Editorial

All clear?

It is no surprise that, in the Journal's papers and the books reviewed, the recurring theme is the analysis of the credit crunch and the regulatory response to it. It is likely to be the case for some years to come as the lessons are learned, and as a more robust approach to the management of market, credit, operational and liquidity risks emerges.

The European Commission believes that a paradigm shift is necessary, to move away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly.[1] As a result, the Commission will propose legislation in mid-2010 that will mandate centralised clearing for standardised over-the-counter (OTC) derivatives and introduce higher capital charges, in the form of initial and variation margins, for those instruments that continue to be traded bilaterally.

For the Commission, the crisis has shown, *inter alia*, that market participants failed to price counterparty credit risk correctly and that the way to mitigate this risk is through clearing and better use of collateralisation. The Commission has identified Central Counterparty (CCP) clearing as the main tool to manage counterparty risks and the G20 shares this view.

In view of the CCPs' systemic importance, and the fact that even those CCPs operating cross-border services remain regulated at a national level, the Commission intends to propose legislation governing their activities so as to eliminate any discrepancies among national legislations and ensure safety, soundness and proper governance. In addition to conduct of business and governance, the CCP directive, which will be drawn up in 2010, will include rules to ensure that CCPs do not employ low risk-management standards, follow the regime currently being finalised by the Basel Committee, and provide legal protection to collateral and positions provided by clearing members' customers.

According to the Commission, in an ideal world, all derivatives should be centrally cleared. In reality, however, not all of them are suitable for this. Some products may be too customised, whereas other products may not be sufficiently liquid for central clearing. Such contracts will continue to be cleared bilaterally with counterparties exchanging collateral to cover their exposure. However, the Commission believes current collateral levels are too low and do not reflect the risk that bilaterally-cleared derivatives trades pose to the financial system when they reach a certain critical mass. It also believes that financial firms need to hold a larger amount of collateral to cover their credit exposure.

The Commission will propose legislation requiring financial firms (eg credit institutions, investment firms and investment management companies) to post initial margin (specific to counterparty characteristics) and variation margin (the change in the value of a contract). It is hoped that these requirements will also provide an incentive to use central clearing, as they would reduce the economic advantage of providing too little collateral compared with the strict collateral demands made by CCPs.

Higher capital requirements would reflect the higher risk that such contracts pose to the financial system. As these capital charges apply after bilateral collateral exchange and netting of exposures, this approach would further strengthen the incentive for market participants to put a wider range of products onto central clearing.

The Commission will therefore ensure that the rules properly distinguish between, on the one hand, the lower counterparty credit risk of contracts that are cleared on a CCP, and the higher counterparty credit risk of those where clearing is done bilaterally, and the primary way by which this can be done is to widen the difference of the capital charges between centrally cleared and bilaterally cleared contracts contained in the Capital Requirements Directive (CRD).

So as not to distort competition and to limit the potential for regulatory arbitrage, these changes should be consistent with the approach outlined by the Basel Committee on Banking Supervision. The Commission will work with its partners to ensure that an agreement is reached and will do its utmost to be able to propose amendments to the CRD, along the above lines, in 2010.

Launched four years ago, NYSE Liffe's Bclear OTC wholesale service is one such CCP service, providing a simple and cost-effective way to register and process wholesale derivatives trades through NYSE Liffe to clearing at NYSE Liffe Clearing, reducing the counterparty, credit, legal and operational risks often associated with OTC trades.[2] The fact that total volume in equity derivatives futures and options registered through Bclear has just passed 250 million, setting a new record for the fourth consecutive year, shows that, in times of difficulty, the market tends towards the safety of CCP clearing by choice.

There is a realisation that the OTC market has a role to play where non-standardised instruments are required and the market being traded is too illiquid for central clearing. As such, it will continue to exist — but at a price.

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References

1 Commission of the European Communities (2009) 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank. Ensuring efficient, safe and sound derivatives markets: Future policy actions', available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PDF (accessed 16th December, 2009).

2 NYSE Euronext (2009) 'NYSE Liffe's Bclear has record year with over 250 million contracts registered in 2009', news release, 16th December, see: http://www.nyse.com/press/1245320379513.html (accessed 22nd January, 2010).