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| 1 October 2014|ESMA/2014/1185 Reply Form |

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| Reply form for the Consultation Paper  On the Clearing Obligation under EMIR (no. 3) |

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| Date: 1 October 2014  ESMA/2014/1185 Reply Form |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - Clearing Obligation under EMIR (no. 3), published on the ESMA website.

Responses are most helpful:

1. if they respond to the question stated;
2. contain a clear rationale, including on any related costs and benefits; and
3. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **6 November 2014**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

1. use this form and send your responses in Word format;
2. do not remove the tags of type < ESMA\_CA3\_QUESTION\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
3. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

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# General information about respondent

|  |  |
| --- | --- |
| Are you representing an association? | Yes |
| Activity: | Regulated markets/Exchanges/Trading Systems |
| Country/Region | Europe |

# Introduction

**Please make your introductory comments below:**

<ESMA\_CO3\_COMMENT\_1>

The Wholesale Markets Brokers’ Association (WMBA) and the London Energy Brokers’ Association (LEBA) (jointly referred to in this document as ‘WMBA’) are the European industry associations for the wholesale intermediation of organised venue and Over-the-Counter (OTC) markets in financial, energy, commodity and emissions markets and their traded derivatives. Our members act solely as intermediaries in wholesale financial markets and do not undertake any proprietary trading. As a result they are classified as Limited Activity and Limited Licence under BIPRU[[1]](#footnote-2) and IFPRU [[2]](#footnote-3)in the UK where they carry out the vast majority of their activities regardless of home domicile of the individual holding companies. WMBA members, and those organised platforms that they operate around the globe arrange and execute the vast majority of wholesale transactions in traded FX markets in general and in NDF products in particular. We note transition in recent years for tenors around one month to trade on the electronic screens redolent of the delivered spot market. Outside this tenor, both shorter and longer, the markets remain entirely voice and voice-hybrid. We note that it is rare, but not unknown, for our members to transact CCP cleared trades in the 13 principally traded currencies. Almost all transactions in NDFs however are concluded with at least one counterparty, and often both in the capacity as a prime broker.

The WMBA is a firm and committed supporter of central counterparty clearing for a wide variety of prudential and liquidity reasons which translate to sound business sense, as well as those more closely related to public policy. We were equally ardent supporters of open access and competition, in this line we have been urging regulators all around the globe to address the barriers posed by an absence of interoperability and economic rents for intellectual property rights. All member firms have devoted considerable resources towards the establishment of simple and straightforward connectivity and certainty for CCP clearing over the last 5 years. These have included connectivity to many ‘middleware’ providers and most clearing houses around the world, pre-trade credit modules and client on-boarding, affirmation and confirmation protocols to enhance clearing certainty, and the development of venues at aggregate liquidity across the gamut of CCP options. We have observed the high level of demand by many wholesale market participants to access CCP clearing in order for the efficient deployment of balance sheet, especially in interest rate derivatives and therefore open access and seamless connectivity is business critical to WMBA member firms every day operation.

Despite the ‘pro-clearing’ standpoint of the IDB industry outlined above, in the opinion of the WMBA, the FX NDF market presents a very different proposition than those credit and interest rate derivatives that have recently been the focus of the clearing agenda. The participants, product, size, global scope and liquidity structure are all very different. Indeed we underline that the absence of differential access and IP ownership has enabled the NDF market to be both liquid and resilient. NDF market participants, as well as those across the FX Options market desire, and should be offered a variety of CCP clearing options. This is not the case currently and has not been prior to today. Even the more established infrastructures such as LCH FX-Clear and the CME have very few clearing members in this asset class and minimal connectivity compared to the more established IRS and CDS capacity. For FX NDFs there are only 20 clearing members at an entity level clearing through the prime CCP, LCH.Clearnet Ltd, of which only two clearing members currently support client clearing activity.

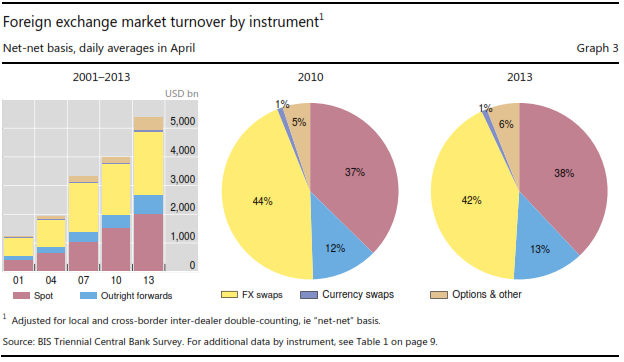
Therefore, we firmly believe that the market is not presently in a position to deal with any mandate for CCP clearing beyond the proportionate costing of the Basle treatment of cleared versus uncleared derivatives. It is unlikely that such a readiness could be achieved prior to 2020. Moreover, given the extensive array of hurdles and risks that CCP clearing entails, both for the system [top down] and for the participants [bottom up] we find it difficult to understand any benefits that a mandate confers over a straightforward offering of choice to market participants.

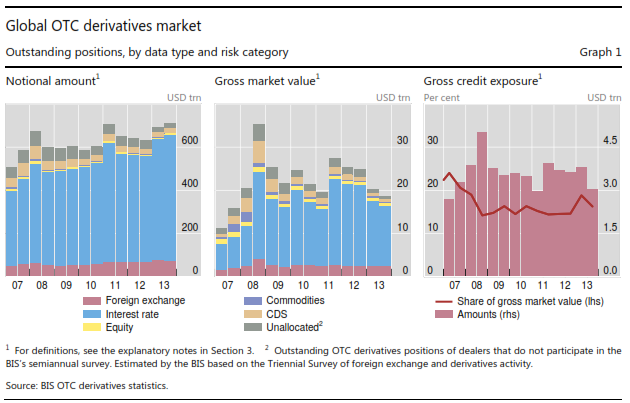
Without entering into undue detail the following characteristics make the FX NDF market unsuitable for any CCP clearing mandate:

1. **Size**: The FX NDF market is significantly smaller than those other OTC derivative asset classes currently being considered on either side of the Atlantic for a clearing mandate. As outlined in the ESMA CP, it is also a very small part of the FX market.
2. **Establishment**: CCP clearing of any FX products, least of all the NDFs is a very new and immature infrastructure. We include the longstanding but purely tertiary clearing of DCMs in the US in this comment.
3. **Netting Sets**: Placing a clearing mandate around one small section of a risk set serves to fragment markets and gross-up normally offsetting risks in portfolios. Most of the underlying assets, receivables or positions in regional emerging markets are not going to be CCP cleared inside the EU.
4. **Trading Protocols and Clearing Certainty**: In markets which operate largely as voice/hybrid and universally operate across geographical regions it adds considerable complications for the participants to guaranty novation and clearing certainty until some point after the trade has been alleged. This puts a degree of doubt into market pricing and serves to ‘ration’ best pricing only to those prime self-clearing counterparties and their fully on-boarded clients. Additionally the uncertainty with regards to *Void-ab-Initio* versus bilateral settlement is very disruptive to wholesale counterparties.
5. **Liquidity Fragmentation**: For venues to offer liquid markets into one primary clearing pool for a set of wholesale participants able to self-clear has proved difficult but possible in credit markets and some interest rate markets; however for venues to offer multiple CCP liquidity pools, to assess pre trade credit between those and to assess their equivalence across borders and regions can only serve to diminish market utility to its participants.
6. **Geography**: Placing a clearing mandate around one small geographical subset of a traded market serves to encourage migration, to fragment market liquidity and gross-up normally offsetting risks in portfolios
7. **Collateral**: Given that the collateral will be in assets not the same as those being cleared (one cannot margin using an FX pair) the imposition of clearing creates systemic risks and linkages not related to the underlying markets.
8. **Margining**: given that the underlying markets are voice-hybrid and essentially illiquid, establishing variation margin prices is an approximate and risky process. Evidently there is a circular and self-fulfilling paradox present whereby those FX markets that are not deliverable and illiquid are those considered to mandated mutualisation and taxpayer subsidy [via CCP access to central bank money] in third countries such as the EU.
9. **Costs**: Whilst CCP access and connectivity is relatively simple for those ‘self-clearing’ participants, it is a costly and burdensome imposition for all other participants for a wide variety of obligations. We note here that given the choice, the market has clearly opted to use Prime Brokerage services in this respect.
10. **Benefits**: There are no immediate and apparent benefits for requiring those trades not otherwise efficient under CCP clearing to be coerced into these infrastructures
11. **Third Countries**: Without full and reciprocal equivalence between the EU and those countries whose currencies would be mandated, we believe that trade barriers, uneven playing fields and asset migration could ensue.

There are related issues that whilst neither conferred upon ESMA as a level 2 mandate under EMIR, nor especially the sole province of structural and conduct regulation in the EU, but still need to be borne in mind when considering the issues in scope here. These relate to the overall objectives and relative importance priorities in the set of market regulations currently being implemented:

* Clearing for NDFs by Banks in the EU as ‘self-clearers’ with sufficiently large portfolios to benefit from cross netting
* Clearing for NDFs by all counterparties in the EU who will likely need to break netting sets
* Preservation of Gross netting sets involving FX NDFs for all counterparties
* Migration of FX trading from NDF Cash settled to Delivered onshore markets
* Migration of NDF markets from EU to those countries whose currency is being traded
* Migration of NDF markets from EU to those third counties where Gross netting sets can be preserved
* Consolidated and heterogeneous or globally fragmented NDF liquidity pools





If you would like any further information/clarification in respect of these issues, please do not hesitate to contact the persons named below. WMBA are happy for these comments to be disclosed.

Alex McDonald

Chief Executive

**Wholesale Markets Brokers’ Association and**

**London Energy Brokers’ Association**

Warnford Court

29 Throgmorton Street

London EC2N 2AT

Telephone: 020 7947 4900

Email: [compliance@wmba.org.uk](mailto:compliance@wmba.org.uk)

<ESMA\_CO3\_COMMENT\_1>

## The clearing obligation procedure

##### Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA\_CO3\_QUESTION\_1>

Unlike their trading of CDS and IRS products, Category 1 counterparties themselves do not currently have the connectivity and contracts in place with neither the WMBA member firm venues, nor with the relevant CCPs in order to enact post-trade affirmation and novation. We note that even in the ongoing operation of SEFs by WMBA members, there is no such capability for venue led novation (nor indeed STR reporting) and the FX NDFs all remain ‘permitted’ rather than ‘required’ products. The below table sets out the contrasting quantum of activity between NDF and other derivatives markets.

Therefore, to attain the necessary proportionality, we believe that ESMA should adopt a single core RTS into which the application of multiple annexes may be set, as the considered classes of OTC derivatives are declared subject to the clearing obligation.

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| **OTC Derivatives** | **Rates** | **Credit** | **FX NDFs** |
| **Average daily turnover** | $2,000 |  | $127 |
| Cleared | $1,700-1,800 (76-79%) |  | $4.6 (3.6%) |
| Uncleared | $500-600 (21-24%) |  | $122.4 (96.4%) |
| **Total market value** | $14,000 | $700 | $90 |
| **Total notional outstanding** | $584,000 | $21,000 | $2,800 |
| Cleared | $443,000-461,000 (76-79%) | $5,500 (26%) | $101 (4%) |
| Uncleared | $123,000-141,000 (21-24%) | $15,500 (74%) | $2,700 (96%) |
| **Tenor of total notional outstanding** |  |  | *Based on DTCC dataset*[[3]](#footnote-4) |
| Less than three months |  |  | $2,520 (90%) |
| Over three months up to six months |  |  | $224 (8%) |
| Over six months up to one year | $198,302 (34%) | $3,655 (17%) | $28 (1%) |
| Over one year up to five years | $234,284 (40%) | $16,162 (77%) | $28 (1%) |
| Over five years | $151,778 (26%) | $1,203 (6%) |  |

<ESMA\_CO3\_QUESTION\_1>

## Structure of the non-deliverable forward derivatives classes

##### Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

<ESMA\_CO3\_QUESTION\_2>

Yes the WMBA notes that the proposed structure for the FX NDF classes is adequate.

We do however note that other issues such as embedded optionality of the delivarable currency, declaration of sanctions or ‘*currency manipulator’* status and ceastion of the fixing benchmark add areas of complexity that CCPs may be unable to simply and uniformly deal with. Principally this is because of the remote cross border nature of this proposed mandate to countires which by definition ESMA considers sub-equivilent (by definition).

<ESMA\_CO3\_QUESTION\_2>

## Determination of the classes of OTC derivatives to be subject to the clearing obligation

##### In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?

<ESMA\_CO3\_QUESTION\_3>

From the brief outlined points made in the introduction above, the WMBA does not believe that mandating the listed set of FX NDF classes addresses appropriately any of the systemic risk associated to NDF derivatives. Indeed it would be more likely to transport systemic risk between the country of the quoted NDF and that of the residence of the CCP and to those of its clearing members.

Furthermore, if the market seeks to preserve its netting sets and therefore its operational efficiency and competitiveness, then the outcome from the criteria would be to migrate the market liquidity away from the EU. Should the FX pair currently quoted as NDF become widely deliverable, then a migration back to the home state of the currency may be appropriate, but without this conditiion being satisfied the consequences would be purely unintentional.

Given that FX NDFs represent only 2 ½% of the average daily turnover of the global OTC FX market[[4]](#footnote-5), it is hard to see the immediate systemic benefits of such a small segment. Indeed it remains readily apparent to the WMBA that since the principal systemic risk present is that of the destabilisation of the underlying currency and therefore of the NDF fixing index. The only proper route towards the mitigation of systemic risk is rather to redesignate trading in these currencies to an onshore nostro delivered market with the associated *herstatt risks* being mitigated by real time CLS settlement.

<ESMA\_CO3\_QUESTION\_3>

##### For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?

<ESMA\_CO3\_QUESTION\_4>

The WMBA understands that the benefits of clearing are proportionate to the term of the contract. As such any mandate for contracts under 1 month would appear to us to be without any particular reason or merit. For NDF markets, this 1 month point tends to act as the liquid or ‘spot’ tenor and as such is the only tenor widely liquid and available as addressable electronic liquidity. Short dated FX NDF contracts with under 1 month remaining to maturity do not offer systemic threats and indeed are better netted within trading books or prime brokerage accounts. Simply put, these have little different risk profiles to delivered forwards.

For longer dated tenors over 12 months the market would have an appetite to self-clear if a large enough netting set can be entered onto a single CCP. It is difficult however to understand how these ‘bottom up’ considerations within the trading book of each wholesale market counterparty could be replaicated in EU law. Rather the market would be motivated to rebook via non USD denominators or in non-EU subsidiaries where the mandate would promote inefficiencies. This process does not appear to us to be symbiotic with a reduction of systemic risk.

Therefore form a systemic risk perspective, for all the currencies cited in Table 10 of the ESMA CP. we would recommend a purely volentary approach to CCP clearing in accordance with maximising liquidity and minimising collateral usage and Basle metric capital costs. (We note that the phase-in of margin requirements for uncleared derivative transactions will begin at the end of 2015, which will increase the cost of continuing to transact FX NDFs bilaterally.)

<ESMA\_CO3\_QUESTION\_4>

## Determination of the dates on which the obligation applies and the categories of counterparties

##### Do you have any comment on the analysis presented in Section 4.1?

<ESMA\_CO3\_QUESTION\_5>

Voluntary clearing for the FX NDF market, which represents only 2.4% of the average daily turnover of the OTC FX market, is estimated to be 0.4%-3.6% depending on the currencies involved. Therefore, at only 1/5000th of the market place, it is difficult to see either the commercial viability of many CCPs continuing without mandating of clearing, and conversely it is hard to endorse legislation attempting to fundamentally renavigate any market, let alone a quintessentially international one.

ESMA’s conclusion that IRS and CDS contracts were appropriate for a clearing mandate via a “bottom-up” approach was predicated on a market infrastructures which had demonstrated real operational capacity to clear such contracts, as evidenced by the statistics noted above (i.e., approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared since 1999 and 2009, respectively). Making a clearing determination now, in the context of the FX NDF market as currently constituted, may be better analysed substantively through the lens of a “top-down” rather than a “bottom-up” approach.

<ESMA\_CO3\_QUESTION\_5>

##### Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.

<ESMA\_CO3\_QUESTION\_6>

Yes the WMBA does agree with the standardisations of the definitions of counterparties. This does not preclude the equivilent treatment for different product sets however.

<ESMA\_CO3\_QUESTION\_6>

##### Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA\_CO3\_QUESTION\_7>

No the WMBA does not agree with the proposed dates as the complexities of the issues involved demand further consideration and would only be feasible in tandem with clearing for delivered FX and for FX options across a wider set of jurisdictions. Even in this case, clearing beyond the set of wholesale global financial counterparties is of dubious value. We would however, envisage global NDF markets to be widely settled physically into the pertinent domestic banking systems by this point in time.

<ESMA\_CO3\_QUESTION\_7>

## Remaining maturity and frontloading

##### Do you have comments on the minimum remaining maturities for NDF?

<ESMA\_CO3\_QUESTION\_8>

The WMBA believes that there would be limited value in applying a “frontloading” requirement to FX NDF contracts, and that any clearing obligation for these contracts only apply to FX NDF contracts entered into or novated on the date of the clearing obligation takes effect.

WMBA also believes that given the widely accepted 1 month ‘effective spot’ protocol for NDFs, that any NDFs with under 1 month remaining to maturity should not be included into any clearing obligation.

<ESMA\_CO3\_QUESTION\_8>

# Annex - Draft Regulatory Technical Standards on the Clearing Obligation

##### Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA\_CO3\_QUESTION\_9>

We refer to the answers above.

<ESMA\_CO3\_QUESTION\_9>

# Annex – Impact assessment

##### Please indicate your comments on the Impact Assessment.

<ESMA\_CO3\_QUESTION\_10>

We refer to the answers above.

<ESMA\_CO3\_QUESTION\_10>

1. <http://fshandbook.info/FS/html/FCA/BIPRU> [↑](#footnote-ref-2)
2. <http://fshandbook.info/FS/html/FCA/IFPRU> [↑](#footnote-ref-3)
3. See Consultation Paper, page 32. Figures in the table above exclude CNY (one of the less liquid FX NDF currencies among the 11 considered by this Consultation Paper) where the share of trades with a maturity between six months and 1 year is 10%. [↑](#footnote-ref-4)
4. See BIS Triennial Central Bank Survey: Global foreign exchange market turnover in 2013 (February 2014); available at <http://www.bis.org/publ/rpfxf13fxt.pdf>. [↑](#footnote-ref-5)