AFG's response to the ESMA consultation paper on the clearing obligation for financial counterparties with a limited volume of activity

The Association Française de la Gestion financière (AFG) welcomes the opportunity to express the French asset management's opinion on the ESMA consultation paper on the clearing obligation for financial counterparties with a limited volume of activity.

Please find below our answers to your questions:

Question 1: To which category of counterparties does your organisation belong: (1) in the context of the 1st Commission Delegated Regulation on the clearing obligation, and (2) in the context of the 2nd Commission Delegated Regulation on the clearing obligation?

The vast majority of AFG's members are in category 3 and remaining others are in category 2.

We would consequently be supportive an extension of deadline for all category 3's market participants to facilitate referencing and avoid consistency issues.
For our adherents that are in category 2, our recommendation would also be to modify the phase-in period applicable: indeed, legal entities are categories 2 because of the classification system adopted in the Delegated Regulations on the clearing obligation is made at group level even if most entities have limited volumes of derivatives on an individual basis. Category 2 entities face similar difficulties than category 3. Postponement of category 2 clearing deadline would not represent a risk of systemic nature.

Question 2: If you offer clearing services, please provide evidence on the constraints that would prevent you from offering clearing services to a wider range of clients.

This is not applicable to regulated funds or asset managers of regulated funds.

However our members view is that a recalibration of the Leverage Ratio and its application to clearing is required.

Clearing members should be able to offset initial margin from the client against their potential exposure with the CCP for a cleared transaction. In its current formulation, the leverage ratio does not provide appropriate treatment for the risk reducing effect of collateral. The result is that clearing members have to hold additional capital against the collateral received from clients which increases the cost of supporting cleared derivatives.

Question 3: Have you already established clearing arrangements (1) for interest rate swaps? (2) for credit default swaps? If not, please explain why (including the difficulties that you may be facing in establishing such arrangements) and provide an estimation of the time needed to finalise the arrangements.

There are two different positions in AFG's membership:

- A minority of AFG members have already set clearing arrangements, and for some of them on a voluntary basis

- The majority has postponed the negotiations with clearing members and/or does not yet finalized the negotiation of clearing arrangements.

We take advantage of this consultation to share the difficulties of French asset managers which are the follows:

1/ <u>regarding the client clearing services</u>

In addition to what has been clearly mentioned in the discussion paper, we have noticed that the clearing members who have maintained their clearing services show a lack of commitment when negotiating with the financial counterparties in Category 3.
Also due to the high costs of the clearing services provided, the clearing members were forced to readjust their service offerings which led them to change their parameters several times.
Moreover, some banks have stopped providing this service and to be sure to have a back-up Clearing member before the clearing obligation deadline, some French asset managers had to select additional clearing members, which was a time-consuming task.

For these reasons, the negotiations of the clearing arrangements have been either suspended or are constantly under discussion. In such circumstances, it is difficult to finalize any agreement.

2/ <u>regarding the proposed client clearing arrangements</u>

The principal clearing model is the one used to establish client clearing agreements. French asset managers have therefore to negotiate *ISDA/FOA Client Cleared OTC derivatives addendum* with clearing members.

French asset managers are in an awkward position: by agreeing with the Clearing members arrangements they will be going against the regulations applicable to the UCITS/ AIF (the Funds Regulation) and they will be held liable for any breach of the regulations applicable to the Funds.

Hereinafter, the risks incurred by the French funds and management companies:

a. <u>Liquidity risks</u>

In accordance with the Funds Regulation (i.e.: article 50, g), iii) of UCITS directive), the OTC derivatives transactions should be sold, liquidated or closed by an offsetting transaction at any time at the Fund's initiative. However, the only option offered by the clearing members is the termination by offsetting transaction which is furthermore subject to the respect of trading limits (the trading limits are set by clearing members and can be modified at any time).
This additional condition creates a risk of liquidity in the portfolios insofar as the management companies could not be able to repurchase or redeem the units when requested by the unit-holders of the Fund.

b. Difficulty to ensure the best execution obligations

The following elements proposed by the Clearing members could prevent the management companies from complying with the best execution obligations:

- Clearing members have no obligation to consent to clearing;
- Clearing members impose additional conditions to the transaction portability (i.e. compliance with trading limits) and wish to frame the offsetting transactions to and with other clearing members. These additional conditions do not facilitate the transfer of transactions to another Clearing member which offers a better price;
- The clearing members can review and increase at any time the pricing of their services. These additional costs are not negotiable or debatable nor measurable;
- The high costs associated with the individual segregated account.

c. Acting in the best interests of investors may be difficult to achieve:

A fund use forward financial instruments to protect its assets or to achieve its investment objective. However, the current requirements of clearing members for margin and collateral (restrictive policy on collateral, conservative policy on margin, lake of advance notice in case of the clearing arrangement modification) may undermine this principle and greatly reduce the asset managers' ability to act in the interests of unitholders. The risk policies on collateral of clearing members may even produce significant effects on portfolio management or even the realization of their investment policy.

3/ regarding recent developments

Recently, some CCPs have launched new *direct access models* (for instance, the EUREX "ISA Direct" and the ICE "Sponsored Principal" models).

However, we consider that some improvements need to be made (in particular in their credit policy: at the moment, some leveraged Funds may not be admitted for direct access therefore more flexibility is needed). Also, some uncertainties still remain regarding: (i) our ability to find a *Sponsor* or a *Clearing Agent* and (ii) what legal documentation we need to set-up.

Finally, we regret that the direct access offerings are not homogenous.

4/ regarding the restrictive ESMA guidelines

The ESMA's Guidelines on ETF and other UCITS issues (ESMA/2014/937) impose constraints on UCITS that are difficult to reconcile with market practices:

- at CCPs, only cash is accepted as variation margin but securities may be provided as initial margin. However, the ESMA's guidelines forbid the re-use of non-cash collateral and restrict the re-use of cash-collateral received by the UCITS. Thus it prevents UCITS that do not hold securities eligible as collateral under CCP's rules to meet their margin calls.

5/ regarding the BREXIT

The BREXIT introduced some uncertainties regarding the enforceability of the current client clearing arrangements with English CCPs.

Taking into account the aforementioned difficulties, we estimate that the financial counterparties belonging to Category 3 and small financial counterparties classified as Category 2 because of their belonging to a group (but not necessarily supported by their group for implementation) need more than two years to establish client clearing arrangements.

Question 4: Please provide information and data you may have that could complement this analysis on the level of experience and preparedness of financial counterparties with CCP clearing.

We do not have information available at the AFG level: the points raised are directly related to the activities that each one of our members has.

Question 5: Do you agree with the proposal to keep the definitions of the categories of counterparties as they currently are and to postpone the date of application of the clearing obligation for Category 3? If not, which alternative would achieve a better outcome?

We have a split view among our members on this question. Some of them understand your concerns to keep the current definition as it relies on an existing system and are satisfied with your approach.

Nevertheless we have to voice out the opinion of members among entities that run large institutional mandates that the quantitative threshold which distinguishes Category 2 from Category 3 may lead to difficulties. Their position gets along the following lines:

- Some financial counterparties experienced difficulties to assess the volume of activity in OTC derivatives at group level which results in some "Estimated Category 3"; for a better outcome, they consider that it would be timely to seize the opportunity to delay the phase-in period for both Category 2 and Category 3 to allow sufficient time for reviewing the approach for defining the categories of counterparties.

- In their opinion, the definition of counterparties' categories should also be amended:
  As specified in the 3 Commission delegated regulations: *"A second and third category should comprise financial counterparties [...], grouped according to their levels of legal and operational capacity regarding OTC derivatives. The level of activity in OTC derivatives should serve as a basis to differentiate the degree of legal and operational capacity of financial counterparties, and a quantitative threshold should therefore be defined for division between the second and third categories …".*
  Those members consider that if the threshold is assessed at group level, the criteria of legal and operational capacity mentioned in the 3 Commission delegated regulations may be overlooked. Indeed, all this means that a financial counterparty with a small volume of activity in OTC derivatives and with a limited legal and operational capacity on OTC market may be classified as Category 2 because it is part of a larger group; moreover belonging to a group does not necessary facilitate the setting-up of clearing arrangements.

- Currently, when executing Investment Management Agreements, the asset managers' Clients require from them to establish client clearing agreements on their behalf and to take on the operational aspects arising from the conclusion of OTC derivatives transactions.

  The bottom line is that the amendment of the definition of the categories of counterparties would enable the definition to be in line and to reflect the reality (i.e. the difficulties of determining the threshold at group level for some financial counterparties) and will also help asset managers' clients to be compliant with their new clearing obligation deadline. It eventually would bring higher legal certainty.

Question 6: Do you agree with the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines?

We agree with your proposal to modify the phase-in period applicable to Category 3. However, a postponement of two years might not be enough.

Considering that (i) the new phase-in period will provide additional time to comply with the clearing obligation, that (ii) the ability for Category 2 and 3 to establish clearing arrangements is linked to the adoption of the RTS in indirect clearing arrangements and to the finalization of the leverage ratio framework and that (iii) once adopted and implemented, the effectiveness of such new regulatory developments on the capacity of Category 2 and 3 to conclude clearing arrangements will require some time, therefore we recommend to modify the phase-in period by adding a reasonable deadline up to two years.

Furthermore, as stated in response to question 3, we affirm that the agency model is the model adapted to the buy-side. Even though some CCPs have recently launched new accounts which may meet our expectations, we consider that some developments are still needed to facilitate the access of such CCPs accounts to Category 2 and 3.

We also assume that the BREXIT and its possible impacts on clearing arrangements may increase the period of time needed to meet the compliance deadlines. The BREXIT has created uncertainty which has led to many questions regarding the clearing arrangements (for instance: clearing arrangements are under English Law, the majority of Clearing members and Executing Brokers are UK entities, the authorized/recognized CCPs are either UK entities or approved by the Bank of England). Thus, we should not underestimate once again the necessary period of time for the Category 2 and 3 to organize itself; the BREXIT turns out to be very challenging for the asset managers.

We understand that the period of time for Category 2 and 3 to meet their compliance deadlines is difficult to quantify, however we ask for a greater flexibility in the estimation of this additional period.

We are concerned that the regulation for collateralization of non-centrally cleared derivatives may impact trades that are within the framework of the mandatory clearing but are not yet cleared for category 3 counterparties; it would be burdensome to start a deal under one regime to switch it to another a couple of month later; we suggest that ESMA explicitly relieves category 3 counterparties from mandatory collateralization on OTC derivatives that are planned to be centrally cleared;

Question 7: Do you agree with the proposal to modify the three Commission Delegated Regulations on the clearing obligation at the same time?

Yes we agree with this proposal: we consider it highly preferable to have a homogeneous approach across all texts.

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