



European Securities and
Markets Authority

Feedback Statement

Consultation on the Clearing Obligation for Non-Deliverable Forwards

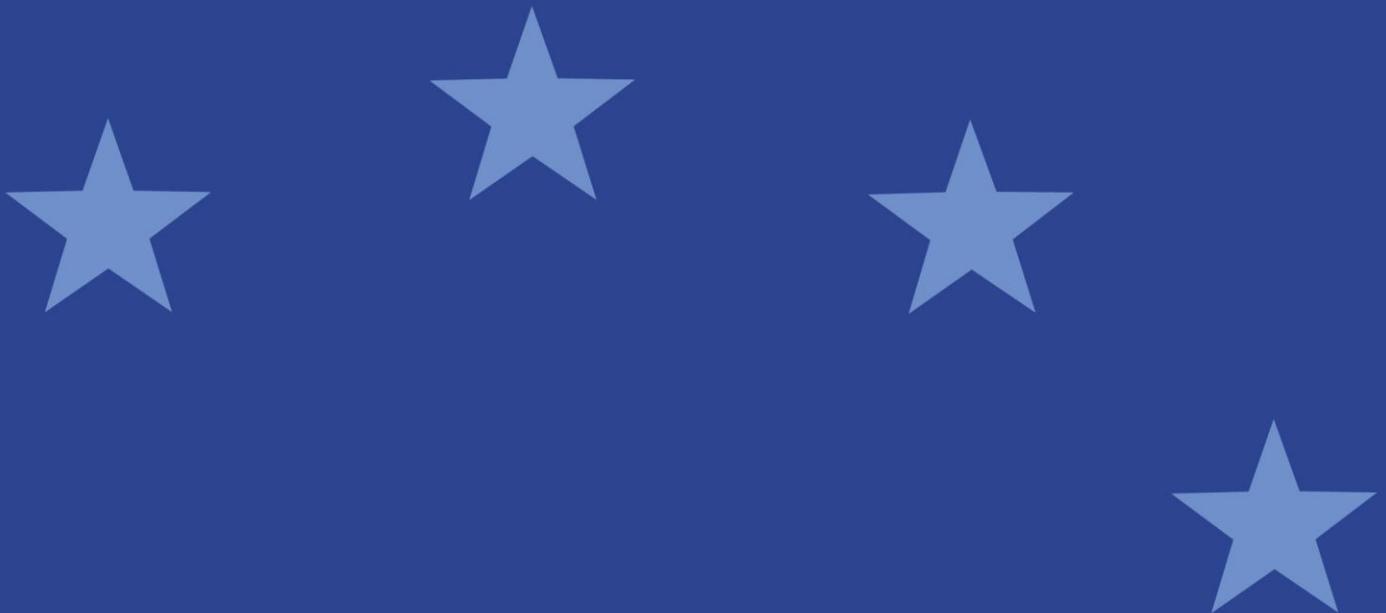


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1 Executive Summary

Reasons for publication

On 1 October 2014, ESMA published a consultation paper on the clearing obligation covering non-deliverable foreign-exchange forwards¹. This consultation paper sought stakeholders' views on the regulatory technical standards that ESMA is required to draft under Article 5(2) "Clearing Obligation Procedure" of the Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR). This feedback statement summarises the responses received to this consultation.

Content

The consultation paper on the clearing obligation covering non-deliverable foreign-exchange forwards contained 10 questions to stakeholders pertaining to the various aspects of the draft RTS included therein. This feedback statement summarises the comments received to the consultation, question per question. Questions 1 to 4 deal with the classes of NDF derivatives. Questions 5 to 7 refer to the categories of counterparties and the dates from which the clearing obligation takes effect. Finally, Question 8 relates to the frontloading obligation and Questions 9 to 10 to other comments and the cost-benefit analysis.

Next Steps

Based on the feedback received to this consultation, ESMA is not proposing a clearing obligation on the NDF classes at this stage. Indeed, ESMA believes that more time is needed to address appropriately the main concerns raised in the responses. However, it is difficult to evaluate at this stage the amount of time needed to address those issues.

This decision is without prejudice to the possibility for ESMA to propose a clearing obligation on the NDF classes (by the submission of a final report to the European Commission including a draft RTS) at a later point in time to take into account further market developments.

¹ 2014-ESMA-1185 Consultation Paper, Clearing Obligation under EMIR no. 3 published on 1 October 2014

2 Background

1. With the overarching objective of reducing systemic risk, the European Market Infrastructure Regulation (“EMIR”) introduces the obligation to clear certain classes of OTC derivatives in Central Counterparties (CCPs) that have been authorised (for European CCPs) or recognised (for Third-country CCPs) under the EMIR framework. Ensuring that the clearing obligation reduces systemic risk requires a process of identification of classes of derivatives that should be subject to mandatory clearing.
2. In accordance with the clearing obligation procedure of Article 5, ESMA shall develop and submit to the European Commission for endorsement draft technical standards specifying:
 - the class of OTC derivatives that should be subject to the clearing obligation referred to in Article 4;
 - the date or dates from which the clearing obligation takes effect, including any phase in and the categories of counterparties to which the obligation applies; and
 - the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii).
3. The consultation paper on the clearing obligation for foreign-exchange non-deliverable forward² (“NDF”) resulted from the bottom-up approach³ triggered by the authorisation of LCH.Clearnet Ltd (UK). Based on the analysis of the classes of NDF cleared by LCH.Clearnet Ltd, ESMA proposed to subject those classes to the clearing obligation.
4. The consultation on the NDF classes was the third consultation paper on the clearing obligation, after consultations on classes of interest rate swaps⁴ (IRS) and credit default swaps⁵ (CDS), and it already incorporated the comments received to those previous consultations. The consultation ended on 6 November 2014 and ESMA received 38 answers.
5. Stakeholders were asked to respond to a series of questions, and the responses thereto are summarised question per question in the next section.

² 2014-ESMA-1185 Consultation Paper, Clearing Obligation under EMIR no. 3 published on 1 October 2014

³ The “bottom-up” approach described in EMIR Article 5(2), according to which the determination of the classes to be subject to the clearing obligation will be done based on the classes which are already cleared by authorised or recognised CCPs.

⁴ 2014-ESMA-799 Consultation Paper, Clearing Obligation under EMIR no. 1 published on 11 July 2014

⁵ 2014-ESMA-800 Consultation Paper, Clearing Obligation under EMIR no. 2 published on 11 July 2014

3 Results of the consultation

3.1 Question 1: Clearing Obligation procedure

6. In Question 1, ESMA asked for comments on the clearing obligation procedure described under Section 1 of the consultation paper i.e., in a nutshell, the approach taken by ESMA to group all the classes of the same asset class in a single consultation paper and a single RTS, to the extent possible.
7. Stakeholders already had the opportunity to comment on this so-called grouping approach and again were broadly supportive of it.
8. Some have requested clarifications on the way in which the different sets of classes subject to the clearing obligation would be reflected in the technical standards, i.e. whether all the classes would belong to the same technical standard, or each set of classes would form a new technical standard.

3.2 Question 2: Structure of the NDF classes

9. In Question 2, ESMA asked whether stakeholders considered that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation.
10. The proposal of the consultation paper was to use the four following characteristics to define the NDF classes:
 - the currency pair e.g. “Brazilian Dollar / U.S. Dollar”;
 - the settlement currency e.g. “USD”;
 - the settlement type i.e. “Cash settlement”;
 - the maturity.
11. In general the responses were supportive of the current proposal. However, an important number of stakeholders advised ESMA to consider additional characteristics which are linked to the documentation under which the contract is concluded. More precisely, they recommended that only contracts which are traded under non-modified EMTA⁶ templates are subject to the clearing obligation. Stakeholders argued that this would ensure that the contracts in scope are sufficiently standardised, in accordance with the EMIR criteria for the clearing obligation.
12. Each EMTA currency template includes two elements that have been cited by stakeholders as important characteristics of the contracts:

⁶ EMTA: Emerging Markets Trade Association

- The primary and secondary fixing sources to be used for valuing the contract for settlement; and
 - The fall-back conventions which address the risk of potential market/sovereign events disrupting the value or settlement of the emerging market currencies underlying these contracts (e.g., suspension of trading, sovereign default, an unexpected bank holiday or other significant disruption to valuation, payment or settlement processes).
13. Consequently, they consider that any contract traded with terms that are different than the ones of the EMTA template, in particular in respect of the characteristics listed above, do not achieve the necessary level of standardisation required for the clearing obligation.
14. Those stakeholders acknowledged that currently, the European CCP authorised to clear NDF (LCH.Clearnet Ltd) only accepts for clearing contracts traded under non-modified EMTA template, and therefore under the bottom-up approach for the clearing obligation, contracts traded under modified EMTA template are de facto excluded from the scope of mandatory clearing.
15. Still, since some third-country CCPs do clear NDF with modified EMTA templates⁷, they advised ESMA to clarify this issue from the beginning, e.g. by the addition to the classes of another characteristic that could be called “Modified EMTA template” and take the value “No”.
16. Similar to the responses to previous consultations, stakeholders called for the addition of a condition to the RTS on the clearing obligation, to mitigate the risk of trading bans in cases where a specific contract meets the characteristics of a class subject to the clearing obligation, while at the same time not being accepted for clearing by any CCP.

3.3 Question 3: NDF classes proposed for the clearing obligation

17. In Question 3, ESMA asked stakeholders whether, in view of the criteria set in Article 5(4) of EMIR, they consider that the determination of the NDF classes addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives.
18. Several stakeholders indicated that the current proposal related to the clearing obligation for NDF addressed the objective of reduction of systemic risk in an appropriate manner and supported the classes as presented in the consultation paper. Half of those respondents were representatives of CCPs or regulated exchanges and the other half represented the buy-side and sell-side. However, it should be noted that overall the NDF

⁷ For example, CME US accepts for clearing NDF contracts with a modified “Maximum days of postponement” (15 calendar days instead of 30 calendar days in the EMTA template). This corresponds to the maximum number of days during which no price is available because of a price source disruption, after which the CCP may choose alternative sources of pricing than the ones envisaged in the original contract.

classes proposed for mandatory clearing were subject to more negative than positive feedback, in particular in respect of the timing for the implementation.

19. Stakeholders justified their reservations towards mandatory clearing for NDF (or at least mandatory clearing under the proposed timeframe) for two main reasons, one being that the clearing offer for this asset class is still in its infancy, and the other one being linked to international convergence.
20. On the first point, several considered the following elements to be impediments to the clearing obligation for NDFs:
 - only one European CCP is authorised to clear NDFs and the third-country CCPs that are clearing them are not yet recognised;
 - the clearing of NDF has started only recently, meaning that market participants globally (CCPs and counterparties) have little experience with it compared to IRS or CDS clearing. As an example of this relative “immaturity”, some responses mentioned that LCH.Clearnet Ltd did not yet experience any price disrupting event. This is also reflected in the low percentage of cleared versus non-cleared contracts;
 - the client clearing infrastructure across all the parties and market utilities involved would require further effort to smoothly scale up; indeed, the current volume is due to direct members, whereas client clearing has not taken place apart from a few token trades;
 - counterparties are in the process of preparing compliance with the clearing obligation for IRS and CDS, which is already consuming significant resources;
 - the definition of FX derivatives is not consistent across Europe.
21. On the second point, many respondents stressed the importance of international convergence when considering the clearing obligation for NDFs, indicating that it is even more crucial for NDF than for the previous classes proposed for the clearing obligation (IRS and CDS) because NDF is a relatively small market -- hence the consequences of market fragmentation would be greater -- and also because of the important share of cross-border transactions in this market.
22. Therefore, stakeholders urged ESMA to coordinate with regulators in other jurisdictions – and in particular the countries where the other CCPs clearing NDF are established – to ensure that, if regulators are minded to adopt mandatory clearing for NDFs, they implement it in such a way that the dates of application worldwide are synchronised to the extent possible.
23. In addition, some reported that in their view, the classes proposed for the clearing obligation do not meet the criteria that are defined in EMIR and that, as a result, the costs that central clearing would bring in respect of those classes would outweigh the benefits linked to the reduction of systemic risk. In particular the following criteria were mentioned:

- the conditions related to the proportionality of margins⁸ and market dispersion in case of default⁹ are not sufficiently supported by evidence;
- the liquidity of the NDF market is limited compared to other classes subject to the clearing obligation, the liquidity is concentrated on short maturities, typically below one year, and it has not been estimated specifically with data for European markets;
- the processing and confirmation of NDF contracts are generally less automated than those of other asset classes.

24. Finally, a few respondents noted that they would see merit in the development of a clearing offer for NDF settled in EUR or GBP.

3.4 Question 4: Maximum maturity of the NDF contracts

25. In Question 4, ESMA asked whether stakeholders considered that, for the currency pairs proposed for the clearing obligation on the NDF class, there are risks to include longer maturities, up to the 2 year tenor.

26. The answers were split. A few respondents supported having a maximum maturity of 2 years, yet a majority of respondents commented on having maximum maturities of 1 year or less. Most of them were referring to the low volume and liquidity of NDF in the longer maturity buckets. Specifically, they pointed out at the lack of activity beyond 1 year as illustrated in the consultation paper.

27. Amongst the majority of respondents that indicated that the maximum maturity should not be 2 years but should be 1 year or less, a range of suggestions of maximum maturities were made: 3 months, 6 months and 1 year. However, there was no clear consensus on which it should be. Some respondents indicated that similar to the argument about low volume and liquidity beyond 1 year, the same argument would also be true beyond the 6 months tenor, yet this was not considered as much of a problem as for the trades beyond the 1 year tenor.

28. Lastly, some commented on the link between the maximum maturity and the possible avoidance of the obligation by trading slightly longer maturities. In general, they commented that due to the nature of this market and the very low volume beyond the 1 year tenor, it would be very unlikely some counterparties would start trading different maturities for this reason. Instead, they suggested that if the maximum maturity was chosen to be 1 year then ESMA could add a few additional days to the definition of the maximum maturity to eliminate the risk of some trading contracts of a maturity of 1 year and a few days. The maximum maturity should not be chosen to be 2 years for this sole purpose.

⁸ RTS on OTC derivatives, article 7(2)(b)

⁹ RTS on OTC derivatives, article 7(2)(c)

3.5 Question 5: Criteria for the determination of the dates

29. In Question 5, ESMA asked stakeholders their view on the analysis presented in Section 4.1 of the consultation paper, which focused on the CCPs and clearing members involved in NDF clearing.
30. Although a couple of responses coming from CCPs or exchanges supported the analysis of ESMA, they were largely outnumbered by responses reiterating their concern over the current number of CCPs available to clear the NDF classes, i.e. only LCH.Clearnet Ltd, to date.
31. This group of stakeholders does not dispute the arguments put forward by ESMA in the consultation paper, i.e. that more CCPs are expected to enter the market and that the number of CCPs available to clear a class is a criteria relevant for the definition of the dates of application rather than the classes themselves. However, consistently with the feedback received to previous consultations on the same topic, they continue to consider that a minimum of two CCPs available to clear the class is essential before any clearing obligation is imposed. Several mentioned a preference for having also at least one recognised third-country CCP available to clear the NDF classes.
32. In addition, in view of the fact that the clearing of NDF was only introduced recently, some echoed concerns over the capacity of CCPs to handle some specific events linked to NDF, such as the management of disruption events which affect the valuation and settlement of FX contracts, given that no CCP has yet had to respond to a disruption event.
33. Finally, a few respondents indicated that the number of clearing members, and those offering client clearing, is insufficient at this stage. Some mentioned they don't expect this number to grow 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.

3.6 Question 6: Categories of counterparties

34. In Question 6, ESMA asked whether stakeholders agreed with the proposal to keep the same definition of the categories of counterparties for the NDF classes as for the credit and the interest rate classes.
35. ESMA received two types of feedback to that question, one on the consistency of the categories of counterparties across the various RTS on the clearing obligation, and one on the categories of counterparties themselves.

Consistencies of the categories across RTS on the clearing obligation

36. On the first topic, there was a broad consensus in favour of the ESMA proposal to keep the same definition of categories of counterparties in the various RTS. In particular for the

counterparties in Category 2 and 3, which have to assess at a certain point in time, depending on their non-cleared OTC derivative activity, whether they fall under one category or the other, stakeholders preferred to keep the same date of assessment for the different RTS. Indeed with this option, the costs would be reduced since the assessment against the 8bn threshold would only have to be performed once.

37. It is to be noted however that a few respondents had the opposite view, and one respondent indicated that the differences in asset classes (hence in the counterparties active in this asset class) may justify different approaches and assessment dates depending on the RTS.

Category 1 (Clearing Members)

38. Similarly to the feedback received to the previous consultations, stakeholders generally indicated a preference for a system of classification in which a counterparty belongs to Category 1 only when it is a clearing member for the classes covered by the specific RTS (approach per asset class, Option 1 in the impact assessment) rather than when it is a clearing member for any class subject to the clearing obligation (cumulative approach, Option 2 of the impact assessment), although one respondent was of the opposite view.
39. Some supporters of Option 1 mentioned that ESMA should not overestimate the possible leverage from prior on-boarding experience with CCPs, because banks are usually organised by asset class with different teams in charge of the business and support functions by asset class.
40. The impact of choosing one option or the other is quite significant for NDFs: one stakeholder estimated that the option “per asset class” would require 70 to 80 clearing members to on-board to LCH.Clearnet Ltd within the 6 month phase-in period foreseen for Category 1.
41. As they had done previously, several respondents encouraged ESMA to publish, or have CCP publish, a list of the clearing members that meet the conditions to be included in Category 1, to increase transparency and allow for a quick and efficient identification of the counterparties in this category.

Category 2/3

42. The main concerns raised by stakeholders pertained to the distinction between Category 2 and Category 3 (counterparties in a group with OTC derivative positions above/below the 8bn threshold).
43. Many respondents indicated that the current proposal related to the timing at which the assessment of the position against the threshold (i.e. before the entry into force of the RTS) was unpractical and was introducing some retroactive effect.
44. Due to the fact that (1) in the version of the RTS included in the consultation paper, frontloading kicks in as of the date of publication of the RTS in the Official Journal and (2)

counterparties in Category 3 are not subject to frontloading while counterparties in Category 2 are subject to frontloading, counterparties are supposed to know already on the date of publication of the RTS in the Official Journal whether they, and their counterparties, are in Category 2 or in Category 3. And since the assessment against the threshold is supposed to be made during the three months preceding the date of publication in the Official Journal, it would leave counterparties less than a month to perform this assessment.

45. Two proposals were made to mitigate this issue, the first one being more supported than the second one.
46. First Proposal: some stakeholders recommended that ESMA modifies the time period during which the assessment against the threshold should be made until after there is full certainty on the legal text and counterparties are aware of that, i.e. after the RTS enters into force. More precisely they suggested that the calculation should be performed during the three months following the date of entry into force, and that an additional month would be necessary for the aggregation of the data and the communication of the outcome to the relevant parties.
47. Based on that proposal, the status of the counterparties in Category 2 or 3 would be known and communicated 4 months after the entry into force.
48. In light of the interaction with the frontloading requirement mentioned above, this proposal comes with another one to modify the frontloading start date until after the counterparties have been given the appropriate time to complete the classification process, i.e. frontloading should only apply to contracts concluded at least 4 months after the date of entry into force of the RTS.
49. Second Proposal: other stakeholders suggested ESMA to go back to the initial proposal included in the first two consultation papers on the clearing obligation, i.e. to have only three groups of counterparties (Clearing Members / Other Financials / Non Financials).
50. Finally, there was a call from a number of stakeholders for ESMA to provide clarification regarding the calculation of the threshold and in particular:
 - Guidance related to the calculation of notional amounts (e.g. conditional amounts, options);
 - Whether intragroup transactions should be included in the calculation;
 - Clarification related to the treatment of funds¹⁰ i.e. that funds managed by the same asset manager should not be considered as being part of the same group , in line with

¹⁰ The recommendation was to incorporate in the definition of the Category 2 the same approach for investment funds as proposed in Recital 5 of the EBA Consultation Paper on Bilateral Margins for non-centrally cleared derivatives, i.e. regulated investment funds should be counted per single fund, which is consistent with international standards.

the definition of group in the context of bilateral margins for uncleared derivatives agreed at international level¹¹;

- Responsibility of the counterparty classification and how to treat counterparties that are unable to provide a representation of their status. Some suggested clarifying those points in a similar way than what has been done in the context of NFC+.

3.7 Question 7: Dates of application of the clearing obligation

51. In Question 7, ESMA asked whether stakeholders considered that the proposed dates of application ensured a smooth implementation of the clearing obligation.

52. On the one hand, a group of respondents supported the phased-in implementation as presented in the consultation, or even suggested to adopt shorter phase-in period. However it should be noted that those answers mainly came from representatives of CCPs or exchanges, as well as from the ESRB which encouraged ESMA to “*consider that over time market participants and end-users can leverage on the experience progressively gained in accessing central clearing facilities and therefore a progressive shortening of these periods can be evaluated.*”

53. On the other hand, a larger group of respondents encouraged ESMA to lengthen the phase-in periods for a range of reasons that were the same reasons as the ones indicated by the stakeholders that do not support the clearing obligation for NDF at this stage (see these reasons and their arguments in the feedback to Question 3).

54. In fact, in a number of cases, stakeholders indicated a preference for ESMA not proposing the clearing obligation RTS at this stage but, should ESMA decide otherwise, then they suggested that lengthening the phase-in would be an alternative to alleviate their concerns.

55. There were various proposals regarding the appropriate dates of application of the clearing obligation for NDF, with the first one being the most often cited:

- Have the dates of application correspond with similar clearing obligation of FX NDF in other jurisdictions;
- Add 6 to 12 months to the dates of applications that were initially proposed;
- Wait until at least one more EU CCP is authorised and/or one Third-Country CCP is recognised to clear NDF;
- Wait until sufficient CCPs and clearing members are able to provide client clearing service to the buy-side;

¹¹ “Margin requirements for non-centrally cleared derivatives”, BCBS IOSCO, September 2013, page 9:
“*Investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy.*”

- Wait until the clearing obligation has been successfully implemented in respect of interest rate and credit asset classes.

3.8 Question 8: Frontloading and the minimum remaining maturity

56. In Question 8, ESMA asked stakeholders' view on the proposal related to the minimum remaining maturity (MRM) of the contracts subject to frontloading. In the consultation paper it was proposed to set the MRM (when applicable, i.e. only during Period B and only for counterparties in Category 1 or Category 2) at three months.
57. The responses to this question were split, with generally more dissenting views than supporting views. In particular, counterparties were not convinced by the argument put forward by ESMA, according to which the minimum remaining maturity should be set at a lower level for NDF compared to the level used for the other asset classes (3 months for NDF versus 6 months for Credit and IRS) because of the shorter maturity of the contracts that are proposed for the clearing obligation.
58. Those stakeholders claimed that, if 6 months was determined as the appropriate threshold for the remaining maturity in terms of systemic relevance in some asset classes, then this should be consistent across asset classes. In their view, the original proposal of 3 months focused less on mitigating systemic risk and more on ensuring that the number of contracts subject to frontloading is proportionate across asset classes. Hence the most supported proposal was to adopt a MRM of 6 months.
59. Some stakeholders went further by indicating that, in view of the generally short maturities of NDF contracts compared to the other contracts subject to the clearing obligation, they saw little merit in having any frontloading obligation in respect of this asset class.

Frontloading start date

60. Similar to feedback received to the previous consultations, stakeholders preferred that the period of time during which frontloading applies (Period B) is set by reference to the date of entry into force, instead of the date of publication in the Official Journal, for the reason that the latter is not predictable and can only be known after it has happened.
61. Besides, there were other proposals related to the modification of the frontloading start date, directly linked with the definition of the Category 2/3, and which were already described in paragraphs 42 to 47 above.

3.9 Question 9: Other comments

62. In Question 9, ESMA asked whether stakeholders had any additional comment on the RTS other than the ones included in the answers to the questions above.

63. The few comments made in response to this question were for the vast majority already covered in the previous questions as well as in the previous IRS and CDS final reports. For instance, the case of trades generated from the execution of post trading multiparty risk reduction exercises, such as compression runs, was one of them.
64. In addition, there was one comment on the need to exempt eligible NDFs when part of a package trade. Some NDFs are traded as an embedded hedge as part of a package and mandating them to clearing while the other legs of the package are not would limit their use as an effective hedge. This exists in the other asset classes, for example an index CDS can be part of a package with a tranche on the same index and be sold altogether as delta hedged. Therefore this comment is similar in intent to comments received in the equivalent section of the previous two consultations indicating cases where respondents explained why a carve out might be necessary.

3.10 Question 10: Cost-Benefit Analysis

65. In Question 10, ESMA asked whether stakeholders had any comments on the cost-benefit analysis.
66. The comments in this section were mainly related to the definition of Category 1 presented in Section 3, i.e. the choice between a definition per asset class (Option 1) or a cumulative approach (Option 2). For ease of references all the comments on this aspect were grouped under the answer to Question 6, more specifically in paragraph 38 above.
67. In addition, some stakeholders suggested that a specific assessment is made on the impact of the NDF clearing obligation on the risk level of funds specialised on emerging markets.

4 Conclusion

68. ESMA takes note of the comments received and summarised above, in particular the ones related to the timing for the entry into force of a potential clearing obligation on non-deliverable forward classes, and its link with the CCPs (in EU or third-countries) available to clear NDF, the experience of counterparties with NDF clearing, and the importance of international consistency in the implementation schedule of the clearing obligation. In this respect, ESMA considers that the criteria for the determination of the clearing obligation should be further assessed considering the global nature of the FX market.
69. Based on the above, ESMA is not proposing a clearing obligation on the NDF classes at this stage. This is without prejudice to the possibility for ESMA to propose a clearing obligation on the NDF classes (by the submission of a final report to the European Commission including a draft RTS) at a later point in time to take into account further market developments.