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EMIR: A Fair Price for Safety and Transparency

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Ladies and gentlemen,

I want to talk today about ESMA and our role in OTC derivatives regulation and supervision. All of ESMA's main objectives and activities are reflected in this specific area. We have an important policy making role involving drafting standards, for example, for CCPs and central clearing of derivatives, and these standards contribute to stability, transparency and investor protection. We will directly supervise trade repositories, contribute to consistent supervision across the European Union with our participation in the supervisory colleges of CCPs and will analyse the data on OTC derivative transactions for stability purposes.

Less than two weeks ago, an important milestone was passed in the regulation and supervision of OTC derivatives in the EU, when the EMIR technical standards drafted by ESMA entered into force. As a result, the various provisions of EMIR started applying from 15 March.

Before entering into the details of the application of the different provisions and who will be affected, let me take a step back to reflect on the challenging timetable that ESMA faced for the delivery of its technical standards, and the political attention that they have attracted at EU level:

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- In September 2010 the European Commission adopted the EMIR proposal and in February 2012 a political agreement on EMIR was reached; then
- In September 2012 ESMA submitted all the draft technical standards, except two, to the European Commission, after having consulted twice with a broad range of stakeholders from February to March and from end of June to the beginning of August.

To draw a parallel with the US, the Dodd Frank Act (DFA) was adopted in July 2010 and most, but not all, of the CFTC rules were released in 2012 while many of the SEC rules have not been developed yet.

Following the delivery of our standards to the Commission last September, they were adopted by the Commission in December 2012 and, after the non-objection period of the European Parliament and the Council the standards were published in the Official Journal in February.

I would now like to speak briefly about the non-objection period of the European Parliament. You may have heard about the motion by the ECON Committee of the European Parliament to object to the standards. Fortunately, the Plenary of the European Parliament did not object to the standards.

I say "fortunately" for two reasons. Firstly, despite the care we take in our work, ESMA can make mistakes of a technical nature and I fully respect the powers of the European Parliament and the Council to scrutinise our work. However, the technical standards are by their nature of a purely technical nature. Scrutiny of our standards should not result in reopening the difficult political decisions that were taken when EMIR was adopted by the European Parliament and the Council. I am convinced that those decisions were fully respected by, and reflected in, our standards. Secondly, we are all committed to an international agenda agreed at G20 level and objection to the standards would have severely compromised the compliance of the European Union with this agenda.

Now coming to what happened as of 15 March:

- First, some risk mitigation techniques have started applying (mark-to-market/mark-to-model, timely confirmation);
- Second, non-financial counterparties have started counting their positions against the clearing thresholds and have started notifying the National Competent Authorities (NCAs) and ESMA if they are above the clearing threshold; and
- Third, trade repositories can start applying to ESMA for registration and CCPs can start applying to NCAs for authorisation under EMIR.

Let me now mention the more medium term changes as a result of EMIR. Three months after the registration of trade repositories, the reporting obligation will start applying to all derivative transactions. So we expect this obligation to start applying from mid-September. As you know, trade repositories will play a key role in the reporting obligation and ESMA has now begun their registration process. For this we have established a dedicated team which we are further expanding for the supervision of trade repositories which will start after their registration.

Six months after the authorisation of CCPs, and following the notification to ESMA by NCAs of that authorization, ESMA needs to issue technical standards identifying the classes of derivatives subject to the clearing obligation. These standards are not expected to enter into force before the end of this year, and after the entry into force a phasing-in period is expected.

To conclude on the process for the delivery of the technical standards, I would like to mention the two standards that were not delivered by ESMA by September 2012 and the reasons for that. These standards relate to:

- Bilateral clearing; and
- Defining which OTC derivatives contracts have a direct, substantial and foreseeable effect within the European Union.

The reasons for the non-delivery of these standards are for the first set of standards, to take into account the development of international standards on the same matter. This concerns the work of the Basel Committee and IOSCO on bilateral margins. We want to ensure international consistency regarding an issue that will have a significant impact on many market participants. For the second set of standards, on the international reach of EMIR, we want to take into account the on-going discussions with regulators of other jurisdictions on the cross-border application of their provisions.

This highlights the importance we give to the necessity to reach agreement at international level on the standards applicable to global markets, and the importance of cooperation with authorities of regions outside the EU.

Having said this, it should be noted that international standards are sometimes high-level principles, which of course results from the need to reach compromises at international level. However, this inevitably leads to a lack of the detail that is necessary when defining the rules for the concrete application in the different jurisdictions.

Therefore, although we all base our rules on agreed international standards, when transposing them into concrete and applicable rules, these might differ. These differences may leave room for regulatory arbitrage: a point I will come back to later on.

This is particularly true for standards for CCPs where EMIR already included more stringent requirements than the high-level principles agreed at international level under CPSS-IOSCO and included a mandate for ESMA to provide further details at the level of technical standards. The reason for this level of detail in EMIR and its standards is: 1) EMIR is based on maximum harmonisation and directly applicable within the EU; and 2) to achieve maximum safety for CCPs.

This leads me to the title of this conference. “EMIR: Transparency at any price?” I would suggest rephrasing it as: “EMIR: A Fair Price for Safety and Transparency” (without the question mark). The reason is that in EMIR, safety is even more important than transparency. Transparency under EMIR is mainly concerned with reporting to regulators. While it is important that we progress on transparency to investors, this part needs to come with the revision of MiFID, which is still under discussion in the political process.

Turning now to focus on safety, and the reason for my removal of the question mark, it is important to understand why EMIR was drafted. EMIR is not only the European Union's implementation of the G20 mandate, as many describe it, but is first and foremost the EU's response to the financial crisis that began in 2007, exploded in 2008 and is still not over.

In response to complaints about the cost of this reform, I would like to point to the near-collapse of Bear Sterns in March 2008, the default of Lehman Brothers on 15 September 2008 and the bail-out of AIG on 16 September 2008 and all the subsequent bail-outs, including of many European banks. The first round of defaults and bail-outs of financial institutions were directly related to problems with OTC derivatives.

When considering the suggestion to link the bilateral margins requirements to the credit worthiness of the counterparties, the lessons from the AIG case can teach us a lot. To refresh our memories, credit default swaps issued by AIG were exempted from being backed by collateral because of:

a) the high credit rating of the AIG parent company; and
b) the fact that AIG only sold CDS on "super-senior" security tranches.

However, as the financial crisis took off in 2007, AIG super-senior tranches were gradually downgraded, triggering the significant collateral calls that AIG could not meet without an injection of public money.

This has demonstrated two things: First, that there should no longer be a full and mechanical reliance on ratings; and second, that the exchange of collateral on bilateral transactions is necessary to cover market risk (variation margins) and counterparty credit risk (initial margins). If we link the level of margins to the safety of the counterparty, we might conclude that highly rated counterparties should not exchange initial margins because there is only a very remote possibility that they will default. The problem is when market conditions change and ratings fall, this is when the huge call for collateral starts, with problems of procyclicality and with eventual recourse to public funding.

Some might say that the AIG case is only relevant for variation margins and nobody is contesting the payment of variation margins. That instead the problem is with initial margins, which should be linked to the creditworthiness of the counterparty.

I would respond to this criticism with three arguments:

1) First, it is thanks to US taxpayers that the AIG case was not relevant for initial margins. This is because initial margins are there to protect from the default of a counterparty and AIG did not default;
2) Second, even in the AIG case the justification for not asking for collateral was the high credit worthiness of AIG and of the instruments issued. The same argument cannot be repeated to call for not requiring initial margins from highly rated counterparties. Margins are there to protect from risks arising following changes in market conditions, and they should be calculated in a conservative manner to limit procyclical effects.
3) Third, let me make a reference to another example, one of a defaulted counterparty that I already mentioned briefly: Lehman Brothers.

Following the default of Lehman Brothers a number of estimates were circulated as to the impact of its default. The one most often cited is the number published by DTCC on the post-credit event pay-outs by protection sellers of CDS on Lehman, which amounted to US$ 5.2 billion in net settlement payments.

Now we all know that the impact of Lehman's default was much bigger than that. The reason is that the impact of this default was due to the replacement cost that Lehman's counterparties faced following its default. This was the major contagion channel and no estimate exists of such an impact. However, just to give you an idea of the actual impact of Lehman Brothers, we can consider the figures published by one of the Lehman's counterparties: Merrill Lynch, which in the third quarter of 2008 disclosed a US$ 2 billion pre-tax trading loss, which was mainly due to the unwinding of trades for which Lehman Brothers was a counterparty. Merrill Lynch was only one of the hundreds of counterparties of Lehman, so the aggregate impact on counterparties' losses of Lehman's default was much bigger than the one generally used. These are the risks and impacts that the use of CCPs and the exchange of initial margins can prevent. In addition to the direct losses just mentioned, we also need to look at the loss in economic growth as a result of the financial crisis in which OTC derivatives played an important role.

I did not intend this to be a history lesson, but sometimes history helps our understanding of the issues at stake.

I would now like to return to the international consistency of the OTC derivatives reforms. I have already explained the necessity but also the limitations of international standards. Now I will quickly mention ESMA's approach towards equivalence and in developing its technical advice on this issue to the European Commission.

For the reasons explained before, when assessing the equivalence of third country jurisdictions we cannot base ourselves on internationally agreed standards. Otherwise we would not tackle the potential regulatory arbitrage that can arise because many detailed differences will exist even when the same high level principles are met by different countries and regions. Many of these detailed differences can be economically significant and might affect in which part of the world OTC derivatives transactions are conducted.

Therefore, to assess whether another country is equivalent to the EU, we need to use the EMIR requirements as the yardstick. However, it should be noted, that ESMA performs analyses that are outcome based, rather than rule by rule based. This means that although the starting point is the comparison of each respective set of rules, when advising the Commission on the equivalence decision, ESMA will analyse:

- Whether different rules can achieve a similar outcome; and
- Whether solutions can be found to prevent, on the one hand, possible market disruptions that a non-equivalent decision may bring and, on the other hand, regulatory arbitrage and risks to the European financial markets as a result of third country entities subject to less stringent requirements.

The reason for the postponement of the delivery of ESMA's technical advice on equivalence for the US and Japan, is to allow sufficient time to identify, together with our US and Japanese counterparts, the appropriate solutions to avoid potential market disruptions.

Coming to my last point, I would like to say a few words about EMIR and pension funds. In general, the EU has taken a holistic approach to developing the new regulations for banks and financial markets. This is appropriate because we do not want to incentivise fragmentation or a shadow banking system. In line with this philosophy, the scope of EMIR is broad covering all financials and those non-financials developing activities like financials. I expect that some in the audience today are unhappy about this approach, but I hope you understand the reasons for it. To mitigate the impact of this holistic approach in EMIR, some exemptions have been introduced. One is particularly relevant in this context and relates to pension funds.

This exemption is limited to the clearing obligation only and it is of a temporary nature. The reason for the exemption is because pension funds do not have the cash needed, or at least it would be very costly, to provide margins to CCPs. The temporary nature of this exemption explains this. In fact, a revision of this exemption is envisaged in 2015 and by that time it is expected that CCPs will have developed the appropriate arrangements to allow pension funds to centrally clear. I expect that these arrangements will include the use of other assets held by pension funds, in addition to cash, for central clearing purposes.

Thank you for your attention.