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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.

Data protection

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Disclaimer’.

# General information about respondent

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| --- | --- |
| Are you representing an association? | No |
| Activity: | Choose an item. |
| Country/Region | Norway |

# Introduction

**Please make your introductory comments below:**

<ESMA\_CO3\_COMMENT\_1>

As a global investor in financial markets we are concerned about systemic risk in the financial system. In our view, an important aspect of financial market regulation is the mitigation of systemic risk and its contributing factors. One such factor is counterparty risk. We support ESMA’s efforts to regulate these markets and the trading of OTC derivatives. We intend to mitigate our exposure to counterparty risk further by clearing our OTC derivatives through central clearing on a voluntary basis. Accordingly, we are interested in contributing our views regarding ESMA’s consultation.  
  
In addition to the detailed responses below we would like to make the following general comments:  
  
• We support the objective of reducing systemic risk through central clearing of certain OTC derivatives. Central clearing of OTC derivatives can reduce complexity in financial markets, reduce counterparty risk between institutions, and increase transparency, each of which reduces systemic risk in the financial system. For this reason, we agree with the majority of the proposals set out in the Consultation Paper and the proposals described therein.

• We believe that regulation of financial markets should be targeted and harmonized across jurisdictions, to the extent feasible. We believe adequate regulation requires monitoring and enforcement, but that exemptions should be granted where the regulation is ineffective, creates inefficiencies and/or unwanted costs.

• A consequence of the proposed regulation is that clearing houses become increasingly important in the financial market infrastructure and, as a result, may themselves pose a systemic risk. To mitigate systemic risk related to those institutions, we believe that regulation, supervision and monitoring of clearing houses will be required to avoid some of the disadvantages associated with central clearing of OTC derivatives. We think particular emphasis should be placed on collateral requirements, as collateral is a critical component in determining the creditworthiness of a clearing house.

<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>

We agree with the procedure described in paragraphs 9 to 13. ESMA’s aim of combining the analysis of the notified classes of OTC derivatives in a limited number of consultation papers and grouping them per asset-class will be much more efficient than running numerous consultations in parallel. We think that the clearing obligation should focus on those asset classes which are already being cleared by at least two CCPs in sufficient volume. The proposals in this Consultation Paper, however, result from the analysis of a class of OTC FX NDFs cleared by a single CCP, LCH Clearnet Ltd. This seems a rather narrow basis, although we note ESMA’s expectation that there will be at least two European CCPs available before the clearing obligation for NDFs takes effect. Nevertheless ESMA’s analysis may be subject to change as soon as other CCPs are authorised and start clearing NDFs.

We also believe that the imposition of a clearing obligation should only become effective when there is certainty as to the capacity and capability of the relevant CCPs to handle expected volumes and effectively manage default and resolution scenarios.

<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, we think that the main characteristics of NDFs are adequately captured by the proposed structure. In particular we find that the structure adequately separates between cash-settled FX forward contracts and physically-settled FX forward contracts.

We think it is important that market participants have certainty as to the exact scope of the clearing obligation. Their determination in respect of the application of the clearing obligation to an individual transaction should be facilitated by reference to a list of clearable instruments which would be made publicly available in a register maintained by ESMA. The proposed use of such a register was described in ESMA’s consultation paper on the clearing obligation for IRS and could be used in the same way for NDFs.

<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>

We think that the criteria and currency pairs chosen appropriately address the objective of reducing systemic risk associated with NDF derivatives. The criteria and categories proposed correspond to a large extent with current market practice as they focus on the NDF currency pairs that are currently being traded in the largest volumes and which are already being cleared by CCPs. We support ESMA’s “bottom-up” approach as described in EMIR Article 5(2) as the preferred approach for the identification of the relevant classes of NDFs. By taking this approach, the clearing obligation targets actual market activity and volumes and will therefore capture the more liquid and most standardised classes of NDFs.

Excluding NDFs that settle in currencies other than USD from the clearing obligation may have unintended consequences if those currency pairs are not offered simultaneously for voluntary clearing. For example, a model buy-side portfolio trading EUR/KRW would not be cleared for the buy-side client, but the sell-side bank which hedges it through a combination of EUR/USD + USD/KRW would clear the USD/KRW leg on a mandatory basis. There may well be costs associated with clearing which the bank would likely pass on to the buy-side client. As a result, the buy-side client bears the cost of clearing without getting any additional benefit. Depending upon how big or small that cost is, non-USD NDFs might become too cumbersome or expensive to trade.

We concur that USD would remain the predominant currency for NDF clearing but please note that funding currency choice is a function of outlook and interest rates. The percentage of USD base currency trades, which was 95% in April 2013, might not be the same in April 2015.

For the reasons outline above, we think it is important that the remaining currency pairs are offered for voluntary clearing as long as they are sufficiently liquid to support adequate pricing and collateral offsetting benefits for clients. We believe regulators should encourage CCPs to offer clearing of NDFs that are not mandatory and fall within this category.

Buy-side clients often have a portfolio approach to emerging markets. The margins they post will be reduced with the increased number of currencies because of the correlation between their portfolios (offsetting effect), especially in light of the long maturities that are proposed to be cleared.

It is important that clearing mandates and, even more so, trading mandates for NDFs are aligned between regulatory jurisdictions (especially the US and the EU), to avoid a liquidity split seen in other asset classes. In order to optimise liquidity and prevent fragmentation NDF currency pairs should not be on one regulator’s list of mandatory NDF currency pairs but not of another’s.

NDFs are predominantly used where there are restrictions on foreign investors investing in certain emerging markets currencies. If those restrictions were relaxed, the need for some NDF currency pairs may decrease which may result in poor liquidity. We therefore support ESMA’s proposal to monitor factors that may substantially reduce structural liquidity because alternative liquidity emerges on-shore. Similarly we think ESMA should remove the clearing obligation for a particular currency pair if liquidity is insufficient, provided this decision is consistent with that taken by regulators in other jurisdictions.

Please also see our response to Question 7 on this point.<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>

Longer-dated NDFs have more risks associated with them than the short-dated NDFs and we therefore think they should be included in the clearing obligation as proposed by ESMA. However, liquidity may be an issue as volumes are much lower than for the shorter-dated NDFs, as also noted by ESMA. Should liquidity become an issue then this will affect the availability of a fair price and hence the calculation of variation margin.

Liquidity is likely to fluctuate in response to differing market conditions, especially for the NDFs already suffering from low liquidity. Such fluctuation will make it difficult to obtain a fair price, and margining of the longer-dated NDF trades will also become difficult, e.g. in stressed market situations.

The risk models used for calculation of initial margins are often VaR or similar models. The weaknesses of those models are well-known, e.g. the responsiveness of the models will often change substantially in normal vs stressed markets. This will in most cases affect risky instruments more than less risky instruments. If margining becomes pro-cyclical, it can lead to destabilization of markets which may exacerbate crisis situations and lead to insufficient margins in stable markets.

<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>

Currently LCH.Clearnet Ltd (UK) is the single European CCP approved for clearing FX NDFs in Europe. We would like to stress the importance of having at least two CCPs available to clear the contracts belonging to a mandatory instrument class. Should too few CCPs be available (i.e. a market dominance situation), our concern is that could be detrimental to the market.

There are several clearing members offering clearing services through LCH.Clearnet, so assuming that at least some of those clearing members will also start clearing NDFs in the future, buy-side clients will have a choice of clearing members under their existing IRS clearing set-up.

Of the 17 clearing members listed, none are currently clearing buy-side trades, so it seems that there is some way to go before the necessary infrastructure will be in place. Also, given the uncertainty around costs of clearing and the impact and constraints of clearing on clearing members’ leverage and capital ratios under Basel III and CRD IV, we are not particularly confident that many clearing members will ultimately offer this product.

<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 definition of the categories of counterparties seem to be sufficiently homogeneous and using the same definition creates consistency and transparency. We agree with ESMA’s approach of having the most active market participants start clearing first, as they already have direct access to the CCPs. Those who are the most remote from clearing should be last in line, as they will need more time to get access to clearing and to implement the necessary internal organisational, legal and risk management framework. There should be adequate time for market participants to evaluate and become accustomed to the risk management practices employed by the CCP to ensure assumed risks are within market participants’ acceptable range.

We believe that ESMA’s approach to categorisation and phased-in implementation is similar to that used in other jurisdictions, and we consider that the optimal approach. National legislation and regulation in the various countries, especially in the US and across Europe, must be coordinated to avoid the risks of market segregation and market disruption, and to prevent the appearance of a geographical divide, with the market becoming segregated between US and non-US counterparties.

<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>

We think that ESMA has chosen a reasonable approach in determining the time line for implementation of the clearing obligation. When determining the clearing categories and their respective timeline for implementation, we think that it is reasonable to take into account the number of clearing members and whether a party already has access to clearing.

We would urge ESMA to consider the liquidity implications before a trading obligation is introduced. Many of the European buy-side clients tend to be price takers (end users) in the NDF market, using NDFs for hedging purposes, and ESMA should keep in mind their liquidity concerns.

For example, take Asian currency pairs, where a lot of liquidity is provided by smaller Asia-based market makers (who can arbitrage onshore and offshore markets) and where central clearing is not such an entrenched notion as it is in jurisdictions such as the US and Europe.

Before a trading obligation on a designated venue is introduced, the risk of market fragmentation should also be part of ESMA’s considerations, as the rules and their extraterritorial effect may not always be immediately apparent. Fragmentation may cause market participants to revert to voice trading, which could jeopardise liquidity and fair pricing.

Continued co-ordination and co-operation between the regulators, especially ESMA and the CFTC, is crucial to provide transparency and to create a level international playing field, especially when phasing in trading obligations, which prevents regulatory arbitrage. The need for harmonisation of cross-border rules and for further regulatory regimes to be declared equivalent, is also very important in this respect. Furthermore regulators should share reporting data among themselves in order to fully understand systemic risk in the global derivatives market.

<ESMA\_CO3\_QUESTION\_7>

## Remaining maturity and frontloading

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

<ESMA\_CO3\_QUESTION\_8>

We agree with ESMA’s approach.

<ESMA\_CO3\_QUESTION\_8>

# Annex II - 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>

No response

<ESMA\_CO3\_QUESTION\_9>

# Annex III – Impact assessment

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

<ESMA\_CO3\_QUESTION\_10>

No response

<ESMA\_CO3\_QUESTION\_10>