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Time for regulators to get a better view of derivatives

Statement on reviewing derivatives markets before the end of the year

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The market for derivatives has grown to around $600 trillion. It is a market little understood by those outside of it. In the current crisis these complex and often opaque instruments have come under the spotlight. Given their size the question most frequently being asked is do they pose unnecessary risks to financial markets?

There are many types of derivatives. Some are fairly standardised and traded on exchanges. But the vast majority of derivatives are bespoke financial products traded off-exchange, i.e. over the counter (OTC) between two parties. Interest rate contracts account for almost 2/3 rds of the total volume outstanding. But the derivative that has shown exponential growth in the last few years is Credit Default Swaps. These now account for around 10% of all derivatives. Unlike most interest rate swaps Credit Default Swaps can result in large payments having to be made in the event of a bankruptcy of a company.

Derivatives were originally devised as an added measure to help companies manage certain risks; for example, to limit foreign exchange or interest rate risks in contracts. These derivatives are by and large OTC (over the counter) derivatives - namely they are not traded through a stock exchange or other multilateral trading platform. Instead the contracts are drawn up between dealers and corporate and institutional clients, in principle, tailored specifically for each clients need. This gives rise to concerns that in the event of the failure of a significant party to honour its obligations there could be serious knock on effects for other financial players. In current fragile market conditions such new tremors could cause major damage.

I am aware of the many reasons why more of these derivatives are not exchange traded. However I am not convinced that more derivatives could not be standardised. This is one of the issues we need to look at in the time ahead. But there is a far more pressing need and that is to have a central clearing counterparty for these derivatives. This has been underlined by the collapse of Lehman who was a major counter party in the derivatives area. In addition there was also considerable speculation on Lehman's default through the use of Credit Default Swaps which again increase the counter party risk in regard to these instruments.

At $600 trillion the size of derivatives markets today are such that we cannot let this OTC market continue without adequate counter party clearing. This is particularly urgent for Credit Default Swaps. According to estimates of the Bank for International Settlements the total notional amount outstanding for credit default swaps is almost $60 trillion dollars that is 10% of the total derivatives market. No one is able to say how these swaps will unwind. Regulators have little sight of potential liabilities that could be building up for individual participants. The opaqueness of these products leads to nasty surprises when things go wrong.

The failure of the Icelandic banks is the latest in a line of credit defaults in recent weeks. Already at least one bank has had to write down a significant amount as a result of the failure. The potential knock on effect to other players in the market is obvious. Regulators need to have a much better view of where the real risks in these instruments lie.

That is why I have decided to convene all the main players concerned to work through this. I would like to have by the end of this year concrete proposals as to how the risks from credit derivatives can be mitigated.

More generally I also would like to have a systematic look at derivatives markets in the aftermath of the lessons learned from the current turmoil.