March 19, 2012

RESPONSE TO ESMA DISCUSSION PAPER ENTITLED "DRAFT TECHNICAL STANDARDS FOR THE REGULATION ON OTC DERIVATIVES, CCPs AND TRADE REPOSITORIES"

Overview

EACH, the European Association of Central Counterparty Clearing Houses, welcomes the opportunity to respond to ESMA's Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories ("the Discussion Paper"). EACH has contributed to the development of the associated Level 1 text, "EMIR", since its inception and strongly supports its central objective of bringing more business in standardised OTC derivatives within the ambit of CCP clearing as a means of managing systemic and contagion risk.

The mandate of the G20 was to promote the attractiveness of CCP Clearing and thereby increase its use in relation to standardised OTC derivatives business. In EACH's view, the approach suggested in the Discussion Paper does not adequately support that mandate and in some respects it may actually undermine it. This is because the thrust of the Discussion Paper suggests that the Draft Technical Standards under EMIR will significantly increase the cost of clearing – for instance in relation to margin levels and eligible collateral – beyond the point stipulated in the Level 1 text. In other words, EACH is concerned that the Draft Technical Standards do not merely add detail to the framework Level 1 provisions, but they would have the effect of creating more onerous requirements than those which have been promulgated by the legislators at Level 1.

Furthermore the upcoming CPSS-IOSCO Principles must be taken into account, given that they will become the new global standards for CCPs and other post-trade financial market infrastructures. If European requirements are significantly more onerous than the accepted global standards, it may undermine the competitiveness of European CCPs, putting them at a regulatory disadvantage - particularly in light of the global nature of the OTC derivative business – and encouraging regulatory arbitrage. The users of those markets are international banks and dealers, multinational corporations and asset managers and they will choose to use particular CCPs on the basis of a set of safety and affordability criteria. CCPs in the EU may satisfy the safety but not the affordability tests, whereas those in other major financial jurisdictions may meet both tests. This raises the prospect of trading and CCP clearing of standardised OTC business being largely conducted outside the EU.

Moreover, many of the requirements suggested in the Discussion Paper deviate significantly from current practice. Some of the proposed requirements will be detrimental to the overall

aim of CCPs, namely to delivery safety, stability and integrity to the financial system. In addition, for some requirements an adequate migration period should be provided.

During the public meeting held on 6 March 2012, ESMA explained that given the diversity of CCP models and products, it was attempting to apply a criteria-based approach in the Draft Technical Standards, rather than a prescriptive approach. Whilst EACH welcomes that overall objective, it is concerned that – on the basis of the contents of the Discussion Paper – ESMA will not achieve the desired result. Moreover, EACH believes that some of the Draft Technical Standards are likely to be too detailed and too prescriptive, and will not adequately cater for the diversity in CCP models and cleared products. EACH would welcome ESMA applying a criteria-based approach instead of a prescriptive approach in most if not all cases. Criteria based approaches can better take into account the type of market the CCP in question is serving. A "one size fits all" approach, on the other hand, is economically insufficient and may even damage the functioning of smaller markets, leading to less safety and integrity of these markets. Moreover an approach which is too prescriptive may result in European CCPs implementing identical measures on the basis of the minimum standards rigidly applied by ESMA, hence reducing the variety of risk management and governance models adopted in Europe. This situation could eventually lead to all the CCPs being exposed to the same systemic risks and can therefore end up in being counterproductive.

The stated purpose of the remit to ESMA to produce Draft Technical Standards is to ensure a consistent application of EMIR. This should be the first and paramount objective of the Draft Technical Standards, which will allow for the implementation of very clear minimum standards while allowing for flexibility and room for competition or variety above the standard.

ESMA states that it wishes to limit competition between CCPs on risk management grounds. Unless identical standards are adopted on a global basis, it will not be possible to eliminate the risk of competition from CCPs outside the EU on risk management grounds. It is the intention of CPSS-IOSCO to set out principles to be adopted by CCPs globally, and EMIR will not assist global consistency of risk management standards by going beyond these principles.

EACH is in favour of appropriate public disclosure. There is inevitably a need however to withhold certain confidential material. We believe that ESMA should limit the RTS to identification of the subject headings where material should be disclosed by CCPs. CCPs are then best placed to make a judgement in the first instance on the extent and detail of disclosure, with competent authorities ensuring that the levels of disclosure are appropriate.

In a number of instances, ESMA proposes testing CCP arrangements and procedures with a broad group of direct and indirect users and related services. Whilst CCPs aim to participate in such industry-wide tests, the logistical difficulties and costs of organising industry-wide tests are substantial, and the compulsion of all necessary entities to participate in such tests is not within the gift of a CCP. The Draft Technical Standards should reflect this practical reality.

The remainder of the document contains EACH's detailed comments on the issues raised in the Discussion Paper. Those issues are covered in the order in which they appear in the Discussion Paper.

Detailed Comments

Art. 3/4- Q1-9 Clearing Obligation / Clearing Obligation Procedure

- During the public meeting on 6 March 2012, ESMA recognised that there is a tension between two competing policy objectives in relation to implementation of the clearing obligation. On the one hand, policy makers wish to define each class of OTC derivatives sufficiently broadly in order to mitigate the scope for avoidance of the obligation, whilst on the other hand they wish to define each class narrowly enough to ensure that CCPs are not obliged to clear contracts which they are unable to risk manage effectively. This is one of the most complex issues which must be resolved within the Draft Technical Standards and the manner in which they are implemented, and it is an issue on which the success of the clearing obligation will rely to a considerable degree. It should be avoided to invent brand new products with the sole aim to evade such an obligation.

- Whilst EACH recognises the problem faced by policy makers in this respect, it is on balance in favour of determining each class of OTC derivatives on a relatively broad basis. This is because EACH considers that the risks of avoidance of the clearing obligation are more apparent than the risks of a CCP not being able to clear a particular class of standardised OTC derivative.

- It is imperative for the functioning of EMIR that there would be a robust economic incentive to use CCP clearing for derivatives (e.g. through the application of appropriate capital requirements which adequately reflect the differing counterparty risk profiles of CCP cleared contracts compared with not cleared contracts). A clearing obligation is important but alone it will not create adequate incentivisation for the use of CCP clearing.

- If CCP cleared trades are economically more attractive compared to non-CCP cleared trades, investors, market participants and infrastructures will have a common interest in organizing a CCP-cleared market, whether an obligation being in place or not.

- It should also be recognised that the OTC derivatives market is not subject to the same standards of transparency as the regulated market, so data on trading volume, open interest, orders and liquidity can be only estimated.

- In order to allow access to account segregation and positions portability indirect clients must be identified by clearing members to the CCP, to clarify who is the real owner of the collateral and its capacity to communicate directly or by mandate with the CCP in case of clearing member default.

Art 5/7 Q10-11 Non financial counterparties

- EACH supports the proposed approach to define thresholds at corporate group level, rather than at the level of each legal entity within a corporate group. EACH also believes that thresholds should be set across asset classes and not per asset class.

- One option is to set the threshold as a sum of equivalent initial margins that would be asked by reference CCPs in order to measure the value at risk. Concerning the contracts not eligible for clearing the same concept, of initial margin, should be established.

Art 6/8 Q12-22 Risk mitigation for OTC derivatives not cleared by a CCP

- As outlined under Q1-9, the relative regulatory obligation applicable to CCP-cleared trades on the one hand and non-cleared trades on the other should recognise their different counterparty risk profiles. This should result in CCP-cleared trades being economically more attractive compared to non-cleared trades. This would have the additional benefit of incentivising investors and market participants to use a CCP-cleared market.

- However, the reverse could be true if ESMA acts as implied in the Discussion Paper and proposes overly detailed and prescriptive requirements in respect of CCP-cleared business, whilst maintaining general standards for non-cleared business. If ESMA refuses to apply a criteria-based approach in relation to more of the requirements concerning CCP-cleared business, it should be consistent and specify more prescriptive requirements for non-cleared business, e.g. the risk management for non-CCP cleared trades should be subject to a comparable regime regarding margins, confidence levels, collateral and additional lines of defence.

Art 8a Q23 Access

EACH welcomes the fact that implementation of the "access to a venue of execution" provision of EMIR in any specific instance is subject to the results of appropriate tests in relation to its potential effects on market fragmentation. This is because there are a number of significant adverse effects associated with fragmentation in financial markets:

- Fragmentation has a negative impact on market surveillance and regulatory oversight
    - E.g. regulators are concerned that fragmentation makes it harder to conduct effective market surveillance against market manipulation and other forms of abuse
- Fragmentation has negative risk implications
    - E.g. multiple interfaces between independent entities will put end-to-end operational stability at risk.
    - It could create perverse incentives for the reduction of standards in the practical application of risk management. Regulators would increasingly find themselves having to mandate the same risk management measures and models for each CCP. However, this would give rise to a monoculture of CCP risk management, potentially transmitting undesirable effects throughout the whole European network.

- Fragmentation is negative for investors due to worsened price discovery and liquidity
    - E.g. the point was made during the public meeting on 6 March 2012 that institutional investors consider that fragmentation makes it harder to access sufficient liquidity in a single venue.
- Fragmentation creates pressure for inter-linkage/ interoperability
    - A model with two or more clearing houses serving one market is economically less efficient. It would lead to pressure for interoperability for OTC derivatives. The risks of interoperability in derivatives are orders-of-magnitude greater than for cash equities, which was the rationale for EMIR restricting interoperability to cash instruments and for requesting ESMA to conduct detailed research by 2014 on the feasibility of interoperability in derivatives.

Art 23-24/27 Q24-31 Recognition, Organisational requirements / Record keeping

- On Question 31 EACH would like to emphasize that the modality of maintaining and making the relevant records available is a significant cost driver for the record keeper and the burden created should therefore be minimised to the extent possible. Furthermore EACH would like to stress that the Technical Standards under EMIR should not have a retroactive effect. Therefore requirements on record keeping - especially making records available - should not be used in order to request records associated with business which pre-dates the implementation of EMIR and the associated Technical Standards.

- The CCP can be a part of larger organisation, so some of the roles and processes can be outsourced. In this case EACH is of the opinion that the only mandatory function in the CCP should be the chief risk officer. The other functions such as the chief technology officer or chief compliance officer could act at a parent company level if the CCP operates within a wider corporate group.

- We propose to include the possibility of not disclosing or disclose selectively certain elements that would compromise CCP's security.

Art 32 Q32-33 Business continuity

- Geographically independent business continuity planning can be a huge cost driver and should only be applied, where appropriate. The principles set out in EMIR level 2 should be completely consistent with CPSS-IOSCO principles for FMIs. A number of proposals set out in the Discussion paper are more demanding than the latest version of the CPSS-IOSCO principles. The Draft Technical Standards should only require a two hour recovery time period, if the CPSS-IOSCO Principles do so. Otherwise EACH supports a 4 hour recovery time period.

Art. 39 Q34-37 Margins

- Most of EACH Member's biggest concern is that the combination of margin levels (therefore confidence level) and default fund size should be a decision of each CCP and their Clearing Members, adapted to the type of products concerned and subject to the oversight of the relevant competent authority.

- Nevertheless it should also be remembered that the 99% minimum is defined in the Level 1 text. EACH would again like to emphasize the need for consistent regulations. For example CPSS-IOSCO also proposes a confidence level of 99%. The general view therefore is that additional requirements above 99% will disincentivise the use of European CCPs.

- In general the quantity of margins will rise significantly under the new clearing obligation and may hinder economic growth. EACH is concerned that the cost of collateral and the corresponding liquidity for end users should not explode due to such a restrictive margin regime. This effect is not mentioned in the Pros and Cons description under Paragraph 93 of the Discussion Paper.

- In general, when considering the requirements for confidence levels above 99%, the CCP's other lines of defence should be taken into account.

- Considering the validation regime established in articles 39 and 46, a too prescriptive approach seems unnecessary.

- Q34: The confidence level means the number of days (expressed as a percentage) for which initial margins would cover the expected losses upon default.

- The calculation of the confidence level is not standardized. Methods differ structurally. E.g. results calculated by an out-of-the-sample back testing method cannot be compared with results achieved by an in-sample historical look back view.

- Considering liquidity risk may result in a longer close-out period and accounting for non-linearity may result in not applying a normal distribution. Both cases may not necessarily lead to an increase of the confidence level.

- It should be considered that lowering the risk of loss sharing / using the default fund may not be in the best interests of managing systemic risk. Clearing members will be less strict in supervising CCPs' risk management due to higher margins available from the defaulting clearing member. Even for surviving clearing members there will be fewer incentives to participate in a liquidation process (such as an auction of outstanding positions) due to reduced exposure to the default fund.

- Q36: EACH considers the liquidation period as the time since the last collection of margins to the close-out or hedge of the position. We don't think a table with the exact number of days should be part of the RTS. Each CCP should retain the right to estimate the appropriate time period according to the peculiarities of the markets it serves.

Art 41 Q39-41 Liquidity risk controls

- EMIR (Article 41 §4) establishes that CCP may require non-defaulting clearing members to provide additional funds in the event of a default of another clearing member. This mutuality agreement should be also considered regarding liquidity risk controls.

Art 42 Q42-43 Default Waterfall

- Regarding the options presented by ESMA, EACH strongly opposes a CCP's "skin in the game" being determined on the basis of a fixed percentage linked to margins as this can become quite dangerous. The requirement may change frequently given the volatility of margins. In this way it could cause a material risk to the CCP's financial strength which would be especially important after a default, when the amount could be a loss to the CCP's capital.

- While EACH would urge ESMA not to link the CCP's "skin in the game" to margins, there are some arguments to link it to the size of the clearing fund or the CCP's capital. However, more thought should be given to the potential incentives and disincentives that each model would create.

- Q43: A yearly calculation with an adaption after a further year would give sufficient time to determine the "skin in the game" element. This would also fit the requirements outlined in Q67.

Art 43 Q44-50 Collateral Requirements

- There are several details which need to be clarified or adjusted because the suggested approach would impose unnecessary restrictions on CCPs' collateral management capabilities (e.g. Q44 Paragraph 120: cash deposited by one CCP with another CCP which has a banking licence should also count as collateral, Bonds issued by clearing members that are guaranteed by a member state should be acceptable as collateral, Emission certificates should be regarded as acceptable collateral).

- It is not clear why, as a general matter, CCPs should not be able to accept collateral accepted by central banks. However, CCPs should not be forced to accept any collateral accepted by central banks.

- Comments on Paragraph 120:

    - (ii) Cash which is deposited through a reverse repo lessens bank credit risk considerations.

    - (v) The full collateralization of bank guarantees affects its competitiveness and will lead to avoid this type of guarantees. This will affect the participation of non financials. Without comparable restrictions in the risk mitigation requirements for non-cleared trades, these entities will choose the easiest approach.

    - Under specific situations bank guarantees and other types of contracts could be valuable instruments to be used as collateral.

Art 44 Q51-56 Investment Policy

- As far as the CCP's balances are influenced by securities settlements and margin inflows, which cannot be fully controlled at all times, the amounts remaining in correspondent bank accounts may temporarily exceed any limits.

Art 46 Q57-68 Review of models, stress testing and back testing

- EACH would like to mention that the full disclosure of the risk management models to clearing members and clients should be avoided. Any optimization of clearing members' risk management based on the knowledge of CCPs' models should be prevented.

- Q66: The simulation of the default procedure with clearing members should only be done where appropriate.

- In the section relating to back testing and stress testing, the discussion paper makes a number of references to testing of client positions and portfolios. EACH does not believe such testing of individual clients should be included in the routine stress-testing or back-testing of a CCP. A CCPs legal and contractual relationship is with its clearing members, rather than with clients of clearing members. Testing programs should only be applied to clearing member portfolios, including those held on behalf of clients**.** Concerning the frequency of back and stress testing, some products have a long delivery period, namely power contracts, meaning that this can impact tests' frequency: probably both timeframes should be aligned. The solution can be, again, a more general criteria based approach.

About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1991. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 23 members:

CC&G (Cassa di Compensazione e Garanzia S.p.A.)

CCP Austria

CME Clearing Europe Ltd

CSD and CH of Serbia

ECC (European Commodity Clearing AG)

EMCF (European Multilateral Clearing Facility)

Eurex Clearing AG

EuroCCP (European Central Counterparty Ltd)

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This document does not bind in any manner either the association or its members.

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