EU derivatives regulation

A success story that requires further efforts

Central counterparties (CCPs) – also known as clearing houses – are the **risk managers of the financial market**. They act as a neutral entity between buyer and seller of securities and derivatives, assess the risk and demand collateral accordingly. If one party defaults, CCPs take measures to offset losses. First, the collateral of the defaulting market participant is used. In extreme situations, a CCP's own funds and the collateral of the non-defaulting clearing participants are used to rebalance the CCP. CCPs reduce the counterparty risk for all participants and prevent chain reactions that would destabilise the market. Due to their central position in the system, CCPs are ensuring that the market keeps its balance even in times of crisis. In practice, the system has proven to be extremely robust: even the failure of the important participant Lehman Brothers at the beginning of the financial crisis 2008, did not create losses for non-defaulting participants of the German CCP Eurex Clearing AG.

Regulators have therefore acknowledged the stabilising effect of CCPs.[1] With the European Market Infrastructure Regulation (EMIR) on OTC derivatives, CCPs and trade repositories, the EU has introduced an effective regulatory framework, which focuses on making derivatives markets safer. The protection mechanisms of the CCP applies when a CCP participant defaults. CCP participants have an incentive to support high risk management standards: in doing so, they can protect themselves against risks.

In the aftermath of the financial crisis, one of the most important goals of the Group of Twenty (G20) was to centrally clear as many derivatives as possible. Where this is not possible, transactions should at least be reported and collateralised. The EU's clearing obligation so far only applies to interest rate and credit derivatives. The trading in interest rate derivatives accounts for 69 per cent of the derivatives market. The Financial Stability Board (FSB) recently published data indicating that the share of centrally cleared interest rate derivatives has increased from 40 per cent, at the time of the financial crisis, to approx. 80 per cent.[2] **This is a major achievement with regard to the implementation of the G20 objectives agreed at the Pittsburgh summit 2009 as well as for the overall financial stability.**

The figures, however, clearly show that there is still a lot of work to be done. The quota of centrally processed products could be further increased and the clearing obligation expanded to other product categories. **The more transactions are processed via CCPs, the greater are the benefits for each participant and for financial stability.**

---

[1] Deutsche Börse AG and Eurex Clearing AG (Eds.) (2014). How central counterparties strengthen safety and integrity of financial markets. White paper 2014.
[2] FSB et al. (Eds.) (2018). Incentives to centrally clear over-the-counter (OTC) derivatives. Final Report, November 2018.

The latest FSB consultation[3] as well as EMIR REFIT – the revision proposal for EMIR which has been drafted in the context of the Regulatory Fitness and Performance Programme (REFIT) – both seek to improve incentives for using CCPs in the long term, avoid inefficiencies and to provide access to central clearing also for smaller market participants.

The FSB consultation has put the focus on the incentive scheme for the use of CCPs. The balance of margin requirements for bilateral and central clearing is one of the key elements here. The design of capital requirements and access models to central clearing also plays an important role. The broad response to the consultation confirms the work of the FSB and the need to take this issue forward.

At EU level, the EMIR REFIT revision proposal triggers technical adjustments, which aim to increase the efficiency of the regulation and to reduce the regulatory burden. In this context, it is important **not to establish hasty exemptions from the clearing obligation, but to work on solutions, which facilitate access to central clearing for affected market participants**. This would also increase the overall benefit for all market participants.

Especially smaller market participants have had difficulties in finding adequate access to central clearing. In principle, market participants who are not directly connected to a CCP gain access via a clearing broker. However, supply from clearing brokers is scarce, and an increasing concentration on merely a few providers can be observed. Apart from that, no market participants should be excluded from the benefits of central clearing. **Thus, incentives need to be created now to expand the clearing brokers' offering**. As a market-driven solution, Eurex Clearing already offers an alternative access model to market participants that allows direct access to reduce the tensions of the current situation.

In addition to the obligation to use CCPs, incentives which highlight the advantages of central clearing could also be provided. For example, the balancing of the requirements for calculating margins for centrally cleared transactions in contrast to bilaterally cleared transactions should reflect the higher risk that bilaterally cleared transactions inherit. **The strict implementation of this principle would automatically create incentives to choose the safe option, i.e. central clearing**. This approach should also be applied analogously to capital requirements.

Looking ahead, it is important to find **the right balance between the complexity of regulation on the one hand and support especially for smaller market participants on the other** to make better use of the advantages of central clearing. At the same time, sight of the implications for the incentive structure must not be lost in order to ensure the functionality of the system in the spirit of financial market stability.

Finally, the interaction of EMIR REFIT with other regulations and geopolitical decisions may not be forgotten. The Markets in Financial Instruments Directive II (MiFID II) has already changed the market structure and will continue to do so. Among other things, it ensures greater transparency in derivatives trading and **will provide further positive impetus with the trading venue obligation for liquid derivatives**. Furthermore, the finalisation of the Recovery and Resolution Regulation for CCPs, with the aim of making the EU derivative markets crisis-proof, forms an important cornerstone. The approaching Brexit and the associated loss of the EU passport for UK market participants presents major challenges to the EU, as London is currently the most important financial centre in the EU. **The revision of the CCP third-country regime is only a small element to cope with this challenge**.

---

[3] FSB et al. (Eds.) (2018). Incentives to centrally clear over-the-counter (OTC) derivatives. Consultative document, August 2018.

Publisher

Deutsche Börse AG
60485 Frankfurt/Main
www.deutsche-boerse.com

November 2018

Contact

Group Regulatory Strategy
E-mail regulatory.strategy@deutsche-boerse.com

Torsten Schaper
Head of Regulatory Strategy
Deutsche Börse AG
E-mail torsten.schaper@deutsche-boerse.com

Steffen Kabitzke
Regulatory Strategy
Deutsche Börse AG
E-mail steffen.kabitzke@deutsche-boerse.com

This article was first published in the “Rules and Regulation” newsletter of Börsen-Zeitung on 27 November.