



European Commission's proposal on OTC derivatives, CCPs and trade repositories. November 2010.

This proposal, submitted by the European Commission (COM) on 15th September, responds to the EU's commitments in the G20 and is in line with the approach taken by the USA. The proposed Regulation provides that OTC derivatives should be reported to trade repositories and be accessible to supervisors. There will also be more information available to all market participants. The COM also proposes that standard OTC derivative contracts be cleared through authorised and supervised central counterparties (CCPs), which must be subject to organisational and prudential requirements.

The proposal must be adopted by the European Parliament and the Council, after a period of negotiation that has just begun. It is expected to enter into force at the end of 2012.

Scope.

The proposed reform is extensive and applies to financial and non-financial institutions, to all classes of OTC derivatives, to CCPs as a result of the clearing obligation and, because of the reporting requirement, to trade repositories.

Exemptions are envisaged for the members of the European System of Central Banks, public bodies intervening in the management of the public debt, and multilateral development banks.

Clearing obligation and information for OTC contracts.

Financial institutions shall clear the standardised OTC contracts that they negotiate with other financial institutions through authorised CCPs, either as members or as clients.

Standardised contracts are those that are eligible for clearing by a CCP. In order to identify them, a process based on a dual approach has been defined:

- A "bottom up" approach, under which a CCP decides to include certain contracts, then seeks approval from its competent authority, which informs ESMA which, in turn, may decide to extend this obligation to all European contracts that fulfil certain objective requirements.
- A "top down" approach, under which ESMA and the ESRB determine which contracts should potentially be subject to the clearing obligation.

Non-financial institutions will be subject to this Regulation when they are particularly active in the OTC derivatives market and if this is not a direct consequence of their commercial activity. To that end, the fact that their positions reach a threshold and are considered to be systemically important will be taken into consideration. This process is based on the definition of two thresholds: a) an information threshold, under which institutions shall notify the competent authority and provide justification for taking those positions; b) a clearing threshold, under which institutions will have to clear all their contracts.

These thresholds shall be determined by the COM based on a binding technical standard (BTS) proposed by

ESMA, taking into account the systemic relevance of net positions and exposures by counterparty per class of derivatives, with the exception of those derivatives contracted to cover the risks related to their commercial activity.

Financial and non-financial institutions above the clearing threshold must report the details of any derivative contract they have entered into and any modification thereof (including novation and termination) to a trade repository.

In addition, financial and non-financial institutions subject to the clearing obligation, which enter into OTC derivative contracts not subject to that obligation, shall use mechanisms to monitor and mitigate credit risk, such as early identification of the terms of the contract, dispute resolution, monitoring the value of contracts using daily prices, exchange of collateral and holding of capital.

Member States shall create a penalty system to be used in the event of non-compliance with these rules, including publication of penalties.

Authorisation and supervision of CCPs.

National authorities retain the responsibility for authorising and supervising CCPs. Given their systemic relevance and the cross-border nature of their activities, ESMA participates in the authorisation, will develop BTS for the correct application of the Regulation and will facilitate the adoption of opinions by the colleges of supervisors.

The State where it is established will chair a college responsible for coordinating supervision, defining contingency plans for emergency situations and expressing their opinion on risk assessments made by their local supervisor. The college shall consist of ESMA, the local supervisor of the CCP, the supervisors of the three members with the largest contributions to the default fund, the supervisors of the markets served by the CCP, the central bank that issues the most relevant currency for clearing and the supervisors of CCPs with whom interoperability agreements have been established.

Organisational requirements for CCPs.

CCPs must have in place robust governance arrangements which will respond to any potential conflicts of interests between owners, management, clearing members and indirect participants. The role of independent directors is especially relevant. There will be a risk committee which shall be responsible for the risk management and shall report directly to the board and should not be influenced by any business lines. They should be subject to independent audits and governance arrangements shall be publicly available.

Prudential requirements

In order to mitigate credit risk exposure, a set of participation requirements of members, financial resources and other guaranties shall be laid down. They will have an initial capital of EUR 5 million and own resources to be determined in a BTS proposed by ESMA, after consulting the EBA.

Outsourcing of functions is only allowed if it does not impact on the proper operation of the CCP and its ability to manage risks, including those arising from the outsourced functions. No risk management functions will be allowed to be outsourced.

CCPs shall maintain a risk exposure management and monitoring system in real time or near to real. Exposures of its members and other CCPs which have interoperability agreements shall be covered by means of margins. In addition, there will be a default fund to which their members will have to contribute. This default fund allows them to face losses in case of the insolvency of one or more of its members, after collecting the margins of the defaulting member(s). CCPs will also be able to maintain additional resources or mechanisms to face losses

resulting from the default of their members.

The Regulation also introduces rules on segregation and portability of positions and collateral, as well as an ongoing review of monitoring systems and the implementation of stress and back tests to assess their resilience and the reliability of the methodology adopted.

Interoperability

Post-trading arrangements of this type should be approved by the competent authorities.

Trade repositories.

Trade repositories will collect information on OTC derivatives transactions. ESMA will deal with their registration and surveillance and will ensure an unfettered access to all competent authorities.

These trade repositories will be subject to organisational and operational requirements that ensure appropriate protection and transparency of data. They will also publish aggregate positions by class of derivatives.

Link to the proposal on OTC derivatives and trade repositories: http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#proposals.