

OTC Derivatives Trading & Clearing in Europe after the Crisis The Perspective of the ECB

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OTC Derivatives Trading & Clearing

- I. Background**
- II. Regulatory and oversight concerns**
- III. Challenges for the future**

I. Background

OTC Derivatives Trading & Clearing

- **Long history of infrastructural challenges in OTC derivatives**
- **CPSS 1998: documentation backlogs, use of collateral to mitigate counterparty risk, CCP clearing**
- **CPSS 2007: follow up to 1998 report, plus other aspects such as prime brokerage novation, closeout**
- **CCP only one aspect in tackling infrastructural problems**

The role of OTC derivatives in the financial crisis:

- **Significant growth in credit default swaps (CDSs)**
- **Considerable impact of CDSs on financial stability**
- **Lehman, Bear Stearns, AIG**

II. Regulatory and oversight concerns

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- **High degree of complexity of OTC environment: decentralized trading and highly commoditized products**
- **Lack of transparency: prices and risk exposures are difficult to determine; regulators (and market participants) not fully aware of individual and overall risk exposures**
- **More complex and demanding risk management techniques for non-standardised products (e.g. single name CDS)**
- **Insufficient collateralisation: degree of collateralisation has been unclear (lack of reliable data) and in general too low**

Three main measures:

- Make use of **central counterparty clearing** and its benefits to greatest extent possible: risk management, multilateral netting, liquidity savings
- Establishment of **trade repositories** where not yet existent
- Stringent capital and **collateral requirements** for trades that continue being bilaterally cleared

Safety and soundness: ESCB-CESR recommendations of June 2009

- Access criteria (non regulated entities)
- Protection of non-clearing members
- Transferability of positions
- Credit event and dispute resolution
- Risk management (asymmetric margins, separate default fund)
- Price transparency and availability
- Market structure: compression, standardisation, warehouse, acceptance of trades from multiple venues

III. Challenges for the future

European Market Legislation:

- **CCP eligibility of OTC products?**
- **Exemptions from mandatory use of CCPs for certain participants, e.g. corporates and end users? Incentives for banks?**
- **What requirements for CCPs?**
- **What requirements for Trade Repositories?**
- **Scope? Also links? Role of authorities?**
- **How many Legal Documents?**

Location of CCPs:

- **Clearing of CDS in Europe is effectively monopoly**
- **Almost 100% of euro-denominated CDSs cleared by ICE Clear Europe (UK), i.e. entity outside euro area**
- **Two concerns: oversight and provision of liquidity**
- **Governing Council decision of 18 December 2008: need for at least one CCP located in the euro area**

Moving OTC trades on exchange:

- **Possible benefits: real-time trade matching, elimination of backlogs, increase market liquidity and transparency**
- **Standardisation of contracts may be beneficial as it facilitates more trading on exchange**
- **But there is demand for customized contracts, so bilaterally negotiated contracts must continue to be allowed**
- **Greater benefits from central clearing than from on-exchange trading (CCP possible without exchange)**

Co-ordination with regulatory initiatives beyond EU:

- **CPSS-IOSCO review of RCCP**
- **General review of the Standards**
- **Derivatives Regulators Forum**