

European Union derivatives regulation: Too little too late?

A Eurodad briefing by Marta Ruiz

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“Financial regulation should be aimed at reducing the proliferation of such instruments, which seem to be more efficient at masking the risk to investors than in minimizing it”. UNCTAD 2009



The huge volume of opaque derivatives transactions was a major cause of the financial crisis. Derivatives markets have made commodity and other prices more volatile, and have created huge losses, destabilising economies. The regulatory measures that the European Union and other powers are currently considering on certain types of derivatives are inadequate. They should be replaced by bolder measures to regulate finance for the benefit of citizens in Europe and across the world.

What are derivatives and what problems have they caused?

Derivatives are financial instruments whose value is derived from making a bet on the future price of an underlying asset such as commodities, bonds or mortgages. Derivatives can be used to guard against the risk of a change in the price of the underlying asset which a farm, business or other entity produces or uses. However, derivatives trading has taken on a life of its own, with finance companies that have no use for the commodities using them to speculate. These bets on future prices have caused harmful volatility in oil, food and other sectors. For example, the food imports bill for developing countries increased from about \$190 billion in 2006 to \$254 billion in 2007 largely due to speculation in agricultural products and oil derivatives.¹

‘Speculators dramatically affect the price of transport and food for millions of people.’

These price hikes, as UNCTAD notes, have resulted in an additional 100 million people with inadequate access to food². Speculation was also partly responsible for the nearly 50% surge in oil prices in the first seven months of 2008.³ Speculators dramatically affect the price of transport and food for millions of people. Currency speculation can also cause severe problems for many governments and traders.

Most derivatives trades are invisible to regulators as they are traded “Over the

Counter" (OTC), in other words bilaterally between two companies without passing through an exchange. OTC derivatives have grown enormously over the past years. The high volume of derivatives trading, especially in OTC markets last year, created huge losses and destabilised whole financial markets as multiple organisations had to unwind their positions at the same time, thus driving down prices.⁴ A type of derivative called credit default swaps (CDS) – used as insurance against the risk of companies defaulting - has proved particularly harmful.

These mechanisms are so hard to manage and regulate that even insiders with access to information struggle to understand their company's position. One of the administrators who are winding down Lehman Brothers Europe told the BBC that it is "the most complex insolvency case I have ever dealt with and am ever likely to" and would take up to a decade to conclude.⁵ This is a large problem– the total amount of OTC derivatives contracts outstanding was nearly \$US600 trillion at the end of December 2008.⁶

¹⁰. The financial industry is the primary stakeholder being heard in this process. Following the G20 conclusions, the EC has received proposals from the financial industry.¹¹ In July the EC issued a communication¹² claiming that it will introduce measures that make derivatives "efficient, safe and sound"¹³. Yet investor Warren Buffet has called derivatives financial "weapons of mass destruction", and he and others have suggested that many types of derivatives cannot be made safe and should be banned.

The EC's proposals are tentative, and include many qualifiers. On central counter-party clearing the Commission claims that it is "*considering ways to strengthen incentives wherever possible*". The EC proposes that only some derivatives will be standardised, such as Credit Default Swaps. It also proposes

EU proposes limited measures

G20 leaders have agreed on the need to support exchange traded or electronic trading platforms for CDS and expand OTC derivatives market transparency.⁷ The European Union has proposed similar measures.⁸

The G20 London summit concluded with a: "call on industry to develop an action plan on derivatives contract standardisation" by autumn 2009.⁹ This industry led regulatory approach risks over-relying on the industry's perspective and not taking into account any broader consequences for society. The G20 made vague proposals to "expand OTC derivatives market transparency" and focus on "support [for] exchange traded or [electronically traded] CDS". These are worthwhile steps but will not prevent a repeat of the damage derivatives have wrought recently.

EU industry led agenda

The European Commission (EC) launched a consultation that should lead to new legislation by mid-end 2010 establishing a central data depository for all OTC derivatives, to enhance transparency. Finally the EC proposes the use of public exchange markets for trading standardised derivatives. The EC acknowledges that this "would improve transparency and strengthen risk management" but stresses the costs this might have in terms of "satisfying the wide diversity of trading and risk management needs".

Greater transparency alone will not solve the problem. Emrah Arbak of the Centre for European Policy Studies, a Brussels-based think-tank, said "There are many examples of securities where the transactions are extremely transparent and yet there are big problems," giving the sub-prime loan sector in the US as an example.¹⁴

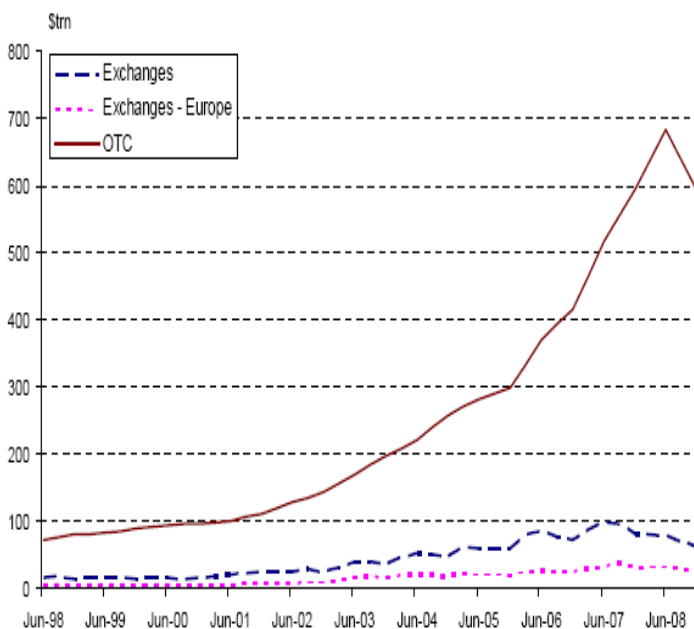
Derivatives are financial "weapons of mass destruction"

- Warren Buffet, investor

What still needs to be done to prevent harm to economies and citizens

EU regulators have started to take measures to regulate derivatives but these fall very short of what is needed to avoid uncontrolled speculative behaviour. Much more comprehensive measures are needed. Many of the current measures are addressed to specific types of derivatives, mostly CDS, leaving out others and, more worryingly, leaving the possibility for new types of derivatives to escape regulation.

Graph: Size of the derivatives market, in trillion \$US



OTC markets allow the proliferation of over complex products that allow intense and dangerous speculation and cannot be regulated. All derivatives should therefore be traded in the exchanges market and under the strict control of publicly supervised clearing houses. This has already been successfully implemented in the past in some markets in the US.¹⁵

- Clearing houses should substantially raise the compulsory guarantee deposit that traders must put down when making a trade¹⁶. The EC should base deposit requirements on empirical evidence and according to the precautionary principle, rather than relying on

the industry to come up with appropriate figures.

- Speculation on commodities is particularly harmful for developing countries. Derivatives have played a key role in such speculation by allowing dealers to circumvent rules limiting the size of speculative positions. To avoid commodity price speculation, traders should be required to trade the “underlying asset” covered by the derivative rather than just take positions as a bet.¹⁷ This could be implemented by introducing a trade register where only actors who are trading the underlying assets are allowed. By doing this, hedge funds and other institutional speculators which are not listed would be prevented from trading.¹⁸

Many types of derivatives should no longer be permitted. A financial products safety commission should be established in each country to determine whether certain trades or loans are permissible. This would work similarly to the determinations by the US Food and Drug Administration which decides whether medicinal and food products can be sold.¹⁹ This should, for example, apply to proposed new derivatives such as those on carbon, which threatens to be a new bubble.²⁰

Clamping down on derivatives, which were at the heart of the financial and economic crisis, is vital. It must, however, be accompanied by broader reforms such as separating the functions of banking and overhauling banking regulation, permitting restrictions on capital movements, reducing the leverage and increasing the capital requirements of financial institutions, and levying taxes on financial transactions.

Taking action

The banks that dominate the OTC derivative markets are fighting many of the EC’s proposals. They are also being very active in media outreach. The European Commission and decision-makers from Member States need to be strong and resist this pressure. Instead they need to enact measures that safeguard the public interest, not cater to a narrow private one.

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Notes

¹ Institute for Agriculture and Trade Policy. "Commodities market speculation: The risk to food security and agriculture". A: www.iatp.org/tradeobservatory/library.cfm?refID=104414

² UNCTAD. The Least Developed Countries Report 2009. The State and Development Governance.p91.

³ CFTC prepares crackdown on speculators, in The Financial Times, 7 July 2009. See: www.ft.com/cms/s/0/958cd848-6ae5-11de-861d-00144feabdc0.html

⁴ These problems are outlined in our October 2008 briefing "Dangerous derivatives at the heart of the financial crisis". See:

www.eurodad.org/uploadedFiles/Whats_New/News/Dangerous%20derivatives%20%20pager%20final.pdf

⁵ 'Decade' to wind up Lehman Europe, BBC, September 2009. At:

<http://news.bbc.co.uk/2/hi/business/8255782.stm>

⁶ The gross market value of derivatives (i.e. once all trades between entities are netted out) was then \$33.9 trillion. Source. Bank for International Settlements Semiannual OTC derivatives statistics.

<http://www.bis.org/statistics/derstats.htm>

⁷ See declaration here: www.iasplus.com/crunch/0811g20declaration.pdf

⁸ EC, Staff working document - Ensuring efficient, safe and sound derivatives markets, 7 July 2009. At:

http://ec.europa.eu/internal_market/financialmarkets/docs/derivatives/report_en.pdf

⁹ Standardisation has two main dimensions, the "legal" terms of the contracts (e.g. applicable law, dispute resolution mechanism, etc.) and the "economic" terms of the contracts (e.g. in the case of CDS the maturity of the contract, the coupon to be paid etc.) For more information see:

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/314&format=HTML&aged=0&language=EN&guiLanguage=en>. See declaration here: www.g20.utoronto.ca/2009/2009-london-ifi-090402.html

¹⁰ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of Regions and the European central Bank. Ensuring efficient, safe and sound derivatives markets: Future policy actions. 20 October 2009.

¹¹ ISDA letter to McCreevy on Clearing of CDS in a European clearing house. 11 March 2009.

¹² See: http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm

¹³ EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009.

http://ec.europa.eu/internal_market/financialmarkets/docs/derivatives/communication_en.pdf

¹⁴ See: www.businessweek.com/globalbiz/content/jul2009/gb2009077_649522.htm

¹⁵ In the 1930's, the US Congress closed some derivative markets considered as too speculative. See. Gaspard Denis. CNCD-11.11.11 La finance décomplexée: 10 propositions pour s'en débarrasser. February 2009. See : www.cncd.be/spip.php?article552

¹⁶ F. Lordon, in ZACHARIE, A., AVERMAETE, J-P., 5 April 1999, « Le marché des produits dérivés ».

¹⁷ This would automatically exclude speculative contracts, namely "contracts for difference" or commodity swaps.

¹⁸ For a more detailed analysis of speculation on food see "Speculation undermines the right to food: www.eurodad.org/debt/?id=2190

¹⁹ See Report of the Commission of Experts to the President of the United Nations General Assembly on the Reforms of the International Monetary and Financial System. 2009.

http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf

²⁰ Lohmann, L., Unregulatability in Carbon Markets, Cornerhouse, 2009. At:

<http://www.thecornerhouse.org.uk/pdf/document/Unregulatability.pdf>