

Prospects for Europe's market infrastructures

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European Commission
Internal Market & Services DG



Cash equities: Code of Conduct

- Code of Conduct in force since 1/1/08
 - Price transparency
 - Access & interoperability
 - Service unbundling & accounting separation
- Significant achievements but outstanding issues:
 - Price comparability: conversion tables/simulators...
 - Barriers to links: private/public
 - Effectiveness of unbundling & separation: tbc

Derivatives: safety and soundness

- Financial crisis: change of focus
 - Material scope: cash equity → derivatives
 - Personal scope: on-exchange → OTC
 - Shift primary objective? Efficiency → safety & soundness?
- Credit default swaps
 - Limited size (\$28trn / \$680trn)
 - But important: link to (i) credit and (ii) banks mean significant potential effect on financial system & economy if disruption.

Derivatives: the importance of clearing

- Crisis illustrate market failure:
 - Bear Sterns, Lehman Brothers and AIG
 - Uncertainty on size & distribution of losses as well as effect on counterparties.
 - Uncertainty → liquidity drying up = market paralysis
- CCP most immediate way to reduce risks:
 - Risk mitigation & mutualisation of losses
 - Improves market liquidity
 - Solves disruptive information problems
 - Increases operational efficiency

Derivatives: is a global CCP desirable?

- At first sight:
 - CCP clearing characterised by economies of scale and scope
 - Concerns:
 - Static vs. dynamic efficiency
 - Regulatory differences
 - Reliance on third country authorities
 - Amplified in a crisis situation:
 - Limits to central bank emergency liquidity provision beyond currency area
 - Single point of failure
 - Legal risks in case of default (access to assets)
- ➔ Need CCP located in Europe, even if costly

Costs vs. benefits

"In the private sector, greater financial discipline at individual institutions must be reinforced by a renewed commitment to collective discipline in the spirit of elevated "financial statesmanship" that recognizes that there are circumstances in which individual institutions must be prepared to put aside specific interests in the name of the common interest.

Such a commitment may require market participants to (1) make costly investments in infrastructure (human capital and technology) and (2) change business processes, and accept changes to market practices, that in the past have generated sizeable revenues but at the cost of weakening the underlying foundation of the markets.

Costly as these reforms will be, those costs will be minuscule compared to the hundreds of billions of dollars of write downs experienced by financial institutions in recent months to say nothing of the economic dislocations and distortions triggered by the crisis."

Gerald Corrigan, Counterparty Risk Management Group (2008)



The industry's commitment

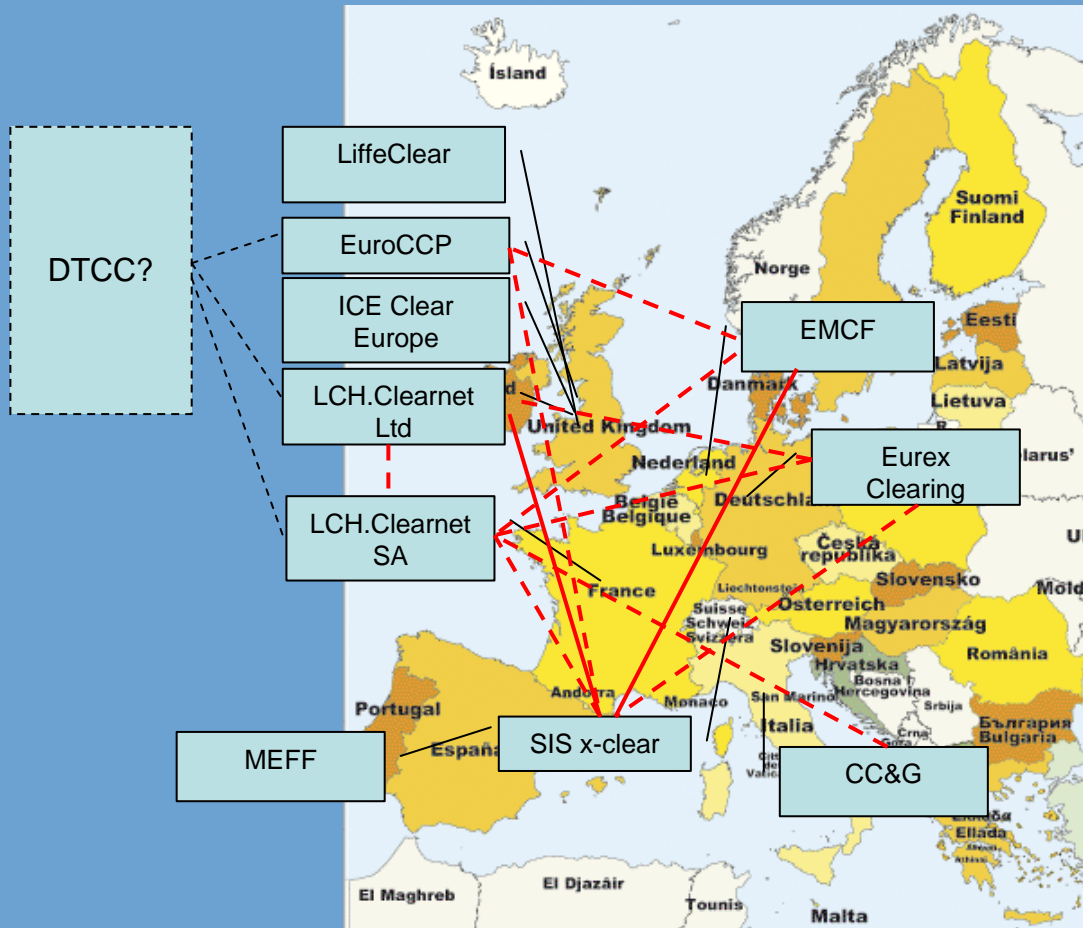
- Dealers commit to:
 - Use CCP(s) for CDS (index and single name) in the EU
 - Resolve issues such as restructuring credit event, auction process for cash settlement and dispute resolution mechanism
 - Backload outstanding existing contracts
 - Complete move to CCPs by 31 July 2009
- Monitoring:
 - Commission monthly Working Group (Infrastructures, Dealers, Buyers)
 - Commission Report on derivatives by June 2009: On this basis, consider appropriate initiatives
 - European Parliament

Conclusions (on CDS)

- CCP clearing for CDS uproots existing power relations in value chain
- Initially, dealers resisted on commercial grounds, now agreement to act.
- Welcome, as risk imperatives clear; action needed.
- Importance of monitoring



Part of evolving market structure



- Evolving market structure:
 - Entry
 - Link requests
- Consequences:
 - Fee reductions
 - Broadening of services
 - Fragmentation...
- Linked to competition for control of trading and post-trading value chain
- CDS CCP clearing process occurs in that wider context
- CCP success depends on overall positioning in value chain competition.
- Future market structure?