Chapter 2
The Case for Regulatory Reform

Opening Address: Andreas Preuss, *CEO, Eurex AG*

Robert Schwartz: I would like to introduce my friend who has crossed the Atlantic to be with us today. It is with great pleasure that I present Andreas Preuss, CEO of Eurex (applause).

Andreas Preuss: Thank you Bob. Let me begin my presentation with a question: "What do our financial markets need?" Put another way, in the current political and regulatory environment, "What will our financial markets actually get?"

About a year ago, the financial markets experienced the unimaginable: the default of the large market participant, Lehman Brothers.[1] It turned out that we were all short on imagination. The default of a large market participant had been considered a most unlikely occurrence until that fateful episode in financial history. We then faced a sequence of once in a lifetime events. Finally, the massive intervention by central banks and governments has been necessary to stave off the potential collapse of the financial system and to shore up confidence in the orderly functioning of our markets.

The loss of confidence had been significant. It spread out well beyond the financial markets. It had negative impacts on the real economy in ways that may become more apparent in the near future.

With the worst hopefully behind us, our focus naturally shifts towards the lessons learned and towards restoring confidence and rebuilding market structures that are sustainable in their safety and integrity. The need for reform is clear. Not surprisingly, the current political and regulatory debate in the USA and Europe, especially on OTC derivatives markets, is about financial market stability. I sense that an

[1] Lehman Brothers Holdings Inc. was a global financial services firm, the fourth largest investment bank in the USA with 25,000 employees worldwide, behind Goldman Sachs, Morgan Stanley, and Merrill Lynch. Lehman's main business was investment banking, equity and fixed-income sales, research and trading, investment management, private equity, and private banking. It was also a primary dealer in the US Treasury securities market. On September 15, 2008, the firm filed for Chapter 11 bankruptcy protection.

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increasingly common understanding is developing across political leaders, regulators, and the industry on what went wrong. Today, I do not want to weigh in on this debate from a regulatory perspective. I want instead to offer the perspective of an organizer for the global derivatives market.

My focus, which is on market safety and integrity, is divided into three parts: first, the current market status; second, the needs of the derivatives market; and third, a market structure blueprint to effectively reduce systemic risk. That is a proposal to make financial markets more stable and less crisis-prone than they have been in the past.

Let us look at the structure of the global derivatives market as of today. With all of the discussions on derivatives over the past month, I consider it important to emphasize one aspect: Derivatives are good for you! The global derivatives markets are major pillars of the international financial system, playing a useful role in the economy. They can be employed to transfer all or part of the risks inherent in economic activity from agents who are not willing to take risk, to agents who are. This function, if properly used, is most important and indispensible for economic growth and employment.

Derivatives protect against economic risks with a minimum upfront investment and capital consumption. More than 90 % of the largest businesses worldwide use derivatives to hedge their economic risks by reducing uncertainty about future prices. They also contribute to price discovery for all sorts of underlying assets. Derivatives are widely used by financial firms and other players.

The derivatives market worldwide has grown by 25 % per annum between 1998 and June 2008. It has become the largest single segment of the financial markets. By the end of 2008, the market had reached a total size of €471 trillion by notional amount outstanding. That is the equivalent of roughly $700 trillion US. To put this in context, the annual gross domestic product of the USA was $14.5 trillion in 2008.

You can see in Exhibit 2.1 that 90 % of the market's notional amount outstanding is OTC-driven and 10 % is exchange-driven. Fixed income, the largest single underlying asset class in derivatives, has an 80 % market share. It is followed by foreign exchange, credit, equity, and commodity underlyings importance of OTC derivatives. This is so mainly because of declining interest rates and increasing market volatility.

The bottom line is this: While the figures mentioned indicate that the total derivatives market size has decreased by face value, the economic lever of OTC derivatives, as the largest part of the total derivatives market, has still increased with the financial crisis.

Let us look at some of the important structural elements of the current market. Exhibit 2.2 presents an overview on the market structure for the global derivatives market. The structure encompasses market safety and integrity: trading, clearing, collateralization, and registration/reporting, or more broadly, market transparency.

Derivatives are traded in one of two ways, either OTC or on regulated markets (i.e., on exchanges). Exchange traded derivatives are typically standardized, whereas many OTC derivatives are customized contracts. Additionally, the OTC and the

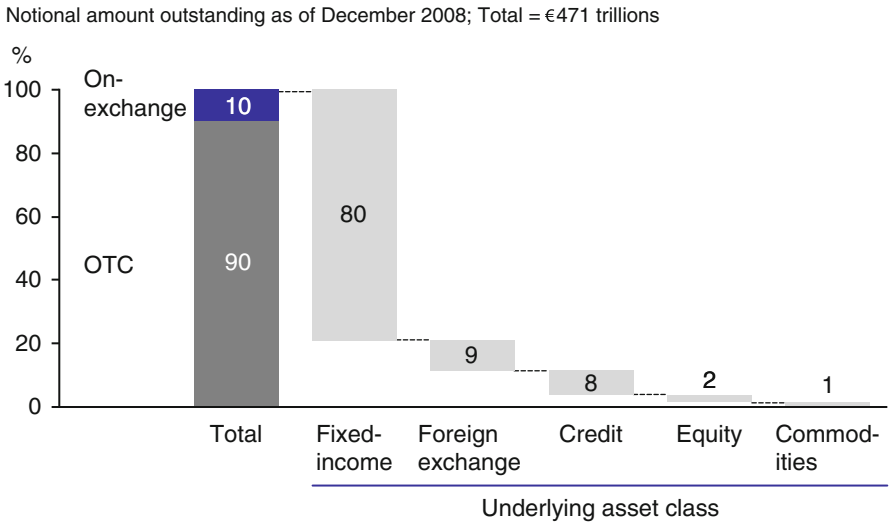


Exhibit 2.1 The global derivatives market—breakdown of OTC vs. on-exchange and by underlying asset class

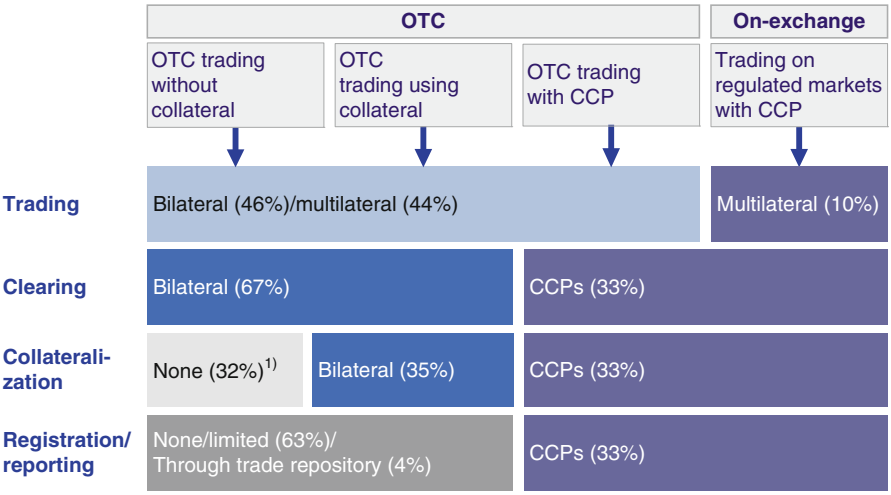


Exhibit 2.2 The global derivatives market—current market structure

on-exchange segment are structured differently. In trading, the OTC segment accounts for some 90 % of the market's notional amount outstanding. Here, volumes are equally split between bilateral trading between two parties, and multilateral trading, that is, trading across a number of different market participants on organized marketplaces. Exchange trading accounts for 10 % of the market and is, by definition,

multilateral. This is because you can match your trades with a broad base of orders since there are more than two parties submitting trades to the order book.

In clearing, approximately one third of the market's notional is cleared via central counterparties (CCPs)[2] which consolidate and manage market and counterparty risks. Exchange-traded derivatives are always cleared centrally via CCPs, thus ensuring full collateralization of open-risk positions and guaranteeing the final fulfilment of contracts.

For OTC derivatives that are not centrally cleared, risks are partially mitigated through bilateral collateralization (i.e., pledging of assets to secure against counterparty default). Nevertheless, some 32 % of notional amounts outstanding are currently not collateralized at all.

Looking at net counterparty risk exposure within the OTC market, this has, interestingly, grown by more than 200 % between 2005 and 2008. Progress has without doubt been made in the collateralization of those exposures. Still, some 59 % of the net counterparty risk exposure remains uncollateralized today. This equals counterparty risk in the amount of some €4.1 trillion. That's an increase of 86 % from 2005 to 2008. In fact, €4.1 trillion of uncollateralized net counterparty risk exposure in OTC derivatives is equivalent to some 42 % of the US gross domestic product in 2008.

Registration is not mandatory for OTC derivatives in most jurisdictions. Moreover, there is no comprehensive reporting of trading volumes and market prices. In practical terms, this means a lack of market transparency in certain OTC segments. Market information is only provided on a larger scale by regulated markets, by CCPs, and by so-called trade repositories.[3] They collectively account for approximately 37 % of the market.

In the case of exchange-traded derivatives, all trades are registered. There is a comprehensive post-trade transparency regime, thereby ensuring optimal transparency on contracts traded and on risk positions. Indeed, as you may already well know, even though the number of traded contracts and the resulting risk positions in central clearing are not made public, the clearing house and the clearing members always have a comprehensive and effective view on the risk positions that are open.

Let me now turn to what our financial markets need (Exhibit 2.3).

There are four indispensable imperatives for a well-functioning market: Safety, integrity, efficiency, and innovation. This holds equally true for the derivatives market as it does for other financial markets.

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[2] Central counterparty (CCP): Legal entity that acts as an intermediary between the parties involved in a securities or derivatives trade and acts as the seller to every buyer and the buyer to every seller, thus minimizing the default risk and facilitating the netting of risk exposures without revealing the buyer's or seller's identity.

[3] A trade repository (also known as a central data repository) is a platform where data on traded derivatives contracts is registered and post-trade record keeping on contracts is enabled. A repository provides information on, for example, the number and value of outstanding contracts, the size of counterparty risk, or outstanding positions.

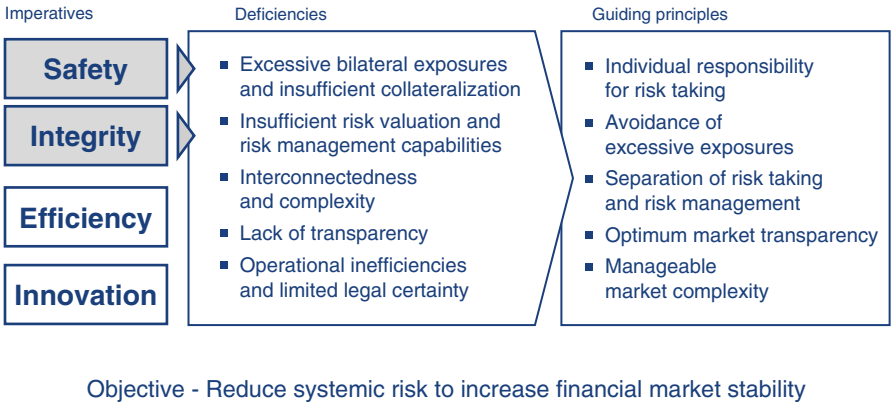


Exhibit 2.3 Rethinking regulatory structure—what do our financial markets need?

But let me stick to the derivatives market as my area of personal expertise. While efficiency and innovation have been center stage in regulation for many years, safety and integrity were taken for granted. And again, this assumption about safety and integrity has proven to be wrong with the financial crisis. Market safety and integrity are the necessary prerequisites for the healthy functioning of our financial markets.

From my perspective it is important to note that derivatives did not cause the financial crisis. The derivatives market as a whole has functioned well. But, yes, the derivatives market by its sheer size, structure, and role in the global financial system, has certainly been affected by, and has played a part in, market turbulences.

To be more precise, during the financial crisis, some parts of the market and its institutions have proven to be robust and resilient. These in particular include derivatives traded on exchanges as well as central counterparty-cleared derivatives. At the same time, the financial crisis unearthed deficiencies in less regulated segments of the derivatives market. These deficiencies include a lack of adequate risk management and mitigation, as well as a necessary level of transparency including:

– Excessive bilateral exposures with insufficient collateralization built up in the OTC derivatives market.
– Price signals that were not reliable anymore; market and counterparty risks as well as the availability of liquidity that have been both undervalued and often enough poorly managed.
– The high interconnectedness of market participants and resulting market complexity that developed into an uncontrollable chain of effects. This ultimately required the intervention of public authorities and taxpayers' money to avoid a possible collapse of the entire system.

That said, it appears evident that a few simple principles are helpful to reform and strengthen current market structure:

– The individual responsibility for risk taking needs to be assured again.
– Excessive risk exposure needs to be avoided.

– Risk taking should be separated from risk management to avoid conflicts of interest and to ensure the accurate pricing of risks.
– An increased level of market transparency is necessary and market complexity needs to be reduced to a manageable degree.

Let me rephrase this: Merely introducing stricter regulatory or supervisory requirements alone may not suffice from my perspective. Instead a stronger market structure with checks and balances, as well as built-in principles to minimize systemic risk, is necessary to restore the orderly functioning of financial markets. It is also necessary to ensure stability on a sustainable basis. Having in mind that some 90 % of the derivatives market is OTC-driven, the necessity to strengthen risk management capabilities and market transparency is of particular importance for the OTC derivatives markets.

At first glance, as the financial crisis appears to be stabilizing, and as the memory of market turbulences recedes, the objective of market reform should be unambiguously clear: Enhance financial market stability by reducing systemic risk.

Let me now turn to what the derivatives market needs. Exhibit 2.4 presents a blueprint for a market structure that, from my point of view, can effectively reduce systemic risk in the future.

After all the experiences with market structures and institutions that have either proven their value proposition or not during times of stress, I regard four elements as essential to strengthen current market structure:

1. The maximum use of derivatives trading on organized markets for derivatives trading is the best option.
2. The maximum use of central counterparties (CCPs), where trading on organized markets is not feasible, is the second best option.
3. The bilateral collateralization of derivatives exposure (preferably handled by a neutral third party) where contracts are not suitable for organized trading or central clearing.
4. The mandatory registration of open-risk positions, establishing reporting standards for all derivative contracts as a necessary minimum requirement.

Eurex and Deutsche Börse published this blueprint in conjunction with a White Paper in early September 2009. The blueprint is available on our Web sites.[4]

It provides a proposal for a comprehensive and uniformly applicable market structure across all parts of the market (asset classes and trading forms). The emphasis is on effective risk management and an improved market transparency for the global derivatives market (with a special focus on OTC derivatives).

[4] Deutsche Börse AG and Eurex Frankfurt AG, 2009: "The Global Derivatives Market: A Blueprint for Market Safety and Integrity", http://www.eurexchange.com/download/documents/publications/WPDerivativesMarketBlueprint.pdf.

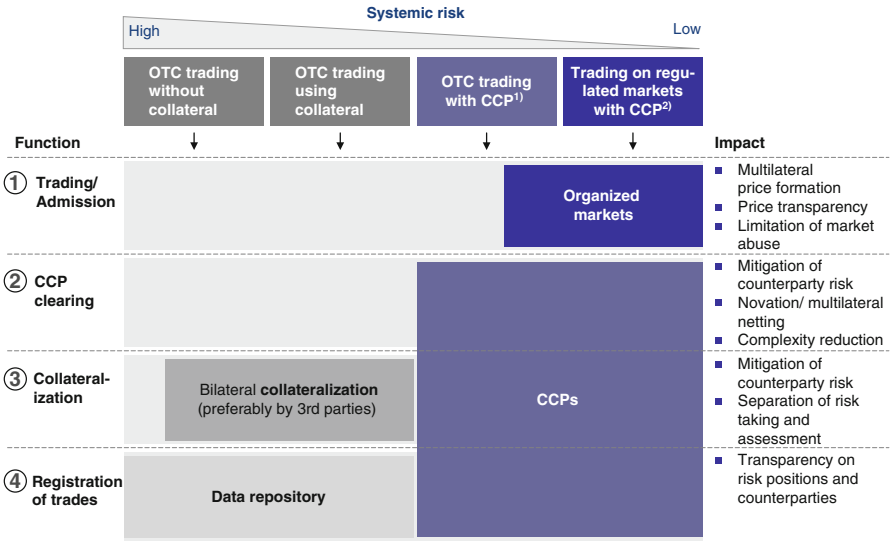


Exhibit 2.4 Blueprint for market safety and integrity—four key elements effectively reduce systemic risk

Exchanges and clearinghouses have proven their value proposition under stress. But this may not help very much from a total market perspective. That is because the largest market participants are active both on-exchange as well as on OTC markets, and in many financial markets beyond derivatives too. In this case, we are all in the same boat. We have the obligation to ensure the well-functioning of the derivatives market, both on-exchange and OTC.

Therefore, the registration of trades is necessary to overcome the opaqueness of large parts of the OTC derivatives market. One cannot manage or supervise what one cannot measure. Trade registration builds the basis for the transparency of open-risk positions. Transparency of open-risk positions is a prerequisite for any subsequent risk management and for effective market supervision.

Collateralization of open-risk positions should be standard in risk management, by central counterparty clearing services or, if that is not possible, at least on a bilateral basis. This standard is at the heart of the blueprint. It will ensure the effective mitigation of counterparty risks by netting and margining, as well as the factual reduction of market complexity. In addition, collateralization targets a more accurate pricing of market and counterparty risks. The valuation of open-risk positions and margining is preferably done by neutral institutions that are independent from any trading interests (i.e., clearinghouses or third-party collateral managers).

Moreover, trading on organized markets delivers an efficient price discovery process that limits the potential for market abuse. It can also improve both pre- and post-trade transparency. The more the market moves to the right-hand side of such a market structure blueprint, the lower is the systemic risk inherent in the financial market.

The current proposals for regulatory reform in the political and regulatory debate in the USA and in Europe appear to be moving in the direction of such a blueprint.[5] In the USA, the administration made its proposal in May; and the House Financial Services Committee approved legislation to require the comprehensive regulation of the OTC derivatives marketplace last week.[6] It is likely that we can soon expect the conclusions of the European Commission deliberations on policy actions in the CCP space.

In addition, there are numerous self-commitments of market participants with regard to improving the safety and the integrity of OTC derivatives markets which still await implementation.

That said, the part of "what needs to be done" appears to be well recognized and, hopefully, implemented in a positive way too. The crystal ball for the regulatory framework is becoming clearer. But it is important to note that no final decisions have been made. That may still take a few more months.[7]

The political and regulatory debate in the USA is possibly further ahead. There might be an outcome here by the end of this year. In the European Union, we will see a changeover in the elected members of the European Commission. With the release of policy actions in the EU the way forward is becoming clearer. The next EU Commission must act on them. Nevertheless, it is not easy to implement market reform ideas.

From my perspective, the implementation of necessary market reforms is not the task of regulators alone. It requires a joint effort between the derivatives industry and regulators. This effort should follow the principles of the following:

1. Market-driven solutions.
   In general, market-driven solutions are preferable as a default option. They should be considered as a superior means of implementation in contrast to mandatory solutions, or the public provision of services wherever possible. Of course, we all know that market-driven solutions may not always be possible. Therefore, mandatory solutions cannot be excluded if necessary to overcome market failure.
2. Neutrality of risk management.

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[5] See, Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties, and trade repositories published by the European Parliament, September, 2010.http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0484:EN: NOT.

[In] the US, the "Dodd-Frank" Act.

[6] The Wall Street Transparency & Accountability Act of 2010 imposed oversight of the OTC derivatives markets which previously were mostly unregulated. ("Dodd-Frank" Act.)

[7] As noted, in September 2010, the European Commission published its Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories in the EU. The Proposal is compatible to the OTC derivatives legislation adopted in the United States (the "Dodd-Frank" Act). As also noted, the Wall Street Transparency & Accountability Act of 2010 imposed oversight of the OTC derivatives markets which previously were mostly unregulated.



Exhibit 2.5 Blueprint implementation requires a joint effort between the derivatives industry and regulators

Providers of critical functions in the derivatives market should be neutral and independent, particularly in risk management. This needs to be independent from risk taking to avoid conflicts of interest.

3. European solutions.
   This point may sound a bit challenging here in New York as the derivatives market is certainly a global market. Nevertheless, jurisdictions and regulatory regimes still lack this attribute.
   As a consequence, European markets should be "independent in their functioning." This means that critical infrastructure must be located, operated, and regulated in Europe.

Look at the right side of Exhibit 2.5. I regard the standardization of derivatives products and related operational processes as a key lever to promote safety and integrity in the OTC derivatives market. Standardization should be seen as a continuous effort. It should enable the implementation of all four blueprint elements. It should support the market to factually perform a desired move from the left to the right side of the blueprint as described in Exhibit 2.4, and by that towards a state of reduced systemic risk.

As already mentioned, safety and integrity can only be achieved through a joint effort by public bodies and the industry. First, regulators and supervisors must lay the foundation. As already noted, the USA and the EU have launched dedicated regulatory initiatives to do this. It is imperative that these initiatives do not lose momentum. However, any excessive regulatory burden should be avoided. Market participants and infrastructure providers should still have explicit incentives to trade products freely, and they should continue to innovate. Additionally, it is important that both regulatory and supervisory changes are coordinated

internationally to ensure a level playing field, and to avoid loopholes and regulatory arbitrage in a global market environment.

Then there are the market participants. They are central to the implementation of the derivatives market blueprint. They benefit most from increased safety and integrity as a prerequisite for successful and sustainable business development. Therefore, market participants should drive the standardization and the automation of the OTC derivatives market. They should also proactively increase collateralization and the use of third-party providers. The close collaboration of market participants, regulators, supervisors as well as infrastructure providers working towards a common target is the best basis for a joint implementation effort of necessary market reforms.

Finally, infrastructure providers, such as exchanges and other trading venues, clearing houses, collateral managers and trade repositories, should work with other stakeholders towards implementing the blueprint. Most importantly, these providers need to expand their offerings to fill the current gaps in the market structure, or to expand the product scope for organized markets. These offerings should include CCP services. Providers have to ensure that their services are sound and reliable. Processes and products and CCP clearing should be developed in close cooperation with all market participants, explicitly including smaller sell-side and buy-side market participants.[8]

Let me conclude. What is necessary to make the financial system less crisis prone is evident. From my perspective, it is important not to lose any momentum. And it is important to avoid potential loopholes or regulatory arbitrage among various marketplaces by ensuring that their regulations are compatible with each other for this purpose. Regulation plays an important role in setting a framework for market participants. It should allow us to overcome the deficiencies and to allow the financial markets to function well again, even without central bank or government intervention.

In the best-case scenario, regulatory reforms provide the market with proper economic incentives that align the individual rationality of market participants with the collective rationality of a well-functioning market. That would benefit the financial industry and, more importantly, benefit growth and employment in the real economy. Thank you.

[8] The speaker noted in a follow-up explanation that this approach would enable these second-tier and smaller players to participate in a new structure. Business is usually scale-driven with the tendency towards consolidation amongst market participants, he noted. Thus, as this implies, the tendency is towards building larger banks that are, in the end, "too big to fail," as he noted, a phenomena of recent market history. In other words, the smaller players should not be excluded in processes and products and CCP clearing in this race towards scale.



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