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Council adopts rules on derivatives

The Council today[1] adopted a regulation aimed at increasing transparency in derivatives and reducing risk in the over-the-counter[2] (OTC) derivatives market (PE-CONS 8/12).

Adoption of the regulation follows an agreement reached with the European Parliament; accordingly, the Council accepted all amendments voted by the Parliament at first reading on 3 July.

The regulation requires:

– the *clearing* of standardised[3] OTC derivative contracts through central counterparties (CCPs)[4] in order to reduce counterparty risk (i.e. the risk of default by one party to the contract). This is aimed at preventing the default of one market participant causing the collapse of other market players, thereby putting the entire financial system at risk. To be authorised, a CCP will have to hold a minimum amount of financial resources. Specifically, the regulation requires a CCP to have a mutualised default fund to which members of the CCP have to contribute

– the *reporting* of all derivative contracts to trade repositories (i.e. central data centres). Trade repositories would have to publish aggregate positions by class of derivatives, thereby offering market participants a clearer view of the derivatives market. The European Securities and Markets Authority (ESMA) will be responsible for the surveillance of trade repositories and for granting and withdrawing their registration.

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1 The decision was taken by written procedure.
2 A derivative not traded on an exchange but instead privately negotiated between two counterparts.
3 Those that have met predefined eligibility criteria
4 CCPs are entities that interpose themselves between the two counterparties to a transaction and thus become the 'buyer to every seller', as well as the 'seller to every buyer'

P R E S S

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ESMA will also be responsible for the identification of contracts subject to the clearing obligation, while national competent authorities, in coordination with a college of supervisors, will be responsible for authorisation and supervision of CCPs, except in the case of CCPs from third countries, which will have to be recognised by ESMA, provided they meet certain conditions.

If a contract is not eligible for clearing by a CCP, the regulation requires the application of different risk management techniques, including the exchange of collateral and the holding of additional capital.

The obligation to clear OTC derivatives contracts through a CCP and report them to trade repositories applies to financial firms, while non-financial firms will only be subject to the clearing obligation, provided their OTC derivatives positions reach specified clearing thresholds, to be set by ESMA and the Commission

The regulation provides for venues of execution, such as multilateral trading platforms or exchanges, to have access to any CCP to clear OTC derivatives transactions, and vice versa, subject to technical and safety requirements.

The regulation, which will apply from the end of 2012, is intended to implement commitments made by G-20 leaders in September 2009. One year after the collapse of Lehman Brothers – a major player in OTC derivatives markets – G-20 leaders agreed in Pittsburgh that all standardised OTC derivative contracts should be cleared through CCPs by the end of 2012, while non-centrally cleared contracts should be subject to higher capital requirements. They also resolved that OTC derivative contracts should be reported to trade repositories.