

**ALFI comments**  
**on**  
**ESMA's**  
**Discussion Paper**  
**The Clearing Obligation under EMIR**

**12 July 2013/ESMA/2013/925**

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers. According to the latest CSSF (Commission de Surveillance du Secteur Financier) figures, on June 30, 2013, there are 3 890 undertakings for collective investment in Luxembourg (UCITS and non-UCITS), representing 13 558 active compartments representing a total, in terms of net asset value EUR 2 486.584 billion.

ALFI welcomes the ESMA Consultation Paper – Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR (hereafter, the “Consultative Document”) and welcomes the opportunity to provide its comments and expertise to the ESMA work stream on this Draft Regulatory Technical Standards.

Regarding the questions raised in the Discussion Paper, hereunder our comments:

**A. Respondent**

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Name: Association of the Luxembourg Fund Industry

Country: Luxembourg

Category: please use the table below

Category	Please select
Audit/Legal/Individual	X
Banking sector	
Central Counterparty	
Commodity trading	
Government, Regulatory and Enforcement	X
Insurance and Pension	
Investment Services	
Non-financial counterparty subject to EMIR	
Regulated markets/Exchanges/Trading Systems	
Other Financial service providers	

## **B. Introduction – General comments**

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On the general approach proposed by ESMA: rather ok. The key point is how it will be possible "easy" to identify whether a contract is clearable or not. In our opinion it should go through the information available in the Public Register of ESMA.

## **C. Comments on the discussion paper and answers to questions**

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**Comments on paragraphs 1 to 6: N/A**

### **1. Procedure for the determination of the classes to be subject to the clearing obligation**

**Comments on paragraphs 7 to 17: N/A**

### **2. CCP-cleared classes of OTC derivatives**

**Comments on paragraphs 18 to 30: N/A**

## 2.1 Credit derivatives

**Comments on paragraphs 31 to 39: N/A**

### **Question 1 (Series for Index CDS):**

Please indicate your preference between the options presented. Do you believe that the possibility for a new series to exhibit low liquidity is a risk worth being considered when defining the classes of Index CDS? Under Option C, which criteria do you believe are relevant and how should they be calibrated?

**Answer 1: N/A**

### **Question 2 (Index CDS):**

Do you consider that the main characteristics of Index CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 2: N/A**

### **Question 3 (Index CDS):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 3: N/A**

**Comments on paragraphs 41 to 44: N/A**

### **Question 4 (Single name CDS):**

Please indicate your preference between the options presented. In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

**Answer 4: N/A**

**Comments on paragraphs 45 to 50: N/A**

**Question 5 (Single name CDS):**

Please indicate your preference between the options presented. Under Option C, which criteria do you believe are relevant and how should they be calibrated?

**Answer 5: N/A**

**Question 6 (Single name CDS):**

Do you consider that the main characteristics of Single Name CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 6: N/A**

**Question 7 (Single name CDS):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 7: N/A**

**2.2 Interest rate derivatives**

**Comments on paragraphs 52 to 58: N/A**

### **Question 8 (Interest rate derivatives):**

Do you consider that the main characteristics of the interest rate derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

#### **Answer 8:**

Yes, but some other broadly used natures of swaps like CCIRS could be added, i.e. in the fixed-to-float class, but with a multiple settlement currency type instead of a single currency one.

As the proposed classification is based first on the nature of the IRD, clear and unambiguous definitions of those classes should be given so that for a given IRD there is no doubt about the clearing obligation.

### **Question 9 (Interest rate derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

#### **Answer 9:**

The article 5 (4) of the EMIR relates to the following criteria :

- a. the degree of standardization of the contractual terms and operational processes for the relevant class of OTC derivatives;
- b. the volume and the liquidity of the relevant contracts within the relevant class of OTC derivatives;
- c. the availability of fair, reliable and generally accepted pricing information

There is no direct link between the above criteria and the variables defined in the Table 9 to 12.

Nevertheless according to the type, the FR index and settlement currency (i.e such as the type fixed-to-float, LIBOR based swaps in currencies such as USD, EUR and GBP) should prove to be additional criteria to find the best candidates to clearing obligation in addition to those of the EMIR 5(4).

### 2.3. Equity derivatives

**Comments on paragraphs 59 to 70: N/A**

#### **Question 10 (Equity derivatives):**

Please indicate your preference between the options presented. Under Option D, which criteria do you believe are relevant and how should they be calibrated?

**Answer 10: N/A**

**Comments on paragraphs 71 to 73:**

#### **Question 11 (Equity derivatives):**

Please indicate your preference between the options presented.

In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

**Answer 11:**

Option A should be preferred as geographical zones do only carry limited information compared to currency information. Geographical zone classes may be added to similar to the proposed Table 13.

For example, a single name equity derivative may be settled in Europe in USD instead of EUR. Hence the risk associated to this instrument relates to the currency. Whether the derivative transaction is settled in Europe or elsewhere is economically of lower relevance.

Furthermore, information about the settlement currency is already available. Classification procedures to geographical zone may need in most cases be established resulting in unnecessary additional costs without any significant benefit.

**Question 12 (Equity derivatives):**

Do you consider that the main characteristics of Equity OTC derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 12:**

Generally, Table 13 provides a reasonable amount of data for equity OTC derivative classes. However, we would like to emphasize the following issues:

Disregarding the key of transaction type might hide the need of clear identification of the contractual features as there may be hybrid products for which it is unclear how they should be treated or even how they could be treated without diluting the information usefulness of the gathered data. ESMA should be clear on how hybrids should be treated (classifying in a group where the majority of features belong to or bifurcation of instrument).

For the sake of formality, Equity class number 6 in Table 13 shows Europe as geographical zone. This may be a mistake.

**Question 13 (Equity derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 13: N/A**

**2.4. Foreign Exchange derivatives**

**Comments on paragraphs 75 to 78:**

**Question 14 (FX derivatives):**

Do you consider that the main characteristics of the FX derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 14:**

On different classes of products: we have a comment on the FX part only. We would advocate to obtain exemption from the clearing of FX swaps and forwards, this in order to be aligned with the position of the U.S. (exemption granted by the US Treasury).

**Question 15 (FX derivatives):**

Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 15:**

See our answer under 14 here above.

**2.5. Commodity derivatives**

**Comments on paragraphs 79 to 84: N7A**

**Question 16 (Commodity derivatives):**

What is in your view the best approach to specify the underlying assets within each OTC Commodity class?

**Answer 16: N/A**

**Question 17 (Commodity derivatives):**

Do you consider that the main characteristics of the Commodity derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 17: N/A**



**Question 18 (Commodity derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 18: N/A**

**3. Preliminary analysis of the readiness of asset classes vis-à-vis the clearing obligation**

**Comments on paragraphs 85 to 105:**

**Question 19 (readiness of the classes):**

Do you agree with this analysis?

**Answer 19:**

Yes

Despite the lower portion of the OTC Global market of the instruments other than those of the IR class, it would be useful to investigate why classes such as equity derivatives exhibit such a low level of eligibility and other exhibit such a large gap between their eligibility level and actual level of electronic processing.

The difference between the level of eligibility and the level of electronic processing for each class of the Figure 1 of the Discussion Paper could be weighted by the respective volumes that those classes represent to assess the overall increase and focus on the improvements that will yield the most important reduction of systemic risk.

**Additional points**

- We think that there is a mistake in the name of the equity class name n°6 in the table 13 as the name should read “Vanilla basket Europe” according to the key characteristics.
- Reducing systemic risk by creating a clearing obligation where there is only one CCP could be counterproductive and could even make the cure worse than the disease.

#### **4. Determination of the phase in, and the categories of counterparties to which the CO would apply**

##### **4.1. Dates, phase in, categories of counterparties**

##### **Comments on paragraphs 106 to 115:**

##### **Question 20 (dates, phase in):**

What would you consider to be the shortest delay to impose a clearing obligation to a class of OTC derivatives when there are several CCPs available? And when there is only one CCP available?

Please specify in your answer whether the cause of delay is due to operational issues (e.g. time for CCP/counterparties to be ready for the CO) and/or to market issues (e.g. time for a CCP to add a new product to its offering).

##### **Answer 20:**

When there are several CCPs available, central clearing could start within a delay of 12 months (instead of currently proposed 6 months) after the related RTS entered into force. If there is only one CCP available, time should be given to allow potential competitors to enter into the market. Monopoly market structures do not only enhance concentration risk, but they may lead to highly inefficient and ineffective services including, but not limited to, unreasonable high costs. ESMA should avoid such situations which severely would harm the industry with a potential spill-over effect to the whole economy. Therefore, we believe a reasonable notice period should be given which should not be less than two years.

##### **Question 21 (dates, phase in):**

What would you consider to be a reasonable delay to allow CCPs which clear the same asset class or a similar Class+ to clear a new Class+?

##### **Answer 21: N/A**

**Comments on paragraphs 116 to 119:**

**Question 22 (dates, phase in):**

What should be the assumption regarding market share which the CCP would have to be able to assume? Should it be requested that each CCP be able to handle the whole volume to tackle the worst case scenario?

**Answer 22: N/A**

**Question 23 (dates, phase in):**

What should be the elements (e.g. number of transactions, increase in risks, number of active counterparties, new jurisdiction involved) for ESMA to investigate, after consulting the NCAs responsible for CCPs authorisation, on the ability of the relevant CCPs to handle the expected volume and to manage the risk arising from the clearing of the relevant class of OTC derivatives?

**Answer 23: N/A**

**Question 24 (dates, phase in):**

Should there be a default period of [x] months whenever there is a need for a CCP to upgrade its service considering incompressible internal/external validation processes? If not, how to evaluate the time to upgrade services based on the result of the criteria assessment?

**Answer 24: N/A**

**Comments on paragraphs 120 to 128:**

**Question 25 (categories of counterparties):**

Please indicate your preference between the options presented. Would you rather use an option that is not detailed here? Under Options B and C, do you agree to base the clearing

access approach on the asset class to which the counterparties have access? What should be the date on which clearing access/threshold calculation should be assessed?

**Answer 25:**

Option A would be the simplest and most efficient to implement.

**Question 26 (categories of counterparties):**

What would in your view be the appropriate timeframe for counterparties with / without access to clearing in the relevant asset class?

**Answer 26:**

We suggest 12 months and the same phasing in approach outlined as per Q25 could be used. This allows buy side firms to budget and develop their systems in time – an earlier timeline could be applied to sell-side firms who have more resources to be able to meet shorter timelines.

**Comments on paragraphs 129 to 130:**

**Question 27 (categories of counterparties):**

Do you agree that a key factor to take into account when defining the phase in for the counterparties to comply with the clearing obligation will be the number of clearing members offering client clearing services? Is the client clearing capacity of the CCP also a relevant factor? What could be the other criteria?

**Answer 27:**

We don't believe this is a key factor for phasing. We think this should be based on the type of counterparty and recognising the difference in capabilities and obligation of the financial or non-financial counterparty. The CCPs must prove that they have a robust model in place for clearing and the waterfall effect in the case of defaults occurring simultaneously, additionally they must also ensure their systems are stress tested and can manage significant volume during periods of market stress.

**4.2. Minimum remaining maturity of the OTC derivative contracts referred to in EMIR Article 4(1)(b)(ii)**

### **Comments on paragraphs 131 to 135:**

#### **Question 28 (remaining maturity):**

What are your views regarding the calibration of the remaining maturity of the contracts to be subject to the CO? What criteria should ESMA take into account when defining it?

#### **Answer 28:**

We believe that ESMA's approach is reasonable as long as it is ensured at all times that a period of 15 months is the absolute minimum for the remaining maturity and should not be further lowered.

## **5. The clearing obligation in specific cases**

### **5.1. Contracts concluded with Covered Bond issuers**

### **Comments on paragraph 136 to 138:**

#### **Question 29 (covered bonds):**

Are there other specific features of the contracts concluded with covered bond issuers or with cover pools for covered bonds, to be considered by ESMA in the context of the clearing obligation?

#### **Answer 29: N/A**

#### **Question 30 (covered bonds):**

What would be the legal or technical challenge faced by covered bonds issuers and CCPs, if a clearing obligation was imposed on some of the OTC derivative contracts included in the cover pools of covered bonds?

#### **Answer 30: N/A**

**Question 31 (covered bonds):**

Have CCPs developed solutions to be able to differentiate the derivative contracts of the issuer from those of the cover pool?

**Answer 31: N/A**

**Question 32 (covered bonds):**

Would an appropriate phase-in for these counterparties alleviate these challenges? If so, how?

**Answer 32:**

Yes, we are in favor of a phase-in implementation, with a finer distinction than FCs / NFCs. A distinction between inter-dealer and buy-side can be a good approach. In addition, we also believe that the number of GCMs is also a factor to be taken into account. We need it to be high enough to avoid concentration risk.

## 5.2. Foreign exchange OTC derivatives

**Comments on paragraphs 139 to 140:**

**Question 33 (FX derivatives):**

Within the foreign exchange asset class, for which type of contracts do you consider that settlement risk is the predominant risk, and what criteria or characteristics should be used by ESMA to identify those contracts?

**Answer 33:**

The FX swaps and forwards market is markedly different from other derivatives markets. Existing procedures in the FX swaps and forwards market mitigate risk and help ensure stability. While central clearing requirements will strengthen the rest of the derivatives market, the potential benefit is reduced in the FX swaps and forwards market because existing practices already help limit risk and also ensure that the market functions effectively. This market plays an important role in helping businesses manage their everyday funding and investment needs throughout the world, and disruptions to its operations could have serious negative economic consequences. Furthermore, settlement of the full principal amounts of the contracts would require substantial capital backing in a very large number of

currencies, representing a much greater commitment for a potential clearinghouse in the FX swaps and forwards market than for any other type of derivatives market

Given these considerations, Treasury has issued a final determination providing that certain mandatory derivatives requirements, including central clearing and exchange trading, will not apply to FX swaps and forwards »

- Type of contract for which settlement risk is predominant? = FX fwd and FX swaps
- Characteristics should be used by ESMA to identify those contracts
  - Fixed terms, Physical Exchange of Currency : In contrast to other derivatives, FX swaps and forwards always require both parties to physically exchange the full amount of currency on fixed terms that are set at the outset of the contract. Market participants know the full extent of their own payment obligations to the other party to a trade throughout the life of the contract
  - **Well-Functioning Settlement Process:** Because FX transactions involve the actual exchange of currency, settlement risk (the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought), is the main source of risk in these transactions. The strong, internationally coordinated oversight of this market led to the establishment of a well-functioning settlement process that effectively addresses this risk for a majority of transactions. There is extensive use of payment systems that permit the transfer of one currency to take place only if the final transfer of the other currency also takes place
  - **Shorter Duration contracts:** FX swaps and forwards are predominantly short-term transactions (68 percent of the market matures in one week or less and 98 percent in one year or less). Other derivatives have much longer average maturity terms, ranging from two to 30 years. Because of their short duration, FX swaps and forwards pose significantly less counterparty credit risk than other derivatives, reducing the potential benefits of central clearing for these instruments.

### 5.3. Interaction of portfolio compression and the clearing obligation

#### Comments on paragraph 141:

#### Question 34 (Portfolio compression):

Are there ways in which the imposition of the clearing obligation in the EU could hamper the effectiveness of compression services? If so, please provide evidence of the potential impact. Are there ways in which exclusions to the clearing obligation could be defined which alleviate the problem without creating opportunities for avoidance?

**Answer 34: N/A**

#### **5.4. How to withdraw a clearing obligation on a class or subset of it?**

**Comments on paragraphs 142 to 148:**

##### **Question 35 (Modification of a Class+):**

For which reason (other than the fact that a CCP does not clear it any longer) do you believe that the clearing obligation of a class - or subset of it - would need to be removed? Please focus on the risks which could stem from a clearing obligation on contracts which would no longer be appropriate for mandatory clearing and provide concrete examples.

**Answer 35:**

We believe same threshold criteria used to determine clearing obligations should be inversely applied for exiting clearing obligations, i.e. if a criterion is not met anymore, clearing obligation should be abandoned those criteria are not met continuously over a period of 12 months.

##### **Question 36 (Modification of a Class+):**

In case a clearing obligation would need to be reviewed, how crucial would be the time needed to dis-apply the clearing obligation?

**Answer 36:**

The clearing obligation should be regularly reviewed, but at least on a monthly basis. As soon as not all criteria are met continuously over a period of 12 months, the clearing obligation should be abandoned. We believe 12 months is reasonable as the clearing obligation should be abandoned as soon as the entry criteria are not met anymore. However, immediate stop would also not be reasonable as market fluctuations around some thresholds may indicate that not all criteria are met anymore even though this observation is not sustainable rather than irregular. Such fluctuations should generally not trigger a change (either for establishing the clearing obligation or by abandoning it).

Furthermore, we would recommend establishing a reasonable transition period of at least 18 months between the removal of the central clearing requirement and the requirement to fully



apply the rules for non-centrally cleared OTC derivative transactions. It takes some time to establish sound risk mitigation processes and procedures (e.g. for variation margin calculation, etc.) for the particular instrument type which was centrally cleared before.

## Contact

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