

ESMA

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Dear Sir/Madam

**Comments on ESMA’s consultative paper ‘Draft Technical Standards for the Regulation on OTC**

**Derivatives, CCPs and Trade Repositories’, 25 June 2012**

CME Group is pleased to offer stakeholder input to assist the development of the technical standards. CME Clearing Europe (CMECE) will be directly affected by the standards as a central counterparty incorporated in the UK and regulated by the FSA. CME Clearing in the US will be affected because the technical standards will have a bearing on the assessment of the equivalence of third country CCPs under the provisions of EMIR. CME Group will be affected as the owner of the two clearing houses.

As a member of EACH, CMECE has also contributed to input from that association.

*General comment*

The introductory text explaining the choices that ESMA has taken in response to feedback on its initial thinking refers to the technical standards having to offer more granularity than the CPSS-IOSCO standards, in order to “…effect global compatibility and permit EU CCPs to compete on a global basis”. Our reservation about the proposed standards in several respects is that they demonstrably do not bring about global compatibility, because the approach taken differs from the CPSS-IOSCO principles and that taken outside the European Union. We pursue the notable examples of that incompatibility in the detailed comments that follow.

*Specific comments*

*Indirect clearing arrangements*

In the introductory text explaining its choice of proposal concerning margins, ESMA refers to the importance of “…clearing members’ willingness to accept clients”. That is indeed a very important consideration, not least in relation to indirect clearing arrangements. There seem, however, in the proposed references to indirect clearing arrangements in the consultative paper, to be at least two proposals which would constrain the risk management actions of clearing members to such an extent as to make the provision of indirect clearing arrangements difficult to achieve, thus frustrating the policy intent of EMIR. Article 2 (2) seems to go too far in requiring a clearing member to honour all obligations between its client and the clients of its client, when it is stated that the client shall define those obligations. Article 4 (6) requires the clearing member to hold and be responsible to the CCP for the financial performance of the positions of clients of its failed client for at least 30 days after attempts to transfer those positions have proved impossible, but no reference is made to legitimate action by the clearing member to protect its risk during that period.

*Risk mitigation for OTC derivative contracts not cleared by a CCP*

Our concerns in this area are that the overall risk management of un-cleared OTC derivatives should be sufficiently robust, so as not to de-stabilise central counterparty arrangements, and that those overall risk management standards, and notably the associated regulatory capital required to support un-cleared positions, should be proportionately stricter, so as not to undermine the logic of mandating the central clearing of standardised OTC derivatives. The core proposals of relevance are not contained in the consultative paper but we nonetheless flag our over-arching concerns in this area.

*Regulatory colleges*

Regulatory colleges with the composition envisaged in EMIR and the technical standards represent a significant departure from the typical regulatory oversight arrangements for CCPs in the EU. For that reason, we believe that the colleges’ governance arrangements should be fully transparent and clear. Article 3 (3) CG does not, in our opinion, measure up to that standard. It refers to the refusal of a college member to sign the written agreement governing the establishment and functioning of the college. But it does not make clear whether any such “refusenik” will remain a member of the college. In our opinion a “refusenik” should not be a college member, as its presence could disrupt the effective operation of that college. The logic of our position is reinforced by Article 8 (5) CG. That clause refers to the need to postpone decision items until such time as a college quorum is assured. As the “refusenik” has rejected the written documentation of the “constitution” of the college, its retention in the college would reasonably be thought likely to make the achievement of a quorum more difficult.

*Governance and organisational requirements*

Article 2, headed risk management and internal control mechanisms, contains in clauses 2(7) and 2(8) notification and reporting requirements concerning haircuts on collateral and concentration limits, respectively. Taken as a whole the proposed technical standards include a very large number of notification and reporting requirements for CCPs, to regulators, clearing members, end-clients, and in some cases the public. By no means all the proposals are novel, insofar as notification or reporting already occurs, but in the context of what will certainly be a considerable increase in such requirements driven by regulation rather than CCP practice, it is preferable that the regulatory-driven requirements are presented by ESMA in consolidated rather than scattered form. The location of the requirements for collateral haircuts and concentration limits in a section dealing with very different governance and organisational issues illustrates the need for consolidation. We would also note that the references in 2(8) seem to duplicate those in Article 4(7), concentration limits.

*Reporting lines for risk officer and internal auditor*

Article 4 (6) ORG refers to the chief risk officer reporting to the board through one of its independent members and we presume that that proposed reporting line reflects the reference in the explanatory text to ESMA’s receipt of “…an interesting suggestion…to have an additional reporting line from the chief risk officer to an independent member of the board”. Such a reporting line is logical insofar as the chair of the risk committee must, under EMIR, be an independent board director, but we do not believe that the reporting line to the board should be exclusively through the chair of the risk committee: that may not be practicable in certain circumstances. The latter point is a minor one, however, and our principal comment is that the logic of the reporting line from the chief risk officer to the independent director chair of the risk committee should also operate in respect of internal audit and the chair of the audit committee. For reasons not made explicit in the introductory section of the consultative paper, the current text ignores best practice standards in relation to audit committees, at solo or group level. More than that, it seems to rule out their existence in its reference to internal audit reporting directly to the board. A preferable text would read: “Internal audit should report to the board through the chair of the CCP’s audit committee or the chair of the audit committee of the group to which it belongs, if there is such a committee”.

*Margins: percentage confidence intervals and time horizons for the liquidation period*

The introductory text explains that the proposals, which we would classify as likely to increase initial margin requirements from current levels, in some cases quite appreciably, are in essence driven by the regulatory desire to increase margins to limit pro-cyclicality, supported by banks’ (dealers’) views favouring greater coverage of tail risk through margins (adjustment of the margin/default fund boundary).

The result is proposals that establish differential minimum margining rules for cleared OTC derivatives, on the one hand, and for other cleared contracts, on the other. The reasoning is general, being in essence that OTC derivatives share a number of characteristics that warrant more conservatism in risk management than ‘listed’ products, and that the CPSS-IOSCO principles make that case. Building on the minimum rules, ESMA then proposes that higher standards should be applied on the basis of risk assessment.

For reasons advanced in our input to ESMA’s initial discussion document, we believe that appropriate margins should be viewed on a case-by-case basis, with liquidity and market depth as the principal determinants, and that broad-brush rules can be inappropriate. Reduced liquidity is mentioned in the introductory explanation as a negative aspect of the proposals, “…too high margins as a consequence of the higher confidence interval might disincentivise trading in particular products, thus reducing their liquidity” (p.30). This risk does not seem to have received adequate recognition, not least in relation to default management, where illiquidity can undermine established protections.

We do not regard a simplistic distinction between OTC derivatives and other cleared products as appropriate. To be concrete in respect of our reservations, we regard the proposals in terms of percentage coverage and liquidation time horizons as appropriate for IRS and CDS, and the liquidation periods in the proposals of course resemble a typical ‘time to completion of auction schedule’ for those asset classes. We do not regard them as appropriate for those OTC commodity derivatives that have a longer record of clearing, including client clearing, and which are closely twinned with exchange-traded derivatives. The adverse impact of the higher margins on liquidity referred to above could be particularly pronounced in respect of cleared OTC commodity derivatives. We consider that the proposed ‘other financial instruments’ minimum rules, which are also those indicated in the CPSS-IOSCO principles, are more appropriate to those OTC commodity derivatives, combined with a rule stipulating that additional margin requirements (add-ons) should be used to reflect differences in liquidity and market depth.

CME believe that the minimum confidence interval for all products should be 99% rather than 99.5%. The rationale for this being:

every CCP should design an overall solution that covers extreme historical events and “extreme yet plausible” theoretical events; however, when it comes to striking the balance between margins and the default fund, the choice of a 99.5% confidence interval, rather than 99%, means that margins are larger and default fund contributions are lower, which could lead to an inefficient use of Clearing Members’ liquidity and may be detrimental to the market.

Inconsistency with US regulations which prescribe a minimum of 99% for all products, which could lead to a loss of business from Europe to the US as Clearing Members take advantage of lower margin requirements, and therefore greater capital efficiencies, in the US.

Regarding the liquidation period, we propose:

1. OTC derivatives with a formal default management auction: 99% confidence interval with a 5-day liquidation period. This time period is a conservative estimate of the time required to hedge or liquidate a book of OTC derivatives in developed markets. Products eligible for clearing need to satisfy this liquidity test.
2. All other cleared products: 99% confidence interval with a 1-day liquidation period, with liquidity add-ons as appropriate, to be determined in conjunction with the Risk Committee.

*Margining: time horizon (look-back period) for the calculation of historical volatility*

The proposal is a hybrid or compromise approach, which in the ‘most stressed market conditions’ reference period moves a key margin parameter towards a permanent stress-testing or default fund calibration parameter, but moderates that parameter with the ‘current volatility’ reference period, at least as long as current volatility is not at new historic highs. This would seem certain to achieve the intended regulatory result, higher initial margins, but in a way which must be classified as arbitrary. It seems to advance margins towards the “extreme but plausible” frontier, which is recognised in the technical standards as the province of the default fund and related stress testing rather than of margins. ESMA states that most stakeholder respondents to its discussion document favoured an approach combining current and past reference periods. We doubt whether a majority would have expressed their support for the mechanical approach proposed, even if they favour both current and past volatility being taken into account.

We favour bounded discretion for CCP risk managers, in conjunction with risk committees, in which the relevance of historical moves is objectively assessed alongside more recent history, but not looking exclusively at as short a period as six months.

A 6 month lookback period is insufficient for any reliable and statistically coherent risk measure, especially when the desired confidence interval is high (e.g. 99% or higher). The inclusion of the most volatile period raises several concerns:

1. Historical VaR models uses historical data in order to forecast potential changes in market parameters over the assumed liquidation period. Effective forecasting relies on sophisticated techniques, which take into account not only the observed volatility during the historical period, but also the current volatility environment. Depending on portfolio composition, the most extreme scenarios used in VaR calculations are driven not by volatility per se, but rather by changes in the correlation structure between different tenors or other model variables. Therefore, the data from ostensibly the most volatile period may neither represent the most risk to the portfolio, nor adequately scale risk to reflect the current economic environment. Prescriptive over-reliance on this data may breed a false sense of security and lead to complacency. We believe that the most extreme moves should be covered by the default fund, the calculation of which should cover model risk and data risk. Requiring margin models to account for these risks is inconsistent and could lead to excessive margins and a sub-optimal balance between margins and default fund, thus affecting liquidity; and for OTC products where margining is performed typically on a portfolio level using a historical VaR model it’s likely that different products’ extreme 6-month windows occurred at different times. Therefore, as volatility of the correlation structure has a very strong effect on margins, using different historical periods for different products breaks model consistency.
2. Rather than prescribing a lookback period, clearing houses should be encouraged to deploy floors in their margining algorithms and include a product or portfolio specific liquidation premium, to ensure adequate defaulter-paid safeguards during periods of default. We propose that CCPs should also be encouraged to choose a lookback period for margining that meets two criteria:
* the lookback period adequately covers a period equivalent to that of a full business cycle for that particular market; and
* provides enough data points for a statistically robust and stable estimate given the desired confidence level.

The decision whether to include periods of extreme stress in margining should be predicated on the liquidity profile of the individual markets or products, and CCP Risk Committees should be used to make that determination.

A particular objection to the proposal is that volatility regimes may fundamentally shift, making historical moves that are not scaled inappropriate. However, the proposal in Article 2(2) refers to the un-scaled, most stressful reference period as an absolute floor, and the reference to assessment of margin models in 2(3) does not appear sufficiently flexible.

It is not clear if/how the proposals recommend scaling data when the volatility regime shifts. Most margining models (historical simulation or otherwise) employed by CCPs, differ in terms of how historical absolute returns are scaled to current volatility in the market. By stipulating a short and statistically unstable lookback period it could lead to CCPs scaling returns in ways that are economically and statistically incoherent, solely in order to reduce margins. This defeats the whole purpose of including stressful periods in margin calculations. Our strong suggestion is therefore to allow the choice of longer lookback periods based on the suggestions above and also leveraging the Risk Committee to approve the appropriate lookback period and scaling methodology for each asset class.

*Portfolio margining*

The introductory explanation notes that ESMA’s proposal drew on an analysis of “…current practices among European CCPs”. On the basis of the proposal, we would conclude that the analysis was based on a sample of those using parametric initial margin models, unless the intention, which is not obvious from the drafting, is that it is not intended to apply to non-parametric models.

We cannot see how the proposal could be expected to apply to historical value-at-risk models, which are increasing in usage, and which do not use an explicit correlation approach. Our view is that the approach of those models and potentially of other more statistical approaches to margin should be treated separately. Insofar as such models produce portfolio-level margin requirements, as do all margin models in fact, but without building up that portfolio requirement from the level of individual products or instruments in the way that parametric models do, separate treatment would remove some of the ambiguities in the current text. For example, in Article 1 (1) MAR, the reference to the calculation of initial margins for each financial instrument “…that is margined *on a product basis*”, and in Article 9(3) SBT the reference to “If a CCP collects margin at a portfolio, as opposed to product level, it…”.

Measuring correlations along the lines suggested in the text doesn’t make sense for a majority of OTC products and several ETD products. For example, a typical IRS curve has 15-20 tenors and across 15 currencies we run into measuring thousands of correlation points, making this prescription impossible to implement. A similar argument holds for CDS indices and a number of energy products. Even with single-dimension products where a correlation measure is possible, the overall correlation benefits are portfolio dependent.

If the objective of ESMA is to prohibit offering unreliable correlation benefits that could be exposed during periods of stress, we recommend that CCPs be encouraged to ensure that margin models are stress tested for correlation breaks that can jeopardise the required confidence interval and/or liquidation period. Severe correlation adjustments that happen during tail events should be allowed to be captured in a mutualised pool, such as the default fund, which is more efficient for tail risk. For product combinations where liquidity is questionable and correlations seem unstable, CCPs should be encouraged to incorporate correlation break scenarios in margins, as opposed to having a very high requirement for all products. The threshold of liquidity and correlation credits should be determined by the Risk Committee and validated by independent validators.

In relation to parametric margin models, we view the 70% negative price correlation minimum as inappropriately high and believe that the CFTC’s requirement, that the CCP should demonstrate that the price relationship is stable and that there is a clear structural linkage between the products or instruments before granting offsets, is the correct approach. We note that ESMA proposes to follow the CFTC’s approach in respect to the time-to-maturity of debt instruments (p.39) and recommend the treatment of margin offsets as another area of alignment with the CFTC.

The proposal that all financial instruments offset for initial margining calculation should be covered by the same default fund is also unnecessarily prescriptive.

*CCPs’ contributions to default resources*

We agree that CCPs should contribute to total default resources and a size linkage to capital is reasonable. We cannot, however, see why it is thought necessary to prescribe that the contributions to separate pools of default resources should be proportionately equal. We believe that governing principles that CCP contributions to default funds are transparent and reviewed whenever the size of a default fund changes are sufficient.

*Collateral*

The general treatment of acceptable collateral using a criteria-based approach is an appropriate one, including that relating to bank guarantees (but see our later comment on bank guarantees under concentration limits). There are, however, two restrictions that seem excessive. The first is that guarantors must not be providers of “…essential services to CCPs” ; the second that the guarantees are “…fully backed by collateral that satisfies the requirements of sub-paragraph 3(b) and the CCP can demonstrate can be realised on a same-day basis”. In relation to the first restriction, we would classify settlement banks as providers of essential services to both clearing members and CCPs. As they must meet the issuer criteria of Article 3(c) (ii) and (ix), and the CCP will have the ability to remove them from the list of eligible guarantors if they fall below the minimum credit standards, it seems excessive to disqualify them from an activity that is closely linked to their client relationships. In relation to the second restriction, the requirement seems to relate to the practices of the bank guarantor rather than the CCP. Taken literally, the CCP would have to insist that the guarantee was at all times fully collateralised by the client with collateral meeting the eligibility criteria as a financial instrument (and could not accept the guarantee if cash was used to cover some of the value of the guarantee), and to test at intervals the collateral supporting the guarantee to take a view on its same-day realisability. We wonder whether the reference to same-day realisability is intended in fact to be a reference to the ability to call for same-day funds under the guarantee itself, a more important characteristic to the CCP than collateral backing if the guarantee is irrevocable and issued by a sound bank.

*Concentration limits*

Article 4(3) COL refers to a clearing house for whom commercial bank guarantees constitute more than 50% of total collateral being granted exceptional treatment in being able to accept 25% from one entity or group of connected entities. Given that the article in question refers earlier to the aim of “…avoid[ing] a high credit exposure to an individual issuer”, and given the stated intention of strengthening CCP risk protections through the technical standards, a concentration of over 50% and an individual/group limit of 25% could be thought to undermine the credibility of the proposals

*Reporting requirements vis-à-vis trade repositories*

With respect to the area of transaction reporting specifically, CME Group has applied for registration as a swap data repository in the United States with the Commodity Futures Trading Commission (“CFTC”) and has commented extensively on the CFTC’s development of its swap data reporting regime.

CME supports the objective of establishing mandatory data reporting regimes in the derivatives markets. Market participants should be subject to a system that requires them to make complete and detailed transaction reports regarding derivatives transactions. Such reports can provide regulatory authorities with a comprehensive audit trail for important regulatory purposes. In addition, we believe that increased public transparency for derivatives transactions also generally benefits all market participants and is a worthy goal. However, in our view it is critically important to design any such mandatory reporting system in the most cost effective and efficient manner possible. Leveraging existing infrastructures where possible rather than building from scratch is prudent and can help manage industry implementation costs. It can also help assure that the best and most effective regulatory access to data is secured.

*Reporting requirements for cleared transactions*

In the area of cleared trades, the clearinghouse serves as the natural repository of data for the transactions it clears. Clearinghouses necessarily have already established connections with relevant execution venues and other market participants for cleared trades. These existing connections can be leveraged for reporting purposes as well. Requiring entirely redundant reporting channels to non-third party repositories for cleared trades is at best unnecessary and costly and at worst could create unnecessary ambiguity about the true state of a trade or position. We note that the central counterparty clearing model breaks the originating trade and replaces it with positions between the clearinghouse and the original parties. The post-clearing positions are uniquely maintained by the clearinghouse.

There are overwhelming operational reasons why it is critical to ensure that clearinghouses act as final repositories for regulatory information regarding cleared trades. First, calling on clearinghouses to play this role would be the lowest cost and least burdensome path available to implement the regulatory reporting requirements for derivatives transactions. This is so because each clearinghouse that clears swap transactions already possesses the majority of transaction records that will be required to be maintained. Any required records that are not currently maintained by a clearinghouse that clears a particular derivatives transaction can easily be reported to such clearinghouse at the time a transaction occurs. Execution venues that are matching standardized OTC derivatives transactions that will be cleared will necessarily be required to establish connectivity with clearinghouses for the purpose of clearing. These connections could easily be used to facilitate reporting as well. Therefore, industry technology build outs for reporting purposes would be as limited as possible

Second, any system that would result in the creation of a separate set of trade details housed away from a clearinghouse and at a third party non-clearinghouse repository introduces potential ambiguity about the true state of a position. When a trade is cleared on a clearinghouse, it is unarguable that such clearinghouse must always be the holder of the “gold copy” of the trade. This is required because that clearinghouse must margin the position, must calculate open interest, and must interact with the back office systems of its clearing members. These are the core functions of clearing and cannot be delegated.

*Reporting transactions to 3rd party trade repositories*

To the extent any clearinghouse would be required to report cleared derivatives trades into a non-clearinghouse repository, and to maintain the state of the trade in the non-clearinghouse repository, the result would essentially be requiring clearinghouses a redundant replication of data processing tasks. It would involve a time consuming and potentially impossible syncing process nearly every moment the clearinghouse is in operation to establish a usable state of records in the third party repository. This type of scheme would be highly wasteful and expensive, and even if built, would always result in the third party repository copy of the data only being up to date as of the last “sync” with the clearinghouse. These costs would come with no apparent regulatory benefit given that regulators could simply access the data needed via the clearinghouse.

Many jurisdictions have considered the capabilities of existing vendors that currently provide certain services (e.g., confirmation and affirmation services) to the over-the-counter derivatives markets when designing derivatives reporting regimes. These current OTC repositories currently do not have the capabilities possessed by a clearinghouse as far as cleared markets are concerned. Substantial work would be required to complete core regulatory warehousing functions for cleared transactions. These existing vendors generally operate in batch mode and may not have the skills or technology to handle live data and constant streaming of messages and historical state changes of positions. Building these capabilities in existing vendors could be time consuming and there are likely to be growing pains even when finished. However, it should be noted that the current positioning of these vendors with market participants is well suited for servicing the uncleared markets and acting as repositories for mandatory reporting of uncleared trades.

*Transaction and entity identification*

The development of mandatory derivatives reporting regimes will also certainly require the development of unique transaction and counterparty identifiers, a significant undertaking. The process for developing these unique identifiers must be coordinated with other regulators to the maximum extent possible. Given that market participants frequently transact in multiple jurisdictions and therefore are subject to multiple regulatory requirements, it makes sense to strive for compatible identification protocols to avoid the need for developing separate systems. In addition, to the extent required identification codes are designed to be compatible, regulators would be able to share information more effectively. In our view, any mandatory reporting requirements should not go into effect unless and until industry wide and internationally coordinated standards for product, swap and counterparty identifiers are firmly in place.

We are at the disposal of ESMA if it should wish to pursue any of our comments in more detail.

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