Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

Response from the ABBL to the ESMA Consultation 2012-379 On Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Information about the ABBL:	
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Introduction and general remark

The ABBL[1] recognises that ESMA had a particularly difficult task to issue such a consultation in such a short time and under such pressure. This pressure has now percolated to industry groups and their representatives as well as users or clients, direct or indirect, of the CCPs to respond to an extensive consultation in about a month during the summer break, usually not an ideal timing.

The ABBL is aware of the objectives set by the EU Commission and willingness to be ready for the G20 deadline of January next year, but at this stage, with all what remains to be developed and created, our priority will be to introduce a dose of pragmatism and realism into the time framework. What counts is good quality regulation not speed. This level 2 regulation will interact with other regulations notably the MiFID and CRD IV, the consequences of which may redraw the landscape of derivatives trading and issuance. The Association notes that under the current MIFIR, there may be an obligation to have interoperability among CCPs even for derivatives.

[1] The Luxembourg Bankers' Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members' universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.

Additionally, competition among clearers on a given trading platform may have the perverse effect of concentrating trades among the largest institutions who will be the only ones able to be present on most trading platforms and members of most CCPs. Thus, the side effect will be to further concentrate the risks on a few, but large SIFIs (Systemically Important Financial Institutions).

The reading of both texts (MIFID II and EMIR) leads the Association to raise the following question: will there be in the future 2 classes of derivatives; those agreed at Member State level but not authorised under EMIR and those that are EMIR regulated? This analysis stems from the dual approval process at MS and ESMA level as well as from the MIFID, which requires the maximum number of financial products to be cleared (at least once they are available on a trading platform). This problem may be particularly acute during the interim period when only EMIR will be applicable.

Under EMIR a lot has been said regarding the OTC derivatives, but the regulation will also apply to all trades on a trading platform according to MIFID II. The impact on CCPs' interoperability may then be that this will be the place where all risks concentrate; in the end, a super SIFI. That is why conditions for licensing CCPs and the stability of their shareholders are of paramount importance.

What is still surprising at this advanced stage is that so many subjects are not yet clarified, notably which instruments will be eligible for clearing. This seems to have been pushed from G20 to the EU Commission and then from ESMA to MS Authorities and CCPs. This situation is complex for future members of CCPs and even more so for clients of these members that are a bit further down the chain and have consequently reduced visibility on what is going on and how to fill their obligations.

Finally, ESMA should bear in mind that many contracts that are OTC are in fact divided into two legal instruments, the master agreement and addendum per specific transaction. The reference used should generally be to the master agreement not each individual addendum.

The ABBL will focus its comments on selected areas of the Consultation paper, principally on the clearing eligibility and some requirements on margins at CCPs, and invites ESMA to consider the EBF (European Banking Federation) response for other points, including comments on tables for reporting, as it is shared and supported by the ABBL.

Specific remarks

Annex II OTC derivatives

In the first part under ICA, the ABBL has the general feeling that good intention has taken over reality and as consequence the proposed RTS go beyond what is foreseen in the level 1 Regulation of EMIR, notably by imposing arrangements between CCP members and their clients (under indirect clearing arrangement). Notably under article 3 a contract agreed between a member and its client cannot force or create liabilities for the CCP. It is neither legally acceptable nor operationally feasable: CCPs are not insurers of transactions.

Article 2.1 ICA is not explicit enough. The ABBL understands this the following way: a client of a clearing member is allowed to offer clearing services provided that it respects regulation. What is not clear is what regulation is considered here, and to what extent the term clearing services is used? It should at least be possible for these entities to issue/negotiate derivatives contracts with their own clients (be they other banks, corporate or any other clients) on a contractual basis. In addition, this notion of "is permitted" may mean that clearing members may forbid their clients to issue or act as counterparty in derivative contracts, which is of course not acceptable.

Article 2.2 ICA The Association invites ESMA to be more specific on the level at which this paragraph applies. The reference to client providing the service is not explicit enough. Does it refer to the clearing member, its client or a client of an indirect participant/member?

Article 4.1 ICA Although the need for transparency of commercial terms is an important tool, maybe the model should be built on the Code of Conduct for market infrastructures so that information is available to any counterparty and does not go against article 2, which seems to authorise negotiation on fees (in case of large volume for example).

Article 4.2.a ICA. The ABBL generally supports the idea of segregation of assets between the clients and the service provider. It would, however, like to remind that most countries operate under omnibus accounts. What is not clear is if the reference to segregation is vis-à-vis clients of the clearing member or clients of the indirect participants. Knowing that in any case MiFID rules on segregation of assets should apply. This point may then be rephrased along these lines:

> "*Keep separate records and accounts enabling indirect clients to distinguish in accounts with the clearing member their assets and positions from those held for the account of other indirect clients or from the clearing member itself.*"

Article 1 DET The Association considers that many provisions in the first 2 paragraphs are subject to wild interpretation, notably:

1.e what evidence would be sufficient to be considered standardised?
1.f and g should these be understood as prior "clearing eligibility" or expectations?
1.h will not the clearing requirement itself determine pricing transparency?
2.a considering the fact that once a derivative becomes clearing eligible, the first to be granted a licence to clear will by default be granted with a 100% market share. Has this side effect of "quasi monopoly" been envisaged?
2.b ESMA probably knows this information because of registration/notification.
2.d the term counterparties is not defined, should this thus be considered at clearing member level or any other counterparty that may intervene in a given class of derivatives?

Article 1.4 DET The rationale for having reliable price references seems appropriate for the transition period to accommodate new contracts, but in the future this may prevent the clearing of new categories of products because no prices are available by nature of it being a new product.

Article 1.5 DET Ideally to ensure a level playing field it would be appropriate not to offer MS authorities the possibility to add additional requirements in the notification to ESMA, as these may be filed by applicants and may create as a consequence regulatory arbitrage.

Article 1.7 DET. Based on the EMIR regulation and this article, one may draw several interesting conclusions, notably:

- Products will be authorised at MS level, probably as proposed by CCPs. These will in turn be notified to ESMA who will make them clearing eligible in the meaning of EMIR, which is, in fact, forced clearing at EU level.

- This means that there may be on CCPs, EMIR OTC derivatives subject to forced clearing and at the same time non-EMIR OTC derivatives, and thus not subject to EU Clearing obligation but at MS level (or even not forced). Concretely, there would be a host of various but probably similar products that will either fall under or out of EMIR. The big issue is then how to discriminate between products.

- This specific paragraph raises an additional issue. Given that according to EMIR article 5 asks ESMA to undertake a 6-month EU wide consultation to "validate" EU clearable products, article 1.7 DET furthermore offers the possibility to rerun the process. Does this also mean an additional 6 months for validation? The consequence may then be that contracts, in order to get an EU status, will spend several years in the regulatory approval process. An interesting feature may be that if they become tradable on a MIFID II platform they may be "by nature" subject to clearing. This may impact clearing members and their clients, as the cost of non-clearing may be prohibitive in terms of prudential requirements.

- In the end the question may be what would happen if, as envisaged today, all clearable contracts were subject to "forced trading" under MIFID because they will have to be negotiated on a trading platform. Will there still be OTC contracts and what would happen with contracts that are cleared in a given MS because they are subject to trading but not eligible as an EMIR product (because of delays or any other reason)? Or with those traded on a platform but where ESMA or an MS have rejected clearing approval?

Article 1.4 CRI. Again, will the fact that a contract is negotiated on a MIFID trading platform be enough to qualify it as clearing eligible? As a consequence, will that be sufficient to qualify for reliable prices?

Article 1 CRI

In the ABBL's view hedged transactions relating to covered bonds should be exempted of clearing obligation according to article 5 of EMIR and this regardless of counterparties. These derivatives contracts are insulated from the insolvency of the issuer and the collateral in these transactions is in most jurisdictions posted unilaterally by the counterparty hedging for the default, whereas the counterparty has a preferential claim on the covered pool.

Due to the special set-up of those hedged transactions, it will in practise be extremely hard if not even impossible to clear such contracts in a CCP. Given the little time left, it is now key that a clear statement is made as to the exemption of covered bonds from the clearing obligation. In addition, a consequence of the affirmation of the exemption for covered bonds is that, given these contracts are by law and by nature exempted from CCP clearing, they should also be exempted under the CRD additional requirement for non-centralised cleared instruments.

Article 1.2 LF. Until now the problem has not been about "not being able to clear" a contract but about being faced with many clearers able to do it and as a consequence having both sides of the trade on 2 different CCPs. EMIR prevents interoperability among CCPs for OTC derivatives. Although, one may first dispute the reliance on what is a trading venue when according to EMIR there may not be interoperable clearing in any case for these products.

From the ABBL's stand point, liquidity fragmentation refers to the fact that because there may be too many players, the chances that 2 counterparties are clients of different but not interlinked CCPs is too high and results in a quasi impossibility to clear some products. It is worth remembering that some derivatives have mutual obligations that may last over years. The practical consequence would be that any stakeholder will have to be member of each and every market and all its clearing houses, which is unmanageable for smaller and medium sized institutions.

Article 1.3 LF. The Association questions this particular point. How would it be possible and how would one determine the point a. of having one common CCP who will be "forced"; and b. why and how to choose or abandon a preferred CCP? Furthermore, this would probably contradict the new version of MIFID, which seems to impose some form of competition among clearing houses and limit the possibility of a trading platform to reject the application of a new (additional) CCP. Conceptually, only very large institutions will then be able to be member of all CCPs (and trading platforms), which will in turn probably concentrate systemic risk among a handful of CCPs and financial institutions.

Article 1 NFC. The ABBL is of the opinion that it is the NFC that informs the financial counterparty of its status above or below threshold as envisaged in level 1. Furthermore, as ESMA has identified several typologies of derivatives, the ABBL would support the idea that the NFC qualifies for the clearing obligation per typology or category. It would be meaningless to force an NFC to clear all transactions when it is mostly active in just one category, say commodities. In the definition, the ABBL is wondering what would be the qualification of airline companies that hedge their cost of oil over several years? Does this support their activity or is it financial speculation?

Article 1 RM. According to the ABBL, one of the first things to do is to determine what is meant by confirmation. Is it the "physical" signature, an exchange of document, or the simple fact of confirming key features of the trade by phone (on the master agreement or each addendum). The industry jargon makes a difference between affirmation of a trade, which is an exchange of the key parameters of a given derivative, and confirmation, which is a legally binding document.

Articles in the RM. The ABBL is of the opinion that FX should be exempted from the threshold for reconciliation and portfolio compression.

Article 3.3 RM. Does it make legal sense to terminate contracts that offset one another? This should probably take some time. Thus a delay may be introduced. In addition, the meaning of fully off-set should refer only to exactly the same contract but in "opposite" direction, not that they have the same effect…

Article 5 RM. The Association understands the concept of inactive market, but a delay should probably be introduced in terms of non availability and as to what the inactivity is related: is it to the derivative market or the underlying or both?

Article 7.4 RM. Considering that notification is at the transaction level for intra-group exemption, the Association would plead in favour of defining a framework based on the criteria in 7.2 & 7.3 RM with yearly assessments per class of products/ contracts so that it removes some paper work pressure at authority level and within groups. This approach would also ensure the legal status of contracts (in or out) and not subject it to a discriminatory approval process transaction by transaction with potential retroactive (because of the 14 days delay) effects.

As a general comment on Article 7 RM, the Association is not certain as to who has to apply to the “competent authority”. A range of scenarios may be envisaged. Among them parent vs. daughter, or the reverse or 2 or more sisters companies. By the fact that they are legal entities in their jurisdiction, this may open the door to different approaches by supervisory authorities (e.g. Member State A is “always positive” and Member State B “always refuses”).

ANNEX III CCP Requirements

Article 1 MAR. It is interesting to note that the difference between an OTC product and the other instruments is only 0.5%. This is all the more noticeable as one of the combined consequences of MIFID (MIFIR) and EMIR may be that very few contracts will remain pure OTC. Thus de facto the next day that MIFIR is be applicable, a wide range of contracts will be reclassified as non-OTC. Therefore, does the risk over these remaining contracts still justify a 0.5% difference? The Association would therefore opt for a single 99% interval. Pure OTC will be subject to full collateralisation and be out of CCPs and trading in any case.

In addition, shouldn't the reference to "on a product basis" be understood as per class of products? In the end, all products in the same class will converge to the same requirement, depending on the granularity of the definition of what constitutes a class.

Article 2 MAR. The ABBL has several technical issues. First of all, what would happen if the last 6 months and the "worst 30 years 6 months" coincide? Then, should those worst 6 months be in a row? Hopefully yes. Finally, do the worst 6 months over the last 30 years refer to the contract itself, the underlying or any other reference market or index/benchmark?

Because the underlying idea is to balance regular days with real stressed scenarios, if it is impossible to go over 30 years, will this "worst half" not be over-represented if the interval is say 5 or 10 years? Should one understand that the requirement is to balance proportionally the normal days with an equivalent period of rainy ones, be it 6-6 months or 4-4 months? The Association thinks it would make some sense.

This comment also applies to articles related to the default fund (article DF2).

In addition it may even be debatable if emphasis on stress testing is so relevant once this approach is taken, indeed if in any case the worst experienced period is always used as a reference why then further require to do stress testing?

Article 3 MAR. A balance shall be found between practice and theory, the longer the delay probably the safer but at the same time the more costly for participants (direct or indirect) thus ESMA proposal seems an appropriate compromise

Article 4 MAR. The Association would prefer to opt for a split along contract length and refer to a few buckets. Contracts with a short lifecycle should not be under the assumption of paragraph 2, which uses a 2-year reference to compute correlation.

The rate of 70% of opposite correlation is probably too high. There is no need to remind that a 0 correlation already means that 2 instruments are not in principle moving together. Thus, a minus 50% correlation is probably by default the most appropriate day-to-day measure (with a second threshold set at 30%) and an option may then be left at CCP level/authority to raise the bar in case of extremely volatile and converging markets. It is then obvious that the levels of offset should be proportionately introduced (under 4.4). In the end, it should be understood that the direction of the trade might also be taken into account, as by definition a buy and a sale of a same (or similar) instrument by the same operator will act in opposite directions.

Articles COL. The ABBL notes that it is generally speaking difficult to split collateral per currency, moreover when this shall be done on a daily basis.

ANNEX IV record keeping by CCPs

The ABBL invites ESMA to refer to the EBF document for more details, the Association nevertheless has the feeling that a lot of field are required which sometimes are of little relevance or for which the complexity to report is not balanced by the benefit of the new information.

ANNEX V data to be reported to trade repositories, registration as TR & details of data to be made available by TRs

The Association has no specific comments beyond the fact that ESMA shall avoid transitory measures to the maximum extent as the MIFID/MIFIR requirements on reporting may force some changing, in an ideal world EMIR reporting rules shall be “integrated” into the MIFID/MIFIR framework that will cover all financial instruments.

Regarding identification, the Association pleads for the recourse to the maximum extent to the global standards available, in transitory situation (LEI), ESMA shall not force the use of a new transitory coding, but let individual use their “preferred” method as long as it is consistently use until the date when global standards are available.

The ABBL is highly concerned by the new requirements laid down in articles 3 and 6, and tables 1 and 2, which set out an obligation to report the market value and the amount of collateral posted in view of every single transaction to be reported. The reporting thus becomes an obligation to constant market valuation transaction by transaction taking into account the level of collateral per each item.

In the ABBL’s eye there is no legal basis in the EMIR level 1 for such an extensive and constant reporting obligation, article 9 (1) EMIR requires reporting on any conclusion, modification or termination of the contract accordingly the market value (and its collateral posted) nor changes thereto is neither an element of the conclusion, nor of the modification nor of the termination of the contract. Consequently, the relevant provisions as envisaged have no legal basis.

In the Association’s views the requirement to report market and collateral values are also conflicting and inconsistent with the Regulation. Such requirement forces counterparties to an obligations they are exempted from in level and it also seems to conflict with legal concepts accepted and encouraged under other regulations:

- Under Article 11 (2) of EMIR the obligation to assess the market value of a transaction is expressly limited to financial counterparties (plus NFC that are above the threshold however the reporting obligation will apply to all transactions regardless of the counterparties including NFC below threshold. The ABBL is of the view that they shall be expressly exempted, at least this shall be clarified.
- Then, the requirement to report the level of collateralisation on transaction basis does not take into account the fact that collateralisation occurs most of the time on a net basis because of the risk reducing effect of netting agreements. This practice is not only accepted but actively encouraged by other regulatory rules notably the capital requirements (CRD/CRR) and the Financial Collateral Directive. Article 6 and the relevant sections in Table 2 need to be revised.
- Last, market valuations of positions/collateral to be reported by counterparties will probably never perfectly match. The information received will thus be

conflicting when both parties report or irrelevant when one party reports following a delegation of this obligations.

In general, the ABBL believes that the reporting obligation should be similar to the requirements under the Dodd-Frank Act in the US. Trade repositories are developing as well in Asia and shall not be forgotten.

Finally, reporting obligation under MiFID I and future MIFID II shall be addressed and compared to EMIR in order to avoid double reporting or worse conflicting content in reporting or nearly identical reporting to be posted to various institutions. The ABBL welcomes the efforts by ESMA to work towards this convergence between EMIR and MiFID.

Specifically on **article 7 TRs** on reconciliation process at TR level, the Association invites ESMA to clarify who is in charge of reconciling data (trade repositories or counterparties). Should TRs be in charge of this task, the Association invites ESMA to clarify how TRs will deal with the reconciliation of data reporting to them when these data do not match, both within the same TR (i.e. when both counterparties use the same TR) and among two different TRs located in two different jurisdictions, beyond the use of agreed international/universal standards.

ANNEX VI format and frequency of trade reports to TRs & format of registration for TRs.

No specific comments