Position Paper

Insurance Europe response to ESMA's draft technical standards for the Regulation on OTC Derivatives, CCPS and Trade Repositories

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Contact person:	David Ogloza, Policy Advisor Economics and Finance	E-mail:	ogloza@insuranceeurope.eu
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Insurance Europe welcomes the opportunity to respond to ESMA's discussion paper on the draft technical standards for the Regulation on OTC Derivatives, CCPS and Trade Repositories.

The consultation paper on the draft technical standards provides essential clarification of some of the Regulation's requirements. However, they also present some new questions that will need to be clarified in a short time period if the end of 2012 implementation deadline is to be met. Since the true impact of the Regulation on the investment community can only be assessed once all of the technical details are finalised, we would like to ensure that the standards produced are practicable, realistic and credible, and achieve their stated objectives.

In particular, we would request clarification from ESMA on FX swaps. As they are not regarded as derivatives in the US and, as noted in Recital 19, there is no intent to diverge significantly from US practice, we would appreciate something in the text to confirm that these instruments do not have obligatory clearing.

On margin requirements for non-centrally-cleared derivatives, we wholly support the decision of the joint-ESAs to delay the publication of their draft technical standards in order to align with the international approach. We understand that these Regulatory Technical Standards (RTS) will be consulted on after the publication of the BCBS/IOSCO report due at the end of 2012.

Please find our detailed comments on the proposed technical standards below.

1. OTC DERIVATIVES

Indirect Clearing Arrangements

We support the indirect clearing arrangements that ensure that the ultimate client in any indirect clearing arrangement is afforded the same rights and protections as are afforded to a direct client of a clearing member – but without necessarily the same account structure, by using tiered participation arrangements.

Insurance Europe aisbl
rue Montoyer 51, B-1000 Brussels
Tel: +32 2 547 5811 • Fax: +32 2 547 5819
www.insuranceeurope.eu

These include ensuring that client positions and margin are isolated from the insolvency of both any direct or indirect clearing member; and including prompt and frictionless pre- and post-default portability of both positions and margin. However, we would appreciate further clarifying provisions granting practical guidelines, e.g. confirmation of contracts, settlement, etc.

Furthermore, we believe that indirect clients should have the option to ask for a fully segregated account in the CCP to be unnecessary as the direct client already has the ability to make that choice.

Clearing Obligation Procedure

It seems that the level of granularity required – product group level or individual product, e.g. credit derivatives, or individual names or specific contracts has not yet been decided. We would suggest that ESMA retain a pragmatic outlook, and uses both quantitative and qualitative information to strike the balance for setting the level of granularity required. However, we do not believe that it should be set by asset class and question the logistics of setting it at a contract-by-contract level.

Additionally we do not believe it should be too detailed, or there is potential for the development of very slightly different products that would then not meet the criteria for being centrally cleared. We believe that the CCP should be given an economic incentive to clear, given that they cannot be forced to clear.

We would request clarification from ESMA on FX swaps. As they are not regarded as derivatives in the US and, as noted in Recital 19, there is no intent to diverge significantly from US practice, we would appreciate something in the text to confirm that these instruments are not subject to obligatory clearing.

The Consultation Paper includes details of the information that a competent authority should include for the purposes of assessing whether a class of derivatives should be subject to the clearing obligation, including the date from which the obligation takes effect as well as the minimum remaining maturity of the OTC derivative contracts required to be "front-loaded". This "front loading" requirement for contracts entered into after the notification to ESMA but before the entry into force of the clearing obligation has similar problems to those previously raised with regards to "back-loading".

Retrospective application of the clearing obligations to contracts which were entered into after notification of authorisation by the competent authority and before the relevant regulatory technical standards take effect could create significant uncertainty for counterparties entering into OTC derivative contracts.

Pricing is dependent, among other things, on factors unique to the relevant CCP, and these factors will not be known to the counterparties at the time of entering into the contract. Moreover, once the clearing obligation takes effect, even if both counterparties to the contract wish to comply, there could be differences and delays around agreeing terms (e.g. on pricing or over which CCP to use), which would cause multiple instances of non-compliance.

The front-loading requirement is not present in the Dodd-Frank Act and as such represents a material difference between the EU and the US regulation. The front loading requirement makes the phasing in of the clearing requirement significantly more problematic and legally ambiguous in Europe than will be the case in the US. Most eligible OTC derivatives will eventually be transferred to a centrally cleared environment either voluntarily or during a resetting of the asset during its lifetime and as such the retrospective obligation to clear is unnecessarily burdensome and potentially creates systemic risk due to the alignment of the clearing requirement across all existing contracts in the market.

ESMA should ensure that if a retrospective clearing requirement is applied, it is only made for contracts with significant long-term maturities which would not otherwise naturally move to a CCP during their lifecycle.

We support the new requirement to provide detailed analysis of trends as and when the data become available.

Public register

Insurance Europe would like to emphasise the general importance of clear, certain and timely information about the classes of OTC derivatives subject to the new central clearing obligation. The publication of clear and explicit definitions of OTC derivative classes subject to the clearing obligation as well as the publication of dates from which the respective clearing obligations take effect in ESMA's public register are very much appreciated. Although this is not prescribed in EMIR, we would appreciate if ESMA could also publish in the public register when the reporting requirements for different classes of derivatives will enter into force. With this publication, transparency and a common level of information for all market participants will be guaranteed.

Risk Mitigation Techniques

Entry into force of article 11 EMIR

EMIR was published in the Official Journal on 27 July 2012 and will consequently enter into force on 16 August 2012. We assume that article 11 (risk mitigation techniques) will not enter into force or apply until i) the regulatory technical standards enter into force and ii) the central clearing obligation enters into force / applies. We would appreciate if ESMA (together with EBA and EIOPA) could clarify this on its (their) website (s).

Portfolio Reconciliation

We are pleased to support ESMA's proposals for portfolio reconciliation including a base of 500 outstanding contracts in order to require daily reconciliation.

Portfolio Compression

We are pleased to support ESMA's proposals for portfolio compression. It is in all participants' best interests to undertake regular portfolio compression as often as they see fit and we believe that the frequency should be left to each participant's discretion for best risk mitigation. This tool will undoubtedly be deployed at least twice a year.

Dispute Resolution

We are pleased to support ESMA's proposals for dispute resolution. There are already recognised dispute resolution arrangements in place within the existing bilateral OTC world which constitute good industry practice and which need to be supported.

As investors, we welcome the standardisation of documentation but the new draft RTS regarding dispute resolution processes contains a significant increase in reporting obligations. According to Article 4 RM subparagraph 3 insurance companies would need to report any disputes regarding OTC derivative reaching or exceeding €15m and outstanding for at least 15 business days to the competent authority. We are of the opinion that this reporting obligation is not required and unnecessarily places on the market participants even higher reporting requirements. If, however, the dispute resolution reporting obligation is introduced, it should at least be clearly stated that the reporting obligations can be delegated to third parties, such as collateral agents, and a clear reporting scheme should be provided. From our point of view monthly reporting on an aggregated basis would be sufficient for supervisory needs and reduce the reporting burden on market participants.

Intra-group collateral transfer exemption

(i) General increase of reporting requirements

The new requirements as regards notification of intra-group exemptions are too extensive and do not correspond to the low-level risk structure of intra-group derivative transactions. Intra-group transactions do not contain any systematically relevant risks for non-group market participants. The risk remains in the group due to netting benefits.

(ii) Interruption period
Insurance groups need sufficient time to carry out the required notification procedures. Therefore administrative proceedings to obtain intra-group exemptions regarding the obligation for central clearing, as well as the obligation to exchange collateral, need to be exercisable and exercised in a time frame that effectively ensures that the central clearing obligation and the obligation to exchange collateral do not become applicable. Therefore we suggest that the clearing obligation and the obligation to exchange collateral should be interrupted until both counterparties to the intra-group transactions have received the appropriate intra-group exemption.

(iii) Sensitivity of data
Information about intra-group transactions contains commercially sensitive data. Therefore, information under Art. 8 RM should exclusively be accessible to a very limited group of people subject to confidentiality rules and/or agreements, e.g. competent authorities and ESAs. In addition, information about intra-group transactions should only be published on an anonymous and aggregated basis.

Economic beneficiary (reporting obligation)
ESMA is of the opinion that "EMIR indicates that where the economic beneficiary of a derivatives trade is different to the counterparty, the beneficiary of the rights and obligations arising from the transaction should be identified. While back-to-back trades would be reported separately, transparency of other trading techniques must be ensured, including the use of structures where there may be 'morphing' of beneficiaries."

What does ESMA mean exactly by "back-to-back trades" and structures where there may be "morphing" of beneficiaries?

Margin Requirements for Non-Centrally-Cleared Derivatives
We understand there is to be a delay in drafting the RTS by ESMA, EBA and EIOPA at least until BCBS and IOSCO have developed their standards (ESMA news alert 30 July 2012), with the ESAs keen to align with these international requirements

We expect the international process to be completed by the end of this year / early next year, and understand that the ESMA, EBA and EIOPA standards to define margin requirements will follow that, and until such time, that practical and legal impediments and what constitutes adequately sound, robust risk-management procedures consistent with the level of complexity of the derivative transaction cannot be defined. In connection herewith we assume that article 11 paragraph 3 of EMIR will not apply until the RTS have entered into force.

We would be grateful for ESMA's continued updating of news on its timetabling on this matter.

Cross-Border / 3rd Countries
Insurance Europe suggests that ESMA aligns with the Commodity Futures Trading Commission (CFTC) to agree on the equivalence of the regulatory requirements for derivative business of the European Union. The upcoming regulation of derivatives in the US will extend under certain conditions to non-US persons. Those in jurisdictions that enjoy an equivalent regulatory regime may get relief from certain US requirements. The procedure for obtaining recognition of equivalence by the competent US authority – the CFTC - can either be initiated by foreign persons individually, groups of foreign persons from one jurisdiction or the competent regulatory authority from that jurisdiction.

We understand that ESMA will be bringing out its proposed requirements on extraterritoriality very shortly and we welcome ESMA's decision to consult on these separately. We would like to request that these requirements do not conflict with the extraterritoriality requirements under Dodd-Frank or other international standards and, for example, include a clear definition of an EU branch.

2. CCP REQUIREMENTS

Insurance Europe welcomes the implementation of a precise mechanism regulating the case that a CCP by mistake wrongly calculates positions. Operational sequences as well as binding periods should be clearly regulated as clients and indirect clients do not have the possibility to directly raise claims against the CCP. However, we believe that the authorities seem to have taken an *in extremis* view for capital requirements.

The migration of OTC derivative business from bilateral to central clearing is an important aspect of the global regulatory agenda to mitigate risk in the financial system. It would be perverse if this were to result in increased overall capital requirements reflecting higher perceived risks due to concentration of these risks in exposures to CCPs.

We also fear that no-one yet has a feel for how much this is going to cost the industry in total. The CCPs do not yet appear to have figures for wind-up costs. There also does not appear to be any analysis to show the potential impact of, for example: 12 months of wind-up instead of 9 months, and with 60% of operational costs instead of 80%; nor yet with an amended notification threshold of, say, 115% instead of 125%.

We feel that these three important variables should be thoroughly investigated by the authorities, so that everyone can understand the order of magnitude of the total costs that are going to be required by the industry as a whole.

Given the CCPs' requirement additionally to hold further capital for the default waterfall which is based on the underlying required capital and with very strict investment restrictions, we would ask for due consideration of the time the CCPs will require in order to recoup their initial investment and thus to claw it back from the enforced users, ie the investors, in order to not make it excessively onerous to those investors.

While the potential fee income gives – as previously requested – the CCPs an economic incentive to clear, we question if this is in fact the right type of incentive.

We believe that without further investigation as to the basis of the costs, this could lead to a withdrawal of a large number of market participants from trading in some classes of derivatives. This withdrawal of participants will reduce market liquidity and is likely to increase the level of volatility and risk, rather than mitigate these factors

We believe a balance needs to be struck between the costs for business continuity and disaster recovery plans while maintaining both the smooth functioning of the market and confidence in the CCP.

Governance and Disclosure

We believe CCPs should have appropriate governance arrangements that include strong representation of clients, including on the CCP Board and in the CCP risk committee.

We believe that the Risk Committee for each CCP should have client representation as it is client failure that is likely to be one of the main reasons for CCP failure, and not to represent its members and its members' clients on its Risk Committee seems inappropriate.

However, we are unwilling to suggest a prescribed amount, as each CCP will have a slightly differing clearing member and client book which would determine "the extent" to which clients should be involved.

From this should flow full, detailed disclosure to all parties in order fully to understand the costs and risks at each CCP. This disclosure should include up-to-date organisation charts.

However, we feel that requiring CCPs to publish final prices and volumes daily is not necessary.

Margin Requirements
We believe that the current distinction in confidence intervals for margin calculation between exchange traded (99%) and OTC derivatives (99.5%) is inappropriate and unnecessary. To increase the confidence interval to 99.5% would make it more expensive to clear centrally in Europe than clearing through a 3rd Country CCP. We believe that ESMA should create a single interval of 99% applicable to all derivative products. As ESMA has indicated it has no intention to deviate from international standards where the 99% figure is the market norm.

We believe that procyclicality has been taken account of in the margin requirements. The globally-accepted 99% figure has been agreed as it is regarded as sufficiently robust to deal with times of market stress.

Collateral
We believe the list of permissible collateral is overly prescriptive and should, instead, contain a description of the types of possible collateral. We would urge ESMA to consider that CCPs can accept other forms of highly liquid collateral as per their own risk assessments.

We would also like confirmation that, at the very least, CCPs must accept instruments which fulfil the criteria in Article 1 COL, section 3 (b).

In a distressed market the sources of funding for the current variation margin requirements may be experiencing illiquidity. We ask ESMA to press for the CCPs to be flexible enough in their collateral requirements, particularly in respect of variation margin, such that the market is not set an unachievable task at a time when confidence in liquidity and stability is key.

While accepting bank guarantees instead of cash is welcomed, requiring full collateralisation on a daily basis increases the cost, so they virtually cease to be an alternative to cash anymore.

3. TRADE REPOSITORIES

Insurance Europe is of the view that there should be recognition that this is a global market place which requires global trade repositories, by asset class, to enable consolidated global positions and access for regulators.

We would request clarity around situations, for example, where a swap has notional daily changes, then is there the requirement to report daily? We understand that where there is substantial change or a counterparty risk that regulators would want to know and there is therefore the need to report. However, there are scenarios whereby a firm may be the counterparty for one hour and would need to report – and would then need to report again an hour later when they cease to be the counterparty.

We believe this potential for multiple reporting with continual changes would serve no useful purpose and propose that ESMA clarifies what constitutes "substantial" change. Similarly, ESMA could consider a system whereby the reported trade includes a notional value with a separate calculation, or similar.

(i) Reporting time frame

We believe that look-through along the chain of beneficiaries should stop at fund/trust level or insurance company level. It is unlikely there will be many funds or insurance products that have only one beneficiary and it would be unnecessarily complex or burdensome without any additional gain to require reporting at different levels.

(ii) Data on exposure
We are of the opinion that the data on exposure is not covered by Article 9 of the EMIR regulation and ESMA is therefore exceeding the limits of the EMIR regulation. However, for insurance companies, which have often – as already stated above – not installed any daily reporting system yet, the daily reporting of exposure constitutes a heavy administrative burden.

We do have doubts over whether supervisory authorities will be able to meaningfully use the subsequent flood of data.

(iii) Transition period
It should be possible to still use the services of a reporting service provider declared unfit for a transition period of one month. The transitional period is required to manage the change to another reporting service provider or to set up the required reporting processes in-house respectively.

(iv) Costs of using a trade repository
The exercise of reporting duties should be free of charge for the obliged party or the third entity instructed respectively, similar to the DTCC model for CDS/ CDX. We would also request consideration of the numerous reporting requirements being imposed on asset managers and if in due course trade repositories can act as the main entity for trade reporting, we would find this a most attractive option.

(v) Data availability
With respect to public access, the CPSS/IOSCO recommendations do not define how often the data is aggregated as they believe it depends on the specific market. We believe that we should aim for consistency globally and we are still concerned that weekly data could still identify counterparties/positions, particularly if thinly traded. We would therefore suggest a monthly or less frequent interval as being appropriate for public disclosure.

Furthermore, the applicant should have the possibility of permanent access to his own data delivered to the trade repository, in order to use this information for other reporting obligations as well.

We fully support the development of the Legal Entity Identifier (LEI) process as a means of establishing a global solution to identifying counterparties to a contract. We believe it is important to avoid any inconsistencies in the data sent to Trade Repositories, and believe it would be preferable to delay the reporting obligation until the global LEI system is established, rather than endeavouring to implement any kind of interim solution. While ESMA is proposing a 20-character field (which is LEI length), we would propose a 32-character length field in order to align with international (CFTC) standards.