

New rules will increase transparency and safety in derivatives trading

The Danish Presidency has achieved another concrete result. Agreement was reached today between the Council and the European Parliament over new rules for trading in financial derivatives.

The new EU rules mean that all trades in financial derivatives shall now be cleared by a central counterparty. The central counterparty stands between buyer and seller and guarantees that both parties in a trade are always assured of getting what they are owed, even if one of the parties gets into difficulties.

This creates greater security in the system than today, where most derivatives trades take place directly between buyer and seller, and where a party is directly exposed if the other party cannot pay. The new rules reduce the risk that a crisis-hit financial institution can "infect" the rest of the financial system via derivatives markets.

Minister for Business and Growth Ole Sohn and Minister for Economic Affairs and the Interior Margrethe Vestager said:

"The Danish EU Presidency has an ambition to contribute to strengthening financial regulation in the EU. Therefore we welcome the success in concluding an important agreement on the regulation of trading in financial derivatives.

The rules are a big step towards counteracting future financial crisis, as they reduce the risk of contagion from a crisis-hit financial institution "infecting" the rest of the financial system via derivatives markets.

The Government is pleased that the Danish Presidency has demonstrated its effectiveness and focus on results, by finding a compromise which the European Parliament, Commission and Council all support."

The agreement also means that all derivatives trades will now be reported to a central register, which gives supervisory authorities a much better overview of derivatives markets and reduces uncertainty in the market if a financial institution gets into trouble.

Finally it creates organisational and capital requirements for central counterparties. Central counterparties will often be systemically important, and it is very important that they cannot be affected by the collapse of other actors in the financial market.

By concluding this agreement, the Presidency is ensuring that the EU meets the G20 objectives in this area.

The compromise will have to be finally confirmed by the European Parliament and the Council of the European Union.

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Background

In September 2010, the European Commission adopted a proposal for a regulation governing trading in so-called financial derivatives. Financial derivatives are financial instruments linked to an underlying asset, e.g. a share, a bond, a currency, a commodity, etc. Financial derivatives can be used for the hedging of risk, when the underlying assets change in price.

One example of a derivative is a so-called "futures contract", which gives the owner a right or an obligation to buy or sell an asset (e.g. shares, bonds, currency or commodities) at a certain price at a point in the future. The buyer of such a futures contract can thereby ensure future delivery of the concrete asset at a price known in advance. This can be advantageous for a business which (for a fee) wishes to remove the risk of large future increase in the price of the asset.

Such a trade requires that another market participant is willing to sell such a future, and that someone is thereby willing to take the opposite position, i.e. to speculate that prices will not increase. The economic profit for buyer and seller by entering into such a futures contract will depend on the real market price of the underlying asset at the future point in time when the trade is carried out, and how this relates to the price agreed in the futures contract.

The financial crisis highlighted the potential systemic risk posed by derivatives trading. Insufficient transparency in derivatives markets played a prominent role in connection with the collapse of Lehman Brothers and the subsequent "contagion" to the rest of the financial system. The financial crisis underlined the need to limit the likelihood of losses spreading from one actor to another via derivatives markets, and for greater transparency and supervision of derivatives markets.

The new EU rules will increase financial stability by introducing an obligation for eligible financial derivatives to be cleared by so-called central counterparties. This will ensure that losses at one market participant do not spread to the rest of the market. The central counterparty stands between the two parties in a derivatives trade and ensures that counterparties always get what they are owed.

Central counterparty clearing houses are large organisations which identify what the two parties to a transaction are owed ("clearing") and organise completion of payment ("settlement"). Firms benefit from using central counterparties because their credit risk exposure – i.e. the risk that the party with whom they are trading will default on the trade – is reduced. In return for a fee, the central counterparty stands between the two parties and guarantees that each party always gets what is owed. All firms using the central counterparty contribute to a fund which ensures that the central counterparty always has enough money available to perform its role properly.

Finally, it creates organisational and capital requirements for central counterparties. Central counterparties will often be systemically important, and it is very important that they cannot be affected by the collapse of other actors in the financial market.

Negotiations within Council and with the European Parliament took place during 2011 under the leadership of different presidencies. The Danish Presidency has worked intensively since the beginning of its presidency to conclude the negotiations, which has now been achieved. At ECOFIN on 24 January 2012, the Economic and Home Affairs Minister received an expanded negotiating mandate to conclude negotiations with the European Parliament. Negotiations were then completed at the meeting on 9 February 2012.

More information: <http://eu2012.dk/en/NewsList/Februar/Week-6/Emir>
