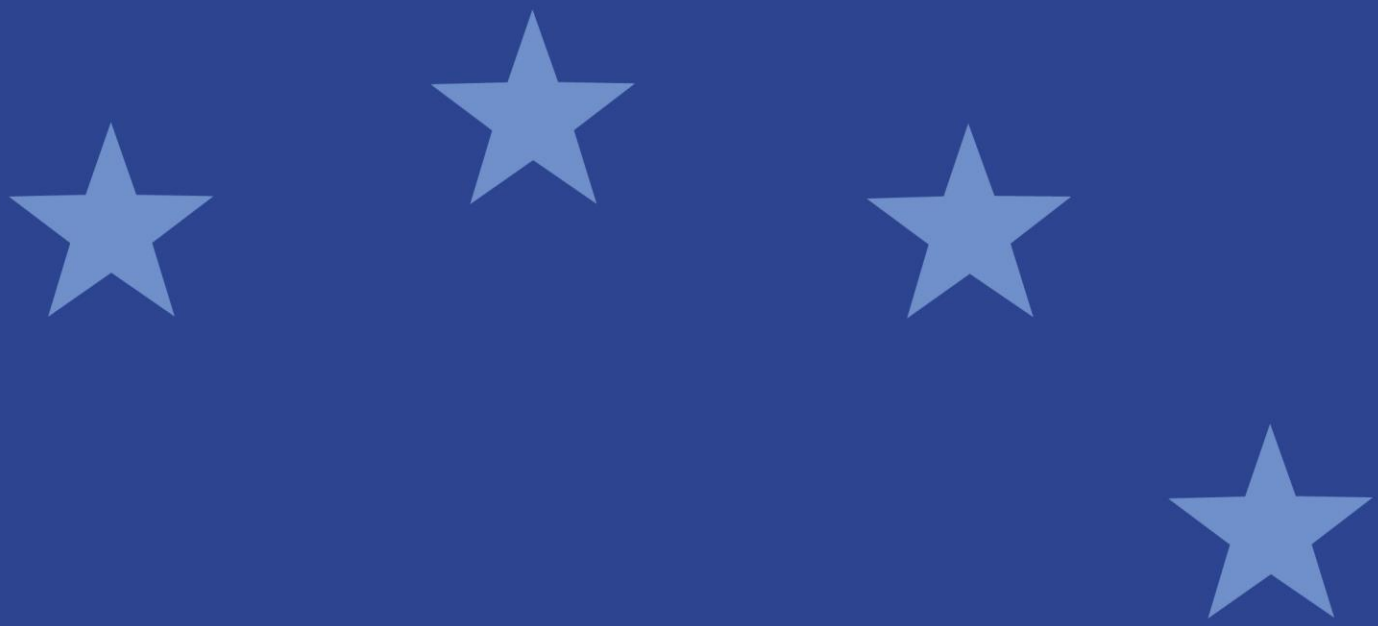
esma European Securities and Markets Authority

Reply form to the Consultation Paper on the Clearing Obligation under EMIR (no. 1)



11 July 2014|2014/799 Reply Form

European Securities and Markets Authority

Date: 11 July 2014
2014/799 Reply Form

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the questions listed in the Consultation Paper on the Clearing Obligation under EMIR (no. 1), published on ESMA's website.

Comments are most helpful if they:

- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives 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.

ESMA will consider all comments received by **18 August 2014.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

How to use this form to reply

Please note that, in order to facilitate the analysis of the responses, ESMA will be using an IT tool that does not allow processing of responses which do not follow the formatting indications described below.

Therefore, in responding you are kindly invited to proceed as follows:

- use this form to reply and send your response in Word format;
- type your response in the frame "TYPE YOUR TEXT HERE" and do not remove the tags of type <ESMA_QUESTION_1> Your response should be framed by the 2 tags corresponding to the question; and
- if you have no response to a question, do not delete the tags and leave the text "TYPE YOUR TEXT HERE" between the tags.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions which will be subject to the clearing obligation, as well as central counterparties (CCPs).

General information about respondent

Name of the respondent	European Banking Federation
Are you representing an association?	Yes
Activity	Banking sector
Country/Region	Europe

Introduction

Please make your introductory comments below:

<ESMA_COMMENT_1>
The beginning of mandatory clearing will be a significant change to the whole market, even if clearing in some classes is already widely used on a voluntarily basis. We are pleased to see that the ESMA will at first consider mandatory clearing based on the bottom-up approach only. This will make it easier for the markets to adjust to the mandatory clearing based on mostly existing solutions. Even with this approach many more counterparties, especially smaller financial counterparties and NFC+ will start clearing for the first time following these rules. For these entities, it will be a substantial change whereas existing clearing members and central counterparties will need to be able to provide clearing services to much more diverse clientele than before.

Our key concerns can be summarised as follows:

- The method by which the clearing obligation for different asset classes and product categories is to be introduced over time

The manner in which the clearing obligation for different asset classes and product categories is to be introduced where this cannot be done at the same time by one single regulatory technical standard is currently not entirely clear. However, on the basis of the two current consultation papers and the proposed regulatory technical standards contained therein, it appears that – unless the relevant proposals are adopted at the same time and thus combined – the first RTS to be adopted covering a certain asset class (presumably IRS) would later be replaced by a new RTS incorporating both the asset class previously covered by the already existing now to be replaced RTS and the new asset class to be covered (effectively, by replacing the first RTS by a new RTS with identical provisions but an extended Annex).

To avoid any uncertainty over the scope of an RTS setting out a clearing obligation and, in particular, regarding the dates relevant for the phase-in period and frontloading requirement, it could be considered to set out the method how future extensions of the clearing obligation are intended to be addressed or how the various RTS to be proposed and adopted are intended to interrelate.

- The understanding/application of terms and concepts:

We assume that all terms and concepts used in order to define the specific product categories covered by the clearing obligation (unless expressly defined) are to be understood and applied in accordance with market practice, in particular, in accordance with the understanding attributed to them by central counterparties (CCPs) which use these terms and concepts in order to describe or define the products cleared by them.

- The process for quick “de-listing” of products subject to clearing obligation.

It is of paramount importance to establish workable and efficient processes for ensuring that products which are no longer clearable are eliminated from the list of product categories subject to the clearing obligation. We welcome the initiative to address this important issue in the upcoming EMIR review but strongly believe that a pragmatic solution to this problem needs to be found and established before such a review.

- The phasing-in of the clearing obligation beginning with clearing members

The current proposal on the phase-in period regarding the first category of market participants (clearing members) appears to subject the counterparties falling into this category to the clearing obligation even in the case where the relevant other counterparty is not member of the same CCP. This would clearly and

unfairly disadvantage clearing members in comparison to other counterparties falling into the second category.

It should be considered to establish a register of clearing members, in particular of clearing members of any recognised third-country CCP. This would avoid any uncertainty over the status of a counterparty in particular in connection with third-country CCPs where it may not always be clear whether the type of membership in question qualifies as clearing member for the purpose of the clearing obligation. If such register is not established, authorised CCPs or recognised third-country CCPs should at least be required to make available information on their clearing members
<ESMA_COMMENT_1>

1 The clearing obligation procedure

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

<ESMA_QUESTION_1>
We are pleased to see that ESMA has decided to group derivatives in to five asset classes and consult based on this categorisation. Indeed, this will help market participants to assess the effects of any clearing obligations on a more systemic and comprehensive basis.

It is not clear from the description of the clearing obligation procedure how ESMA intends to present draft regulatory technical standards for different asset classes. Accordingly, we call on ESMA to clarify whether there will be one RTS on the clearing obligation, which will be modified each time ESMA determines that a new class of derivatives should be subject to the clearing obligation, or whether separate, standalone, RTS will be proposed. We would specifically welcome the attempt to capture all classes notified by (authorised and future authorised) CCPs belonging to the same type of asset class in a single consultation – and consequently, also one single regulatory technical standard (RTS) on the clearing obligation for such asset class. As set out under item 10 et seq., it would be clearly desirable to avoid that several RTS would have to drafted and consulted and – even more importantly, that several RTS with a similar material scope were to be adopted successively. The operational implementation of the clearing obligation would become even more complex and challenging, if clearing obligations in respect of certain products belonging to the same asset class were to become effective at different times over a period of time with varying or overlapping phase-in periods or dates of application of the frontloading requirement.

Regarding any potential changes, whereby products/currencies not currently subject to clearing obligations in the future might be re-assessed and assigned a clearing obligation, it is essential that this is communicated in due time ahead of any change. It would require less time for clearing members and non-members that already clear e.g. IRS in EUR, to start clearing in another currency offered by the same CCP. However, a large number of small Financial Counterparties that are non-members, such as savings banks and pension funds, in EU countries outside the Euro-area will only use OTC derivatives in the domestic currency. These FCs will not be more prepared for CCP clearing in the future than most FC in Euro-area countries are today. A potential phase in for new products and/or currencies should therefore be the same going forward for non-members as they are in this CP.
<ESMA_QUESTION_1>

2 Structure of the interest rate derivatives classes

2.1 Characteristics to be used for interest rate derivative classes

Question 2: Do you consider that the proposed structure defined here for the interest rate OTC derivative classes enables counterparties to identify which contracts fall under the clearing obligation as well as allows international convergence? Please explain.

<ESMA_QUESTION_2>
No. Whilst we welcome ESMA's statement in paragraph 22 of the consultation paper that a particular contract will only be subject to the clearing obligation if it is supported by CCPs and has the seven characteristics set out in Annex 1 of the draft RTS, the current text of the RTS does not reflect this dual requirements test. Without explicitly incorporating the two-step test into the RTS, we are concerned that the current drafting of the RTS will require parties to clear a contract which meets the seven characteristics in Annex 1 but which, in practice, cannot be cleared by any authorised or recognised CCP. In addition, the RTS should specify that that there must be CCPs which are authorised to clear and actually do clear a particular contract. It is the view of the EBF a contract should only be subject to the mandatory clearing obligation if at least two CCPs are authorised to clear and actually clear that particular contract.

In this context we assume that all terms and concepts used in order to define product categories are – unless expressly defined – to be understood and applied in accordance with market practice, in particular, in accordance with the understanding attributed to them by central counterparties (CCPs) which use these terms and concepts in order to describe or define the products cleared by them.

We especially appreciate the fact that the proposed structure is consistent with other jurisdictions. Consistency and convergence are especially important in derivatives markets which are global by nature.

We support the proposal in point 24 on page 12. In case more product types (such as swaptions, caps, floors and inflation swaps) are considered against the clearing obligation in the future, they will need to be consulted separately and categorised in additional classes of interest rate OTC derivatives.

However from our point of view, the product specification is not sufficient, since certain IRS characteristics cannot be cleared. This will generate confusion when trading these products, or might even prevent that those products will be traded going forward, since they would fall under the clearing obligation as defined of today. The seven characteristics listed in Annex 1 of the RTS inadequately reflect the breadth of trade terms which determine whether a particular contract can be cleared at a CCP. The specifications used to determine the classes subject to the clearing obligation should be more granular and include further distinguishing features. We urge ESMA to consider adding additional characteristics, both positive and negative, to those already listed in Annex 1 to better align these with the trade terms which determine whether a contract can be cleared at a CCP. This would prevent specifications that are too broad and that cover products which are not clearable because they have features that no CCP can replicate.

Also, we would like to ask for verification from ESMA that “variable” related to notional type (2.1 (17) Additional characteristics) means “roller-coaster” type, i.e. where the specific notional related to a specific payment is set at inception of the swap. If so, the information is sufficient for identifying swaps mandatory for clearing.
<ESMA_QUESTION_2>

2.2 Additional Characteristics needed to cover Covered Bonds derivatives

Question 3: Do you consider that the proposed approach on covered bonds derivatives ensures that the special characteristics of those contracts are adequately taken into account in the context of the clearing obligation? Please explain why and possible alternatives.

Stakeholders (CCPs and covered bond derivatives users, in particular) are invited to provide detailed feedback on paragraph 38 above. In particular: what is the nature of the impediments (e.g. legal,

technical) that CCPs are facing in this respect, if any? Has there been further discussions between CCPs and covered bond derivatives users and any progress resulting thereof?

<ESMA_QUESTION_3>
The proposal takes adequately into account the characteristics of covered bonds derivatives and the conclusion is correct. However, some fine-tuning could be done to ensure a more workable approach both in this respect and in the risk mitigation scheme for non-centrally cleared derivatives.

According to the first requirement (point 54 (a), it seems that no event of default (e.g. payment default) relating to the issuer would be permitted. This requirement would be incompatible with market practice and would reach beyond the requirements applied by the rating agencies for AAA compliant covered bond related derivatives.

The purpose of this restriction should be to avoid that the derivative is terminated as a result of the issuer's insolvency, not to prevent the counterparty from terminating upon other limited non-insolvency related defaults. Therefore we propose that the words "insolvency related" are added before "default" in paragraph (a) of point 54.

Regarding point 54 (f) we believe it should be sufficient to have a de facto 2% over collateralisation and not a necessity to have a legal requirement in each jurisdiction.

The clearing and other risk management procedures in EMIR and in the EU delegated legislation issued under EMIR (such as the draft RTS) only applies to derivatives transactions which involve two or more counterparties. Hence, the rules do not apply with respect to derivatives transactions entered into within the same legal entity (see ESMA's response to TR Question 14 in the EMIR Q&A published by ESMA on 23 June 2014). If, in accordance with national legislation and upon prior approval by its competent authority, a bank issues covered bonds on its own balance sheet and internally hedges the risks relating to such covered bond issues, all such hedging arrangements are made within the same legal entity. It would be both desirable and advantageous to clarify that the RTS does not apply to such internal hedging transactions.

We welcome ESMA's proposed treatment of covered bond derivatives, however we would urge ESMA to consider whether there are other types of derivatives that deserve a similar regulatory approach. In particular, we are of the view that many of the reasons listed by ESMA in Section 2.2 of the consultation for exempting swaps associated with covered bond transactions from the clearing obligation are also applicable to securitisation swaps, and that securitisation swaps should also be exempted from the clearing obligation.
<ESMA_QUESTION_3>

2.3 Public Register

Question 4: Do you have any comment on the public register described in Section 2.3?

<ESMA_QUESTION_4>
The importance of a rapid removal of clearing obligations cannot be overstated. We welcome the indication that ESMA will flag the deficiency of the current clearing obligation process and recommend its review to account for the level of urgency that may be required to remove an asset class from the clearing mandate. As set out in the IRS-Consultation Paper, it is necessary to establish processes which

allows for a quick “de-listing” of no longer clearable products or otherwise ensure that counterparties are not effectively forced to stop transactions in products which are nominally still subject to a clearing obligation but are no longer clearable.

We concur with the analysis, in particular regarding the concerns over the fact that the definition of the classes of derivatives subject to the clearing obligation by way of a RTS severely limits the possibility to implement any necessary subsequent adjustments, such as excluding a class of products which has become ineligible for clearing (de-listing of no longer clearable products), in a sufficiently timely manner. As set out in the IRS-Consultation Paper, it is necessary to establish processes which allows for a quick “de-listing” of no longer clearable products or otherwise ensure that counterparties are not effectively forced to stop transactions in products which are nominally still subject to a clearing obligation but are no longer clearable.

These concerns are of particular practical relevance in connection with series of index credit default swaps which are regularly readjusted. The issue will therefore need to be addressed in the RTS proposed in the Consultation Paper - Clearing Obligation under EMIR No. 2 concerning credit default swaps (CDS-Consultation Paper). It will be crucial to find a workable, more flexible solution for this in the coming EMIR review. This problem may, for example, be addressed through the non-enforcement of the clearing obligation in a situation where counterparties subject to the clearing obligation intend to enter into transactions in the timespan between the point in time where it has become apparent that a listed product is no longer clearable and the point in time of its “de-listing”.

However, we remain cautious whether any amendments based on the review will be implemented soon enough. It is expected that the EMIR review will be highly debated due to many outstanding issues. We therefore urge ESMA to find a way to go round these limitations and to build a robust system together with the co-legislators as soon as possible and before any clearing obligations enter into force.
<ESMA_QUESTION_4>

3 Determination of the OTC interest rate classes to be subject to the clearing obligation

Question 5: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

Please include relevant data or information where applicable.

<ESMA_QUESTION_5>
We agree that the prioritised products and currencies appropriately address systemic risk. As the proposed clearing obligation covers the largest share of the systemic risk in the market, we would urge ESMA to thoroughly consider the impact on liquidity and financial stability of an EU member state default in smaller non-Euro currency markets before potentially setting any clearing obligation in products in non-Euro currencies. Information on product scope, currency scope and also the expected timing for possible future clearing obligations would be most helpful in preparing market participants.

We would like to comment on standardisation of contractual terms analysis in Section 3.2.1. In many jurisdictions, the derivatives traded may be subject to non-standardised in-house master agreements which may differ from the ISDA standard. The standardisation argument is not specific to interest rate derivatives as ISDA master agreement do not distinguish and cover all asset classes in general (although specific annexes or provisions at the confirmation level may exist for certain product types).

The market dispersion analysis shall be related to a specific asset class and take into account the discrepancies in the offering and membership on various CCPs. Small local CCPs with restricted clearing offer and mostly local banks as clearing members are not equivalent clearing/porting alternatives to "international" CCPs such as the two largest derivatives CCPs. Clearing of EUR, USD, GBP currencies is most likely to be concentrated on LCH, leaving only small volumes for the same products to the local CCPs. In practice, the successful porting will depend on existence of arrangements with back-up clearing members. We believe that many local clearing members will not be able to compete with big market players on "international" CCPs and will not establish connections with several CCPs as suggested in the consultation. Likewise, the CMs at LCH will not have incentive to establish themselves as clearing members on small local CCPs if they can clear the same products on a more liquid international CCP. In other words, there may be barriers between the various CCPs that the consultation paper analysis as apparently equivalent.

Furthermore, some small to medium sized general clearing members are considering their role as general clearing members. There are several reasons for this: the introduction of clearing obligations where one might need to establish clearing relationships to new CCPs, segregation requirements and new account structures, possible new organisational requirements under the MiFID II regime, capital requests and amendments to CCP rules following their EMIR authorisation and general consolidation trends as examples. Therefore ESMA should in its analysis of a future scenario also take into account the possibility of a lower number of general clearing members than today.
<ESMA_QUESTION_5>

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

4.1 Analysis of the criteria relevant for the determination of the dates

Question 6: Do you have any comment on the analysis presented in Section 4.1?

<ESMA_QUESTION_6>
Whilst we note ESMA's analysis in paragraph 145 of the consultation paper that ESMA has no legal basis on which to refuse to launch a clearing obligation procedure solely on the ground that a class of derivatives is cleared by a single CCP, we believe that ESMA is entitled to take this into account in its determination of whether a class of derivatives should be subject to the clearing obligation. In our view, the clearing obligation should only be imposed when at least two authorised or recognised CCPs clear a particular class of contracts.

We agree that the number of clearing members clearing a class of derivatives should be regarded as a vital part of ESMA's assessment of whether a clearing obligation should be imposed on that class. We would stress, however, that the number of clearing members for a class should be monitored on an ongoing basis to ensure that the continued imposition of the clearing obligation remains appropriate.
<ESMA_QUESTION_6>

4.2 Determination of the categories of counterparties (Criteria (d) to (f))

Question 7: Do you consider that the classification of counterparties presented in Section 4.2 ensures a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_7>
As mentioned in EBFs response to the ESMA discussion paper on clearing obligation (Ref: EBF_003888E), we understand that there is a need to differentiate between FCs as this concept is too broad and the entities it covers are very diverse. FCs should be further subdivided according to some objective criteria. However, EBF cannot express a preference for any of the options presented.
<ESMA_QUESTION_7>

4.3 Determination of the dates from which the clearing obligation takes effect

Question 8: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_8>
EBF agrees with ESMAs proposed dates for application. As mentioned in EBFs response to the ESMA discussion paper on clearing obligation (Ref: EBF_003888E), phase in-periods between at least 6 months for counterparties with an access and at least 12 months for those without an access seem to be a minimum time period. The 12 month phase-in period is required in order to grant the relevant counterparties the necessary time for the establishment of the operational and legal framework for clearing, sufficient time for testing and analysis of technical compatibility, etc.
<ESMA_QUESTION_8>

5 Remaining maturity and frontloading

Question 9: Do you consider that the proposed approach on frontloading and the minimum remaining maturity ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? If not, please explain why and provide possible alternatives compatible with EMIR.

<ESMA_QUESTION_9>
We welcome the clarification that contracts concluded with non-financial counterparties are not subject to frontloading obligation. We also greatly appreciate the decision to only apply frontloading to a limited number of contracts within Period B (between the publication in the Official Journal of the RTS and the date on which the clearing obligation takes effect (the date of application)).

The frontloading requirement will be challenging for counterparties belonging to Category 2. This is especially true if one takes into account the dimensions related to non-financial entities being within the scope of the clearing obligation. Most non-financials that had to start calculations regarding the clearing threshold in order to prove they were out of scope are larger companies with large derivative portfolios than many of the financial counterparties falling into Category 2 which would be subject to frontloading requirements regardless of their portfolio size. These challenges are similar to the once described in section 224, including the economic effect of switching collateral already posted relative to the maturity of the contract and also the difference on initial margin and variation margin posted under a bilateral set-up vs. a central clearing set-up. It will require significant legal and operational measures to meet the requirements for frontloading. For Category 2 counterparties it will be expected that OTC derivatives concluded during the "frontloading period" and subject to the clearing obligation will only be traded under conditions which largely reflect the central clearing set-up. For Category 2 counterparties that have not established access to relevant CCPs through a clearing broker this will mean illiquid markets and the risk of considerable friction.

We recommend, as a matter of legal certainty, that Period A should be set as the period between the notification of a class of derivatives to ESMA and the date of entry into force of the RTS introducing the clearing obligation for that class of derivatives. It should not, as the current drafting of the RTS mandates, end on the date the RTS is published in the Official Journal. This recommendation is in line with ESMA's proposal on frontloading to the European Commission in its letter dated 08 May 2014. It also reflects the Commission's answer dated 08 July.

It is suggested that the frontloading requirement for Period B is also eliminated through further regulation of the remaining maturity period. The attempt to reduce the systemic effects through the frontloading requirement is addressed in the upcoming leverage ratio regulation. Absence of the frontloading requirement will therefore not lead to an increase in not-cleared OTC derivatives contract in the period leading up to the entry into force of the clearing requirement.

Members have expressed concern that the proposed approach might generate confusion when pricing IRS with Category 2 counterparties during Period B. The majority of these trades have a maturity profile of 3 to 5 years, and would therefore fall under the clearing obligation. Assuming a Category 2 counterparty enters into an IRS during Period B with a remaining maturity of greater than 12 month, then those IRS are at the time of execution bilaterally under an ISDA agreement which needs to be back-

loaded once the clearing obligation starts. At this point in time the IRS would change from an ISDA / CSA agreement to a clearing agreement which will change the valuation of the IRS and therefore makes it difficult to find a correct price at time of execution. This might lead to reduced liquidity.

In order to avoid the uncertainty arising from the frontloading requirement, Category 2 counterparties should be explicitly excluded from the frontloading requirement during the 18 month phase-in period. The minimum remaining maturity of contracts entered into during the phase-in period would then reflect the approach taken for Period A. A sufficient phase-in period would be required for Category 2 counterparties to establish clearing arrangements.

Ultimately, there is also some concern that the proposed provision in Art. 4(1) may result in uncertainties or misunderstandings and should therefore be clarified. We understand that this provision is meant to ensure that transactions with non-financial counterparties are not subject to any obligation to "frontload" transactions which have been entered into before the date of application of the clearing obligation for this class of counterparties, that is effectively exempt these transactions from frontloading in general. We fully agree that such exemption is merited. However, it should be considered to set this out more clearly to avoid uncertainties.

Likewise, in view of the fact that the understanding of maturity is of fundamental importance in this context, it could be considered to define the term or at least clarify that maturity is intended to capture any situation where the obligations under a transaction have been fully performed or the term of which has been completed or which have ended in any other manner.
<ESMA_QUESTION_9>

6 OTC equity derivative classes that are proposed not to be subject to the clearing obligation

Question 10: Do you have any comment on the analysis on the Equity OTC derivative classes presented in Section 6?

<ESMA_QUESTION_10>
The analysis takes duly into account the characteristics of the equity derivatives markets. At the time being, they are not significant from a systemic risk perspective.
<ESMA_QUESTION_10>

7 OTC Interest rate future and option classes that are proposed not to be subject to the clearing obligation

Question 11: Do you have any comment on the analysis on the OTC Interest rate future and options derivative classes presented in Section 7?

<ESMA_QUESTION_11>
We agree with the analysis and the conclusions drawn.
<ESMA_QUESTION_11>

Annex I - Commission mandate to develop technical standards

Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

Question 12: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_QUESTION_12>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_12>

Annex III - Impact assessment

Question 13: Please indicate your comments on the CBA.

<ESMA_QUESTION_13>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_13>