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**Derivatives,
central counterparties
and trade repositories**

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES
ECONOMIC AND MONETARY AFFAIRS

DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES

COMPILATION OF BRIEFING NOTES

Abstract

This compilation of briefing papers deals with two crucial questions related to the European Commission's Proposal for a Regulation on OTC derivatives, central counterparties [CCPs] and trade repositories (also known as EMIR the European Market Infrastructure Regulation): 1. possible solutions to regulatory differences between the US Dodd Frank Act - i.e. the US legislation in this area - and the Commission's Proposal, in particular in ensuring equal conditions for market access for EU CCPs. and third country CCPs; 2. recommendations for criteria/reference points for the adoption of information and clearing thresholds for non-financial counterparties according to Article 7 of the Proposal, i.e. whether thresholds might be fixed according to the volume of general business and/or the balance sheet of the non-financial counterparty - taking into account the reference period and the period of validity.

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NOTE

by Kern ALEXANDER

Abstract

This paper examines the legislative and regulatory proposals by the United States and the European Commission to increase regulation of the over-the-counter derivatives (OTC) market by requiring more OTC derivatives to be traded on exchanges and electronic trading platforms and to shift the clearing of these instruments away from opaque bilateral structures to centralised clearing through transparent and regulated central counterparties (CCPs). These proposals are designed in substantial part to control systemic risk in wholesale capital markets and in particular in the OTC derivatives markets, which was a source of the systemic risk that toppled Lehman Brothers in 2008 and nearly caused the collapse of the European and US financial systems. The paper suggests that the proposed EU Regulation has in key areas different prudential regulatory requirements for CCPs than what the US has proposed so far and therefore this could potentially create market access problems for CCPs based in the US seeking access to the EU market. But the EU and US proposals are at an early stage and future convergence remains possible. Other issues addressed concern the type of ownership model for CCPs and the role of the European Central Bank in overseeing CCPs.

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INTRODUCTION AND BACKGROUND

The efficient operation of financial markets depends on well regulated clearing and settlement systems. Clearing typically involves a central counter party (CCP) or clearing house acting for a fee as a buyer for every seller and as a seller for every buyer in a securities or derivatives transaction.¹ A CCP is a specialised financial institution that mediates between the buyers and sellers of securities. The centralised clearing of financial instruments usually occurs through a single clearinghouse,² interposed as the counterparty and guarantor to every trade, requiring standardised contracts, including minimum initial margins and margin variations, isolating counterparty risk and minimising risk through conservative risk management practices and multilateral netting so that CCP members have smaller exposures overall.³

To perform its clearing function, a CCP must have an effective risk management system that allows it to calculate and collect margins from its members, and maintain a default or guaranty fund to protect itself and its non-defaulting members from the risk of a member's default. A well-regulated and efficiently operating CCP will reduce counter-party credit risk in derivatives transactions, thereby mitigating systemic risk which can arise because of counterparty defaults in the over-the-counter (OTC) markets. The negative fallout from the collapse of Lehman Brothers and AIG in 2008 was exacerbated by the lack of transparency in the OTC markets which led to the failure of OTC counterparties to price adequately the risk they were exposed to, thereby increasing systemic risk.⁴ A well-regulated CCP can result in more efficient pricing of financial risk in the securities and derivatives markets and a reduction in systemic risk.

The growth of CCPs in Europe in recent years has been dramatic with significant horizontal consolidation across Member States, allowing market participants to increase their netting capabilities across many more asset classes on European-referenced entities or indices based on these referenced entities.⁵ In recent years, a key innovation is the development of a default management process whereby every member must participate in an auction of a defaulting member's portfolio. A facility can also be offered whereby non clearing clients can be offered clearing through a clearing member. If there is a default of this clearing member then positions can be transferred to another clearer. The clearance of financial instruments has strategic importance for financial stability and is beneficial for the efficient workings of the financial markets.

¹ The European Commission has defined clearing as the process for calculating and establishing net positions in settlement, and for ensuring that adequate securities and cash are available for settlement (European Commission, 2005). Similarly, the Committee on Payment and Settlements Systems (CPSS) has defined clearing as 'the process of transmitting, reconciling, and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement.' (CPSS, 2001).

² Clearing houses traditionally performed clearing for exchange-traded derivatives and commodities. As central counterparties (CCPs), they become the buyer to every seller and the seller to every buyer of a particular set of contracts (eg., those contracts executed on a particular exchange or exchanges). See Papatthannassiou (2010, 1; observing that CCP services were first made available for commodities and for related exchange-traded derivatives, such as futures).

³ A CCP should not be confused with a centralised deal registry, to which parties report as to the trades they have entered into bilaterally and related transfers of collateral. A CCP also is not a formal exchange, which provides transparency on prices and volumes of transactions processed, broader access including to retail investors, and even less counterparty risk due to the contribution of capital from market makers.

⁴ A major weakness in the OTC derivatives market is that there are relatively few players involved in transacting a very large numbers of trades. Hedging can be cyclical, meaning that if one counterparty fails, there could be a domino effect with systemic implications.

⁵ The CCP industry has begun to consolidate because of competitive pressures. In Europe, the main CCPs (owners in parenthesis) are: CC&G (London Stock Exchange), Eurex Clearing (Deutsche Borse/SIX), EuroCCP (US DTCC), Iberclear (Bolsas y Mercados Espanoles), MEFF (Bolsas y Mercados Espanoles), ICE Clear Europe (ICE) LCH Clearnet Ltd (user owned), and X-Clear. The main US CCPs are: CME Clearing (CME Group), Options Clearing Corporation (eight US options exchanges), ICE Trust (Intercontinental Exchange), ICE Clear US (Intercontinental Exchange), Canadian Derivatives Clearing (TMX Group), National Securities Clearing (Depository Trust and Clearing); see *Financial Times* 'Clearers' ownership model under scrutiny', (23 Dec 2010) p. 30.

Centralised clearing, however, also presents major challenges: it is a collateral intensive process that involves relatively complex documentation. Determining margins and valuing collateral for default funds requires a high level of operational complexity. Moreover, there could be regulatory concerns with mandatory clearing of derivatives because CCPs may find it very difficult to close-out some illiquid positions held by defaulting members, which could affect the liquidity of a group of members, especially large banks and financial institutions who are also CCP members and whose access to liquidity can become a financial stability issue.

The G20 Pittsburgh Summit Communique of September 2009 endorsed proposals for mandatory trading of standardised derivative contracts on exchanges or electronic trading platforms and mandatory clearing of such trades through a CCP by the end of 2012.⁶ Non-centrally cleared contracts would be subject to higher capital requirements. Following this, the European Council agreed in its 'Conclusions' of 2 December 2009 of the need to substantially improve the mitigation of counterparty credit risk and enhancing the transparency, efficiency and integrity of the derivative markets,⁷ and the European Parliament's Resolution of 15 June 2010 on 'Derivatives markets: future policy actions' called for mandatory central clearing and reporting of OTC transactions.

EU and US policymakers and regulators have spearheaded the G20 initiative by proposing legislation and regulations that would require most standardised OTC trades to be migrated on to CCPs and recorded in trade repositories. Specifically, the EU's proposed Market Infrastructure Regulation (EMIR)⁸ and the Dodd-Frank Act of 2010⁹ aim to shift more derivatives on to exchanges and other trading platforms and to be cleared through CCPs, which would increase market transparency and potentially reduce systemic risk. The obligation to clear OTC contracts under both laws would result in increased collateralisation of OTC and swap trades, reduced counterparty credit risk, and greater liquidity in the wholesale derivatives markets. Moreover, because of the size and influence of the EU and US financial markets, these laws will have a major global impact.

EMIR and Dodd-Frank will result in a substantial increase in the amount of OTC derivatives subject to a central clearing requirement. Accordingly, CCPs will need to establish more robust risk management practices and sound organisational structures. The Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions are already addressing the need for enhanced CCP risk management and governance by revising their 2004 international principles of best practice for securities clearing and settlement, which are expected to be proposed in early 2011 (ECB, 2010).¹⁰ However, these recommendations only provide general principles for regulating clearing and settlement systems, while leaving much discretion for implementation to national authorities.

⁶ The G20 Pittsburgh Summit Communique (Sept 2009) states in relevant part that:

- 'all standardised OTC derivatives contracts should be traded on exchanges [...] and cleared through a Central counterparty by the end of 2012 at the latest';
- OTC derivative contracts should be reported to trade repositories; and
- Non-centrally cleared contracts should be subject to higher capital requirements.'

⁷ Council of the European Union, 'Council approves enhanced regulation of the OTC derivatives market', (2 Dec 2009). The EU welcomed 'the paradigm shift in the approach to derivatives markets [...] namely moving from so called "Light handed regulation" to a more ambitious and comprehensive regulatory policy, that is aimed at reducing counterparty and operational risks, increasing transparency of the derivatives market and strengthening market integrity and oversight and, operationally is expected to shift derivatives trading and clearing from predominantly OTC bilateral transactions towards centralised trading and clearing infrastructures'.

⁸ See: Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories', COM(2010)265, 15.9.2010.

⁹ The Wall Street Reform and Consumer Protection Act of 2010 ('The Dodd-Frank Act'), Public Law 111-203, 124 Stat. 1376 (2010). For example, section 619 provides the so-called 'Volcker Rule' that requires mandatory separation of proprietary activity from client activity. Previously the question of activity separation had been left to the discretion of the regulator.

¹⁰ Also, the Committee of European Securities Regulators (CESR) and the European System of Central Banks (ESCB) addressed systemic risk and other financial stability issues with the publication in June 2009 of voluntary 'Recommendations for securities settlement systems and central counterparties in the European Union.' (CESR/ESCB, 2009).

EU and US policymakers and regulators are now moving ahead with EMIR and Dodd-Frank by proposing more detailed and possibly higher standards for regulating the OTC markets and CCP operations. This report considers some of the significant differences that have emerged between EMIR and Dodd-Frank over the regulation of CCPs which raise issues regarding EU market access for third country CCPs. The report also analyses these regulatory differences and related issues concerning the role of the European Central Bank in CCP oversight, the applicable international trade law principles to third country CCP access to the EU market, and what type of CCP ownership model is most suitable for achieving regulatory objectives.

1. REGULATORY DIFFERENCES FOR CCPS UNDER EMIR AND THE DODD-FRANK ACT

In considering some of the different requirements of EMIR and the Dodd-Frank Act, it is important to bear in mind that EMIR is intended to be more prescriptive as a legislative measure with the European Securities and Markets Authority (ESMA) clarifying certain technical standards over time, whereas the Dodd-Frank Act delegates substantial rulemaking authority to the US regulatory bodies – the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) – to define the most important regulatory requirements such as the exceptions for financial instruments eligible for clearing and defining the prudential regulatory requirements, governance and conduct of business standards for CCPs and acting with other federal regulatory bodies to define and regulate systemically important CCPs. In contrast, EMIR establishes most requirements for CCPs expressly in the proposed Regulation and the Commission will have an ongoing role to approve most substantive regulations adopted by ESMA covering prudential regulation, governance and conduct of business not already established in EMIR. Generally, US regulators will have broader authority to respond to market developments by adopting or modifying regulatory rules and standards and for enforcing regulations in administrative tribunals. In contrast, ESMA will be engaged in a challenging exercise of overseeing the implementation of EMIR across the EU in a harmonised way and in ensuring that Member State supervisory authorities interpret and apply EMIR in a similar way that promotes internal market objectives. US regulators will have more flexibility to respond to global financial developments and to coordinate with foreign regulators, whereas ESMA will be significantly constrained in responding to market developments because it will need Commission approval for substantive changes in many regulatory requirements which will likely involve amending EMIR.

Regarding regulatory differences for CCPs, it is important to realise that most of the US regulatory rules are not yet finalised and are undergoing review and efforts are ongoing to coordinate to achieve a high level of convergence between both regimes.¹¹ The US Commodity Futures Trading Commission (CFTC) has met to consider its proposed rules, including, among other things, the establishment of CCPs (the Act describes CCPs as 'derivatives clearing organizations' (DCOs), swap execution facilities, and end-user exceptions to the obligation to use mandatory clearing.

ESMA will take up its review of technical standards and harmonised implementation in 2011 and will begin soon to advise the Commission on further substantive rules and possible amendments to EMIR to address legitimate concerns. It is expected that there will be amendments to EMIR to address concerns regarding regulatory gaps and inconsistencies that could lead to arbitrage between the EU, US and other major jurisdictions.

US and EU regulators and Member State supervisors have a long way to go to reconcile any significant differences between the two regimes. The following discussion examines some of these differences in respect to the regulation of CCPs.

¹¹ EMIR is a proposed Regulation subject to proposed amendments by the Parliament and Council. ESMA was authorised to take up its responsibilities in January 2011 but its Board has not yet been appointed nor begun its work on proposing technical standards to implement EMIR. The deadline for ESMA's technical standards is 30 June 2012. In contrast, most of the proposed regulatory rules in Dodd-Frank are expected to be finalised by 15 July 2011 and to take effect by 15 September 2011. This creates considerable uncertainty for practitioners who will be subject to Dodd-Frank in September with EMIR possibly not taking full effect until the following July.

Eligible instruments

Both EMIR and the Dodd Frank Act aim to impose clearing and reporting requirements on a broadly defined class of OTC derivatives (with differences for some classes of derivatives) and provide regulators with the ultimate authority to decide when the clearing obligation should apply. Regarding differences in the scope of application of the clearing requirement, it should be noted that the Dodd-Frank Act applies to a broad class of OTC derivatives including any agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap. The US definition does not appear to cover spot foreign exchange transactions. Under the Act, the Treasury Secretary can exempt both foreign exchange swaps and forwards from the clearing obligation (but not the reporting and business conduct standards). Moreover, the US definition excludes some kinds of physically settled commodity transactions (and certain physically settled forward transactions in securities).

EMIR also applies to a broad class of OTC derivatives but unlike Dodd-Frank is limited to derivatives on specified underlying assets. The EU definition excludes some kinds of physically settled commodity transactions, although the exceptions differ from the US. The EU definition also does not cover spot foreign exchange transactions and the Commission has interpreted the relevant EU definition to exclude commercial forward foreign exchange transactions. However, it may be advisable for the Commission to subject certain other forex forwards and swaps to a clearing requirement. Although there is a view that forex forwards and swaps should not be subject to mandatory clearing because most of these trades are settled through the Continuous Link Settlement System (which mitigates settlement risk) thereby reducing systemic risk in the forex markets, most forex trading still poses significant counterparty credit risk because of longer-dated maturities. Indeed, based on notional value, over one-third of the outstanding forex forwards and swaps have a maturity of over one year.¹² Therefore, it is argued that policymakers should consider a mandatory clearing requirement for longer-dated forex forwards and swaps with some exceptions for commercial entities engaged in hedging.¹³

EMIR does not address whether or not standardised derivatives contracts which are subject to mandatory clearing are also required to be traded on an exchange or electronic platform because it explicitly applies only to post-trading systems (clearing and settlement), whereas the Market in Financial Instruments Directive (MIFID) applies to trading on exchanges or electronic platforms.¹⁴ In contrast, Dodd-Frank requires that if a derivative is eligible for clearing, it must also be traded on an exchange or an electronic trading platform, such as a 'Swap Execution Facility' (SEF).

Both EMIR and the proposed US regulatory rules aim to achieve centralised clearing for standardised derivative contracts by adopting rules, procedures and technical standards for how CCPs should operate and by exempting certain end users from the clearing requirement. Indeed, EMIR contains exceptions for non-financial industrial groups, such as Siemens, Lufthansa and Rolls Royce, who argued that requiring them to process OTC derivatives through CCPs would be too expensive and eliminate the benefits they derive from hedging their commercial risk against, for instance, commodity price volatility.

¹² Bank of England (2010, 57).

¹³ A mandatory clearing requirement for these forex instruments would complement the Continuous Link Settlement Bank's effective management so far of settlement risk in the foreign exchange markets.

¹⁴ The Commission is now considering whether OTC derivative should be traded on exchanges or electronic platforms as part of its MIFID II review.

Capital and margin requirements

CCPs have typically not been required to hold regulatory capital which can absorb unexpected losses against payment, treasury, operational and business risks. EMIR attempts to address this by requiring a CCP, upon initial authorisation, to hold at least 5 million euros in permanent, available capital.¹⁵

Minimum capital levels must be maintained along with retained earnings and reserves must always be sufficient to cover an orderly winding down. In contrast, Dodd-Frank requires that a derivatives clearing organization (DCO) shall have adequate financial, operational and managerial resources as determined by the CFTC, but no specific capital formula is required.¹⁶ A DCO's financial resources shall at a minimum exceed the total amount that would enable the DCO to meet its obligations despite a default by a member creating the largest financial exposure in extreme, but plausible, market conditions and enable the DCO to cover its operating costs for a 1-year period.¹⁷

Despite these requirements, because CCPs will be exposed to much greater counterparty risk with mandatory clearing, it will be necessary for them to increase the quantity and quality of the resources they hold against default. In this regard, the Bank of England has observed that 'there is a strong case for moving beyond the current requirement to cover the default of their largest member', and instead to hold adequate resources (ie., higher capital and margin requirements) against the unexpected default of two or more members under extreme, but plausible, market conditions.¹⁸

In addition, neither regime has addressed yet the potential risks of CCP members being exposed to large or concentrated client positions and the implications this can have for the CCP to meet its obligations. This should be addressed by the CFTC and the SEC in its rulemaking capacity under Dodd-Frank and in Europe by the European Securities and Markets Authority (ESMA).

Regarding margin requirements, EMIR requires that CCPs have access to liquidity in the form of central bank money and specifies that margins shall cover 99% of risk of exposure movements over an appropriate time horizon, with a relatively limited role for the adoption of delegated acts/technical standards to implement those requirements.¹⁹ To do this, CCPs will be required to impose margins on clearing members and CCPs with whom they have interoperable arrangements. CCPs will be required to develop models and parameters based on those models to determine certain margin thresholds which will be tested under stress conditions in which the margin can be collected and called on a daily basis in order to determine the value at risk given a certain probability of loss. The SEC and CFTC have promulgated regulations for determining how to calculate the margin for standardised derivative contracts that cover similar but not identical risk exposures.²⁰ The US regulations do not yet provide for a particular value-at-risk exposure (ie., 99% as provided by EMIR), but instead provide that margin requirements shall be sufficient to cover unexpected losses under normal market conditions and models and parameters used in setting margin thresholds should be risk-based and tested based on available data and reviewed on a regular basis.²¹ These differences in approaches for margin requirements should be reconciled at the bilateral level between the Commission/ESMA and the US regulators and in international bodies such as IOSCO.

¹⁵ EMIR, art (1).

¹⁶ Core Principle 8 requires that DCOs have adequate financial, operational, and managerial resources, 'to discharge its obligations. 17 CFR ??

¹⁷ 17 CFR Parts 1 and 39, *Federal Register*, Vol. 75 No 238, 77578-77582.

¹⁸ Bank of England (2010, 57).

¹⁹ EMIR, art. 39 (1) – (3).

²⁰ For example, US Core Principle (CP) 8 requires that 'a DCO, through margin requirements and other risk control mechanisms, shall limit the DCOs exposure to potential losses from defaults by members and participants to ensure that operations of the DCO would not be disrupted and non-defaulting members would not be exposed to unexpected losses.'

²¹ See CP 8.

Systemically important CCPs

Title VIII of Dodd-Frank authorises the Federal Reserve and the CFTC to regulate systemically important derivatives clearing organizations (SIDCOs).²² CFTC is devising rules to regulate SIDCOs as systemically-important institutions that may require higher capital and stricter margin and collateral requirements for its clearing members and their clients. In contrast, EMIR does not make a distinction between systemically-important CCPs and other CCPs. This could result in higher capital charges and stricter margin and collateral requirements for EU CCPs defined by US regulators as systemically-important if they clear US-traded products or clear certain non-US-traded products for US-domiciled firms subject to mandatory clearing under US law. The US Financial Services Oversight Council has authority, under the Dodd-Frank Act, to assess the systemic importance of non-US financial institutions, including non-US CCPs, and will adopt, no later than July 2011, rules that define which CCPs are systemically important.

In contrast, EMIR makes no distinction between systemically important and non-systemically important CCPs, presumably because EU policymakers consider all CCPs to be equally systemically important. The Commission should address this by assessing the systemic importance of CCPs by working with the US Financial Services Oversight Panel to establish thresholds for the value and volume of CCP clearing. Such an assessment of systemic importance should also include the type of financial instruments being cleared: certain financial instruments create greater externalities than others. This can be measured based on the level of leverage linked to these instruments and whether they have a longer term maturity. Therefore, CCPs which clear credit-linked instruments (ie., credit default swaps) which are linked to leverage and have medium to long-term maturities pose greater systemic risk than instruments linked to less leverage and with shorter maturities, such as equity derivatives.²³ These CCPs should be subject to more intensive scrutiny of their risk management, governance and ownership structures, including higher capital, and stricter margin and collateral requirements. This is similarly the case with certain types of foreign exchange derivatives, such as forex forwards and swaps, that have longer maturities (greater than 1 year) by notional value. As discussed above, these instruments pose greater counterparty and systemic risk and therefore should be subject to a clearing requirement, and the CCPs which clear them should be subject to higher capital requirements along with stricter margin and collateral requirements.

CCP institutional and ownership structure

The growth of CCPs has raised issues about what institutional structure they should adopt and who should own them. Some EU states require CCPs either to have a bank licence or to be owned by a bank. For example, Germany and France require a CCP to obtain a bank licence before it can begin clearing operations, whilst other EU states, such as the United Kingdom, do not require CCPs to be banks or to be controlled by banks, but rather to be authorised by the UK regulator as business. Such institutional regulatory differences pose barriers not only to cross-border trade in CCP services within the Union, but also to international trade in CCP services between the Union and non-EU third countries, such as the United States and Japan. Under EMIR, there are no requirements regarding what institutional form a CCP should take, nor who can own a CCP. By contrast, Dodd-Frank delegates authority to US regulators to adopt a harmonised set of regulations for the institutions structure of CCPs and their operations and governance. For example, US regulators have the authority to define what type of institutional entity a CCP should be (ie., does it require a bank licence or not) and to determine what limits, if any, to impose on its ownership structure, including whether or not they can be owned by large US banks and non-bank financial holding companies supervised by the Federal Reserve.

²² The Dodd-Frank Act, Title VIII provides for the Board of Governors of the Federal Reserve System together with the Financial Services Oversight Council (composed of representatives from all of the Federal Financial Regulators) to have authority to take steps to limit the size of systemically risky entities; reduce the ability to engage in activity regarded as unsafe or unsound; and to take other action to reduce or eliminate risk.

²³ See Bank of England (2010, 57).

EMIR contains extensive provisions directly regulating the organisation and conduct of business of CCPs whereas Dodd-Frank authorises regulators to act with discretion in deciding whether or not to place particular or general restrictions on the organisational structure, conduct of business rules, and ownership of CCPs. Rather than focusing on what type of institutional structure the CCP entity should take (which is left to Member States), EMIR focuses on the CCP's Board of Directors and how they exercise oversight and impose requirements, such as at least one-third of the board members must be independent (and in all cases at least 2 members should be independent).

The Dodd-Frank Act delegates to regulators the authority to micromanage the CCP's structure and to impose conduct of business rules and adopt principles to manage conflicts of interests within the CCP and in relation to its members and to regulate ownership interests and controls in CCPs. Although there are no provisions in EMIR equivalent to Dodd-Frank's ownership limits, holders of direct or indirect significant shareholdings in a registered CCP will require approval by the Member State supervisor. EMIR creates similar requirements for CCPs to manage conflicts of interest.

The Act contains provisions requiring collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer, while allowing for the collateral to be held in omnibus accounts. The Act also specifically states that a registered CCP is not required to accept the credit risk of another CCP. EMIR does not create the same requirements regarding how the collateral for cleared swaps should be held, nor does it address the issue of whether a CCP should accept the credit risk of another CCP. But these are minor issues that can be worked out with further US regulatory rulemaking and Commission revision.

EMIR contains provisions which aim to ensure the portability of client positions and collateral in the event of a clearing member's default. It also permits interoperability for CCPs in relation to cash securities clearing. US regulations presently do not address this.

2. MARKET ACCESS CONDITIONS FOR THIRD COUNTRY CCPS

Regarding the application of EMIR to CCPs domiciled in third countries, there are a number of situations as discussed above where the requirements of the EU and US regimes are not harmonised and may create direct conflicts in legal and regulatory requirements. It should be recalled however that the US regulations are still in a formative stage and ESMA has not yet taken up its role in proposing technical standards and advising the Commission on further modifications or amendments to EMIR as well as proposing guidelines for determining whether third country jurisdictions meet EU legal and regulatory standards of equivalence.

Jurisdictional issues

In respect of jurisdiction, EMIR's scope of coverage is unclear in determining the application of a number of its provisions. Under certain circumstances, however, extraterritorial jurisdiction can be implied because the clearing obligation is applied expressly to financial counterparties (and non-financial counterparties which exceed the clearing threshold) which enter into eligible OTC derivatives with third country entities. For example, EMIR's clearing and reporting requirements would appear to apply to a EU domiciled counterparty who is trading a financial product referencing an EU-based asset, even though the trade is conducted with a counterparty domiciled in a non-EU jurisdiction and the product is trading on a trading platform outside the EU. In this case, Dodd-Frank would create jurisdiction because it applies both to US domiciled parties and to financial products that are trading on exchanges or platforms in the United States or subject to US jurisdiction. These overlaps of regulatory jurisdiction should be addressed by EU-US working groups.²⁴

Third country equivalence

Both EMIR and Dodd-Frank seek to allow cross-border clearing into the EU market by recognising and in some cases exempting non-EU domiciled CCPs from the EMIR regime if the non-EU CCP can demonstrate that it is subject to an equivalent home country regulatory regime and has an agreement with the ESMA to provide timely information of the exposures and operations of the non-EU CCP. EMIR however is less flexible with recognising and/or exempting the incoming cross-border trade of repository services. The US is equally less flexible with trade repositories by requiring them to comply fully with the reporting and governance standards of Dodd-Frank. The EU goes even further by permitting recognition or exemption of trade repositories from EMIR only in cases where the home country of the non-EU repository has concluded treaty with adequate exchange of information with the European Union.

The legal and regulatory differences that divide the EU and US as discussed above are significant but can be overcome by US regulatory rulemaking and by ESMA's adoption of technical standards which can together bridge the regulatory divide in areas such as eligible instruments for clearing, margin and capital requirements, and CCP governance standards and conduct of business rules. This depends, however, on effective bilateral coordination between EU and US officials and multilateral efforts through the Committee of Payment and Settlement Systems and IOSCO.

²⁴ The Global Markets Advisory Committee will be many of the areas that need reconciliation. See also 'Derivatives Reform: Comparison of Title VII of the Dodd-Frank Act to International Legislation', prepared by CFTC Staff for the Global Markets Advisory Committee (5 October 2010).

2.1 General Agreement on Trade in Services and reciprocity

The WTO General Agreement on Trade in Services and its Annex on Financial Services provide the international legal framework governing cross-border trade in financial services. WTO members' national treatment and market access commitments are negotiated by each WTO member (including the EU acting for all EU Member States) and constitute the basis of their negotiated specific commitments to liberalise the services sectors of their economies, including financial services. Indeed, the WTO Appellate Body has recognised the centrality of the Members' schedules of commitments as binding international legal obligations, which means that WTO members cannot avoid their commitments or obligations unless expressly allowed under the GATS.²⁵ Regarding CCPs, the question is raised whether the EMIR's requirement in Chapter 4, Article 23 that a CCP established in a third country may provide clearing services to entities established in the EU only where ESMA determines that the laws and regulations of that third country CCP are equivalent to EMIR violates any GATS commitment undertaken by the EU? A review of the EU's schedule of commitments demonstrates that the EU has made no commitment – either for national treatment, market access or any other commitment – that would preclude it from imposing restrictions on entry into the EU market of a CCP established in a third country. However, the EU has incurred a most-favoured nation (MFN) obligation under Article II GATS to treat WTO members in a non-discriminatory manner with respect to market access. In other words, the MFN principle requires WTO members, such as the EU, to assess the equivalence of third country regulations and laws in an equal manner and not to assess, for instance, the regulatory regime of CCPs in one WTO member in a more that would be considered on objective criteria to be more favourable than how it would assess the equivalence of another WTO member's regulatory requirements. Under the GATS, the MFN principle prevents a WTO member from discriminating between other WTO members with respect to conditions for market access.

A related international trade law issue has arisen because of a European Central Bank legal opinion that was issued in January 2011 regarding Article 23's requirement that ESMA should assess the laws and regulations of a third country jurisdiction for equivalence in order to decide whether to allow a CCP based in that third country to have EU market access.²⁶ As discussed below, the ECB believes, based on its Treaty powers to ensure the smooth operation of the euro area payment system and its responsibility for securities settlement infrastructure (*i.e.* Target 2), that the European System of Central Banks (ESCB) should have oversight responsibility over securities clearing systems, including the operations of CCPs, mainly because of the integral operations of CCPs in securities settlement systems and because EU central banks, as central banks of issue, could be called on to provide liquidity support under EMIR to a CCP during exceptional or stressful market conditions.²⁷ In addressing the issue of what regulatory criteria should apply under Article 23 EMIR, the ECB argues that the principle of *reciprocity* should apply to determine whether the ESMA and the ESCB should recognise a third country CCP.²⁸ The ECB argues that 'the requirement for such recognition should be the reciprocal treatment of CCPs from the Union under the relevant laws of such third countries.'²⁹

²⁵ Article XX:3 (GATS) provides that Members' Schedules are 'an integral part' of the GATS. See also GATS 2001 Scheduling Guidelines.

²⁶ European Central Bank, *Opinion of the European Central Bank of 13 January 2011 on a proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, (CON/2011/1)(hereinafter ECB Opinion of 13 January 2011).

²⁷ ECB Opinion of 13 January 2011, p. 3.

²⁸ The ECB proposes that Article 23 (2) be amended (in bold) in relevant part to state:

'ESMA, **in close cooperation with the members of the ESCB**, shall recognise a CCP from a third country, where the following conditions are met: [...] **(d) the applicable laws in the jurisdiction of the third country CCP ensure reciprocity in respect of CCPs from the Union.**'

²⁹ *Ibid.*

The ECB's proposal for the requirement of reciprocity under Article 23 does not mention how it would be reconciled with the existing principle of equivalence as set forth in Article 23. Rather, the ECB reciprocity proposal could potentially have the effect of making the conditions for market access between the EU and United States reciprocal in a manner that might violate non-discrimination principles under other bilateral agreements entered into by the EU and possibly violating the EU's MFN obligation in the GATS.

As an international trade law matter, under the GATS, where a WTO member has incurred most-favoured nation and national treatment obligations, and has made market access commitments, it may not condition access to its markets based on the principle of reciprocity. The MFN and national treatment principles as set forth in the GATS are non-discrimination principles which preclude the application of the reciprocity principle.³⁰ Although the EU has not made any national treatment commitments under Article XVII GATS and no market access commitments under Article XVI GATS, it has incurred a most-favoured nation obligation which is essentially an obligation not to treat other WTO members in a discriminatory manner. The ECB's reciprocity proposal raises important issues about whether any reciprocal arrangements between the EU and US might have discriminatory effects on trade relations between the EU and other third countries in violation of the MFN principle of bilateral trade agreements and the GATS. The EU should therefore reject the ECB's reciprocity language and stick with the principle of equivalence as currently stated in Article 23 because the conditions for equivalence are less likely to violate any existing (or future) bilateral or multilateral trade obligations between the EU and other third countries based on the principle of non-discrimination.

³⁰ See Kern Alexander et al., *Global Governance of Financial Systems; the International Regulation of Systemic Risk* (2005, Oxford: OUP) p. 103. See also, Juan Marchetti 'What Should Financial Regulators Know About the GATS' *WTO Discussion Paper* (2003).

3. RELATED ISSUES

3.1 CCP ownership model

Should policymakers consider whether the for-profit shareholder ownership model provides adequate incentives for CCPs and their shareholders to mitigate systemic risks? And whether some other type of ownership model should be required to achieve regulatory objectives? Most of the biggest CCPs in Europe and the US operate with the for profit shareholder-ownership model: many of these CCPs are owned by exchanges which provide the CCPs with a steady order flow of business. The Bank of England in its December 2010 Financial Stability Report suggested that '[f]rom a risk perspective, not-for-profit, user-owned CCPs provide strong incentives for effective risk management.'³¹ In contrast, the incentives for effective risk management are weaker among CCPs that operate with the shareholder-owned for profit model or those which are not user-owned. Although the Bank was mainly concerned that the shareholder for profit ownership model did not 'closely align the interests of CCPs and providers of risk capital', the real regulatory risk is whether the shareholder ownership model based on limited liability creates an incentive for the shareholders of a CCP to encourage the CCP to take on greater risks that could threaten financial stability.

The Bank suggested that enhanced capital requirements and stricter risk management standards for CCPs, along with 'user ownership and not for-for profit arrangements' would contribute significantly to financial stability objectives.³² The issue will become especially important once EMIR and Dodd-Frank are implemented because many CCPs will have an incentive to increase revenues by attracting more of the OTC clearing business stemming from the regulatory reforms. The concern is that for profit CCPs will lower standards in areas such as margining, quality collateral and risk measurement in order to attract more business from their members and their clients. The Bank of England suggests that CCPs operating with an user-owned business model will have less of an incentive to reduce operating standards to attract more business than if the CCP is driven by the for profit shareholder ownership model.³³ This is an issue that merits further analysis.

3.2 The regulatory role of the ESCB

The European Central Bank adopted an opinion on 13 January 2011 that EMIR should be amended so that the European System of Central Banks (ESCB) would be given oversight responsibility for the operation of EU central counterparties and any third party central counterparty operating in EU markets. The legal authority cited for this proposal was the fourth indent of Article 127 (2) of the Treaty and Article 3.1 and Article 22 of the Statute of the European System of Central Banks and of the European Central Bank. One of the basic tasks to be carried out through the ESCB is the promotion of the smooth operation of the payment system.³⁴ Further, Article 22 of the Statute of the ESCB provides the ECB with the important power to adopt regulations to ensure the efficiency and soundness of EU clearing, settlement and payment systems within the Union and between the Union and other countries.³⁵

³¹ Bank of England, *Financial Stability Report*, (Dec 2010) p. 57.

³² Indeed, the Bank of England observed that '[f]rom a risk perspective, not-for-profit, user-owned CCPs provide strong incentives for effective risk management.' Ibid.

³³ A related issue is whether Basel III should require banks to hold more regulatory capital against positions held in a CCP with a shareholder-ownership for profit business model, as opposed to holding less capital against positions in CCPs that are run as user-owned utility-type structures (Bank of England, 2010).

³⁴ Art 127 (2) (TFEU) – fourth indent.

³⁵ Article 22 of the Statute of ESCB provides : 'The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure the efficient and sound clearing and payment systems within the Community and with other countries.' See Alexander et al (2005) p. 122 and p. 282.

Based on these treaty powers, the ECB has proposed that EMIR be amended so that the ESCB's role in exercising oversight of EU clearing systems is recognised and that it has joint authority with ESMA to review and approve regulations of CCPs and the infrastructure of clearing within the EU, and with ESMA to recognise the laws and regulations of third country clearing systems as a condition for allowing third country CCPs into the EU market.³⁶ In addition to the ESCB's responsibility for the smooth operation of payment systems, the ECB argues that the ESCB's responsibility 'to implement the monetary policy of the Union' in Article 127 (2) indent 1 (also provided in Article 3.3 of the Statute of the ESCB) depends on its ability to promote the smooth operation of clearing and settlement systems and infrastructures and therefore is a basic task of the Eurosystem.³⁷ The ECB also observes national central banks whose currency is not the euro would also have similar powers to oversee clearing and related infrastructure as the ECB would have in acting through the National Central Banks of the Eurosystem.

On the other hand, the ESCB's oversight authority over clearing may lead central banks and in particular the ECB operating through the Eurosystem to engage in supervisory oversight of CCPs, which are in many EU states authorised credit institutions, which cannot be subject to direct 'prudential supervision' by the ECB unless there is unanimous consent by the Council of Ministers.³⁸ This raises important issues regarding the scope of the ESCB's oversight of the EU clearing system and when does the scope of its oversight of the clearing and payment systems overlap with Member States' prudential supervision of CCPs. Generally, however, it would appear that the ESCB would have a strong claim as a legal matter to be involved in the oversight of the clearing system. Accordingly, the Commission may want to consider appropriate amendments to EMIR to recognise the ESCB's role in this area.

³⁶ See discussion in section 2.1 about the ECB's proposal for a reciprocity requirement for third country jurisdictions.

³⁷ See ECB Opinion of 13 January 2011 (Con/2011/1), p. 2.

³⁸ Art 127 (6) TFEU provides in relevant part: 'The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions.'

CONCLUSION

CCPs enhance the efficient operation and stability of financial markets because they offer a framework that embraces mark-to-market valuation, collateralisation and monitoring of all positions on a daily basis, multilateral netting, mutualisation of risk, and a default fund. EMIR and the Dodd-Frank Act both require central clearing of OTC derivatives and securities-based derivatives and that they be recorded in trade repositories, while the Dodd-Frank Act requires that eligible OTC derivatives are traded on exchanges or electronic trading systems. These regulatory reform initiatives are designed to increase transparency and reduce systemic risk in the opaque OTC derivatives markets, which was widely regarded as having exacerbated the financial crisis. This report examines the EU and US regulatory reform proposals for the OTC derivatives market regarding the regulation of CCPs and how their regulation can potentially create market access problems for CCPs based in third countries seeking access to EU financial markets. EMIR delegates to ESMA the authority to recognise a third country jurisdiction's laws and regulations as equivalent to EMIR in order to grant a CCP based in that jurisdiction access to the EU market. Although there are presently differences in some of the regulatory requirements for CCPs between EMIR and Dodd-Frank, most of these regulations remain under consultation and could be adopted and implemented in a way that would minimise any market access problems. Further, if ESMA exercises its authority to recognise third country regulations as equivalent in a reasonable manner there should be no market access problems with respect to CCPs established in third countries, such as the US, with robust regulatory requirements. Finally, Article 23 EMIR does not violate the EU's commitments under the WTO GATS, but the ECB's proposed amendment to Article 23 requiring a reciprocity test could possibly violate the EU's trade obligations under the GATS and bilateral trade agreements. Further, the ECB's proposal that EMIR be amended to take account of the ESCB's oversight responsibility in EU securities clearing and settlement systems is a reasonable interpretation of the ESCB's treaty powers the implementation of which can be adopted by amendment of the Regulation and implemented in coordination with ESMA.

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**SOLUTIONS TO REGULATORY DIFFERENCES BETWEEN THE
US DODD FRANK ACT AND THE EUROPEAN COMMISSION'S
PROPOSAL, IN PARTICULAR IN ENSURING EQUAL
CONDITIONS FOR MARKET ACCESS FOR EU-CCPS AND
THIRD COUNTRY CCPS**

NOTE

by Peter O. MÜLBERT

Abstract

The briefing paper discusses solutions to conflicts in (transatlantic) cross-border situations between the draft Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories, and the US regime established by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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EXECUTIVE SUMMARY

European and US financial reforms aiming to comprehensively regulate OTC derivatives, respectively the European Market Infrastructure Regulation (“EMIR”), and the Dodd-Frank Wall Street Reform and Consumer Protection Act, broadly share the same goals with respect to derivatives, such as mandatory trading on exchanges, central clearing, and reporting to trade repositories. Although the European Commission explicitly aims to achieve regulatory consistency with US law, some differences have emerged. Although there are a number of technical differences between the two regimes, which will affect the obligations of counterparties in each respective jurisdiction, this paper focuses primarily on those differences, which will have a bearing on transatlantic transactions. With respect to potential conflicts between US and EU law affecting such transactions, three areas of regulation are of particular interest.

Firstly, the potential ambiguity arising from a dual EU/US clearing obligation is possible if each party falls under the gambit of their respective home regulations. A solution to this problem would be to allow parties in such circumstances to choose a CCP even though such a unilateral opening for (transatlantic) cross-border situations, i.e. an opening solely on the part of the EU, would act to the advantage of US CCPs. Hence, in order to guarantee a level playing-field and to uphold the principle of reciprocity, the option to choose a CCP in cross-border transactions could be granted for a limited time-period only, i.e. the pertinent provision could take the shape of a transitional rule.

Secondly, Article 23 of EMIR provides for the liberal recognition of third-country (e.g. non-EU) CCPs, while it is not clear how liberally US regulatory authorities will recognise non-US CCPs. In order to ensure the principle of reciprocity vis-à-vis third countries, the EMIR should provide for a more differentiated dual-track regime

- the slightly amended recognition procedure contained in Article 23, and
- an authorisation and supervision regime that is comparable to the regime for CCPs established in the EU.

In particular, Article 23(2) should be amended by inserting the following additional condition for authorization:

“the Commission has adopted a decision that the conditions for authorisation/recognition of a CCP established in the EU are similar to those stipulated by Article 23”.

The alternative regime should primarily be geared towards equal treatment of EU CCPs and CCPs from third countries. However, for the purpose of determining a competent authority of an EU Member State for authorization and supervision, the third-country CCP should be able to choose a Member State as its home Member State. Moreover, the Commission should be empowered to grant exemptions from the requirements set out in the EMIR provided that the third-country CCP is subject to comparable requirements in its home country.

Finally, differences between the requirements of each regulatory regime creates the likelihood of counterparties to a derivative contract will face a dual EU/US reporting obligation. With this problem in mind, the EU should consider requiring such counterparties – and even counterparties in general - to report to the same repository to the extent feasible, in order to ensure the accuracy of the information reported and published.

1. INTRODUCTION

The regulatory regimes for OTC derivatives established by the European Commission's Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories,³⁹ known as the European Market Infrastructure Regulation ("EMIR"), and Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, officially designated as "Wall Street Transparency and Accountability Act of 2010"⁴⁰, differ in many respects.

In part, these differences result from a difference in the scope of the topics covered. The Wall Street Transparency and Accountability Act of 2010 aims at dealing comprehensively with OTC derivatives by amending existing US law, in particular the Commodity Exchange Act and the Securities Exchange Act. In contrast, the European Market Infrastructure Regulation provides for an additional set of rules alongside existing EU law, e.g., the MiFID.

Still, for two interrelated reasons, at least, differences are much less pronounced than could be expected. First, both the EMIR and the Wall Street Transparency and Accountability Act of 2010 implement the G-20 leaders' agreement regarding OTC derivatives reached at the Pittsburgh summit that

"[a]ll standardised OTC derivatives should be traded on exchanges or electronic platforms, where appropriate, and cleared through central counterparties [...]. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements".⁴¹

Second, the Commission participated in various international fora, such as the OTC Derivatives Regulators Group and the Basel Committee's Risk Management and Modelling Group, and has engaged in frequent dialogue with non-EU authorities, in particular US authorities (the CFTC, the SEC, the Federal Reserve Bank of New York and the Federal Reserve Board and the US Congress).⁴²

Against this backdrop, the next chapter (2.) outlines in a summary fashion the existing differences between the two regulatory regimes. Despite the Commission's intention to achieve and maintain consistency with the US regulation, some major differences emerge, while, at a more detailed level, differences even abound. However, for the purpose of this briefing paper, only those differences are of interest that impact on (transatlantic) cross-border transactions or, more generally, on (transatlantic) cross-border business activities. From that point of view, difficulties result not only from differences between the two sets of regulations but also from the fact that the rules on the international (extraterritorial) application of the two regimes are rather similar. Hence, the remaining three chapters (3.-5.) discuss these problems as well as Article 23 of the EMIR.

³⁹ COM(2010)484 final.

⁴⁰ See Sect. 701. Title VII comprises Sect. 701 to Sect. 774.

⁴¹ See COM(2010)484 final, p. 2. See also Recital 5 of the Proposal.

⁴² See COM(2010)484 final, p. 4.

2. (MINOR) DIFFERENCES BETWEEN THE TWO SETS OF REGULATIONS

In line with the Commission's focus on consistency vis-à-vis the US regime, the Commission claims consistency with the recently adopted US legislation on OTC derivatives, Wall Street Transparency and Accountability Act of 2010. According to the Commission,

"[t]he Act has a broadly identical scope of application. It contains similar provisions requiring the reporting of OTC derivatives contracts and the clearing of ligible contracts. Furthermore, it puts in place strict capital and collateral requirements for OTC derivatives that remain bilaterally cleared. Finally, it puts in place a regulatory framework for trade repositories and upgrades the existing framework for CCPs. Similarly to the Commission's proposal, the Act foresees the further elaboration of a number of technical rules".⁴³

Analyses undertaken by third parties, e.g. market participants and law firms, corroborate the Commission's assessment. For example, a publication of November 2010⁴⁴ concluded that the draft EMIR is broadly similar in many respect to the reforms adopted in the US under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Wall Street Transparency and Accountability Act of 2010, when fully effective, will make sweeping changes to OTC derivatives markets in the US and to participants in those markets. Depending on how they are implemented, EMIR and other European legislative proposals are likely to have a similar effect in the European markets.

In slightly more detail, the publication offers the following overall assessment regarding *key similarities*

- Mandatory clearing for standardized contracts
- Very broad scope of derivatives covered⁴⁵
- Exemptions from clearing for end-users
- Reporting of cleared and OTC transactions by (nearly) all financial counterparties

and *key differences*

- Clearing organization ownership rules
- Mandatory exchange trading requirements provided for by Dodd-Frank but being considered separately by the European Commission
- The "Volcker Rule" - restrictions on bank proprietary trading not adopted at the EU level
- Swaps "push-out" rule (swaps business in a separate entity from banking) not adopted at the EU level.

⁴³ See COM(2010)484final, p. 3.

⁴⁴ Shearman & Sterling, Proposed US and EU Derivatives Regulations : How they Compare, of November 10, 2010 (at <http://www.shearman.com/proposed-us-and-eu-derivatives-regulations--how-they-compare-11-10-2010/>). See also Derivatives Reform: Comparison of Title VII of the Dodd-Frank Act to International Legislation, Prepared by CFTC Staff for the Global Markets Advisory Committee, of October 5, 2010 (at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/gmac_100510-cftc2.pdf).

⁴⁵ The EMIR covers all OTC-traded derivative contracts set out in Annex I Section C numbers (4) to (10) of Directive 204/39 (Article 1(1)). Not covered are spot foreign exchange transactions and, in principle, commercial forward transactions (it should be noted that the reference in Article 1(1) to Annex I Section C number (6) is misleading since, for the purpose of the MiFID, these instruments are only covered "provided that they are traded on a regulated market and/or an MTF). The Wall Street Transparency and Accountability Act of 2010 covers swaps, options (other than options on futures) and security-based swaps (including mixed swaps); foreign exchange swaps and forwards may be excluded.

In addition, for the purpose of the present briefing paper, three more elements are of interest, namely the following

key similarities

- Regarding the extraterritorial application of the clearing requirement, the EMIR and the US rules basically follow the same approach: the requirement to clear an eligible contract with a registered EU-CCP applies if one of the parties to such contract is a EU-established entity that falls within the ambit of the Regulation. The US regime operates roughly the same way.
- Regarding the extraterritorial application of the reporting requirement, the EMIR and the US rules basically follow the same approach: the requirement to report a non-eligible contract to a trade repository applies if one of the parties to such contract is a EU-established entity that falls within the ambit of the Regulation. The US regime operates roughly the same way.

and key differences

- The EU clearing exemption for non-financial counterparties is threshold-based whereas the US approach has exclusions for particular behaviours
- Non-EU CCPs can (only) apply to be recognized as a CCP by ESMA pursuant to Article 23 of the EMIR whereas non-US CCPs, without being entitled to choose, will either be recognized by US authorities in a simplified procedure or have to register with US authorities along with US CCPs.
- US requirements do not specifically provide for the recognition of non-US trade repositories (in contrast to the possibility of recognising non-US CCPs).

3. DUAL EU/US CLEARING OBLIGATION

Counterparties to a derivative contract that are subject to two different clearing obligations face a dilemma. Given the draft EMIR, such a dual clearing requirement could apply if the counterparties are a EU-established entity and a US person.

3.1. The clearing obligation stipulated by the EMIR

The clearing obligation stipulated by the EMIR kicks in if, at least, two elements are present:

- the contract is an eligible derivatives contract (Article 4), and
- a counterparty to the contract is a financial counterparty (Article 2(6)) or a non-financial counterparty that takes positions in OTC derivatives contracts exceeding the clearing threshold (Article 7(2)).

Whether and, if yes, to what extent the quality of the other counterparty (as a third element) is of any relevance for the clearing obligation to kick in is unclear. Even though the problem does not bear directly on the issues discussed here, it seems worthwhile to elaborate somewhat on this rather fundamental ambiguity:

- On the one hand, the clearing obligation for financial counterparties stipulated by Article 3(1)(1) applies only with respect to eligible derivative contracts with other financial counterparties. On the other hand, the clearing obligation for certain non-financial counterparties stipulated by Article 7(2) applies regardless of the quality of the other counterparty. In the same vein, Article 3(1)(2) provides for a clearing obligation of financial counterparties and certain non-financial counterparties with respect to contracts with third country entities, i.e., non-EU-established entities, regardless of the quality of such entity. Hence, at first glance, the reference in Article 3(1)(1) to “other financial counterparties” appears to be misleading and should be deleted.
- The interpretation is less straightforward, if Article 3(2) is taken into account, as well. The provision stipulates that, for the purpose of complying with the clearing obligation, financial counterparties and the non-financial counterparties referred to in Article 7(2) shall become either a clearing member or a client. However, since clearing requires that both counterparties are a member of the same CCP or, at least, are a client of such member, the application of the clearing requirement to eligible derivatives contracts with all non-financial counterparties would – in practice, not by law – require all counterparties to adhere to a CCP, either as a clearing member or as a client.
- The upshot is that Article 3(1) and Article 7(2) should be clarified to reflect the proper scope of the clearing obligation. The reference in Article 3(1) first sentence to “other financial counterparties” should be amended by adding “or non-financial counterparties referred to in Article 7(2)”. In turn, Article 7(2) should be amended correspondingly.

Regarding cross-border situations in particular, the clearing obligation applies to all financial institutions established in the EU and to all non-financial counterparties established in the EU (Article 2(7)) irrespective of whether the other counterparty is also a EU entity or not (e.g. a US person). As just noted, Article 3(1) second sentence explicitly mandates such far-reaching international application of the clearing obligation.

3.2. The clearing obligation stipulated by the Wall Street Transparency and Accountability Act of 2010

The Wall Street Transparency and Accountability Act of 2010 provides for an all-out clearing requirement for those swap contracts and for those swap-based contracts that the CFTC and the SEC respectively have determined as “required to clear” (Section 723(a)(3) and Section 763(a)).

Exceptions to the clearing requirement are available if one of the counterparties to the (security-based) swap

- is not a financial entity,
- is using (security-based) swaps to hedge or mitigate commercial risks, and
- notifies the Commission on how it generally meets its financial obligations associated with entering into non-cleared (security-based) swaps.

The Act does not provide for provisions similar to Article 3(2) of the EMIR, i.e. provisions that explicitly determine whether a US person is subject to the clearing obligation if she or he enters into a (securities-based) swap that is determined “required to clear” with a non-US person. Commentators have pointed out that the Dodd-Frank Act applies to activities outside the US that have a “direct and significant connection with activities in, or effect on, commerce of the United States” and hence, in practice, this will likely mean that non-US persons dealing with US persons in (swap-based) swaps will become subject to the requirements of the Act, unless an exemption can be obtained.⁴⁶

However, for present purposes, it does not matter whether that interpretation holds true or whether the extraterritorial application of the clearing requirement is less broad. Even if the non-US counterparty were not be subject to the clearing obligation, the US entity would still be required to submit the (securities-based) swap for clearing to a derivatives clearing organization that is registered under the Commodity Exchange Act and a clearing agency that is registered under the Securities Exchange Act, respectively, or that is exempt from registration.

3.3. Possible Solutions

The upshot of the preceding discussion is that the clearing obligation stipulated by the EMIR as well as the clearing obligation introduced by the Wall Street Transparency and Accountability Act of 2010 can apply if a derivative contract between a EU counterparty and a US counterparty is an eligible contract in the sense of Article 4 of the EMIR and also a (security-based) swap determined “required to clear”.

To be sure, unless the US clearing requirement finds an extensively extraterritorial application, in legal terms, both counterparties to the contract are only subject to one clearing obligation each: the EU entity to the obligation stipulated by the EMIR and the US person to the one introduced by the Wall Street Transparency and Accountability Act of 2010. In practical terms, however, both counterparties face a potential dilemma. The EU counterparty has to clear the contract with a relevant CCP established in the EU (Article 10(1)) unless a relevant third-country CCP has been recognised pursuant to Article 23 of the EMIR.

⁴⁶ Shearman & Sterling, Proposed US and EU Derivatives Regulations : How they Compare, of November 10, 2010, p. 14 (at <http://www.shearman.com/proposed-us-and-eu-derivatives-regulations--how-they-compare-11-10-2010/>).

Conversely, the US counterparty has to clear the (security-based) swap with a registered derivatives clearing organization and a registered clearing agency, respectively unless a relevant third-country organization/agency has been exempted from registration.

Hence, a possible solution would be to lower the requirements of Article 23 for the recognition of US CCPs even further. However, this would contravene all efforts at ensuring a level-playing field for EU CCPs and US CCPs. Moreover, the counterparties to an eligible derivative contract would still face an insoluble dilemma as long as the recognition of a relevant US CCP in the EU is pending.

The superior solution is to allow counterparties that are subject to conflicting clearing obligations to choose the relevant CCP they use for complying with their clearing obligations. Both the EMIR and the regime introduced by the Wall Street Transparency and Accountability Act of 2010 are familiar with the idea that the counterparties may choose among several relevant CCPs.

Admittedly, such a unilateral opening for (transatlantic) cross-border situations would still act to the advantage of US CCPs even though US CCPs would benefit far less from such an option than from a across the board-lowering of the requirements stipulated by Article 23 for the recognition of third-country CCPs. Still, in order to guarantee a level playing-field and to uphold the principle of reciprocity, the option to choose a CCP in cross-border transactions could be granted for a limited time-period only, i.e. the pertinent provision could take the shape of a transitional rule.

4. ARTICLE 23 OF THE EMIR

The EU recognition process for third-country CCPs provided for by Article 23 of the EMIR is non-demanding and will facilitate access by third-country CCPs to the EU under a simple blanket EU-wide approach. In essence, recognition is subject to the following conditions:

- determination from the Commission that the legal and supervisory arrangements applicable to CCPs in the third country ensure that those CCPs are subject to legally binding requirements equivalent to requirements resulting from the EU regulation, and that CCPs are subject to supervision and enforcement in that third country on an ongoing basis;
- determination that the CCP is authorized in and subject to effective supervision in the third country;
- establishment between ESMA and the relevant competent authorities of the third country of cooperation arrangements ensuring a mechanism for exchange of information and procedures concerning the coordination of supervisory activities.

The approach in the US, in contrast, leaves the regulator with discretion as to whether to recognize or require registration for third-country CCPs. The pertinent provisions introduced by the Wall Street Transparency and Accountability Act of 2010 permit - but do not require - the CFTC/SEC to exempt from CFTC/SEC registration and supervision a foreign regulated CCP that is comparably regulated (Sections 725, 763). In contrast, the current wording of Article 23 requires the relevant single EU regulator, ESMA, to exempt the third-country from EU registration and supervision and thereby adopt a more open recognition process.

In order to ensure the principle of reciprocity vis-à-vis third countries, the EMIR should provide for a more differentiated dual-track regime

- the slightly amended recognition procedure contained in Article 23, and
- an authorization and supervision regime that is comparable to the regime for CCPs established in the EU.

The recognition procedure provided for by Article 23 deems adequate if a third country subjects EU-CCPs to a similar non-demanding recognition or authorization process. Whether this condition is met is to be determined by the Commission. Hence, Article 23(2) should be amended by inserting the following additional condition for authorisation:

"the Commission has adopted a decision that the conditions for authorization/recognition of a CCP established in the EU are similar to those stipulated by Article 23".

The alternative regime should primarily be geared towards equal treatment of EU CCPs and CCPs from third countries while, indirectly, this approach will also ensure some degree of reciprocity. As a starting point, third-country CCPs should be subject to the same conditions for and procedures of authorisation that apply for EU CCPs. Moreover, third-country CCPs should be subject to the same standards of continuous supervision and oversight as EU CCPs. However, two deviations from the regime for EU-established CCPs should be provided for:

- First, for the purpose of determining a competent authority of an EU Member State for authorisation and supervision, the third-country CCP should be able to choose a Member State as its home Member State. Tasking ESMA with the authorization of third-country CCP would create a split between the two tasks "authorisation" and "supervision" that should be avoided.

Second, similar to the pertinent provisions introduced by the Wall Street Transparency and Accountability Act of 2010, the Commission should be empowered to grant exemptions from the requirements set out in the EMIR provided that the third-country CCP is subject to comparable requirements in its home country.

5. DUAL EU/US REPORTING OBLIGATION

With respect to the reporting obligation, i.e. the obligation to report all (cleared and non-cleared) derivative contracts to a trade repository, the problems resulting from a dual reporting obligation in (transatlantic) cross-border situations are somewhat different from the ones resulting from a dual clearing obligation.

To begin with, both the EMIR and the regime introduced by the Wall Street Transparency and Accountability Act of 2010 stipulate a reporting requirement for all derivative (swap) contracts covered. In more detail:

- The EU reporting regime obliges all financial counterparties to report the details of an OTC derivatives contract to a registered or a recognised trade repository. The counterparties to a contract are not required to report to the same trade repository even though one of the two counterparties may delegate the reporting to the other counterparty (Article 6(3)). Non-financial counterparties are subject to the reporting obligation only if they take positions in OTC derivatives contracts that exceed an information threshold (Section 7(1)). Whether such non-financial counterparty may also delegate the reporting to the other counterparty is unclear but should be admitted.
- In contrast, the US reporting regime requires both counterparties to report all (securities-based) swaps to a data repository whether cleared or non-cleared.

As a consequence, any derivatives contract covered by both regimes between a EU and a US counterparty triggers a reporting requirement both under the EMIR and the reporting regime introduced by the Wall Street Transparency and Accountability Act of 2010.

EU counterparties shall report to a registered trade repository, i.e. a trade repository that is a legal person established in the EU (Article 51(2)), or a third-country trade repository recognised by ESMA pursuant to Article 63. In contrast, US counterparties have to report to a data repository registered with the CFTC and the SEC, respectively. Rules on the possibility for recognising third-country trade repositories are not available.

As a consequence, dual reporting of a given derivatives contract between a EU and a US counterparty will necessarily occur unless a EU trade repository is also registered with the CFTC/SEC or if a US data repository is recognised by ESMA pursuant to Article 63 and – in addition – if both counterparties report to the same repository.

Obviously, the data collected and published by trade repositories will be misleading if dual reporting occurs. In order to ensure the accuracy and reliability of the data it is worth considering a requirement that counterparties to a derivatives contract – if legally admissible and to the extent possible - report to the same trade repository (if several trade repositories exist).

ISSUES POSED BY THE APPLICATION OF A REGULATION DESIGNED FOR FINANCIAL INSTITUTIONS TO CORPORATES

NOTE
by Mr Achim KASSOW

Abstract

Article 7 of the proposed regulation on OTC derivatives, central counterparties and trade repositories opens the potential for non-financial users of OTC derivatives to come under the scope of a regulatory framework primarily designed for financial institutions. This paper explores the potential implications for corporate end-users of derivatives and the additional infrastructure requirements market participants would have to deal with in order to comply with a more comprehensive reporting of trading activity. It argues for respecting the structural differences among users of OTC contracts and for thresholds to be formulated based on actual market risk rather than to rely on notional based thresholds.

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EXECUTIVE SUMMARY

This briefing addresses open points raised by Article 7 of the proposed CCP Regulation. It proposes measures to avoid unintended consequences arising from applying regulation originally and primarily designed for financial institutions to non-financial corporates. Corporate users of financial instruments, even where frequent users, are often ill equipped to satisfy liquidity requirements resulting from extensive use of collateral due to the significant differences in their asset structure and less scope to profit from netting. There are also significant operational hurdles to fully integrate non-financials into the financial infrastructure. While major banks are far down the road of standardised trading and clearing, the proposed framework constitutes a challenge already for the systems of many other financial institutions. A broad application of the requirement to process transactions in trade repositories requires significant additional investments in infrastructure on the part of corporates, banks and existing service providers. This includes the development of open standards to describe transactions, ways to uniquely identify market participants and protocols for the secure transmission and storage of trade information.

Fully collateralised clearing through a central counter party (CCP) significantly affects the liquidity and competitive situation of non-financial corporates. Differentiation of the treatment for trading activity depending on a classification as commercial or speculative poses an operational challenge. Summary declarations of intent and the involvement of relationship banks to bridge infrastructure gaps will be required. At the same time, a possible outcome of the current developments is an increased concentration of trading activity on the largest and most highly rated international banks with competitive advantages in collateral management and accessing liquidity. Considering that incentives at these institutions, which may not face the same regulatory requirements as their European counterparts, are usually aligned to maximise trading activity, an increase in economic risk may result from a stronger decoupling of the trading activities of corporates from their broader banking relationship.

The proposed regulation leaves significant room for interpretation and evolution. The introduction to the proposal emphasises the focus on financial stability and the desire to exempt commercially motivated activities of non-financial companies. Given this statement the imposition of CCP clearing requirements should be a rare event and warrants a case by case analysis rather than a reliance on fixed thresholds. A general drive to improve available data and the exact formulation of the conditions under which non-financial companies fall under the scope of Article 7 may still yet result in tens of thousands of corporate users of derivatives to be directly affected by the regulatory process.

Given the paucity of existing data, the establishment of an efficient clearing system covering the primary participants in a given class of OTC products should be a necessary condition before rules can be formulated to enforce participation of secondary participants. Established members of clearing houses will have to play a pivotal role in facilitating access to clearing for their clients and provide them with liquidity transformation services as well as assist them in satisfying reporting requirements.

1. BACKGROUND AND INTRODUCTION

Article 7 of the proposed EC Regulation on OTC Derivatives, Central Counterparties and Trade Repositories⁴⁷ (“CCP Regulation”) intends to require non-financial users of OTC derivatives to provide regulators with detailed information on their trading activities and to force them to participate in central counterparty (CCP) clearing systems. This proposed legislation is part of a wider drive to prevent financial markets from negatively affecting growth, as laid out most recently in the Commission’s communication on the regulation of financial services for sustainable growth (COM(2010) 301). The CCP Regulation re-enforces the efforts by recent proposals of the Basel Committee on Banking Supervision to reduce market-wide counterparty risk by making collateralisation the preferred way to manage the risk of OTC transactions.

In an idealistic economy, a host of economic actors engage in real-world economic activities and banks facilitate the flow of liquidity and credit. Economic realities in the third millennium cast doubt on the validity of a simple division of the world into “financial” and “non-financial”. The interactions and interdependencies between the two worlds have evolved significantly beyond the deposit-and-borrow relationship. Risks are increasingly transferred and shared between the two parts of the economic system. Still, differences persist: non-financial entities enjoy a comparatively larger degree of freedom in their economic decisions, including the option to stop doing hedging business altogether. Financial institutions continue to have easier access to liquidity but are subject to intense regulation due to their critical role in sustaining a largely credit-based economy.

In the aftermath of the crisis, corporates are increasingly facing a regulatory framework largely unfamiliar to them. While legislation like the proposed CCP Regulation represents only an incremental change for regulators and financial institutions, for non-financials it represents a paradigm shift. Simultaneously the regulatory focus expands from protecting consumers, investors and other market participants, to protecting the market per se with increasing uncertainty on the best course of action. While it is straightforward to ensure adequate disclosure of risk on corporate balance sheets and in financial product documentation, it is not quite as evident which steps benefit a given market or even the whole financial system, the latter being a wide and unspecific concept in its own right.

It is clearly a positive development when obligations of market participants are increasingly based on objective criteria describing the amount and type of risk their activities contribute to the risks borne by counterparties or even whole markets. Any steps to restore confidence and trust in markets and institutions are also to be welcomed. However in the transition to a new regime, special attention ought to be given to the potential results of applying rules and concepts developed for financial institutions over several decades to unprepared non-financial corporates.

⁴⁷ COM(2010)484 of 15 September 2010, see http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm.

2. OTC TRANSACTIONS – RISKS AND REMEDIES

This section sets out the core principles of over the counter (OTC) transactions. It sums up the main sources of risk, and how netting, collateralisation and central counterparties help to reduce operational complexity and credit risk. It also points out the trade-off between credit risk in un-collateralised trading relationships and heightened liquidity risks in arrangements relying on the availability of eligible collateral.

2.1. Risks of OTC Trading

Over the counter (OTC) transactions in financial instruments conducted between two counterparties give rise to a number of risks. Apart from the market risk borne by each party, which is usually expected and priced, the largest risk is the ability of the other counterparty to perform its contractual obligations. Each party has a potential credit exposure to the other party. The amount at risk in derivative transactions is usually not the notional or reference amount but the mark-to-market value of a trade. Credit risk is therefore dynamic and the bearer of risk can change several times during the life of a transaction.

For exchange traded derivatives, daily settlement of valuation gains or losses in cash reduces the credit risk run by the central counterparty to close to zero. But where a transaction has been entered into in order to smooth cash-flows over a longer period of time (like in an interest rate swap) such an immediate settlement would thwart the purpose of the trade.

Operational risk - like inaccurate trade documentation or faulty trade documentation - may result in a transaction not having the desired economic effect. Standardised documentation, electronic straight through processing and auxiliary services like the reference entity database for credit derivatives and trade repositories facilitating the closure of trades have helped to reduce these risks in the last years.

Between financial institutions, there usually exist a large number of transactions giving rise to "credit" and "debit" positions on both sides. The relevant counterparty risk in such a situation is only the net amount owed, resulting from the valuation of all open positions. Even in a perfectly balanced relationship with a net zero exposure, it is likely that one counterparty defaulting on its obligations would result in some losses on the other side as trades need to be re-established with a new counterparty in order to maintain the desired overall risk positions.

Netting is by far the most important tool to reduce the complexity of trading relationships and to allow a satisfying resolution of trades in a default scenario. Market standard agreements like the ISDA Master Agreement allow netting in a number of situations. To be effective in a default scenario though, where netting may come in conflict with bankruptcy procedures, the concept requires backup in legislation. This has happened in most countries with a developed financial system. In the EU, the Directive on contractual netting (96/10/EC) first recognised netting for the calculation of risk capital. Further milestones were the Directive on Settlement Finality in Payment Systems (98/26/EC) and of course the Capital Requirements Directive (2006/48/EC and 2006/49/EC).

Because of the contingent credit risk in OTC transactions, entering into a position with a counterparty is subject to credit checks similar to those performed when granting traditional loans. Compared to a simple cash credit, OTC trade credit is more complex. The possibility that the market risk born by the counterparty could cause its insolvency has to be considered in addition to exogenous credit risks.

In the context of financial market stability, the default of a systemically important market participant could result in significant economic losses to many other market participants, which could either trigger or aggravate a financial crisis as such an event is likely to erode the confidence in financial mechanisms which is the critical ingredient to the functioning of any financial system ultimately relying on credit.

In assessing the role of an individual market participant as a source of systematic risk it is useful to contrast the case of Lehman Brothers with that of AIG. Lehman's had been a major counterparty in many derivative markets. In interest rate swaps alone it accounted for a notional value of 9,000bn USD in over 66,000 trades⁴⁸. Lehman's default clearly caused major issues – but losses to OTC counterparties resulting from its default were contained as the net exposure was significantly smaller. No major defaults occurred as a consequence of its role in the derivative market. A default by AIG, on the other hand, would likely have resulted in multi-billion losses at a number of bank counterparties and therefore caused wider systematic problems. The difference was that it acted as the *de-facto* ultimate risk taker in a large number of trades while Lehman's had taken a comparatively limited amount of active risk and had largely acted as a middle-man for others.

In summary,

- OTC transactions can give rise to credit risk in addition to market risk.
- Netting reduces operational complexity and settlement risks following a default.
- A single counterparty is most likely to become a source of systemic risk where it acts as the anchor – *i.e.* the ultimate risk taker – to large parts of the market. In such a situation a high correlation between a situation of market stress and a likely default of such a market participant would have to be assumed.

2.2. Risk mitigation through collateralisation and central clearing

Posting collateral, *i.e.* transferring cash, securities or other assets to the counterparty mitigates the residual credit risk. Shortfalls after netting all transactions can hopefully be satisfied from liquidating the collateral. Compared to daily cash settlement this has the advantage that less liquid assets can be pledged as collateral.

In recognition of potential liquidity issues, the range of assets which can be used as collateral has expanded over the years. Collateral agreements need to confer the effective ownership of an asset to the collateral taker, while at the same time ensuring that collateral can be included in an overall close out. In principle, banks can utilise large parts of the assets on their balance sheets as collateral, including loans. Nevertheless, in practice the most important collateral besides cash remains short dated government bonds, despite their relatively high price volatility when compared to other liquid and secure possible forms of collateral, like covered bonds.

Ideally, the collateral is placed not with the original counterparty, where extraction of initial margins can become an issue in default proceedings, but with a bankruptcy remote entity. Apart from largely removing credit risk, clearing trades through a CCP also has the additional advantage to allow netting of trades done with different counterparties. These considerations, further incentivised by capital adequacy guidelines, have led to industry-led initiatives for the development and adoption of CCP solutions for Interest Rate Swaps (IRS) and Credit Default Swaps (CDS).

⁴⁸ Source: LCH.Clearnet.

Over the last decade, collateralisation and central clearing has become the “gold standard” for regulators when it comes to mitigate credit risk and stabilise markets. Collateral agreements, like netting, have received legislative support in order to be “effective” in the face of national insolvency laws. In the EU, this has happened in the above mentioned directive 98/26/EC, and was further refined in the Directive on Financial Collateral Arrangements (2002/47/EC).

The present proposed CCP Regulation hopes to achieve a significantly higher degree of market stability through the enforcement of collateralisation and central counterparty clearing wherever possible. While largely eliminating credit risk for the bulk of OTC business, liquidity risk has the potential to become a destabilising factor.

Another risk to be weighted against the desired positive effects of universal CCP clearing is the reduced effectiveness of netting across asset classes when each derivative class is cleared through a specialised CCP. Where there is competition between different CCPs for a given OTC category within or outside the EU, the loss in netting efficiency – and associated increase in liquidity requirements – will even be more noticeable.

2.3. Liquidity risk as a consequence of CCP clearing

Less liquid collateral is provided in place of cash; avoiding the need to raise additional funds in the credit markets and incur the associated interest costs, in addition to the risk of being denied credit should credit limits be exceeded.

Using collateral alone does not eliminate risk: not only can the value of collateral change, but it can fall while credit exposure increases. Along with the potential of a derivative liability to bankrupt an imprudent user, this aspect gives rise to a correlation between market risk and credit risk, both on a micro and macro level.

Where a counterparty to a bilateral collateral agreement receives illiquid collateral, but has to post more liquid securities (like government bonds or cash) to another counterparty, like a central clearing house, the transaction assumes the character of a liquidity swap. For the intermediary this creates the risk of not being able to source enough CCP eligible collateral in a market stress situation despite having received notionally enough collateral from the original trade counterparty.

Collateral requirements of clearing houses differ from those used in bilateral agreements, as generally only highly liquid and default remote securities are accepted – cash, government bonds and occasionally precious metals. Less liquid or more risky securities are subject to significant haircuts.

When CCP clearing becomes the norm, prime collateral or cash will become a necessary ingredient to almost every financial transaction. Additional demand results from the requirement to post initial margins. The implementation of currently proposed regulation is estimated to result in a demand of roughly 50bn EUR in additional margins⁴⁹.

In market stress situations it is likely that prime collateral will be hoarded and the normal “recycling” of collateral through repo⁵⁰ arrangements will no longer work as normal. Apart from price distortions, liquidity and market depth will be reduced not just in cash but also in derivative markets.

Paradoxically, a reliance on high quality collateral may thus result in a systemic liquidity crisis as a number of market participants may find themselves in a situation similar to that faced by Lehman’s in September 2008, in particular where collateral requirements are linked to the credit quality of a counterparty, thus strengthening the correlation. For intermediaries providing liquidity transformation services to clients this could result in financing issues despite a theoretically risk neutral and fully collateralised trading position.

⁴⁹ ‘Let’s post collateral’, Stangl et al, Commerzbank Research, 18 November 2010.

⁵⁰ ‘Repo’ stands for “Repurchase Agreement”.

2.4. Differences between financial institutions and non-financial corporates

The discussion in 1.1 to 1.3 has mostly concentrated on banks. This is representative for the public debate at large, despite a recently increased focus on trading in non-financial products like emission allowances, electricity, commodities or even freight derivatives. It is also despite the fact that clearing houses have been operating in the commodity space for more than 100 years and also attract some OTC derivative activity in this area.

Most of the regulatory effort though has centred on financial products, where banks are the main players. Considering the need to protect in particular bank retail depositors and to maintain a free flow of funds within and credit to the economy, this focus is not overly surprising.

As the existing framework has been developed largely for and by financial institutions, the significant differences to non-financial corporates have to be considered before subjecting them to the same rules:

- Differences in asset structure

Non-financial enterprises have the vast majority of their assets in non-financial, illiquid assets. Generally, cash is unproductive capital and kept to the minimum required to satisfy ongoing payment obligations. Only a very limited number of corporates operate with a strategic liquidity reserve to manage a potential stress scenario. The underlying assumptions of financial regulation are that the majority of assets are financial, liquidity is always available – if necessary from the central bank – and that the primary role of capital and liquidity is to serve as a prudential buffer in order to protect creditors. These assumptions are usually not applicable to non-financial firms.

- Asymmetric exposure

Non-financial institutions often have one-sided exposure in a given market, as they are aiming to offset risks from their commercial activities. In an analysis purely focusing on financial instruments they will therefore frequently be found at the end point of a chain of transactions, either as ultimate risk taker or ultimate buyer of protection. Netting therefore provides little relief to them.

- Trading activity is primarily motivated by hedging considerations

The overwhelming reason for a corporate to enter into a derivative transaction is to reduce earnings volatility and to smooth cash-flows over time. Marking-to-market is thus often counteracting the underlying rationale for a trade.

- Different accounting frameworks

Corporate users of derivatives usually regard derivatives differently from financial users. This includes issues of booking, internal documentation, economic context, etc. Frequently, accounting schemes will recast transactions in the context of an organisation. These cultural and operational differences make it difficult for most these users to provide ad-hoc reports on their positions, aggregate risk positions or details on individual trades. Considering that financial instrument profiles are meant to offset real-world risks, the view of aggregate risk from a corporate stand point will thus differ substantially from a purely financial view.

3. ISSUES IN IMPLEMENTING ARTICLE 7

Article 7 has left significant points for ESMA to clarify. Open issues are (i) a practical concept of how to assess the systemic risk of a counterparty, including the nature and level of thresholds, (ii) the exact scope of information requirements, (iii) the nature or disclosures required by way of “justifying” positions and guidance on how to delineate between positions commercially motivated and those not.

As a consequence of these intentionally vague points, a large number of corporate users of OTC derivatives are facing insecurity in how and if they should continue their hedging activities in the future, given the significant impact the clearing requirement in particular could have on their liquidity planning. Clarification in this area at an early stage thus seems warranted.

In practice, only a very small number of firms are likely to be classified as “systemically relevant”. A stronger emphasis should thus be placed on the individual evaluation of the role a company plays in OTC markets rather than focusing on thresholds. Generally, establishing concrete criteria will only make sense following the establishment of a working CCP system in a market segment capturing the primary market participants, since any criteria will have to be determined in terms of the share of net risk in a given market assumed by a counterparty rather than absolute numbers.

Depending on absolute risk and market developments, alternative outcomes should also be taken into consideration. Just because Article 7 opens the possibility to set thresholds, it needs not be a forgone conclusion that it has to be adopted for every OTC market, even where a central clearing facility exists. A market itself can be too small to pose a wider systemic risk. Benefits of clearing may also prove to be so compelling for each individual market participants that it can be safely assumed that all market participants of close to critical size would choose, or already have chosen, to avail themselves of the CCP facility. The possibility of zero thresholds also applies: where the infrastructure to report trades is easily accessible to all possible users of an OTC market, it may be the easiest and most efficient solution for all trades to be centrally reported and possibly even centrally cleared. This could also mean summary information on OTC activities of all non-financial counterparties being provided by financial institutions or CCPs to regulators.

3.1. Issues in measuring and assessing systemic risk

Establishing any kind of operational criteria for the purposes of Article 7 depends upon the availability of reliable and meaningful data to judge the systematic importance of a market and the role of individual participants within it. To a large extent, the data currently available does not provide a useful base for the assessment of how risks are distributed or how to identify a critical path in a transmission process culminating in a potential systemic crisis.

Among the available sources, information from CCPs is vastly more useful for arriving at a quantification of market risk than surveys based on notional amounts. This becomes apparent from the IRS and CDS markets. LCH.Clearnet, the primary CCP for IRS transactions, reports the total notional of interest rate swaps, where it acts as the central counterparty, at 248 trn USD as of November 2010⁵¹. Against this notional it holds less than 25 bn USD (or about 0.01%) in margins. Similarly, for the widely traded iTraxx Europe CDS contract, DTTC (another CCP) shows a total gross notional of 72 bn USD⁵², while the corresponding open interest shown on ICE Europe is just 9.2 bn EUR⁵³. The actual effect in terms of variation margin of a “2 standard deviation event” is thus just 45 mn EUR, or about 0.05% of the gross notional.

⁵¹ <http://www.lchclearnet.com/swaps/volumes/>.

⁵² <http://www.dtcc.com/>, Trade Information Warehouse Date week ending 10 December 2010.

⁵³ <https://www.theice.com/marketdata/>.

Thus, a necessary condition before formulating thresholds under Article 7 for a given market segment is an established and working CCP covering the primary market participants for the derivative class in question. This two-stage approach allowing for evidence based criteria also seems warranted as the application of the provisions rules of Article 7 could force non-financial corporates to undergo a change in business practice and processes with potentially significant effects on their competitive position vis-à-vis either domestic or international competitors facing a different regulatory environment.

A clearer statistical picture though is hardly the point of the regulation, but the identification and ultimately regulation of systemically relevant entities. In assessing the systemic relevance, total business volume relative to the average transaction volume of other market participants gives an initial indication of potential importance. Net risk assumed, measured e.g. as value at risk (VaR), again by comparison to other (presumably regulated) market participants will usually be a better gauge - although this metric neglects the possibility for a derivatives user to be perfectly risk neutral, but being the nexus to a large web of trades and hence operationally highly system relevant. Also, simple one-dimensional VaR measures neglect the non-linear nature of derivatives and different quality of transactions. Clearly, writing a call option has an entirely different quality from buying a call option where the risk is capped at the purchase price of the option – an identical delta of the two transactions notwithstanding.

A definition of systemic relevance has to be at the start of operational criteria to apply Article 7. Where a counterparty is the ultimate bearer of a risk, i.e. accepts a risk which is large compared to the premium received for it, for an unusually large number of counterparties or accounts for a large share of the total net risk traded in a market, there is a strong argument for re-directing trades to a CCP. Similarly, where an unusually large number of counterparties is connected to a non-financial counterparty and above average total risks are incurred, a higher systemic risk is likely.

The definition of “larger than average” relies on comparable data for existing regulated entities available to regulators through clearing houses, taking into consideration that the average non-financial enterprise is likely to have often a higher net risk compared to financial institutions due to the nature of many transactions hedging commercial risks outside the scope of the financial analysis.

3.2. Operational issues in monitoring thresholds

A reporting and monitoring regime has to answer the question of who is the source of which risk, i.e. whom to subject to stronger regulatory oversight. While simple in principle, several obstacles need to be overcome.

A straight-forward solution to the issue is to request, and to rely upon, individual users to hand in regular reports to the responsible agency detailing trades, positions, risks and the reason for all their trades. While simple, this approach ignores the idiosyncratic reporting frameworks at various companies discussed above. It also fails to identify non-reporters. As a rule – except for trading ventures dominated and usually set up by non-financials in the first place – corporate end users of OTC contracts, as well as smaller financial users, will rely on an intermediary with specialised systems to process trades and monitor risks.

It should thus be assumed that most reporting activity, in particular on a technical level, will be indirect, as provided for in Article 6(3), and aided by market counterparties who will frequently also be members of one or more clearing systems. In an indirect reporting framework, the issue of aggregating information gains particular prominence.

Identifying counterparties and actual risk takers

Establishing the identity of risk takers is the first operational hurdle. The name of a counterparty does not result in a satisfying mapping. Unrelated companies with identical names exist. Names are highly error prone – even in many in-house CRM (client relationship management) systems duplicate entries abound. Names, legal form and location of a company are also subject to constant change.

To complicate matters, the task at hand requires aggregation of information at a relevant level. Some businesses use separate legal entities for each of their locations – which can number in the hundreds in a single territory. A corporate active across the European Union and potentially globally is likely to conduct business out of a number of operational, holding and financing units – frequently with names unrelated to the ultimate corporate parent.

In short, identification of a counterparty requires the establishment and maintenance of a European directory of the users of OTC derivatives. Existing nomenclatures, like SWIFT identifiers for banks, VAT identifiers or central bank identifiers used for reporting significant loan positions may serve as starting points. But this needs to be augmented by establishing relationships among entities and identifying the ultimate risk taker. This does not necessarily need to be a parent or holding company: in the case of a fund management company it will actually usually be the individual fund.

An example for an audited framework used to identify not just the identity of an entity but also relationships relevant in the case of a bankruptcy – which is the underlying risk at question in the whole present discussion – is the Reference Entity Database (RED). RED has been developed to provide certainty about the entity actually referenced in a CDS transaction and currently maps about 5,000 entities. Based upon in-house data we estimate that eventually about 30,000 to 50,000 entities across Europe would have to be covered by a European OTC Risk Directory.

Reporting trades

Besides identifying the counterparties, information to be furnished to trade repositories comprises the description of the details of a transaction. There has to be sufficient information to allow the calculation of a risk charge at the level of a central counterparty. Where a transaction of a counterparty subject to the reporting requirements of the proposed regulation can not be processed by a trade repository, it has to be reported directly to the regulatory authority.

The issue of determining if a market (segment) is sufficiently standardised to allow for a CCP to be established seems to be closely related to the question if the details of a given transaction can be easily transmitted and processed. Practically, if the desired outcome is indeed to establish aggregate risk positions for markets and individual participants, and eventually across markets, a common language for the description of payoff schedules for derivative contracts will have to be developed. Such a language clearly benefits from the work done for CDS and IRS, but also from efforts related to the FIXML protocol used for trade reporting and other purposes.

In many of the few cases where the use of derivatives has led to problems for a user or even contributed to market instability, the inadequacy of internal and external risk control systems was to blame. By creating the possibility for effectively outsourcing this important function, a unified reporting standard for trade information could potentially turn out to be the biggest contribution of the proposed regulation to achieve a reduction of systemic risks.

Measuring and aggregating risks

Provided all transactions have been reported in an easy to process format and attributed to a uniquely identifiable risk-bearing entity, this still leaves the issue of arriving and aggregating risk positions. Establishing the market value of a transaction, the ability to subject this value to various risk scenarios and to gauge the degree to which other positions can provide risk reduction effects requires a sophisticated “risk engine”.

A trading repository does not imply automatically the existence of such a risk engine. Here, operational benefits can already be achieved at a much simpler level, e.g. from the aggregation and netting of fixed cash-flows. For the establishment of the margining framework needed for a CCP, a risk engine though is a necessary pre-condition. Without the existence of a CCP, regulators interested in aggregating and analysing risks already at the level of the trade repository, would either have to establish an own risk-engine or alternatively charge the trade repository to provide (or contract for) one.

The aggregation of risk not just within a single CCP (and thus derivatives class) but across multiple types of derivatives will pose additional challenges. At the moment this is not an urgent problem, as existing CCP clearing ventures are concentrating on classes of derivatives for which there is little to no risk offset, like between CDS and IRS. Establishing a CCP for FX transactions – potentially spanning FX forwards, FX basis trades and FX options – though is going to make this a relevant point given the interrelationships between FX products and interest rate curves in the two currencies referenced in a transaction. At this point, risk aggregation and cross margining is likely to become a focus topic.

3.3. Information threshold

Article 7 specifies that companies whose net exposure per class of derivative exceeds a threshold (to be determined taking into account their systemic relevance) become subject to the reporting requirements laid out in Article 6 for financial counterparties. This means reporting of all OTC derivative transactions on a t+1 basis into a trading repository, as well as novations and alternations to these transactions. For the purpose of both determining a breach of the information threshold, as well as for the reporting requirement the motivation for entering into the transactions in question is not relevant. An explanation has to be provided to the regulator upon breaching the information threshold though.

The main use of the information requirement appears to be to initiate a regulatory dialogue, and in particular to determine if the risks posed by a market participant are more than just temporary. Given the significant implementation costs, a full clearing requirement should be reserved for cases where the OTC activity is likely to remain at critical levels for a prolonged period of time. This regulatory holding pattern should not be indefinite: after two years at the latest should be possible to resolve the systemic risk status and either keep the counterparty under normal monitoring or enact other regulatory measures – just like in medicine, where expensive diagnostic techniques are usually not applied, when it makes no difference to the treatment.

A more practical solution to increasing market transparency and heightening general risk awareness may be a more general reporting requirement. For the majority of all OTC trading relationship the reporting regime introduced for rolling FX contracts at historical rates (HRR) in the early 1990s could serve as a blueprint. Here, the corporate declares the commercial intent of his activity and is informed about the implicit credit relationship. For all his OTC trades a corresponding declaration could be renewed every three years, and include the permission for banks to pass trade details on to a trade repository.

In addition, financial institutions may provide their counterparties with regular reports on the VaR and short-fall risk, i.e. the maximum amount of liquidity they may be required to source for fulfilling their contractual obligations. A derivative user without the system capabilities to continuously evaluate market risks can then easily aggregate the information and satisfy a summary reporting requirement. Moreover, financial counterparties could report their largest counterparty risks in an efficient manner, similar to current reporting obligations for large credit exposures.

Such a comprehensive but summary reporting requirement clearly constitutes a burden on banks and will most likely have cost implications for them and their counterparties. Nevertheless it seems to be a more efficient and overall cheaper reporting mechanism than to expect market participants without specialised reporting systems to evaluate their risks on an ongoing basis. Additionally it avoids issues certain to arise when an entity has to reach a full t+1 reporting requirement without any prior exposure to regulatory processes.

3.4. Clearing threshold

Article 7 stipulates that under certain circumstances a non-financial counterparty can become subject to the requirement to clear all its transactions through an established counterparty and otherwise to report its trading activity. The clearing requirement would only apply to transactions entered in circumstances not justified by underlying commercial activity – but be based on the total OTC activity of a counterparty. A sensible clearing requirement should cease if a corporation significantly and lastingly reduces its OTC activities, with similar observation periods as before the initial application of measures.

Given the possibility that only a small fraction of the bulk of transactions conducted by a company – and giving rise to the assessment of being systemically relevant – may thus actually be cleared, the effectiveness of the clearing requirement in reducing risk for the market seems questionable.

Where a default of a counterparty would have market-wide consequences, and imposing a clearing requirement on all (i.e. also commercially motivated) transactions has material negative effects, the existing regulatory instruments might have to be expanded to include capital adequacy criteria taking into account all available assets of an enterprise. While including firm specific properties defining the risk taking capacity of a corporation like size, asset structure or credit rating in the original assessment of systemic relevance seems neither practical nor helpful, these measures become more important when evaluating potential remedies.

Thus, the approach to assessing the net risk of non-financial counterparties appears to be more important than some numerical thresholds. Assessing the systemic risk posed by this net-exposure consequently also requires evaluating the effectiveness of the underlying business situation to mitigate the risk borne by counterparties of such a corporate.

This question is known from the context of IFRS hedge accounting, which stipulates that hedges must be “effective”. The underlying of this classification process is always a going concern assumption, without which the underlying commercial transactions may never happen. Even here though there is a crucial difference between a financial and non-financial entity. A bank going bankrupt ceases to be a bank. An industrial enterprise though more often than not continues to operate even when under insolvency proceedings and frequently re-emerges as a, usually somewhat leaner and less indebted, operation. The offsetting benefits to a derivative transaction thus may still be realised, even if in default. Given this greater inertia of non-financial corporates it seems justified to account for offsetting “real world” risks in the analysis of the total risk position amassed by a corporate.

For the purpose of fulfilling the clearing obligation, Article 3(2) calls for companies above the clearing threshold to either become a clearing member or a client. Practically, most market participants, including the majority of financial counterparties, required or choosing to participate in a CCP system will thus most likely do so as a client of an established member firm helping them to bridge the liquidity and infrastructure gap rather than becoming full members themselves. An exception to this rule are those cases where firms are producers or users of the underlying of an OTC transaction and where the physical delivery to satisfy obligations under the contract is more than just a theoretical possibility.

This indirect solution enables financial intermediaries to provide liquidity transformation services. A bank could for instance establish a lien on a power station as collateral for interest rate derivative obligations of an electricity provider and generate liquidity in a default scenario from auctioning this asset. Apart from the drawback of the above solution in not helping the bank in addressing its liquidity needs to satisfy obligations under offsetting transactions, it is difficult to imagine such collateral being accepted by a CCP.

Existing capital adequacy rules have clearly contributed to a trend to establish central settlement and clearing infrastructure among financial institutions and for a broader adoption of collateral arrangements. Proposals under Basel III are likely to make collateralisation and the use of central clearing even more attractive for a larger number of market participants. It is thus likely to be a rare occurrence for a market participant to become subject of the clearing requirement without already conducting a sizable part of its business over the mandated infrastructure.

3.5. Identifying commercially motivated trading positions

Article 7 exempts commercially motivated transactions from clearing requirements. Art 7(4) stipulates they should be “objectively measurable as directly linked to the commercial activity”. This definition is likely to exclude transactions designed as a “macro hedge” to counteract developments affecting the profitability of the commercial business of a firm, addressing many factors influencing input or output prices, but only indirectly.

Also excluded may be transactions designed to stabilise or improve financing conditions for the business. Generally these transactions will be diminishing the volatility of results or the asset position of the firm over the cycle. Financing costs also clearly enter a cost based calculation of output prices. As such, it can be argued that securing stable financing conditions is indeed directly linked to the commercial activity of an enterprise.

Accounting concepts like designated hedges for IFRS accounting are certainly helpful but are too narrow and subject to change resulting from considerations unrelated to those of financial market stability.

In practice the delineation will prove difficult, and as such it is sensible to decouple the assessment of systemic relevance from the motivation for trades. Still, the distinction may result in the adoption by corporates of the equivalent of a “banking book”, covering all commercially motivated trades and a “trading book” for transactions purely designed to create investment returns unrelated to commercial or financing activities. While attractive to the consulting profession, such a development is unlikely to yield significant benefits for market stability. A more differentiated set of regulatory measures mitigating the negative liquidity effects of a 100% clearing requirement and the restriction of an itemised classification to those cases would help to prevent the categorisation question from gaining undue importance.

CONCLUSION

The measures proposed in the CCP Regulation aim to minimise the exposure of financial markets to the credit risk of individual counterparties and to increase the transparency of OTC markets by emphasising collateralisation and the use of central counterparties. This reinforces developments undertaken by the industry in the last years to improve the technical and legal market infrastructure. As a result of these initiatives, derivative markets have continued to work largely normally during the recent financial crisis and have managed to deal efficiently with the default of a large and systemically important counterparty. The crisis though also made apparent that collateral requirements can contribute to a deterioration of the liquidity situation at some counterparties.

Liquidity considerations are gaining increased prominence when subjecting non-financial counterparties to a framework established for financial institutions that can utilise the majority of their assets as collateral and have direct access to money markets. A framework aiming to improve overall financial stability thus has to consider the relationship between credit risk and liquidity risk. The increased importance of prime quality collateral, in particular in a CCP framework, has the potential to expand the scope of financial regulation in controlling the leverage of the financial system to the whole economy and directly affect operational decisions in non-financial enterprises.

Extending financial regulatory measures to non-financial counterparties, whose use of OTC markets is largely in support of their commercial activities, should remain an extraordinary measure given the liquidity implications which can materially affect the competitive position of companies. The criteria for the application of the clearing requirement in particular should be made subject to an individual assessment of the amount and quality of risk posed by a given market participant, where the information requirements stipulated in Article 7 should give the opportunity to decide on the appropriate regulatory course of action. For identification of potential sources of systemic risk a more general, though indirect, risk focused reporting requirement may be considered. Further development of infrastructure to facilitate standardised reporting of trade and risk information will be required to efficiently monitor these criteria. Criteria will largely have to be formulated relative to total market risks and large primary participants in OTC markets. Establishing a working CCP framework therefore is a necessary first step before extending requirements to secondary market participants.

Financial firms - and full CCP members in particular - will have to play a crucial role in mitigating the impact on the liquidity requirements of non-financial market participants resulting from an increased focus on documenting and collateralising OTC trades, independently from if they are done with a central counterparty or bilaterally. They will also have to provide non financial firms with support in order for them to satisfy their reporting requirements, considering the vast majority of non-financial users are not equipped to provide a flow of trade information in standardised formats or to provide high frequency reports on their total active and passive market risk position.

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RECOMMENDATIONS ON CRITERIA/REFERENCE POINTS FOR THE ADOPTION OF INFORMATION AND CLEARING THRESHOLDS FOR NON-FINANCIAL COUNTERPARTIES

NOTE

by Mr István FARKAS

Abstract

The Commission introduced a Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories. The proposal intends to involve non-financial counterparties in regard to central counterparty clearing systems and trade repository information flows, provided the non-financial counterparty meets certain thresholds.

The Briefing Paper examines the main issues of how to qualify these thresholds. Attention is paid to market relevance, the risk taking capacity of the given non-financial undertakings, and the importance of the information coverage which should be as complete as possible.

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EXECUTIVE SUMMARY

The Commission introduced a Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories.⁵⁴ The proposed regulation intends to extend the clearing and reporting obligations to non-financial counterparties which exceed certain thresholds, as indicated in Article 7 of the proposed regulation. This Briefing Paper analyses some criteria for the adoption of information and clearing thresholds for non-financial counterparties

On one hand, the use of central counterparty (CCP) clearing for over-the-counter (OTC) derivatives aims to mitigate counterparty risks; and by doing so, systemic risk should be reduced. From this point of view, OTC derivative positions of non-financial counterparties which are relevant for the given market segment should be used to serve as a threshold. (threshold "A"). However, the "relevance" level should not be fixed at the very low end, in order to provide sufficient room for daily hedging activities (the paper indicates that the threshold "A" might be 0.1 % of the gross value of the non-financial undertakings' share of the given OTC asset class).

On the other hand the risk taking capacity of non-financial undertakings should not be threatened by counterparty risk which might occur in the bilaterally cleared OTC contracts. To avoid that, the Briefing Paper recommends using a threshold (threshold "B") based upon an amount of 50% of the balance sheet of the non-financial counterparty. The fully hedged positions however shall be deductible from the derivative contracts in case of threshold "B". The two thresholds shall be applicable in a way that both of them should be applicable in parallel, i.e. the lesser of the thresholds will be the prevailing one.

As far as the validity period is concerned, the suggested period is 12 months. This will be long enough to bring stability into the clearing system but shall avoid at the same time that the obligation causes an unnecessary burden.

The reporting obligations should follow the clearing obligations. Taking into consideration that a large part of the non-financial counterparties' transactions are made with dealers, the reporting threshold shall be used exclusively for such transactions that only involve two non-financial counterparties.

⁵⁴ COM(2010)484 of 15 September 2010, see http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm .

1. BACKGROUND AND INTRODUCTION

The Commission introduced a Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories. The regulation lays down, inter alia, uniform requirements on financial and non-financial counterparties, as well as all categories of OTC derivative contracts. Prudential and organisational rules are established for CCPs; and the regulation sets rules for trade repositories.

One of the sensitive issues is the treatment of non-financial counterparties which are not regulated entities but have to meet some obligations in their capacity as participants of the derivative markets. This Briefing paper is focusing on the subject of recommendations on criteria/reference points for the adoption of information and clearing thresholds for non-financial counterparties according to Article 7 of the proposed regulation.

As far as the clearing threshold is concerned, the paper analyses the qualitative and quantitative issues of determining a threshold. In this regard, the business rationale for the usage of derivatives is an important point. The qualitative approach analyses the relevance from the point of view of the market as well as the non-financial undertakings. Some recommendations for benchmarks and the reference period for them as well as some measuring considerations are given.

The growing usage of the OTC derivatives revealed the importance of post trading regulation. One of the lessons of the current financial crisis is that derivatives which initially had a role to manage different risks, turned out to be a critical risk element of the financial market. The problems encountered are mainly stemming from the opaque clearing and settlement system in this field.

Several steps were made during the last couple of years in order to strengthen the European post trading regime of OTC traded securities and derivatives. Inter alia some market initiatives were introduced such, as the Code of Conduct for Clearing and Settlement,⁵⁵ which aimed to bolster the links among the European CCPs. A remarkable event was the issuance of the ESB-CESR recommendations on clearing and settlement.⁵⁶ The second phase of the crisis ("post Lehman period") placed special attention on OTC derivatives, most eminently on the CDS market. Following market efforts within the Derivatives Working Group coordinated by the Commission,⁵⁷ it is now very obvious, that a sound and transparent market requires (i) a more comprehensive view on OTC derivatives and (ii) a binding regulation. This is moreover a global issue. The G-20 leaders agreed in Pittsburgh on the requirement for more transparent and regulated post trading regime for OTC derivatives.

The "Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories" COM(2010)484 ("the Proposal") is a significant milestone. It is comprehensive: it does not limit the scope to credit default swaps (CDS) or just to the derivatives clearing but extends its reach to CCPs, and has as a regulation a further benefit: it would be binding and would not provide room for discretions via national implementing measures.

⁵⁵ See page 67 of the CESAME report (http://ec.europa.eu/internal_market/financial-markets/docs/cesame/cesame_report_en.pdf) and the work of the Monitoring Group (MOG, http://ec.europa.eu/internal_market/financial-markets/clearing/mog_en.htm).

⁵⁶ See http://www.ecb.int/pub/pdf/other/pr090623_escb_cesr_recommendationsen.pdf?d600cc87bb4b57ff496e0a3a34215167.

⁵⁷ http://www.ecb.int/pub/pdf/other/pr090623_escb_cesr_recommendationsen.pdf?d600cc87bb4b57ff496e0a3a34215167

2. THE CLEARING THRESHOLD

The concept of clearing derivative trades centrally (regardless of whether those trades are OTC or standardised and exchange traded) aimed at achieving a transparent and managed risk post trading regime. The usage of a CCP in case of OTC derivatives shall provide protection against counterparty risks (as the CCP interposes itself between the counterparties, it is becoming the seller to every buyer and buyer to every seller of any trade); and having a closely supervised CCP entity would be providing a central information point as well. The opaque nature of the OTC derivatives trade would be reduced by the centrally organised information system (Trade Repository) as well.

On the basis of such a framework, only well defined cases could be entitled to opt out from these requirements – which is in fact the most important reason to issue a Regulation and not a Directive. Also, according to the Proposal all financial counterparties and non-financial undertakings (achieving certain thresholds) shall be subject to the regulation.

2.1. Qualitative approaches

The issue is how those thresholds shall be determined. Prior to analysing the thresholds as a quantitative measurement it is worth to mention two qualitative approaches:

- (i) from the point of view of derivatives held by non-financial undertakings
- (ii) from the point of view of the business rationale of non-financial undertakings

2.1.1. The OTC derivatives used

Derivatives were initially used for risk management. Once an undertaking holds an asset, some of the risk elements of this asset can be mitigated by buying a contract which covers those risks. According to the underlying asset the contract could be related to an interest rate, a physical commodity, a company's equity shares, an equity index, a currency, a credit or virtually any other tradable instrument upon which parties can agree. In other words, a derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset.

Therefore, derivative contracts by nature manifest in broad variety. This fact together with the extremely increased volume of these contracts, however, provides a contradiction: a risk mitigation tool became a serious risk element of the financial market. A series of bilaterally negotiated and individually booked contracts enlarged counterparty risks, the different terms (in maturity, pricing, volume etc.) made the market less transparent and, as a consequence, less complete and comprehensive information did not help the decision making process of market participants.

In order to reduce contradiction of derivative contracts, the main tool is standardisation. When the contracts are standardised and the market is liquid (there are lots of financial and non-financial undertakings which have similar risks to be mitigated and the positions are opposed) these standardised contracts are exchange traded. Obviously, the listed derivatives are executed over a centralised trading venue and then booked with a CCP. Mainly futures and options contracts fall under this category.

The other groups of derivative contracts, however, did not reach the level of liquidity which would warrant exchange trading. These contracts remain OTC traded. It is worth mentioning that derivative contracts have to be characterised as dynamic instruments. New risks might be covered with a new derivative contract and in the beginning, it will be a very individualised business. As the usage of such contracts will grow over time, the possibility of standardisation opens.

OTC derivatives are customised, bilateral agreements that transfer risk from one party to the other. The intention of the proposal is to transform as much as possible the customised contracts to standardised ones in order to be eligible for CCP clearing.

Should the OTC derivatives be eligible for CCP clearing, in theory all of those have to be cleared with CCPs, regardless of whether the parties involved are financial or non-financial counterparties. In case of the latter, the contracts are negotiated bilaterally by the non-financial counterparty (which acts on the buyer's side), but it would be booked with the CCP where the non-financial counterparty would be a client of a clearing member (financial counterparty).

Whenever an undertaking covers a risk which is a specific one, it would be difficult or even impossible to turn to a standardised form, therefore these contracts would not be eligible for CCP clearing, so these derivatives (e.g. privately negotiated swaps) shall be booked directly with each other. In this case, the counterparty risks are run by the individual contracting parties. The need for transparent markets and the aim of reducing systemic risks would require that all of the eligible OTC derivative contracts should be cleared with CCPs. From this point of view, non-financial undertakings would be subject to the clearing obligation whenever eligible OTC derivatives are concerned.

2.1.2. The business rationale of non-financial undertakings

Non-financial undertakings are using OTC derivatives for several reasons. The most obvious purpose is that derivative instruments are solely used for the purpose of hedging partially or totally - market risk (general and specific market risk) relating to positions of non-financial undertakings.

Whenever the derivative contract used for hedging maturity and value of the underlying assets is matched with the derivatives bought, the seller is not faced with fundamental counterparty risks. At the same time the non-financial undertaking runs the risk of a financial counterparty which is a regulated and strictly supervised entity which should minimise the counterparty risk of the buyer. In this case, assuming that the derivative product itself shall not be cleared with a CCP, the non-financial undertaking transaction should not be subject to a CCP clearing obligation.

However the non-financial undertaking may use OTC derivatives for non-risk covering activities as well. This might be aimed at making use of market imperfection (arbitrage) or taking positions in order to make profit on market movements (speculation). Should non-financial undertakings open such positions, they will be active participants of the financial market and so the counterparty risk of them should be better managed by using CCPs. From this point of view, only the derivatives used solely for hedging purposes would be excluded from the obligation to use CCP clearing.

2.2. Quantitative approaches

The question is if the theoretically valid starting point, namely that all OTC derivative contracts used by non-financial counterparties which are eligible for CCP clearing should be booked with a CCP, is rational. From the opposite perspective: whether it is reasonable to allow opting out of CCP clearing only in case of OTC derivatives used for hedging purposes.

There are two conflicting facts: The transparency of the financial market as well as the need for a robust and resilient post trading regime would require an extensive CCP usage. At the same time however, the CCP clearing would impose costs to the non-financial undertakings which might lead to the taking of un-hedged risks and/or the sacrifice of profitable opportunities which – at the end of the day – may cause financial instability as well. This Briefing Paper addresses these issues, i.e. the question of significance of the OTC derivatives market and of the non-financial undertaking's balance sheet.

2.2.1. Relevance of non-financial counterparties

As far as the market is concerned, the bulk of the turnover is linked to interdealer transactions, i.e. where financial counterparties are acting on both sides. In this case the proposed regulation would prevail and all the eligible OTC derivative transactions would be booked with a CCP. It would mean that a major part of the market would be covered by CCP provided risk mitigation.

However, the participation of non-financial undertakings in OTC derivative markets cannot be qualified as negligible. According to a survey of the International Swaps and Derivatives Association, Inc. (ISDA), 94% of the world's 500 largest companies use derivative instruments to manage and hedge their business and financial risks. (Press release of ISDA, April 23, 2009.) Of these 500 companies, 377 belong to the group of non-financial undertakings.

The category of "non-financial counterparty" is rather broad. Article 2, paragraph 7 of the Proposal gives a negative definition when it states: "*Non-financial counterparty means an undertaking established in the Union other than the entities referred to in point 6*".) This could cover thousands of medium size undertakings in the Union using OTC derivatives mostly for hedging and hundreds of larger size companies which might use such instruments for profit as well.

As far as the value of the non-financial undertakings' contracts is concerned, the notional amount outstanding exceeded USD 48 trillion, and the gross market value (the deliverable part of the notional values) was more than USD 1.5 trillion by the end of the first half 2010.

Non-financial customers share in the global OTC derivatives market						
(End of June 2010, in billions of US dollars)						
	Notional amount outstanding	Of which: non-financial customers	Non-financial customers share	Gross market value	Of which: non-financial customers	Non-financial customers share
Total	572 442	48 635	8,50%	23 374	1 538	6,58%
FX contracts	62 933	9 731	15,46%	3 158	541	17,13%
Interest rate contracts	478 093	37 677	7,88%	18 508	917	4,95%
Credit derivatives	31 416	1 227	3,91%	1 708	80	4,68%

(Source: BIS Triennial and semiannual surveys, November 2010)

The share of non-financial counterparties in the OTC derivatives transactions indicates that whatever the reason of the transaction (hedging, or for profit), non-financial counterparties may influence the OTC derivative markets. Should a large hedging position of a non-financial undertaking be priced differently from the interdealer market, this transaction may definitely mislead the market as a large undertaking might for instance have a couple of USD million hedging positions in foreign exchange ("FX") OTC derivatives which is no doubt significant in the market. Therefore, to exclude hedging positions from the CCP clearing obligation in general may increase opaqueness of the market and systemic risk, which shall just be reduced by using CCPs. This is the answer to the question if it would not be possible to just let the hedging activities out of the reporting obligation.

There are two remarks worth a note. The first is that there is a reasonably high ratio of non-financial customers in e.g. FX transactions related to the most liquid part of the market. The second is regarding risk mitigation, that the relevant information is the gross market value of the contract which shows the claims against counterparties, and explicitly the value of counterparty risk (This would be the sum that shall be paid immediately in case of settlement today).

The threshold regarding market relevance (threshold "A") would indicate that OTC derivative positions of a non-financial undertaking may influence the OTC derivative market, or, more importantly, may influence the given market segment (or asset class as to be qualified by the Commission), for instance the FX, interest rate, equity or credit derivatives segments.

The benchmark for threshold "A" should be calculated by asset classes according to the gross value of the derivatives that belong to non-financial counterparties. As far as the measurement of the threshold "A" is concerned, this Briefing Paper indicates some considerations and gives a rough example of it. When determining this clearing threshold, one must try to avoid that the obligation for CCP clearing should not cause an unnecessary burden to daily hedging activities, but at the same time will not offer an easy way to avoid obligation for those players which might be relevant from the market point of view.

Taking into consideration the above mention criteria and the data of the last BIS report it appears logical that threshold "A" might be a percentage of the benchmark which should be not less than 0.01 % (to avoid that too many contracts fall under the obligation) and not more than 1 % (to provide no easy exit for relevant market participants). The sample used is based upon a practical approach: 1 o/oo would express a size which might influence the market. Should any one individual non-financial counterparty have 0.1 % market share of the non-financial share of the given OTC derivative asset class it might be qualified as "relevant". This means that for instance a non-financial undertaking which has a CDS exposure exceeding USD 80 million (using the BIS data above) shall be obliged to book it with a CCP.

2.2.2. The reference point and the reference period

Again, the above is a static approach. The maturity of the OTC derivatives may differ, the contract might be sold, modified or terminated, new players may step in etc. In order to avoid uncertainty and complicated regulation, a fixed reference point for the benchmark should be set. It would be practical to say that the reference point of the benchmark is the middle of the previous year. Non-financial undertaking would compare to this benchmark the positions held, and the obligation would start when in the given year the non-financial undertaking first reaches the threshold "A". From that time on, all of the OTC derivatives in the related asset class must be cleared with a CCP. The obligation shall be valid (reference period) at least for 12 months as of that date. At the maturity date of the reference period, the threshold will be calculated again with the new benchmark. Should the non-financial undertaking's exposure exceed the threshold "A", the obligation is continuing, or – in case of it falling below the threshold – will re-start when the exposure first meets the threshold again.

The fixed references ensure that a non-financial counterparty would be able to manage the necessary steps in order to use CCP, and at the same time the clearing member to whom the (financial) undertaking became a client could prepare its client properly in view of the obligations as well. Fixing the benchmark reference point is also a practical issue; the reference must be easily and publicly accessible in a timely fashion.

It would be advisable to provide freedom to non-financial counterparties to allow them to make a decision according to which they will use CCPs after they met the threshold "A" for the first time in the future. In that case, they do not need to recalculate the threshold.

2.2.3. Relevance of the non-financial undertaking's balance sheet

While the significance of the market approach lays in the systemic risk element, a non-financial undertaking is facing individual counterparty risk even in case of smaller amounts. When a non-financial undertaking enters into an OTC derivative contract which will be cleared bilaterally, two types of defaults may occur. Either the non-financial undertaking might be in trouble at the due date (at maturity, or termination) or the counterparty of it might be. The failed settlement however shall cause problems for the business and indirectly for the market as well. In order to avoid that, negotiations between counterparties include margins, i.e. the placing of collateral, to protect clearing and settlement. This is however a cost for the counterparties and it does not create a full protection system.

The Proposal opens the possibility to set the obligatory clearing threshold with the risk taking capacity level of non-financial counterparties in mind. Taking into consideration that non-financial undertakings are very different (in terms of market activity, cash flow profile, capital structure, profitability etc.) this threshold (threshold "B") should be based upon the most common characteristic, which is the balance sheet ("B/S"); in other words: threshold "B" would represent a special leverage limitation.

The basis for the calculation of threshold "B" would be the same as above, i.e. the gross value of the OTC derivative exposure of the non-financial undertaking. The total exposure in this case shall however be reduced by the gross value of those contracts which are used for hedging (modified exposure, or modified gross value). The reason is rather obvious: the full hedged position will not relate to the risk taking capacity of the non-financial undertaking.

The modified exposure indicates the so-called "for profit" (arbitrage, or speculative) OTC derivative position of the non-financial counterparty. This concept gives some hints for the measurement of threshold "B". It seems to be logical that, on one hand, these exposures shall not be higher than the total B/S. On the other hand, threshold "B" should not be too low because it might jeopardise risk taking decisions. The Briefing Paper uses a practical approach indicating the midst of the two points.

Threshold "B" would be 50 % of the total B/S of the undertaking. It would mean that if the modified gross value of any OTC derivative asset class exceeded 50 % of the B/S of the undertaking, this asset class is obliged to clear with a CCP.

The calculation should be made on the basis of the B/S at the end of the previous year (this is the benchmark of threshold "B") and the highest modified exposure of the following quarters of the year. Once the modified gross value of the OTC derivative class exceeds threshold "B", the undertaking is obliged to clear those asset classes with a CCP. The obligation as of that date shall be valid for 12 consecutive months (reference period).

2.2.4. Combination of the two types of thresholds

It is clear that the two types of thresholds (one which is taking account of the market relevance – threshold "A" - and the other which pays attention to the risk taking capacity of the non-financial counterparty – threshold "B") will not result in the same amounts. Moreover, it is possible, that in case of one asset class, the market significance shall require CCP clearing while another asset class might not reach market relevance, but compared to the B/S, shows a limit of risk taking capacity.

In order to make the application as clear as possible, the threshold determination should be combined. The non-financial counterparty would clear OTC derivative contracts with a CCP if any position in the given asset class meets any of the thresholds (threshold "A" or "B"). In other words: any OTC asset class shall be cleared with a CCP when the gross value (or the modified gross value) of the given contracts exceeded the lesser of the amount of threshold "A" or threshold "B". As the validity period (12 month) is the same, this should not create uneven positions.

3. THE INFORMATION THRESHOLD

Information on the OTC derivatives which is as complete as possible is a vital point. Information is needed for supporting fair market decisions thus ensuring a transparent market place. Otherwise, the lack of accurate information will prevent market participants to make sound business decision in order to optimise their trades.

The information should support the decision on whether or not to sell or to buy contracts (securities) based upon reliable post trade information. The information is essential for the decision on which service provider should or should not be involved.

The information is an absolutely key factor in order to evaluate the following issues:

- evaluate the risks associated with the instruments (historical trade data, price information etc.);
- evaluate the performance of products and service providers which is an intrinsic part of fair competition;
- evaluate costs and benefits; and finally
- information on the underlying contracts is one of the most important factors in order to assess and to mitigate legal risks (like credit events; jurisdiction applicable).

Information on OTC derivatives should provide data for self assessments (benchmarking) of service providers, and pave the ground for complying with requirements (like best execution). Last but not least, information is needed for regulatory purposes as well.

In case of non-financial undertakings, the larger part of the transaction is made with dealers, i.e. financial counterparties. In this case the information has to be provided by the dealer who has already an obligation to report to the Trade Repository (see Article 6 paragraph 1 of the Proposal).

However, non-financial undertakings may also conclude transaction with another non-financial counterparty. In this case, the information threshold should be governing the reporting obligation.

It seems to be logical that the information threshold should be the same as the clearing threshold. Non-financial undertakings should report to the trade repository (or to the competent authority in case of the trade repository not being able to record the details) the details of the contract falling into the clearing threshold. In case of both undertakings exceeding the clearing threshold, they would have to agree in the contract on who would be responsible for the reporting in order to avoid double reporting.

CONCLUSION

The clearing threshold for non-financial counterparties should be determined according to the market relevance (threshold "A") and to the risk taking capacity of the given non-financial undertaking (threshold "B").

The clearing threshold therefore should be a combination of the two approaches; it would be the lesser of the thresholds calculated in the two ways.

The calculation basis – taking into consideration that CCP clearing is a mean for risk mitigation – would be the gross value of the derivative contract representing the risk taken rather than the notional amount of it. In case of threshold "B" the calculation of the gross value of the OTC derivative exposure of the non-financial undertakings shall be reduced by the value of the hedging positions (modified exposure).

The benchmark would be the market share of the non-financial counterparties at the middle of the previous year in case of market relevance (threshold "A") and B/S at the end of the previous year in case of risk taking capacity (threshold "B"). Once a non-financial counterparty meets the threshold, it will be obliged to clear the related asset class contracts with a CCP from that time on for the following 12 consecutive months.

The information threshold will be applicable if both counterparties qualify as non-financial undertakings. In this case, all the contracts falling under the clearing threshold have to be reported to trade repositories.

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