial activity.

1.13.1 In order to tackle such risks effectively, the issues of CCP interoperability, confidential data exchange, concentration of data gathering and reporting with the central counterparty and customer involvement in CCP governance should be examined with particular care.

1.14 The EESC recommends that the European institutions:

- swiftly adopt the regulation on OTC derivatives markets, which will restore confidence and calm to the markets and protect savers;
- complete the new regulatory system on derivatives as envisaged by the Commission;
- speed up completion of the whole institutional and regulatory architecture involved in reform of financial markets regulation.

2. The Commission proposal

2.1 The G-20 has on a number of occasions reiterated its commitment to speeding up the adoption of stringent measures to improve transparency and redress the underregulation of OTC derivatives.

2.2 The proposal for a regulation refers to numerous measures suggested in the European Parliament resolution of 15 June 2010 (on Derivatives markets: future policy actions) and is in line with recently-adopted US legislation known as the Frank-Dodd Act.

2.3 When it comes to the clearing, reporting and mitigation of risks from OTC derivatives, clearing via CCPs is envisaged only for standardised OTC contracts. To ensure, therefore, that as many OTC derivatives as possible are covered by the mandatory clearing mechanism, the regulation provides for two approaches for deciding which contracts must be cleared.

2.4 The first is a 'bottom-up' approach, according to which a CCP decides to clear certain contracts and is authorised to do so by its competent authority, who is then obliged to inform ESMA, once it approves the CCP. ESMA will then have the powers to decide whether a clearing obligation should apply to all similar contracts in the EU.

2.5 The second is a 'top-down' approach under which those contracts that have not been cleared by a CCP can be identified. Under this approach, ESMA, together with the European Systemic Risk Board (ESRB), will determine which contracts should potentially be subject to the clearing obligation. Counterparties subject to the clearing obligation must use a CCP.

2.6 As regards non-financial (corporate) counterparties, they will in principle not be subject to the rules of the regulation, unless their OTC derivatives positions reach a certain threshold and are considered to be systemically important.

2.7 The regulation lays down a process for identifying non-financial institutions with systematically important positions in OTC derivatives and subjects them to specific requirements. The process is based on the definition of two thresholds: a) an information threshold, and b) a clearing threshold.

2.8 The regulation therefore requires the use of electronic means and the establishment of risk management procedures. Finally, financial and non-financial counterparties above the clearing threshold must report the details of any derivative contract and any subsequent modification thereof to a trade repository.

3. Requirements applicable to CCPs

3.1 Given that CCPs have to take on additional risks, the regulation requires that, for security reasons, they are subjected to rigorous organisational conduct of business and prudential requirements (internal governance rules, increased capital requirements, and so on).

3.2 A CCP must have in place robust governance arrangements. These will respond to any potential conflicts of interest between owners, management, clearing members and indirect participants. The role of independent board members is particularly relevant. Secondly, to be authorised to exercise its activity, a CCP is required to have a minimum quantum of capital. The regulation will require a CCP to have a mutualised default fund to which its members will have to contribute.

4. Authorisation and supervision of trade repositories

4.1 The regulation provides for a reporting requirement in respect of OTC derivative transactions to increase the transparency of this market. The information must be reported to trade repositories. The trade repositories will be registered with ESMA, which will also oversee them.

4.2 The regulation also contains provisions for trade repositories to guarantee their compliance with a set of standards. These are designed to ensure that the information that trade repositories maintain for regulatory purposes is reliable, secured and protected. In particular, trade repositories will be subject to organisational and operational requirements and ensure appropriate safeguarding.

5. The EESC's comments

5.1 The infrastructure of the securities markets has displayed substantial shortcomings in terms of management of counterparty risk and transparency of trading on the over-the-counter (OTC) derivatives markets, in particular credit default swaps (CDSs), which have been identified as responsible for the 'great recession'.

5.2 These 'atypical' contracts have been partially responsible for lowering perception of the risk and prolonging the current crisis, badly affecting the institutes which issued them and therefore end savers. Lastly, as regards issuers, speculation by banks, which have been selling naked CDSs (without the underlying credit), has led to increased rates and, therefore, higher financial burdens for issuers, even causing them to go bankrupt.

5.3 For these reasons, CDSs have been described as 'lead parachutes'; in other words, they are a potential mortal danger to the world financial system. The only practical solution that has been adopted is not to allow institutes to go bankrupt, recapitalising them with public funds and hence nationalising them. This measure has simply led inevitably to an increase in public debt, thus shifting the problem and the risk from the banks to the country to which they belong, causing serious turbulence on the currency markets in the euro area and forcing all the countries to take severe austerity measures, which have been a factor in slowing down the weak economic recovery.

5.4 In the USA, the Depository Trust & Clearing Corporation (DTCC) has set up a special company (The Warehouse Trust Company LLC) authorised to operate as a trade repository for CDSs. The US Administration has launched a legislative reform of OTC derivatives trading, including a requirement to use central counterparties for standardised contracts and concentration of transactions in regulated markets or organised platforms.

5.5 In Europe, the Commission is working on a legislative proposal (European Market Infrastructures Legislation) intended to increase the transparency and stability of the OTC derivatives market. The measures planned are consistent with the US proposal and seek to avoid regulatory arbitrage, which is important.

5.6 The EESC also warns against a number of risks in terms of the measures planned relating to the derivatives market. The fact is that derivatives and the lack of central counterparties and bans on short selling are not wholly to blame for the collapse of the financial markets.

5.7 From the eighties onwards, increasingly sophisticated derivatives circulated on the financial markets, increasing their effectiveness and bringing them closer to the ideal of market completeness as described by economic theory. The complexity of regulatory activities, supervision and oversight increased accordingly and the reform packages being discussed all aimed at gaining greater control of the markets, often decreasing their efficiency.

5.8 The more the price (or yield) of a security reflects the information available, the more efficient a market is. To make a market more efficient, circulation of information should therefore be facilitated so that it can be incorporated as quickly as possible into security prices. It is important to know what the trade-offs are in terms of efficiency.

5.9 First and foremost, it may be that measures seeking to reduce the range of financial instruments available, such as those limiting naked CDSs or short selling activities, do not increase market efficiency. Indeed, limiting the instruments available reduces markets' capacity to absorb and disseminate the information available to operators.

5.10 It is certainly possible to discuss the usefulness of naked CDS, the additional information they provide compared to other instruments, and how far they influence the cost of financing. However, banning them would not achieve a great deal in terms of efficiency. Limiting the possibility of short selling reduces the system's liquidity and, therefore, capacity to react immediately to new information which becomes available. Furthermore, limiting OTC security transactions, requiring operators to trade all derivatives on regulated markets and using clearing houses, could have a dual effect.

5.11 On the one hand, it would help make the market more transparent (it would be easier, for example, to monitor the sums and risk of securities owned by operators) and would make it possible to limit, at least in part, potential sources of instability. However, in situations of financial stress, transparency alone may not be enough. The Commission proposal gives national regulators clear powers in exceptional situations to limit or lift 'temporarily' a ban on the short selling of any financial instrument, in coordination with ESMA, which will in any case be able to intervene directly on two conditions: that the smooth functioning or integrity of the markets is under threat and that national regulators have taken no or insufficient measures.

5.12 On the other hand, however, the risk is once again that limiting the range of instruments available will increase transaction costs associated with financial activities. The futures market is highly standardised and regulated (as it is important to be able to observe the security prices contracted); the market in forwards (which are conceptually similar instruments to futures), however, is geared to the needs of counterparties and permits operators to structure pay-offs flexibly. These securities are not very standardised and it would be difficult to place them in the context of a traditional regulated market without limiting the options available to investors.

5.13 CCPs are seen as the solution to managing systemic risk and the way to make OTC markets more efficient and transparent. CCPs are certainly a key factor in reducing risk and increasing market efficiency, and when it comes to the market for exchange-quoted derivatives they are an essential part of the infrastructure. Logically, therefore, CCPs should also contribute to the

development of the OTC market. Many institutes and politicians are, however, placing too much emphasis on the benefits that CCPs will be able to offer the CDS markets in the short term.

5.14 In actual fact, CCPs must not be seen as the solution to counterparty risk and may not be able to make the market more efficient, given its current state. As things stand, with numerous CCPs in each region, of different kinds according to whether they deal with credit derivatives or interest rate swaps (IRS), the possibility of using collateral efficiently and reducing exposure to the counterparty is compromised. CCPs can clear exposure on a multilateral basis but only for the region, counterparties or suitable types of derivatives they cover. That means clearing between CDS positions and IRS positions is not possible.

5.15 Bilateral clearing of exposure to several types of OTC derivatives with a single counterparty outside the CCP can result in more efficient use of collateral. It should, moreover, be borne in mind that derivatives will always be innovative, made-to-measure instruments and that there will be a large number of contracts which are not suitable for clearing. These positions should be reconciled, taking into account the credit risk, through a suitable collateral management process which does not include CCPs.

5.16 CCPs help to add value and distribute and isolate risk associated with an individual operator. The EESC endorses this. Their popularity will increase and accelerate the maturing and transparency of the market, with a subsequent welcome expansion of OTC activity in the future.

5.17 However, CCPs are only one part of a sound risk management structure. The counterparty risk will not be eliminated and the bilateral risk will continue to have to be taken into consideration for positions outside the CCP.

5.18 Lastly, in addition to this, there are many companies which do not invest in systems to manage the risk associated with their derivatives portfolio. These companies may well continue to expect to be saved even when their risk management is completely inappropriate.

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The President
of the European Economic and Social Committee
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