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

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:

i. if they respond to the question stated;

ii. contain a clear rationale, including on any related costs and benefits; and

iii. 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 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:

i. use this form and send your responses in Word format;

ii. 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

iii. 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:	Investment Services
Country/Region	UK

Introduction

Please make your introductory comments below:

<ESMA_CO3_COMMENT_1>

The Investment Management Association (IMA) represents the UK-based investment management industry. Our members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members manage investments worth more than GBP5 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the “buy-side” of the market, accessing capital markets on behalf of their clients.

In addition to our answers to questions below we also support the response of the German Investment Funds Association (BVI).

We set out below, a summary of our members’ key concerns:

Impact of front-loading:

Practical implications of applying the frontloading threshold:

We welcome the proposal to effectively limit front-loading to a smaller number of participants and to contracts only entered into during period B. We are grateful to ESMA for taking on board the concerns of the industry as set out in our responses to the consultation papers of clearing Interest Rate Swaps (IRS) and Credit Default Swaps (CDS). However, we are concerned that the practical impact of the application of the front-loading threshold requirements will make it difficult for our members’ clients to take advantage of the exemption from frontloading. In particular, the time frames provided for calculating whether a client is over the threshold, especially where they are part of a larger group or have several investment managers does not allow for the communication of this information to counterparties in an orderly fashion prior to the start of the relevant front-loading period.

Minimum remaining maturity:

We disagree with the decision to impose a Minimum Remaining Maturity (MRM) for Non-Deliverable Forwards (NDFs) of three months, to take into account that the maximum maturity of the NDF classes is lower than the maximum maturity in the IRS class. According to paragraph 133 of the discussion paper, this may be overly burdensome in view of the overarching aim of the clearing obligation, which is the reduction of systemic risk, given that such risk could in this case only materialise during a very limited period of time. In both the interest rate and credit derivatives consultations, ESMA determined that risk associated with contracts only became substantial if the trade matured in over six months. There is no reason why that same analysis should not hold for Foreign Exchange (FX) NDFs. Lowering the MRM to capture a greater share of products (because the bulk of NDFs are traded in the short end) is also inconsistent with ESMA's earlier analysis of the MRM for IRS and CDS.

Phase-in periods:

We are concerned with the length of time proposed for the phase-in of clearing for NDFs. Whilst we appreciate ESMA's desire to bring NDFs into clearing as soon as possible and also to align the application of the clearing obligation across relevant asset classes, no account is taken in setting these parameters of the readiness of the market to move to mandatory clearing. Whilst it is the case that the levels of voluntary clearing for IRS and CDS are already relatively high and there are a number of Central Counterparties (CCPs) already offering clearing of these products, the same cannot be said for NDFs.

The proportion of NDFs which are cleared is a very low. Secondly, there is currently only one CCP authorised under the European Markets Infrastructure Regulation (EMIR) which clears NDFs. Whilst these points are noted in the consultation paper, we feel ESMA should give these issues additional weight in their considerations.

Uncertainty regarding the implementation of the pension exemption:

Under Article 89(1) of EMIR, Over The Counter (OTC) derivative transactions that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements as defined in Article 2(10) of EMIR, will not be subject to the clearing obligation. ESMA has clarified in its EMIR Q&As (OTC Question 16) that pension scheme arrangements which are exempt from the clearing obligation will only have to clear contracts executed after the date when the exemption falls away, and there will therefore be no frontloading.

In order to ensure certainty in respect of the application of the frontloading requirement, entities need to know whether or not they qualify as a pension scheme arrangement or entity under Article 2(10)(c) and (d) of EMIR. With the proposed front-loading requirements likely to commence in late 2014-early 2015, there is very limited time for entities to receive the certainty they need from ESMA and European Insurance and Occupational Pensions Authority (EIOPA) that they are eligible for the pension exemption. If frontloading commences before the pension exemption is clarified and the procedure required by Article 89(2) of EMIR is implemented, then pension scheme entities and arrangements which are not clearly within Article 2(10)(a) or (b) of EMIR and their counterparties will not know whether contracts which they execute, will be required to be frontloaded. This will in turn have a material impact on valuations, and the use of collateral. It is also likely to result in funds incurring significant costs and implying reduced returns to end investors.

Impact of clearing on risk-reducing trades:

We believe that any trade that is reducing a pre-existing position under a bilateral trade, and which is intended to be compressed (and is compressed) with the original trade so that the position is partially or fully terminated should not be subject to the clearing obligation. The remaining stub of the original trade where there has been a partial termination or a novation should also not be subject to mandatory clearing. If these trades are subject to clearing, market risk will actually be increased as offsetting trades are cleared and open at a CCP, whilst the original bilateral positions remain open until maturity.

Application of obligation to longer dated trades:

We do not agree with the proposal to include NDFs with maturities over 1 year. It is clear from the data provided in the consultation paper, and accepted by ESMA, that liquidity in the NDF market is focused on shorter maturities with only a handful of trades in some currency trades being executed in the longer maturities. ESMA is mandated by Article 5(4)(b) EMIR to consider the volume and liquidity of each class of derivatives which it proposes to bring within the clearing obligation in order to assess what is appropriate.

Internationally consistent clearing requirements:

If the clearing requirements for specific contracts differ between the EU and other jurisdictions (e.g, the US), this will lead to a need for firms and clients to implement additional processes and procedures to ensure compliance under different sets of legislation, in respect of their global business and investment portfolios. The obligation to clear then becomes a factor in the decision as to whether or not to trade cross-border, which we do not believe was the intention of the regulators. Lack of consistency internationally, could also mean the potential for creating distortions in counterparties' risk management and hedging processes, which could lead to arbitrage opportunities in international markets. We encourage ESMA and other regulators to work closely together to ensure that the implementation of decisions on mandatory clearing is coordinated at a global level.

<ESMA_CO3_COMMENT_1>

1. The clearing obligation procedure

Q1: Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA_CO3_QUESTION_1>

We support ESMA's proposal to group the analysis of the notified classes of OTC derivatives in a minimal set of consultation papers that are grouped per asset-class.

<ESMA_CO3_QUESTION_1>

2. Structure of the non-deliverable forward derivatives classes

Q2: 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>

No. While we do not have an issue specifically with respect to the structure of the FX NDF classes, we have significant concerns that the proposed structure more generally could create situations where certain derivatives are rendered untradeable on both a cleared and uncleared basis, based solely on the decision of authorised CCPs to cease clearing certain products.

<u>Mitigation of Trading Ban Situations:</u>

We support the effort by ESMA to increase derivatives market participants' ability to determine which contracts must be cleared and to prevent a situation where the clearing obligation would lead to a de facto trading ban on contracts that meet the seven characteristics of the RTS but that CCPs do not clear because of non-standard features. We note that in paragraphs 26 through 28 of the Final Report on the draft IRS Regulatory Technical Standards (RTS) that ESMA considers it has addressed this situation by amending the relevant recitals to *"contracts that the authorised CCPs have accepted for clearing <u>at the time of authorisation</u>"* ESMA reiterated that the bottom up approach overall means that there should not be any trading ban that could result from the structure. This analysis however does not contemplate that a CCP may choose to withdraw a particular clearing service following its authorisation, a process that does not in itself remove the clearing obligation even where no other CCP offers that service. Firms would be left with a situation where a product meets the criteria as specified by the RTS and where it was a clearable product at the time of authorisation but where such a service is no longer available.

According to Article 5(6) of EMIR, if a class of derivative contracts no longer has a CCP, it shall cease to be subject to the clearing obligation. This provision appears not to apply in situations where a CCP ceases to clear a contract within a given class of derivative, but continues to clear other products within the same class. In this instance, the clearing obligation for that particular class of contract is not extinguished, even though the CCP has ceased to clear a particular contract belonging to that class.

We note this issue is complicated further if a CCP removed a clearing service during frontloading period B, and it is unclear how the firm and the client would be able to remediate this situation while remaining in compliance with the RTS, other than by terminating the contracts when they become subject to frontloading. We would be surprised if this was ESMA's intention – as it would amount to a retrospective ban on the trading of a particular contract (contrary to ESMA's intention, as set out in paragraph 26 of the Final Report).

In order to prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR.

<ESMA_CO3_QUESTION_2>

3. Determination of the classes of OTC derivatives to be subject to the clearing obligation

Q3: 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>

We agree that the classes of FX NDF OTC derivatives proposed for mandatory clearing in the RTS appropriately address systemic risk, however, we recommend the obligation only apply to contracts with a one-year maturity or less on the basis that there is very limited liquidity in longer dated contracts.

Liquidity is extremely focused in the shorter end of the FX NDF market, in particular, the on-the-run one-month contract typically accounts for nearly 80% of turnover every day. There is a sharp drop in liquidity in tenors above three months. However, because there is a semblance of a market out to the one year point for most of the currencies and there is some spread trading that takes place within that maturity range, we believe the clearing obligation should only apply to contracts with a maturity of up to one year.

Contracts with maturities over one year are extremely illiquid. For example, in terms of the volume of NDF trades (which is a criteria for assessing systemic risk pursuant to Article 5(4)(b) of EMIR), for some of the currency pairings between one and two year tenors (CLP; TWD; RUB; COP; IDR; PHP), there is very limited interbank market activity, in some cases there is approximately only one NDF trade per week for the abovementioned currencies. Therefore the clearing of these trades would be subject to punitive margin terms at clearing houses without providing any real benefits in terms of mitigating systemic risks.

<ESMA_CO3_QUESTION_3>

Q4: 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>

Please see our response to question 3 above.

<ESMA_CO3_QUESTION_4>

4. Determination of the dates on which the obligation applies and the categories of counterparties

Q5: Do you have any comment on the analysis presented in Section Error! Reference source not found.**?**

<ESMA_CO3_QUESTION_5>

We are concerned that the conclusions drawn by ESMA in terms of the analysis presented glosses over a number of key issues. In particular the maturity of the cleared NDF market and the capacity of CCPs to support the significant increase in demand for clearing of these products which will inevitably result from a mandatory clearing obligation.

As noted in the consultation, the current proportion of cleared FX NDF turnover is limited and NDF clearing is a relatively recent development. ESMA also notes that there is currently only one CCP authorised under EMIR that offers clearing of NDFs. However the Consultation Paper further notes that:

"[i]t can therefore be expected that the CCPs have developed their clearing offer for NDF taking into account the expected volumes that the clearing obligation would bring"

And

"scalability of the CCPs is part of the authorization process of CCPs under EMIR which in the case of LCH taken place recently,"

It is clear therefore that ESMA does not consider that the hurdles of significantly increased volumes in trades which will have to be cleared and lack of readiness of the market generally to clear these products creates any real difficulties, and that the approach to NDF clearing should be no different to that adopted for IRS and CDS clearing, in spite of the clear differences in terms of capacity and maturity of offering. There are significant differences between clearing a class of products that is relatively new – which is the case for FX NDFs – and a class of products with which both the CCP and market participants have developed extensive experience and comfort – such as IRS and CDS – particularly in the context of a mandatory clearing obligation.

<u>Analysis to support a clearing determination for FX NDFs is closer to a "top-down" approach:</u>

While ESMA's Consultation Papers on the clearing obligation (no. 1 for IRS, no. 2 for CDS, and no. 3 for FX NDFs) are each considered as the result of a "bottom-up approach," the evolution of clearing for these three markets is such that the consideration of FX NDFs for a clearing obligation is closer to a "top-down" approach given that FX NDF clearing is, in comparison to IRS and CDS clearing, in its infancy. The "bottom-up" approach, as applied to IRS and CDS, was predicated on a far more developed market with many more providers and with the majority of start-up issues addressed while clearing was voluntary, both before and after the recent financial crisis. The lack of readily available client clearing solutions for FX NDF clearing illustrates this point. ESMA have decided that NDFs should be subject to clearing on the basis of standardisation etc. but have ignored the fact that there are no client clearing solutions in place yet for NDF clearing and only one EMIR authorised CCP. This clearing offering will no doubt develop in time, but imposing an obligation now in the hope that solutions will be available is not in line with the bottom-up approach in EMIR.

<u>Supervisory considerations concerning a potential clearing mandate are materially different when clearing services for the product are in their infancy:</u>

Further, we believe that considerations a supervisor of a CCP would analyse in the context of authorising a CCP to commence its services for a class of contracts is different from the considerations a supervisor would analyse in the context of a clearing mandate. Permitting a CCP to offer clearing of a product results in the small-scale offering of services which may grow over time. A clearing mandate, in contrast, would dramatically increase the volume/value of contracts processed by CCPs authorised to clear such contracts (presently there is only LCH) and rigorously test the resilience and robustness of its design in that context (e.g. default of clearing firms, liquidity available to close out, potential loss if significant position being liquidated/wound-down, etc.).[1]

<u>FX NDF clearing has not achieved the same depth as IRS and CDS clearing had when the clearing mandate was introduced for those asset classes:</u>

In contrast to FX NDF clearing which was first launched in 2011/2012, IRS and CDS contracts began voluntarily clearing in 1999 and 2009. At the time when the first clearing mandates were introduced, approximately 60% of the IRS contracts and 30% of CDS contracts were being voluntarily cleared. This differential can be explained by the introduction of clearing for CDS only five years ago, and 10 years after the introduction of clearing for IRS. In contrast, FX NDF clearing is estimated to be 0.4%-3.6% depending on the currencies involved. It is also important to note that that voluntary clearing has not expanded to the same degree for FX NDFs as it did in rates and credit. Clearing services for IRS and CDS contracts were able to mature and, through experience and time, resolve a number of issues before clearing mandates were ultimately imposed for those markets as a result of G20 derivatives reform. This is in part due to the fact that FX NDFs only represent 2.4% of the average daily turnover of the OTC FX market. In addition, entities transitioning to clearing for FX NDF contracts are likely to be far less familiar with clearing.

FX NDF contracts are often used to hedge currency risk associated with underlying commercial activity in emerging market jurisdictions with restricted currencies. As a result many entities which will be subject to an FX NDF clearing obligation will not be subject to an existing / proposed IRS or CDS clearing obligation. For these reasons, we

[1] See, e.g., remarks provided at the CFTC GMAC meeting on October 9, 2014 by David Bailey, Financial Market Infrastructure, Bank of England.

believe it is important to recognize the current state of FX NDF clearing and allow for sufficient time for the market to develop.

<ESMA_CO3_QUESTION_5>

Q6: 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>

We agree that the same definitions of categories of counterparties should be used and welcome the fact that ESMA has taken on board the potential impact of frontloading if imposed on the majority of the buy-side. However, we are concerned about the practicalities of the threshold approach proposed, particularly in terms of the timing of the calculation of the threshold and the time frame provided for communication of the resulting category of each counterparty.

The effectiveness of the proposed classification of counterparties to ensure a smooth implementation of the clearing obligation must be assessed in the context of the proposed phase-in periods and approach to the frontloading requirement. In our view, these elements cannot be assessed in isolation. When assessed together, we are concerned that the thresholds-based approach for the categorisation of counterparties, and the associated application of the frontloading requirement, will be practically impossible for many market participants to implement in the time and manner currently suggested.

The absence of consultation in respect of the mechanism to be applied and the late introduction of this material variation in approach (in respect of the IRS Clearing Obligation, being as little as 3-4 months before frontloading is scheduled to become effective) presents major challenges to compliance.

The proposed threshold-approach has the effect of:

- applying de facto retroactive legal obligations, by requiring entities to gather group data and assess their status by reference to criteria which are not yet settled or contained in any adopted legislation; and

- As a result, reintroduces the legal uncertainty which it purports to address.

For the reasons set out below, we consider that the Category 2/3 assessment period for FCs should only be expected to apply from the date that the RTS enters into force and that the three month assessment period of the threshold should run from that date at the earliest.

Further we recommend that an additional period at the end of the assessment period should be given to allow FCs time to communicate, via industry tools or otherwise, their status to relevant counterparties. This would have the effect that Period B for FCs not in Category 1 would commence after the expiry of (1) the three month assessment period, which should run from the date that the RTS enters into force, and (2) such additional period of time following the end of the assessment period as is appropriate for orderly communication of categories to be undertaken.

We are keen to get clarification from ESMA in relation to categorisation. In particular, will there be separate categorisations for each asset class or will they apply uniformly across each type? i.e. Is there a possibility that a firm will be in category 2 for NDF, but category 3 for IRS.

<ESMA_CO3_QUESTION_6>

Q7: 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. Please see our responses to questions 5 and 6 above.

We consider that the Category 2/3 assessment period for FCs should only be expected to apply from the date that the RTS enters into force and that the three month assessment period should run from that date at the earliest. And that an additional period at the end of any such assessment be given to allow FCs time to communicate their status to relevant counterparties. This would have the effect that Period B for FCs not in Category 1 would commence after the expiry of (1) the three month assessment period, which should run from the date that the RTS enters into force, and (2) such additional period of time following the end of the assessment period.

We also consider that each of the phase-in periods should be extended by at least 6 months to ensure that sufficient capacity to clear these products is available at the time when the obligation comes into effect for each category of counterparty, given how unprepared the industry is for broad CCP membership for NDFs (as compared to IRS and CDS).

<ESMA_CO3_QUESTION_7>

5. Remaining maturity and frontloading

Q8: Do you have comments on the minimum remaining maturities for NDF?

<ESMA_CO3_QUESTION_8>

We disagree with the decision to lower the Minimum Remaining Maturities (MRM) for NDFs to three months, to take into account the fact that the maximum maturity of the NDF classes is lower than the maximum maturity in the IRS class. The MRM should be set at a level aimed at reducing systemic risk. ESMA itself stated in its 2013 discussion paper on the clearing obligation that if the remaining maturity is very short, contracts may become subject to the clearing obligation only a few days or weeks before the termination dates.

According to paragraph 133 of the discussion paper, this may be overly burdensome in view of the overarching aim of the clearing obligation, which is the reduction of systemic risk, given that such risk could in this case only materialise during a very limited period of time. In both the interest rate and credit derivatives consultations, ESMA determined that risk associated with contracts became substantial if the trade matured in over six months. There is no reason why that same analysis shouldn't hold for FX NDFs. By reducing the MRM for FX NDFs, ESMA will create an artificially asymmetric treatment of the risk associated with different asset classes. Lowering the MRM to capture a greater share of products (because the bulk of NDFs are traded in the short end) is inconsistent with ESMA's earlier analysis.

<ESMA_CO3_QUESTION_8>

Annex I - Draft Regulatory Technical Standards on the Clearing Obligation

Q9: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_CO3_QUESTION_9>

- We believe that any trade that is reducing a pre-existing position under a bilateral trade, and which is intended to be compressed (and is compressed) with the original trade so that the position is partially or fully terminated should not be subject to the clearing obligation. The remaining stub of the original trade where there has been a partial termination or a novation should also not be subject to mandatory clearing. If these trades are subject to clearing, market risk will actually be increased as offsetting trades are cleared and open at a CCP, whilst the original bilateral positions remain open until maturity. Compression is not possible between a cleared and bilateral contract and novating the bilateral trade to a CCP before compressing, is both problematic and inefficient.

- A comparison of traditional forward FX with NDFs indicates that in the case of NDFs a portion of the Net Asset Value (NAV) will be tied up in collateral. We are concerned about the cost of this and whether the ability to deliver investment positions (equities/bonds) or collateral transformation services will address the relative underinvestment which will ensue.

- Similarly, will initial margin be delivered on a net or gross basis? Volatility in the equity or bond market requires adjustments of FX hedge levels which accumulate until the next roll date. This will affect the level of investment in a fund.

- NDFs will require a discrete instrument type due to the differences in the way counterparty exposure will be calculated for an NDF compared with a traditional physically settled forward.

- Our members are concerned about how will clearing brokers/ CCPs manage short term spikes in limit usage if NDF positions are rolled periodically? This would be a new challenge based on our understanding of the FX Clearing model.

- There is a lack of clarity on the standard process where currencies may move between being deemed deliverable or non-deliverable. This would impact, not only a clearing model, but the bilateral margining structure too.

- There is a concern that, if there is only one registered NDF Clearing House under EMIR, there is the potential to impact business due to the concentration of operational risk.

<ESMA_CO3_QUESTION_9>

Annex II – Impact assessment

Q10: Please indicate your comments on the Impact Assessment.

<ESMA_CO3_QUESTION_10>

No comment.

<ESMA_CO3_QUESTION_10>