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Eurofi : "What are the respective roles and duties of both public authorities and private sector for a timely set up of Eurozone derivatives infrastructures?"

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Abstract

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Eurofi : "What are the respective roles and duties of both public authorities and private sector for a timely set up of Eurozone derivatives infrastructures?"

A European policy for dealing with credit default swaps and other derivatives.

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The market for derivatives, especially for Credit default Swaps (CDS) is essentially an OTC market. As a consequence the market is largely based on individual dealings between market participants, although some more organised networks have captured considerable market volume. Systemic risk concerns have lead the public authorities, both in the US and in Europe, to urged several steps to better organise these markets, mainly by improving the post-trade phase. The action developed in the fields of CDS has been an example as to how systemic risk can be reduced, although not entirely eliminated. Indeed the risks in this market segment are considerable, End 2008, ISDA reported a nominal amount of $38,6 trillion of CDS contracts outstanding, down from a peak of $57,5 trillion. In the absence of adequate netting mechanisms these would represent significant risks in case one of the major participants failed. This was illustrated in the Lehman failure although, on an ex post basis, the nominal exposure was reduced from $ 400 to $ 6 to 8 billion by netting defaulted contracts.

The structural reforms took place along two main avenues: the first one related to the registration of the numerous CDS contracts, the transfer of which took place on a contract by contract basis, and often remaining unperfected. As a consequence very big numbers of contracts piled up in the offices of the market participants, without due reconciliation and even formal agreements. In case of a major disturbance in the markets, it would have been near impossible to find out who was debtor and who was creditor. The second step directly addressed systemic risk by requiring that CDSs be netted through a central clearing mechanism that would take the form of a Central Counterparty (CCP). By so doing the compensation between the different market participants could be centralised leading to significant reduction of the outstanding nominal amount of obligations guaranteed, and therefore reduce systemic risk. There is today wide agreement that the risks represented by CDS, and other derivatives should be reduced by using CCP or other mechanisms such as the compression services of TriOptima, Markit or Creditex, not only after a failure, but on a continuous basis.

[1] This paper represents personal opinions. It will be presented at the Eurofi Conference, September 30, in Göteborg.

In the US the first function is organised within the DTTC Trade Information Warehouse, were the data of all transactions is centralised. This function is organised by DTCC, the sole organisation is charge in the US of registering transfer of securities and hence also of CDS contracts. This Warehouse is at present used by market participants in the US and in Europe as well. Although occupying a monopoly position, DTCC is a private corporation, owned and governed by market participants and hence not for profit.

The Clearing of CDS is organised by a number of CCPs: these are market organisations that compete among themselves. Up to now, ICE and CME have started operations in the US.

The European situation is still under construction: two CCPs, to which market participants have voluntarily committed to channel their transactions for clearing, will start operations beginning the 1st of August. These are private sector operators, one a subsidiary of the US ICE, the other a subsidiary of Eurex/ Deutsche Börse. They will start with clearing index CDSs and later move to single name CDSs. Other initiatives – especially of LCH Clearnet - are likely to become operational later in 2010. It is important that in parallel with the US CCPs a similar clearing facility is set up in Europe: not only will this reduce operational risk, but it will also subject transactions to a European legal regime.

With respect to the regulation of these activities, it should first be underlined that it is of crucial importance that they should be well regulated and supervised, and that the safety and soundness of the transactions is a crucial concern for the public authorities. With respect to clearing activities, the Committee of European Securities Regulators and the European System of Central Banks have adopted a series of recommendations dealing with the organisation of clearing both for securities and for derivatives as well. It can be expected that these recommendations will have to be extended in light of the experiences that will be collected in the future. Of special importance are the requirements for efficient clearing of the different positions, and the provisions relating to the risk coverage supported by the central counterparties. As these represent a very high systemic risk, the central banks and the securities supervisors are in charge of keeping a close eye on their functioning.

With respect to the repository for CDS contracts, no EU regulation has been adopted yet. Initiatives about organising a Repository are under study and CESR will develop recommendations about the safety standards that should be respected by these institutions. Whether there would be one single Repository or several, who will be owners and how they will be organised, is left to the market participants and the forces of competition. It is up to the regulators to ensure that the organisation of these important market infrastructures are well conceived, achieve the financial purposes for which they have been set up and that they meet the safety and soundness requirements that will be determined in their regulations, and monitored by the competent supervisor.

The repository where the different contracts for CDS will be registered also play a crucial role in the efficient organisation of this market segment: it will contribute to legal certainty, to transparency of the transactions, deliver the necessary data for monitoring this market, and allow prompt reconciliation with the banks' own portfolios. Moreover, liquidity has to be enhanced by increased standardisation. To make the system comprehensive, all CDS contract in a given reference value will have to be registered in the Repository while all subsequent transfers should be notified for registration. Many single name CDS are based on individual contracts and therefore are not fit for multilateral clearing: efforts should be made to increase the level of standardisation of these contracts allowing them to be included in the clearing

mechanism. For information and monitoring purposes it is essential that information on all CDS be available and this can best be achieved in the Repository to which all transactions should then be notified, whether on the basis of a regulatory provision, or preferably of voluntary action by the industry. In a later stage, trading could migrate to a public market if that appeared necessary from a public policy point of view or in the interest of market participants. This would not unduly alter the freedom of the parties to deal OTC in other derivatives nor to limit their freedom to formulate bespoke CDS if they deem fit.

The repository would play an important role in establishing the individual position of the partipating banks allowing for reconciliation of their books with their positions in the Repository. This information will allow both macro prudential supervision and micro supervision to follow the developments in these markets and may avoid the accumulation of risk that was known in the recent past.

Other concerns also need to be addressed. Recently several investigations have been launched in the CDS market dealing with possible violations of the market abuse rules. The existence of a central repository where transactions will be registered before clearing will allow supervisors to investigate possible violations. But on the longer term, and in order to dispose of more reliable price information, trading may have to be channelled to regulated markets.

The role of the public authorities with respect to the repository is not fundamentally different from the one in the case of the CCPs: the public authorities will determine the conditions of the functioning of the repositories, including the way information will have to be processed and made available to outside parties, including the supervisors. As the risk will be mainly of an operational nature, the usual safeguards – including with respect to the applicable law - against this type of risk should also be dealt with. In order to ensure these guarantees to be strictly adhered to and respected, a registration system for these repositories should be introduced. Efficient interoperability systems should guarantee neutrality of execution and data consolidation.

On the longer term, one should ask oneself what are the differences between these negotiated contracts and the customary securities. Are there fundamental differences that would prevent these contracts to be qualified as “securities” in the traditional sense, and how can these differences eventually be dealt with? The qualification of CDSs as securities would result in a significant number of simplifications: the rules on transfer, on passing of title (DVP), on payments in central or commercial bank money, on dealing with failures to settle, and dealing with the cumbersome three party novation system would all fall under the prevailing rules on securities trading, as these will be streamlined in the forthcoming work of the Legal Certainty Group, an advisory group studying the harmonisation of the rules applicable to trading of securities. It would be worthwhile to discuss in more detail the reasons - pro and con- for such an approach.

Financial Law Institute

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