

OTC derivative reform in the EU – Centralised clearing, standardised contracts and higher capital requirements

By the end of the year, global regulators and legislators expect to have completed proposals for a whole-scale reform of a hitherto lightly regulated market. Until the financial crisis, over-the-counter derivatives were seen as the near exclusive domain of sophisticated professional investors who were fully aware of the risks associated with their various trades and who were able to protect themselves accordingly. Extensive regulation and legislation were not deemed necessary.

The collapse of Lehman Brothers and near collapse of others sparked a global discussion about the role the OTC derivatives market played in the crisis and whether it should be allowed to continue to self regulate, stimulating an international appetite for reform to improve regulatory and supervisory knowledge of this market, as well as its transparency.

In April 2009, in a bid to make the market more robust in the face of possible future financial shocks, the G20 group of nations agreed to promote the standardisation of credit derivatives markets through establishing supervised and regulated central clearing counterparties. By September that commitment was underscored with a declaration that all standardised OTC derivatives should be traded on exchanges or electronic trading platforms where appropriate and cleared through central counterparties by the end of 2012 at the latest.

The G20 also declared that OTC derivative contracts should be reported to trade repositories, non-centrally cleared contracts be subject to higher capital requirements and that regulators should monitor and assess whether enough was being done to improve transparency, mitigate systemic risk and protect against market abuse.

Taking its cue from the international consensus, the European Commission has been developing its own specific proposals to achieve these ends. After consultation it has decided to develop comprehensive proposals for the OTC derivatives market as a whole rather than using a market segment-specific approach, believing that this approach is more likely to prevent possible regulatory arbitrage. The impact of these proposals will be huge and they have important cost implications, so before finalising its proposals – to be published this year – and in an effort to bring the industry on side it will carry out impact assessments and take into account stakeholder evidence on the probable costs and benefits of implementing each proposal.

The EU proposals

The Commission believes central clearing for all standardised contracts should be mandatory and is working with non-EU G20 nations to develop a consistent approach to defining the terms. Although the definition of what constitutes standard and non-standard has yet to be agreed, the proposals for non-standardised contracts are taking shape.

The Commission wants non-standardised or bespoke derivatives to be priced to take into account the systemic risk they entail and believes collateral levels need to be higher to “reflect the risk that bilaterally-cleared derivatives trades pose to the financial system when they reach certain critical mass”.

As a result, it is proposing that financial firms entering into non-standardised contracts must post “initial margin” in proportion to the risk profile of the counterparty and “variation margin” in relation to the change in value of the contract over time. Besides mitigating the risk of default, by increasing their costs these measures are intended to encourage participants use standardised contracts that are centrally cleared whenever possible.

Bilateral, non-cleared OTC contracts will also be subject to higher capital charges. The gap between the relative capital charges for cleared and non-cleared derivatives provided for within the Capital Requirements Directives (CRD) will be widened and the Commission will work with the Basel Committee on Banking Supervision to amend the CRD where appropriate. As with margin, this proposed increased relative cost is in line with the increased risk.

The Commission currently believes regulation should allow non financial institutions hedging specific exposure to be able to continue to transfer risk without posting additional collateral. However, there is currently no definition of a “non-financial corporate counterparty” and it acknowledges that any definition should not give institutions that compete with banks in the OTC derivatives market a regulatory and financial advantage.

Clearing

Central clearing counterparties (CCPs) have operated in Europe for some time, until recently regulated by individual member states, and both the G20 and Brussels are keen to use them as the main tool to mitigate counterparty risk. With their proposed raised importance, consistent regulation and supervision on a pan-European level has become something of a priority and legislation is expected this year to establish common safety, regulatory and operational standards.

Their attraction lies with their ability to reduce the risk of contagion. When there is a bilateral derivatives master agreement under which Party A defaults, Party B is able to meet any net amount owed to Party A against any amount due to it from Party A. This results in a single net figure representing a sum owing from or to Party A, thereby reducing potentially massive gross exposures.

Party A is likely however to have entered into not only one bilateral contract but rather potentially hundreds with different counterparties and if Party A collapses it is not usually possible for all these firms to combine their claims so that only one single amount is claimed against the bankrupt Party A. This increases the risk of knock-on insolvencies.

Where parties deal through a CCP, the single master agreement is replaced by two back-to-back master agreements – one between Party A and the CCP and one between Party B and the CCP. Should Party A default Party A's various net obligations to the CCP are off-set against the various debts owed by CCP to Party A.

Besides mutualising claims, the use of CCPs also makes it easier to monitor market behaviour and gives regulators accurate information about trades that pass through them. The main problem is the risk of the insolvency of CCP itself so to mitigate this CCPs will impose strict requirements for initial margin and variation risk. Investors will want regulators to provide protection in the event of worst-case scenarios so that the repercussions of a CCP failing are not left to chance. To this end, there have recently been calls from the Investment Management Association (IMA) to have agreed operational and prudential standards for CCPs imposed across the EU. In addition, the IMA feel there should be a carefully considered framework in place for ensuring that CCPs are fit for purpose to try and prevent failure coming about in the first place.

The IMA has also warned against rushing the introduction of the counterparty side of the market to central clearing. There is a fear that investors' interests will be overlooked if this happens, with possible repercussions for market stability. One area of particular concern is the protection given to investors in the event of a bank/broker (counterparty) default and there have been strong suggestions that the market would benefit from clear provisions regarding contract portability and customer margin segregation. For CCPs to work effectively and benefit investors careful consideration will need to be given to these two key areas.

It is not envisaged that market participants would trade directly with the CCPs, rather broker dealers will have direct contractual relationships with the CCPs and be known as clearing members (CMs). Where customers post margin with CMs, this margin must be protected from the possibility that, should the CM default, the posted collateral is viewed as an asset of the CM. Customer margin must therefore be segregated from the relevant CM margin through customer omnibus accounts held at the CCP or through other arrangements such as a custodian bank.

In the event of a default by a CM, if portability is included in the standardised contract, open positions can be transferred away from the defaulting CM and ported to an alternative, reducing the need for position close-outs and the associated costs. Where portability is possible, a customer may transfer all but not part of its positions with the defaulting CM to an alternative and with this in mind, customers will be required to have, for example, ISDA Master Agreements in place with alternative CMs before they clear trades through their chosen alternative CM.

In addition to central clearing and the standardisation of contracts, trade repositories, enhanced transparency and maintaining market integrity are all key to the Commission's proposals to reducing operational risk.

Trade repositories

In order to allow regulators to have an overview of the derivatives market, the Commission is proposing that all trades be reported to trade repositories, which can collect and collate information on trades. It hopes legislation will provide a common legal framework to address authorisation, registration requirements, access and participation, disclosure, data quality and timeliness, access to data, security, legal certainty of registered contracts, governance and operational reliability. However, despite the benefits of using trade repositories, the IMA has been quick to warn regulators against total reliance on them. Regulators will need to consider a whole picture of the market and trade repositories' inability to provide information on the underlying positions being hedged for example, has led the IMA to recommend the collection of information from several sources.

To ensure transparency and market integrity, the Commission wants all standardised OTC derivatives contracts to eventually be traded on exchanges or electronic platforms, defined by MiFID as regulated markets, multilateral trading facilities or systemic internalisers. Such a move would make it easier to regulate effectively the OTC derivatives market, although there could be negative side-effects on liquidity and so the Commission has said it will take a measured approach to introducing transparency obligations.

Meanwhile, market integrity and oversight will be addressed in the review of the Market Abuse Directive this year. The EU proposes clarifying and extending the scope of MAD to derivatives and giving regulators the power to set position limits. This

would help regulators ban excessive risk taking and moderate the concentration of risk within certain areas of the market. Importantly, when it comes to commodity derivatives, this can also be used to curb excessive price volatility.

National concerns

The FSA, whilst generally supportive of reform in the OTC derivatives markets, does not believe that supervision of these markets at a European level represents an effective approach. In particular, it has pointed out that European authorities cannot bear fiscal responsibility in the event of a failure of a CCP, and that full supervisory responsibility should therefore reside with the CCP's home state. FSA also disagrees with European proposals for mandatory posting of initial and variation margin, and believes repositories need not be based within Europe so long as they are supported by internationally agreed information-sharing arrangements.

The future

Although to date there have been no legal or regulatory changes in the OTC derivatives market, firms using these instruments need to be aware of what is on the horizon. The Commission has committed to take account of stakeholder concerns like those presented by the IMA and will be carrying out other impact assessments before finalising any legislative proposals later on this year. The accompanying timeline sets out what the Commission intends to do and by when and offers scope for consultation. Firms would do well to examine the proposals and participate in all the discussions.

Objective	Proposed actions	Time line
Reduce counterparty credit risk – strengthen clearing	(1) Propose legislation on CCP requirements governing:	Mid 2010
	(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	
	(2) Amend CRD in order to:	End-2010
	(a) mandate financial firms supplying initial and variation margin;	
Reduce operational risks - standardisation	(b) Substantially differentiate capital charges between CCP-cleared and non-CCP cleared contracts in CRD;	
	(3) Assess whether to re-shape the operational risk approach in the CRD to prompt standardisation of contracts and electronic processing.	End-2010
Increase transparency - trade repositories	(4) Work with industry to increase standardisation of legal regimes and processes	On-going
	(5) Propose legislation on trade repositories:	End 2010
	(a) Regulate trade repositories	
Increase transparency - trading	(b) Mandate reporting by OTC derivatives transactions to trade repositories	
	(6) Amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories;	End-2010
	(7) Ensure trading of standardised contracts on organised trading venues under MiFID;	
	(8) Enhanced trade and price transparency across venues and OTC markets, as appropriate, in MiFID;	
	(9) Conclude review of exemptions from MiFID for commodity firms.	

Objective	Proposed actions	Time line
Improve market integrity	(10) Extend MAD to OTC derivatives; (11) Give regulators the power to set position time limits in MiFID	End-2010