ESMA/2013/926

1. Respondent

Name: ICAP

Country: UK

Category: please use the table below

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| **Category** | **Please select** |
| Audit/Legal/Individual |  |
| Banking sector |  |
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| Investment Services |  |
| Non-financial counterparty subject to EMIR |  |
| Regulated markets/Exchanges/Trading Systems | **√** |
| Other Financial service providers |  |

1. Introduction – General comments

ICAP welcomes the opportunity to submit comments to ESMA’s discussion paper on the derivatives clearing obligation under EMIR. As a leading markets operator and provider of post trade and risk information services, ICAP’s experience gives us a perspective that may be helpful in the context of this consultation.

We have responded to those questions which are most relevant to our business. As general observations, we note the following points:

* We would question whether it is appropriate to introduce a clearing obligation where there is only one CCP available to clear a particular product. Mandating a product to be cleared through a single CCP has competitive implications and could also result in a significant concentration of risk.
* The phase-in of any clearing obligation will need to take into account the number of CCPs that offer clearing in the particular product, the number of clearing members that offer clearing services to clients, as well as the concentration and credit profile of the clearing members.
* New contracts (in classes of derivatives that would otherwise be subject to the clearing obligation) created as a result of portfolio compression or other post trade risk reduction exercises should not be subject to the clearing obligation.
1. Comments on the discussion paper and answers to questions

Comments on paragraphs 1 to 6:

N/A

# 1. Procedure for the determination of the classes to be subject to the clearing obligation

Comments on paragraphs 7 to 17:

N/A

# 2. CCP-cleared classes of OTC derivatives

Comments on paragraphs 18 to 30:

N/A

## 2.1 Credit derivatives

Comments on paragraphs 31 to 39:

N/A

Question 1 (Series for Index CDS):

Please indicate your preference between the options presented. Do you believe that the possibility for a new series to exhibit low liquidity is a risk worth being considered when defining the classes of Index CDS? Under Option C, which criteria do you believe are relevant and how should they be calibrated?

Answer 1:

We prefer Option A.

Question 2 (Index CDS):

Do you consider that the main characteristics of Index CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 2:

Yes, we believe this captures adequately the main characteristics of Index CDS.

Question 3 (Index CDS):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 3:

In relation to the European indices, we believe the most suitable candidates would be iTraxx Main and iTraxx Crossover Series 12 onwards. For CDX, we believe CDX Investment Grade is the most suitable candidate, followed by CDX High Yield & Investment Grade High Volatility. However, mandatory clearing of these products may still need to be subject to some form of phase-in.

Comments on paragraphs 41 to 44:

N/A

Question 4 (Single name CDS):

Please indicate your preference between the options presented. In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

Answer 4:

As a general observation, we note that the jurisdictions which are most advanced in implementation of the G20 commitment for more central clearing of OTC derivatives, namely the US and Japan, do not currently require mandatory clearing of Single Name CDS.

Should ESMA determine it is appropriate to apply the clearing obligation to Single Name CDS, we prefer Option B. We also consider geographical zone to be a more relevant characteristic than settlement currency (although settlement currency is an important criterion, in particular when dealing with non-standard combinations, for example where the contract is traded in a different geographical zone to the settlement currency).

Comments on paragraphs 45 to 50:

N/A

Question 5 (Single name CDS):

Please indicate your preference between the options presented. Under Option C, which criteria do you believe are relevant and how should they be calibrated?

Answer 5:

We prefer Option B.

Question 6 (Single name CDS):

Do you consider that the main characteristics of Single Name CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 6:

Yes, we believe this captures adequately the main characteristics of Single Name CDS.

Question 7 (Single name CDS):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 7:

We do not have a view on which Single Name CDS might be the most suitable candidates for the clearing obligation. However we note that these products are subject to frequent shifts in market liquidity.

## 2.2 Interest rate derivatives

Comments on paragraphs 52 to 58:

N/A

Question 8 (Interest rate derivatives):

Do you consider that the main characteristics of the interest rate derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 8:

Broadly speaking, this captures the main characteristics of interest rate derivatives. However we note that the Discussion Paper does not capture all the potential variables of those characteristics – for example, it does not list all of the currencies, maturities and floating rates that are available.

Question 9 (Interest rate derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 9:

Aligning the scope of the clearing mandate with the approach that has been adopted in the US would help ensure consistency across jurisdictions.

## 2.3. Equity derivatives

Comments on paragraphs 59 to 70:

N/A

Question 10 (Equity derivatives):

Please indicate your preference between the options presented. Under Option D, which criteria do you believe are relevant and how should they be calibrated?

Answer 10:

We believe further consideration is needed of the criteria that will be applied in relation to equity derivatives. In terms of the key characteristics we would suggest that ESMA consider whether the existing ISDA Taxonomy might provide a suitable basis for defining Product Type and Sub Product Type. In relation to the suitability of this asset class for CCP clearing, ESMA should also take into account the different characteristics of OTC equity swaps and listed futures.

Comments on paragraphs 71 to 73:

N/A

Question 11 (Equity derivatives):

Please indicate your preference between the options presented.

In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

Answer 11:

We prefer Option B. However, geographical zone is only one characteristic that needs to be considered when determining eligibility for clearing.

Question 12 (Equity derivatives):

Do you consider that the main characteristics of Equity OTC derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 12:

Other characteristics that may be of relevance include settlement period, roll date, roll frequency, option style and market pricing.

Question 13 (Equity derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 13:

N/A

## 2.4. Foreign Exchange derivatives

Comments on paragraphs 75 to 78:

N/A

Question 14 (FX derivatives):

Do you consider that the main characteristics of the FX derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 14:

N/A

Question 15 (FX derivatives):

Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 15:

N/A

## 2.5. Commodity derivatives

Comments on paragraphs 79 to 84:

N/A

Question 16 (Commodity derivatives):

What is in your view the best approach to specify the underlying assets within each OTC Commodity class?

Answer 16:

An alternative would be to follow the existing ISDA taxonomy which is already used for compliance in other jurisdictions. However, if the ESMA approach is to be followed, we would suggest the Energy – Oil Commodity Class is divided into two:

* Energy – Crude Oil
* Energy – Fuel Oil

ESMA should also clarify what it intends to be captured by the Commodity Class Name “Energy – Inter Energy”.

Question 17 (Commodity derivatives):

Do you consider that the main characteristics of the Commodity derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 17:

Broadly speaking, we believe this captures the main characteristics of Commodity derivatives.

Question 18 (Commodity derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 18:

As the overarching aim is to reduce systemic risk, we would suggest prioritising in the following order:

**HIGH**

Energy - Crude Oil

Energy – Refined Products

Metals – Non Precious

Metals – Precious (GOLD)

**MEDIUM**

Metals – Precious (rest)

Energy – Ferrous Metal

Energy – Electricity

Energy – Coal

Agriculture – Grains Oil Seeds

**LOW**

Remaining categories

# 3. Preliminary analysis of the readiness of asset classes vis-à-vis the clearing obligation

Comments on paragraphs 85 to 105:

N/A

Question 19 (readiness of the classes):

Do you agree with this analysis?

Answer 19:

In line with the approach taken in the US and Japan, IRS and CDS should be considered first.

# 4. Determination of the phase in, and the categories of counterparties to which the CO would apply

## 4.1. Dates, phase in, categories of counterparties

Comments on paragraphs 106 to 115:

Question 20 (dates, phase in):

What would you consider to be the shortest delay to impose a clearing obligation to a class of OTC derivatives when there are several CCPs available? And when there is only one CCP available?

Please specify in your answer whether the cause of delay is due to operational issues (e.g. time for CCP/counterparties to be ready for the CO) and/or to market issues (e.g. time for a CCP to add a new product to its offering).

Answer 20:

We would question whether it is appropriate to introduce a clearing obligation where there is only one CCP available to clear a particular product. Mandating a product to be cleared through a single CCP has competitive implications and could also result in a significant concentration of risk. We would suggest that clearing should be mandated only where there are at least two CCPs authorised to clear a specific product, at least pending the implementation of a resolution and recovery framework for CCPs.

In addition to the number of CCPs, the phase-in of any clearing obligation will need to take into account the number of clearing members that offer clearing services to clients in the particular product, as well any concentration of client business in that product relative to other clearing members.

Question 21 (dates, phase in):

What would you consider to be a reasonable delay to allow CCPs which clear the same asset class or a similar Class+ to clear a new Class+?

Answer 21:

N/A

Comments on paragraphs 116 to 119:

N/A

Question 22 (dates, phase in):

What should be the assumption regarding market share which the CCP would have to be able to assume? Should it be requested that each CCP be able to handle the whole volume to tackle the worst case scenario?

Answer 22:

N/A

Question 23 (dates, phase in):

What should be the elements (e.g. number of transactions, increase in risks, number of active counterparties, new jurisdiction involved) for ESMA to investigate, after consulting the NCAs responsible for CCPs authorisation, on the ability of the relevant CCPs to handle the expected volume and to manage the risk arising from the clearing of the relevant class of OTC derivatives?

Answer 23:

N/A

Question 24 (dates, phase in):

Should there be a default period of [x] months whenever there is a need for a CCP to upgrade its service considering incompressible internal/external validation processes? If not, how to evaluate the time to upgrade services based on the result of the criteria assessment?

Answer 24:

N/A

Comments on paragraphs 120 to 128:

N/A

Question 25 (categories of counterparties):

Please indicate your preference between the options presented. Would you rather use an option that is not detailed here? Under Options B and C, do you agree to base the clearing access approach on the asset class to which the counterparties have access? What should be the date on which clearing access/threshold calculation should be assessed?

Answer 25:

N/A

Question 26 (categories of counterparties):

What would in your view be the appropriate timeframe for counterparties with / without access to clearing in the relevant asset class?

Answer 26:

N/A

Comments on paragraphs 129 to 130:

N/A

Question 27 (categories of counterparties):

Do you agree that a key factor to take into account when defining the phase in for the counterparties to comply with the clearing obligation will be the number of clearing members offering client clearing services? Is the client clearing capacity of the CCP also a relevant factor? What could be the other criteria?

Answer 27:

Yes, we agree that the number of clearing members offering client clearing services is important in determining the phase in of the clearing obligation. We would suggest that the credit profile of the clearing members should also be considered, as well as any particular concentration of client business relative to other clearing members.

## 4.2. Minimum remaining maturity of the OTC derivative contracts referred to in EMIR Article 4(1)(b)(ii)

Comments on paragraphs 131 to 135:

N/A

Question 28 (remaining maturity):

What are your views regarding the calibration of the remaining maturity of the contracts to be subject to the CO? What criteria should ESMA take into account when defining it?

Answer 28:

N/A

# 5. The clearing obligation in specific cases

## 5.1. Contracts concluded with Covered Bond issuers

Comments on paragraph 136 to 138:

N/A

Question 29 (covered bonds):

Are there other specific features of the contracts concluded with covered bond issuers or with cover pools for covered bonds, to be considered by ESMA in the context of the clearing obligation?

Answer 29

N/A

Question 30 (covered bonds):

What would be the legal or technical challenge faced by covered bonds issuers and CCPs, if a clearing obligation was imposed on some of the OTC derivative contracts included in the cover pools of covered bonds?

Answer 30

N/A

Question 31 (covered bonds):

Have CCPs developed solutions to be able to differentiate the derivative contracts of the issuer from those of the cover pool?

Answer 31

N/A

Question 32 (covered bonds):

Would an appropriate phase-in for these counterparties alleviate these challenges? If so, how?

Answer 32

N/A

## 5.2. Foreign exchange OTC derivatives

Comments on paragraphs 139 to 140:

N/A

Question 33 (FX derivatives):

Within the foreign exchange asset class, for which type of contracts do you consider that settlement risk is the predominant risk, and what criteria or characteristics should be used by ESMA to identify those contracts?

Answer 33:

N/A

## 5.3. Interaction of portfolio compression and the clearing obligation

Comments on paragraph 141:

N/A

Question 34 (Portfolio compression):

Are there ways in which the imposition of the clearing obligation in the EU could hamper the effectiveness of compression services? If so, please provide evidence of the potential impact. Are there ways in which exclusions to the clearing obligation could be defined which alleviate the problem without creating opportunities for avoidance?

Answer 34:

Imposing a clearing obligation on contracts that result from a multilateral compression exercise could impact the effectiveness of compression as a risk reduction tool.  Specifically, it would not be appropriate to require clearing of derivatives contracts that result from a compression exercise where the derivatives subject to compression had been entered into prior to the EMIR Effective Date (and consequently were outside scope of the clearing requirement). This is because the compression cycle would no longer be counterparty credit risk neutral as the replacement trades would be required to face a CCP instead of the original counterparty.

As ESMA is aware, these contracts represent risk that participants had on their books prior to the compression exercise and during the course of compression no change of ownership occurs. Therefore we would encourage ESMA to clarify that in relation to any non-cleared derivatives contracts that were entered into prior to the EMIR Effective Date, such trades and their compression replacement trades shall not be subject to mandatory clearing as a result of a compression exercise.

ESMA has dealt with a similar issue in the context of the Regulation on Short Selling and certain aspects of CDS. In relation to the treatment of replacement trades under this Regulation ESMA has taken the following position:

“Provided that the replacement trade does not extend the life or value of the sovereign CDS position beyond what they were when originally taken out before 25 March 2012, ESMA considers that it would be legitimate to treat the trade as an existing rather than a new contract and so not encompassed by the Regulation's prohibition on entering into uncovered sovereign CDS transactions”.

In developing its approach to the clearing mandate, ESMA should also consider other multilateral post-trade risk reduction services that are designed to decrease counterparty credit, operational and systemic risk and move risk from bilateral portfolios to central clearing. This type of exercise involves putting on equal and opposite transactions, where one is cleared and the other is not cleared. Imposing a clearing obligation in this scenario would mean the exercise was no longer counterparty credit risk neutral and as such we believe the clearing requirement should not apply.

## 5.4. How to withdraw a clearing obligation on a class or subset of it?

Comments on paragraphs 142 to 148:

N/A

Question 35 (Modification of a Class+):

For which reason (other than the fact that a CCP does not clear it any longer) do you believe that the clearing obligation of a class - or subset of it - would need to be removed? Please focus on the risks which could stem from a clearing obligation on contracts which would no longer be appropriate for mandatory clearing and provide concrete examples.

Answer 35:

N/A

Question 36 (Modification of a Class+):

In case a clearing obligation would need to be reviewed, how crucial would be the time needed to dis-apply the clearing obligation?

Answer 36:

N/A