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on efficient, safe and sound derivatives markets: future policy actions
(2010/2008(INI))

Committee on Economic and Monetary Affairs

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MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on efficient, safe and sound derivatives markets: future policy actions (2010/2008(INI))

The European Parliament,

- having regard to the Commission communications entitled 'Ensuring efficient, safe and sound derivatives markets: Future policy actions' (COM(2009)0563 and COM(2009)0332),
 - having regard to the Commission communication entitled 'European financial supervision' (COM(2009)0252),
 - having regard to the Commission proposal for a regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board (COM(2009)0499),
 - having regard to the Commission proposals amending the Capital Directives (2006/48/EC and 2006/49/EC),
 - having regard to the Commission communication and recommendation on remuneration policies in the financial services sector (COM(2009)0211),
 - having regard to its resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity¹,
 - having regard to the G20 decisions of 24 and 25 September 2009 in Pittsburgh and the national legislation on derivatives currently being formulated in Europe, the US and Asia,
 - having regard to Rule 48 of its Rules of Procedure,
 - having regard to the report of the Committee on Economic and Monetary Affairs and the opinion of the Committee on Legal Affairs (A7-0000/2010),
- A. whereas derivatives play a largely useful role in spreading risk in the economy, but differ considerably with regard to risk, operational arrangements and market participants,
- B. whereas in the future, too, firms need to be able to manage the risks inherent to their business in a targeted fashion, under their own responsibility, and at comprehensible prices, and whereas, with regard to bilateral derivatives, firms are responsible for risk,
- C. whereas the worldwide derivative trading volume has multiplied in the last decade and, as a result, the uncoupling of economic activities and financial market products has advanced considerably,

¹ OJ C 8E, 14.1.2010, p. 26.

- D. whereas, at the end of 2009, the volume of over-the-counter (OTC) derivatives amounted worldwide to US\$ 605 tn and, as a result of excessive leverage, OTC derivatives have helped to make large market participants mutually dependent in an opaque manner,
 - E. whereas OTC derivatives have become increasingly complex and counterparty credit risk has not been correctly assessed and priced, and whereas there are considerable weaknesses in how derivative markets are organised,
 - F. having regard to the decades-old misjudgment that derivatives need very little regulation chiefly because they are used by experts and specialists,
 - G. whereas most derivatives used by firms involve no systemic risk,
 - H. whereas small and medium-sized enterprises use derivatives under special conditions in that, as regards capital charges and financing variation margins, they are dependent on exemptions,
 - I. whereas, as a rule, non-financial institutions' interest rate, foreign-exchange and commodity contracts need no additional regulation,
1. Welcomes the Commission's initiative for better regulation of derivatives, and in particular OTC derivatives, and backs the calls for standardisation of contracts, the establishment of trade repositories, the strengthening of central clearing houses and the extensive use of organised trading venues;
 2. Backs the call for the compulsory introduction of independent clearing between financial institutions for all standardised derivatives, so as to ensure better assessment of counterparty credit risk, and backs the aim of trading as many standardised derivatives as possible, in future, on organised markets;
 3. Insists 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;
 4. Notes that, as regards regulation, a distinction must be made between derivatives to hedge firms' transactions and pure financial market derivatives;
 5. Calls for risk management and transparency to be strengthened, as the key instruments for greater financial market certainty, without neglecting individual responsibility for taking on risk;
 6. Is of the opinion that, through clearing arrangements and by adjusting capital requirements, counterparty credit risk can be reduced for contracts cleared centrally via central counterparty clearing facilities (CCPs) and non-centrally cleared contracts; backs the Commission in proposing higher capital requirements for financial institutions in the case of bilateral contracts, provided that central clearing is dispensed with;
 7. Backs the Commission in its intention to confer responsibilities for authorising European and third-country clearing houses on the European Securities and Markets Authority (ESMA);

8. Insists that neither must CCPs be organised by users, nor must their risk management systems be in competition with each other;
9. Backs the introduction of repositories for all trades and positions not exchange-cleared and calls for trade repositories to be regulated and supervised under EMSA direction;
10. Calls on the Commission to draw up reporting standards for all derivatives and ensure that they are communicated to central trade repositories and make them accessible to the EMSA and national regulatory authorities;
11. Considers careful clarification of all technical details to be necessary;
12. Backs the Commission in its plan to establish CCPs under independent European responsibility which are independent from key market participants;
13. Assumes that, in the legislative proposal, the Commission will make bilateral clearing for non-financial institutions possible on the basis of an understandable risk assessment in future, too, if graduated capital charges for financial institutions are ensured;
14. Backs the Commission in its intention to provide for exemptions and lower capital requirements for SMEs' bilateral derivatives;
15. Calls, as a matter of priority, for credit default swaps to be made subject to independent central clearing and, if necessary, checked to establish whether individual types of derivative with cumulative risks should only be conditionally authorised or even, on a case-by-case basis, prohibited;
16. Is of the view that high-risk derivatives from non-financial institutions must also be regulated despite accounting, according to the market analyses to hand, for a small proportion of the total;
17. Notes that for trading commodities and agricultural products, but also greenhouse gas emission allowances, it must be ensured that that market operates transparently in order to stem speculation;
18. Underlines the fact that regulation which is as consistent as possible and internationally coordinated is desirable, but, since there are differing viewpoints, considers separate European regulation for derivatives to be necessary;
19. Welcomes the Commission's intention to submit legislative proposals on clearing houses and trade repositories as early as mid-2010 and to discuss the technical details with all institutions at national and EU level, in particular the Council-Parliament legislative authority, at an early stage;
20. Instructs its President to forward this resolution to the Commission, the Council, the national regulatory authorities and the European Central Bank.

EXPLANATORY STATEMENT

Introduction

In two communications - dated 3 July 2009 (COM(2009)332 final) and 20 October 2009 (COM(2009)563 final - the Commission has given its views on future policy actions to ensure efficient, safe and sound derivative markets. In the process, the Commission has stressed that derivatives play a useful role in the economy in that they are used to transfer risks inherent to economic activity from risk-averse economic agents to agents more willing to bear them. As the Commission has pointed up, over-the-counter (OTC) derivatives in particular have contributed to financial market turmoil by allowing leverage to increase and by making market participants more and more mutually dependent.

According to information from the Bank for International Settlements (BIS) in Basle in December 2009, the total volume of OTC derivatives in all categories amounted to US\$ 605 tn, the notional amount outstanding for exchange-traded derivatives being US\$ 425 tn. That volume has risen dramatically in the last decade. The need for - and the point of - such a ballooning of financial market products can rightly be called into question. In July 2009, accordingly, the Commission proposed four complementary tools 'to reduce the negative impact of OTC derivatives markets on financial market stability'.

The proposed policy actions are based on the De Larosière report, the European Council conclusions of June 2009 and the G-20 decisions in the second half of 2009. Essentially, the Commission is proposing four policy action areas:

- further standardisation of derivative contracts;
- the use of trade repositories;
- greater use of central counterparty clearing houses (CCPs);
- greater use of organised trading venues.

The Commission makes reference to a general paradigm shift in what has been its financial market policy to date. It is seeking to break with the traditional view that derivatives require no more than light-touch regulation because they are used by experts, and to propose legislation which, in particular, will increase transparency and enable market participants to price risks properly. As a result, the proposed measures will shift derivative markets from OTC bilateral clearing and trading to more centralised clearing and trading.

Function and relevance of derivatives

Derivatives are financial contracts with a value derived from what is termed an 'underlying', e.g. a commodity price, a share price or an interest rate, which, when a predefined event occurs, give a contractual partner a payment or a right to buy or sell. In the past, derivatives were used by financial institutions and firms (non-financial institutions) for hedging or for speculation purposes. Futures, credit default swaps (CDS), options and certificates are common derivatives. CDS provide for a compensatory payment in the event of credit defaults. Since the start of the financial market crisis - according to BIS documents - particularly speculative CDS derivatives have declined by comparison with previous years. At the end of June 2009, the notional outstanding value of CDS contracts was US\$ 36 tn. Increased netting

of positions by market participants, particularly by key traders, has played a considerable role in this. Unlike the notional value of contracts between financial institutions, which has declined, the notional outstanding value for contracts between traders and non-financial customers has more than doubled. Overall, it can be concluded that derivatives are used either to manage a bank's market risk or for trading purposes; they are designated as financial instruments held at fair value through profit and loss, and are initially included in the balance sheet on a trade date basis at cost. The subsequent accrual of interest and amortisation of premiums paid and discounts received are included in 'interest income' on an effective interest rate basis. After trade date, derivatives are revalued to fair value.

Assessment of the Commission's proposals

The aims of the Commission proposals:

- to reduce default risk,
- to reduce operational risk,
- to increase transparency and
- to enhance market integrity and oversight

are shared by the rapporteur unreservedly. The individual provisions put forward to lay down common safety, regulation and operating standards for central counterparties, collateralisation for bilaterally cleared contracts, higher capital requirements for bilaterally cleared trades, and mandatory central clearing for standardised contracts through CCPs for financial institutions are among the proposals which should be supported. The overall regulatory framework also includes standardisation of contract terms and contract processing. To increase transparency, market participants would be obliged to report non-CCP-cleared positions and transactions to trade repositories, which, in turn, would be regulated and supervised. Trading at exchanges or at other organised trading venues would be made mandatory for standardised derivatives. The review of the Financial Market Directives for all derivative markets, including commodity derivatives, is to increase trading transparency. The Market Abuse Directive is to be amended to extend the scope of market manipulations to derivatives and enable regulatory authorities to set position limits.

Different treatment of corporate derivatives and bank derivatives

In energy or commodities trading - unlike on the financial market - a host of different firms are active. In addition to large market participants (energy utilities, large industrial consumers, oil companies, chemical firms, airlines and banks), there are smaller trading partners on the market, too, such as municipal utilities, distribution companies and independent energy traders.

Unlike pure financial market products traded between banks, corporate derivatives involve no major systemic risk for financial markets. Products traded on the financial market differ significantly from corporate products. While securities and financial instruments such as futures and options are traded on the financial market, the corporate derivatives market is often based on physical commodities, which determines price formation. The market price for those products is based on fundamental price-forming factors (such as, for example, power plant capacity, weather, consumer behaviour, commodity availability and raw material prices)

which are completely different from those on the financial market. In the case of corporate derivatives, no private investors are market participants.

With regard to pricing, transparency and counterparty credit risk, the distinction between mass market products and individual products is of great importance. In many instances, derivatives have been traded too cheaply because risk could not be correctly assessed. In the process, banks have systematically ignored risks or sold them on without sharing them.

Distinctive feature of corporate derivatives

Better and tougher regulation of derivative markets must take account of the special position of firms which have to continue hedging their financial and operating risks on favourable, tailor-made terms by means of derivatives. Using these financial instruments, non-financial firms hedge foreign-exchange, interest rate and commodity risks. Such non-speculative protection helps to create stability and growth for employment and investment. No noticeable deterioration in hedging corporate risks must be brought about as a result of the regulatory actions proposed. Though, in future, the pricing of derivatives must be more market-oriented, firms' liquidity must not be constrained. As firms do not have the same access to liquidity as banks, providing excessive collateral may result in a markedly greater borrowing requirement, which must not overburden firms, in particular small and medium-sized enterprises. Since corporate derivatives - unlike financial institutions' derivatives - have not been a major factor in the financial market crisis, a more discriminating view is imperative here.

Conclusions from the Commission proposals

The Commission proposals should be broadly supported. In addition, in the rapporteur's view, particular attention should be paid to the following points:

- in future, the prices of derivatives must better reflect risk and the cost of the future market infrastructure must be borne by market participants alone and not by taxpayers;
- CCPs and their risk management systems must not be financed by users or be rivals;
- reporting standards must be laid down for all derivatives so as to ensure that they are communicated to central trade repositories;
- in particular for SMEs, exemptions and lower capital requirements must be allowed for bilateral derivatives;
- CDS derivatives must be subject to independent central clearing; and if necessary, where cumulative risks are involved, it must be possible to restrict them or, on a case-by-case basis, prohibit them;
- national regulatory authorities must be given access to trade repositories;
- responsibility for authorising CCPs in the European Union and third states should be given to the European Securities and Markets Authority (ESMA).

To optimise cooperation between national regulatory authorities and ESMA, gradual action is required.