



European Securities and
Markets Authority

Final Report

On the clearing obligation for financial counterparties with a limited volume of activity





Table of Contents

1	Executive Summary	3
2	Introduction	4
3	Impediments to central clearing access for counterparties with a limited volume of activity	5
3.1	Factors limiting the offer of client clearing services by clearing members	5
3.2	Issues faced by clients in establishing clearing arrangements	6
4	Proposal to modify the phase-in period for Category 3	10
4.1	Delaying the application of the clearing obligation for counterparties with a limited volume of activity	10
4.2	Identification of the counterparties with a limited volume of activity	13
4.3	Duration of the delay and timing between Categories 3 and 4	15
4.4	Scope of the proposed amendments	16
5	Annexes	19
5.1	Annex 1 Legislative mandate to develop technical standards	19
5.2	Annex 2: Cost Benefit Analysis	20
5.3	Annex 3: Draft technical standards	22

1 Executive Summary

Reasons for publication

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories (EMIR) requires ESMA to develop draft regulatory technical standards (RTS) in relation to the clearing obligation, in particular on the dates from when the clearing obligation takes effect. Following from this mandate, there are now three Commission Delegated Regulations on the clearing obligation that are based on draft RTS submitted to the European Commission by ESMA.

However, some financial counterparties with a limited volume of activity are facing difficulties in preparing for the clearing obligation. In this context, ESMA consulted stakeholders with a consultation paper on the issues these counterparties are facing in establishing access to clearing, on the regulatory developments affecting access to clearing, on the relative systemic importance of these counterparties in the OTC derivative market and on a proposal to amend the phase-in period of the clearing obligation.

The final report covers the draft RTS amending the three Commission Delegated Regulations on the clearing obligation with respect to financial counterparties with a limited volume of activity.

Contents

The final report incorporates the feedback received to the consultation and explains the reasons for reflecting or not the stakeholders' proposals to the draft RTS.

Section 3 provides information on the factors limiting the offer of clearing services and the issues of access to CCPs faced by financial counterparties with a limited volume of activity. Section 4 sets out the proposal to amend the date of application of the clearing obligation for the smallest financial counterparties.

Next Steps

The final report is submitted to the European Commission for endorsement of the draft RTS presented in Annex. From the date of submission, the European Commission should take the decision whether to endorse the RTS within three months.

2 Introduction

1. With the overarching objective of reducing systemic risk, EMIR introduces the obligation to clear certain classes of OTC derivatives in central counterparties (CCPs) that have been authorised (for European CCPs¹) or recognised (for third-country CCPs²) under Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructure Regulation, EMIR).
2. Three Delegated Regulations on the clearing obligation have already entered into force, which mandate central clearing for some classes of:
 - OTC interest rate derivatives denominated in EUR, GBP, JPY, and USD³;
 - OTC index credit default swaps⁴; and
 - OTC interest rate derivatives denominated in NOK, PLN and SEK⁵.
3. To allow a smooth and orderly application of the clearing obligation, counterparties are classified in four categories with a different date of application for each category.
4. In July 2016, ESMA published a consultation paper⁶ to collect feedback on a proposal to extend the phase-in period for the clearing obligation to the smallest financial counterparties (those in Category 3), justified by the difficulties that those counterparties are facing in establishing the necessary clearing arrangements to meet their compliance deadline, the finalisation of some relevant regulatory requirements (in particular with respect to indirect clearing requirements and the leverage ratio framework) and the limited impact in terms of systemic risk that these counterparties represent.
5. This report provides an overview of the feedback collected during this public consultation, to which 40 market participants responded. These respondents include individual entities or trade associations from a wide range of sectors (in particular banks, insurance companies, funds, corporates and CCPs) and with representatives from the 4 categories defined in the three Delegated Regulations (as indicated in response to Question 1 from the consultation paper). The report explains how this feedback was taken into account in the final proposal that ESMA is now submitting to the European Commission.

¹ The [list of authorised EU CCPs](#) is published on the ESMA website

² The [list of recognised third-country CCPs](#) is published on the ESMA website

³ Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation, OJ L 314, 1.12.2015, p. 13.

⁴ Commission Delegated Regulation (EU) 2016/592 of 1 March 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation, OJ L 103, 19.4.2016, p. 5.

⁵ Commission Delegated Regulation (EU) 2016/1178 of 10 June 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation, OJ L 195, 20.7.2016, p. 3 and Corrigendum in OJ L 196, 21.7.2016, p. 56

⁶ ESMA/2016/1125 published on 13 July 2016

3 Impediments to central clearing access for counterparties with a limited volume of activity

3.1 Factors limiting the offer of client clearing services by clearing members

6. In Question 2 of the Consultation Paper, the stakeholders providing (or potentially providing) client clearing services were asked to reflect on the constraints preventing them from offering clearing services to a wider range of clients.
7. The purpose of the question was to better understand the reasons why client clearing is not being offered more widely despite the upcoming clearing obligation which will increase the number of cleared derivative transactions.
8. In their responses, a large number of stakeholders have mentioned the leverage ratio framework under Basel III and CRR as the main reason why banks are not incentivised to provide client clearing services. Indeed, under the current framework, the leverage ratio does not take into account the risk-reducing effect of client margin. As a result, the client clearing activity would drive a significant increase in the capital requirements for clearing members, who are therefore reluctant to offer it. An indication of the potential lack of commercial interest, and possibly the cost, in the offer of client clearing services is also evidenced by the exit from this business by four clearing brokers, which was acknowledged by many respondents.
9. Instead, clearing members consider that they should be allowed to offset their leverage ratio exposure by the initial margins they collect from clients when providing client clearing. One respondent has provided numbers to quantify the impact of such provision, and claims that the difference between offsetting and not offsetting the exposure by the collateral results in a 79% increase in client cleared transactions leverage ratio exposure.
10. In this respect, ESMA notes that the Basel Committee on Banking Supervision (BCBS) sought public comment on inter alia the impact of the leverage ratio on client clearing⁷. In the consultation paper, BCBS indicates that it will consider both the effects of the Basel III leverage ratio on the client clearing business model and the need for banks to have adequate capital to support their clearing activities in deciding whether to modify the leverage ratio framework, which may include permitting offsetting of a clearing member's exposure with the initial margins posted by clients on whose behalf it clears derivative transactions.
11. With respect to the EU, it is important to refer to the report on the leverage ratio⁸ produced by the EBA on 3 August 2016. Indeed, under Article 511(1) and (2) of CRR, following this report and based on the results from this report, it is then up to the European Commission

⁷ Consultative Document, Revisions to the Basel III leverage ratio framework, April 2016

⁸ The EBA report is available at the following address: <https://www.eba.europa.eu/documents/10180/1360107/EBA-Op-2016-13+%28Leverage+ratio+report%29.pdf>

to submit a report to the European Parliament and the Council and, where appropriate, the report should be accompanied by a legislative proposal on the leverage ratio, in particular on the appropriate calibration of the levels.

12. However, the EBA report did not provide final conclusions for the European Commission on this problem as the BCBS is still looking into the issue. The EBA report states that “*The BCBS is considering this issue carefully and seeking further evidence on the potential impact of the Basel III LR on clearing members’ business models during the consultation period. At this stage, it is too early to draw firm conclusions in this regard.*”
13. ESMA remains of the opinion that while the framework is still being assessed and finalised, the uncertainties of this situation are impacting the access to clearing and re-inforce the need to consider the delay discussed in the consultation paper and in the final report.
14. To a much lesser extent, stakeholders have also cited the regulatory framework for indirect client clearing as a hurdle for smaller counterparties to get access to central clearing. Although they generally welcome the recently proposed revision of the Delegated Regulation on indirect clearing arrangements⁹, they indicate that several implementation issues remain open and that the interest in the development of indirect clearing arrangements remains limited, a position confirmed by CCPs.

3.2 Issues faced by clients in establishing clearing arrangements

15. In Question 3 of the Consultation Paper, stakeholders were asked if they had already established clearing arrangements and/or what were the main difficulties they were facing in establishing such arrangements.

Counterparties’ readiness

16. With respect to counterparties’ preparation for the clearing obligation, the overall picture coming out of the responses is that few counterparties in Category 3 are ready to clear ahead of the compliance deadline (and even fewer have elected to clear on a voluntary basis). The majority of respondents indicate they have started but not finalised the negotiations of their clearing arrangements, for a number of reasons specified below.
17. Not surprisingly, there appears to be a close link between the level of preparedness of the counterparties and their size, or the size of their derivative activity, as those claiming to have finalised their clearing arrangements are generally found to be large asset managers or insurance companies. Some of them indicate that starting the negotiations early has allowed them to benefit from favourable treatment in their relationship with clearing members, in particular when they accepted to clear on a voluntary basis ahead of the compliance deadline.
18. It is interesting to underline that even those who have concluded clearing agreements with one or more clearing members express doubts on their ability to actually be able to clear

⁹ Draft regulatory technical standards on indirect clearing arrangements under EMIR and MiFIR. ESMA/2016/725, 26 May 2016



when they become subject to mandatory clearing. Indeed, they indicate that clearing members tend to adopt various mechanisms to stop providing clearing services if they deem them unprofitable, or that the CCP that they were accessing via a clearing member has stopped using the type of agreement they had previously negotiated and is now requiring the establishment of client clearing arrangements under new standard terms.

19. In terms of those counterparties that are less ready to clear, stakeholders are citing small asset managers and small regional banks which are uneconomical to on-board. Some counterparties are using industry associations to negotiate lower-cost collective clearing arrangements with one clearing member.

Hurdles in the establishment of client clearing arrangements

20. Stakeholders have cited a myriad of reasons why they are experiencing difficulties in establishing clearing relationships with clearing members.
21. First, many explain that the fixed costs of clearing are disproportionately high for counterparties with low volume of activity. One respondent argues that clearing member fees have increased about four-fold over the last couple of years, and that this could be driven by clearing members re-assessing the regulatory capital impact of providing clearing services. The deterioration of the competitive landscape between clearing members, and even more so in the Credit asset class, is another factor that could support the upward trend in clearing fees.
22. Second, counterparties with a limited volume of activity explain that they generally face a lack of commitment from clearing members. While it is possible to start the negotiation, at least with a small group of counterparties, it appears challenging to finalise the arrangements under terms which are satisfactory to both parties. Those stakeholders indicate that clearing members have other priorities, which tends to lengthen their response time, that they adjust their costs and their offer frequently, that the legal documentation models imposed by clearing members are progressively modified to include recent developments such as new available CCPs, including at the very last stage of the negotiation process.
23. Third, several stakeholders indicate that the establishment of clearing arrangements is a complex process by nature, which requires an exchange of information on the dimensions of an entity's current and projected derivative volumes, the evaluation and selection of the clearing members, and the onboarding process with the relevant platforms and accompanying IT issues.
24. According to those respondents, there are therefore very few clearing members who are committed to on-board counterparties with a limited volume of activity. As an example, a counterparty classified in Category 2 explains that of the 11 banks they contacted to ask for a first clearing proposal, only 3 responded.

Back-up clearing member

25. The hurdles limiting the ability of counterparties to find a clearing member appear to be even more acute when trying to establish clearing arrangements with a back-up clearing member.
26. Indeed, several respondents to the consultation point out that it would be difficult to enter into a commercially workable clearing agreement without agreeing to an early termination close, i.e. the possibility for the clearing member to terminate the clearing services with a short notice period (the common period indicated by stakeholders is 1 to 2 months). Therefore, in order to minimise the concerns of being without a clearing member after the primary one has notified the client that it would terminate its clearing services, it appears crucial to respondents to secure a back-up clearing member.
27. However, finding a back-up clearing member also proves to be challenging for the same reasons as the ones developed above for the main clearing member. Furthermore, clearing members are reported to be unwilling to act as pure backup clearing members, as this results in negative regulatory capital implications without any corresponding revenue. The preferred model is to have two active clearing members, each acting as backup of the other. Hence there is a plea for changes to the regulatory capital rules to be more supportive of “cold standby” backup clearing members unless and until positions are ported to them at a later stage.

Unclear outlook

28. Some respondents also claim that the reason why they have not finalised their clearing arrangements is the legal uncertainty around several aspects of the clearing obligation, such as (1) the CCPs that will be authorised or recognised to clear the mandatory CDS classes; (2) the renewal of the pension scheme exemption; and (3) the precise dates on which the clearing obligation will become applicable, which were defined relatively recently and are still subject to changes as discussed in this consultation.
29. ESMA notes that in relation to point (1) the current situation is now clearer: besides LCH SA, who had already been authorised in May 2014, counterparties may now clear Index CDS with one additional EU CCP (ICE Clear Europe, authorised in September 2016) and two additional US CCPs (Chicago Mercantile Exchange recognised in June 2016 and ICE Clear Credit recognised in September 2016).

Collateral issues

30. Beyond the issue of accessing central clearing via a clearing member, some respondents commented on some structural issues which act as disincentives towards central clearing, around the availability of collateral accepted by clearing members. They mention in particular that clearing members do not always accept the same range of collateral as CCPs do, and that clearing members do not offer services of collateral transformation at a reasonable price.



31. Several asset managers encourage ESMA once more to revisit the approach foreseen in the ESMA guidelines on ETF and other UCITS issues¹⁰, which restrain the usage of repos as a tool to provide eligible collateral, thus creating pressure on the capability of funds to deliver collateral.

Inconsistency between Client Clearing documentation and Article 50(g)(iii) of UCITS Directive

32. Representatives of Asset managers and funds have raised an issue related to Article 50(g)(iii) of UCITS Directive. Indeed, this Article requires that OTC derivatives transactions can be sold, liquidated or closed by an offsetting transaction at any time at the Fund's initiative.

33. To close out a cleared OTC derivative position, it usually requires entering into an offsetting transaction, as opposed to unwinds and novations that were the norm in the traditional OTC derivative market. As a result, under the client clearing documentation negotiated by the clearing member and the fund, the only option offered by clearing members to close out a cleared OTC derivative position of a fund is thus to terminate it with an offsetting transaction. Yet, the offsetting transaction is a brand new transaction, which is subject to limits set by clearing members. As a result, where under Article 50(g)(iii) of UCITS Directive, the fund needs to be able to close out the derivative position at any time at its own initiative, this might be challenging for the fund with a cleared derivative position, depending on the terms of the agreement the fund negotiates with its clearing member.

34. On this topic, ESMA would like to refer to section 3.2 of the opinion¹¹ published on 22 May 2015 which already raised the problem of Article 50(g)(iii) of UCITS Directive and the clearing obligation under EMIR.

Capacity issues

35. Some counterparties who have already established clearing arrangements, but are nevertheless not yet clearing on a voluntary basis, expressed concerns around the credit limits imposed by clearing members, which could in turn prevent them from clearing their transactions when they are required to do so.

36. Indeed, clearing members generally define credit limits that constrain the amount of clearing services they provide to a client, which limits are defined slightly above the amounts currently cleared. Given that those levels are typically very low in the current situation where the clearing obligation is not yet applicable, it remains unclear whether clearing members will be able to provide sufficient capacity to their clients when they become subject to the clearing obligation.

37. This effect is amplified by the fact that many clients are expected to become subject to the clearing obligation at the same time, and is even more acute in the case of clients with

¹⁰ ESMA/2014/937 published on 1 August 2014

¹¹ 2015/ESMA/880 published on 22 May 2015



long-dated and directional portfolios (such as insurers and pension funds) as those portfolios are more balance sheet intensive.

Direct Access Model

38. Several stakeholders have mentioned the “Direct Access Model” or “Sponsored Access Model” as a positive industry development which could help smaller counterparties getting access to CCPs. Several counterparties consider that regulators should support such innovation and the development of new client clearing models.
39. This type of model has been developed by several CCPs and can be seen to some extent as a hybrid solution between direct membership and client clearing. A range of drivers can explain why and how these new membership models have been developed, including the intention to minimise the impact of the client clearing activity on the leverage ratio of a clearing member, providing direct access to the CCP to a wider range of entities, limiting risk mutualisation for certain entities that could not become direct members otherwise, offering an alternative distribution of roles for meeting margin calls or contributing to default funds, etc.
40. However, this type of model still requires to be developed in accordance with EMIR, and in particular in accordance with the definition of a clearing member under Article 2, with clear risks and responsibilities attached to it.

4 Proposal to modify the phase-in period for Category 3

41. This section includes the feedback from the consultation and the proposed way forward on (1) the general principle of delaying the application of the clearing obligation for counterparties with a limited volume of activity; (2) the way to identify counterparties with a limited volume of activity; (3) the duration and scope of the delay; and (4) the Delegated Regulations which should be covered by the delay. This corresponds to Questions 5 to 7 of the Consultation Paper.

4.1 Delaying the application of the clearing obligation for counterparties with a limited volume of activity

42. Consistent with the hurdles presented in Section 3, a vast majority of stakeholders welcomed the proposal to provide more time to the smallest financial counterparties to comply with the clearing obligation.
43. They report that the quantitative analysis provided in the consultation paper tends to support the idea that the smallest financial counterparties are numerous in terms of head-count but only amount for a small share of the OTC derivatives volume, and therefore that such delay would not have a material negative impact on the reduction of systemic risk.
44. However, this dominant opinion should be balanced by the feedback provided by other stakeholders who are sceptical or concerned about the proposal to delay the application of the clearing obligation.

Remove the hurdles rather than delay

45. Among this group of stakeholders (primarily representatives of CCPs, but not only), some mentioned that although they agree with the analysis provided in the consultation paper, on the difficulties faced by small counterparties to access central clearing, they disagree with the way to address the problem, and that it would be more efficient to remove the hurdles rather than to grant additional time.
46. According to them, it is therefore necessary to use to delay to make progress on the various impediments to central clearing (e.g. incentives or disincentives for clearing members to provide client clearing services, ensuring indirect client clearing develops as a credible alternative, consider additional CCP access models)
47. ESMA agrees with the concerns raised and in this respect it has already proposed amendments to the adopted technical standards on indirect clearing. However, before the proposed amendments come into force and are effectively applied, sometime is needed. Therefore, ESMA considers that although the delayed phase-in does not solve the problems, it reduces their impacts and provides time to properly address them.

International consistency

48. Another argument advanced by some stakeholders against the delay is the issue of international consistency in the implementation timeline for the clearing obligation. They mention that Europe is already lagging other jurisdictions and that the delay would only take the EU further out of line with international commitments, potentially introducing unfair competition.
49. Given that most jurisdictions have adopted permanent exemptions for small entities, ESMA is not convinced of the relevance of the argument on international consistency with respect to the counterparties in Category 3, who might have benefited from an exemption outside the EU.

Permanent exemption

50. Others consider that the difficulties faced by the smallest counterparties are structural and that the only decent alternative would be to grant them a permanent exemption, similarly to what is proposed in other jurisdictions. While they acknowledge that this is not in the remit of ESMA, they nevertheless encourage ESMA to endorse that idea and to convey it to the European Commission.
51. In this respect, it is ESMA's understanding that the European Commission's services are well aware of this issue – which was raised in the context of the public consultation on the revision of EMIR and in the Call for evidence – and ESMA stands ready to assist the European Commission on this aspect.

Risks

52. Some responses also elaborated on the potential risks associated with the proposal to delay the clearing obligation.
53. First, several mentioned that a delay could act as a disincentive for counterparties facing difficulties in the establishment of their clearing arrangements. As mentioned by the European Systemic Risk Board (ESRB), experience has shown that counterparties tend to defer as long as possible their preparation towards a compliance deadline, and even more so when the compliance calendar remains unclear.
54. Similarly, this could discourage clearing members from developing solutions for client clearing as the date on which they would be able to draw revenues from the activity would be further postponed.
55. In addition, the ESRB mentions that some financial counterparties have made the effort ahead of the compliance deadline to either become a direct clearing member or to become clients of clearing members. According to the ESRB, this could create a situation of moral hazard where the less counterparty-risk sensitive market participants are the ones with no clearing obligation. Without denying this argument, ESMA considers that the feedback received to the consultation reinforces the idea that even if such phenomenon could materialise it might not be that substantial, and in any case, it needs to be weighed against the large feedback on the problems of access to clearing.
56. Finally, the ESRB and a few other stakeholders consider that the proposal to delay the implementation of the clearing obligation would have negative consequences on the primary objective of this obligation, which is the reduction of systemic risk.
57. Indeed, as presented in the consultation paper, it is possible that in some countries all counterparties (or a significant part of the market) would be classified in Category 3, which would leave those countries without a clearing obligation (or a clearing obligation that would have a very limited scope).
58. In this respect, the ESRB reiterates that systemic risk should be considered not only at the aggregated EU level, but also at national or even institutional level, because a significant impairment of all or parts of the EU financial system could potentially have serious negative consequences for the internal market and the real economy. Financial shocks can be transmitted by any jurisdictions across borders within the EU, for example via their participation in the global financial markets, and more particularly, the derivatives market.
59. The ESRB notes as well that postponing the clearing obligation for Category 3 would involve delaying the clearing obligation for their transactions with Category 1 and Category 2 counterparties, leaving Category 3 counterparties exposed longer than necessary to the potential failure of their counterparties, including possibly major market participants in the OTC derivatives markets.
60. ESMA is sympathetic to those arguments and already acknowledged such phenomena in the consultation paper. At the same time, apart from the delay, there does not seem to be alternatives that would address the issues faced by counterparties with a limited activity in OTC derivatives as developed in Section 3. Nonetheless, ESMA is proposing some



changes to its original proposal to accommodate to the extent possible the concerns on systemic risk that were raised by the ESRB.

61. Indeed, as developed in the following paragraphs, the revised proposal by ESMA would be to align the dates of application of the clearing obligation for Category 3 for all interest rate and credit derivative products (thus providing a shorter delay than originally proposed for interest rates denominated in NOK, PLN and SEK and for Index CDS).

4.2 Identification of the counterparties with a limited volume of activity

62. A large majority of respondents supported the approach presented in the consultation paper, according to which the counterparties with a limited volume of activity would be identified using already existing classifications, namely the so-called “Category 3” as defined in the Delegated Regulations on the clearing obligation.

63. Those stakeholders agree that this approach is the simplest one and that any alternative would come with the cost of performing once more a counterparty classification based on new definitions, including a self-assessment of each counterparty and the communication of this assessment to each of its counterparties.

64. A couple of stakeholders nonetheless consider that this proposal is not entirely fair in the sense that two counterparties with similar portfolios, one slightly above and the other one slightly below the EUR 8bn threshold, would have no less than 2.5 years of difference in their compliance deadline. As an alternative, they suggest to further subdivide Category 3 into smaller subgroups with different dates of application, to phase-in the application of the clearing obligation in a smoother way.

65. Although ESMA can see the benefits of the proposal, it still considers that those benefits are out weighted by the costs of counterparty reclassification.

Assessment at group level

66. Stakeholders have expressed contradicting views in relation to one aspect of the definition of Category 3, which is the assessment at group level and corresponding exemption for funds.

67. As explained in Recital (6) of the Delegated Regulations on the clearing obligation, the EUR 8bn threshold to distinguish between counterparties in Categories 2 and 3 applies generally at group level given the potential shared risks within the group. However, for investment funds the threshold applies separately to each fund since the liabilities of a fund are not usually affected by the liabilities of other funds or their investment manager.

68. On the one hand, several respondents noted that, for the purpose of counterparty classification, the positions in OTC derivatives should not be assessed at group level. They argue that this system results in small counterparties being classified in Category 2 just because of the large portfolios of other entities of their groups, and that being part of a

large group does not necessarily facilitate the access to CCP clearing, nor does it make their legal and operational capacity comparable to those of a Category 2 entity. They also explain that the assessment at group level is creating difficulties for counterparties when performing their self-classification as they lack information on the other portfolios of the group. In this respect it should be reminded that the assessment at group level was introduced at international level as a tool to dissuade avoidance practice, consisting of splitting an entity into smaller sub-entities each below the relevant threshold.

69. In addition, this issue should be at least partially addressed by the exemption provided in EMIR for intragroup transactions. The intragroup exemption can act as an incentive for firms to centralise risk management in a single entity, who would be the only one having to establish clearing arrangements, while all the other entities of the group could benefit from the intragroup exemption (hence not be required to clear).
70. On the other hand, other respondents argue that the assessment at group level should also be required for funds¹², for the same reason that it would avoid the potential practice of splitting funds into smaller funds with the only purpose of qualifying as Category 3 instead of Category 2.
71. Those respondents claim that large asset managers typically manage some funds in Category 2 and others in Category 3, and that it should not create difficulties to establish clearing arrangements for their Category 3 funds at the same time as their Category 2 funds.
72. Although there are merits in that proposal, it would again come at the cost of having counterparties re-classifying themselves taking into account the new proposal. It would also mean that some funds would change classification, from Category 3 to Category 2, at a late stage compared to the compliance deadline for Category 2, which would be unfair for those counterparties and should be avoided.
73. It should also be considered that for the purpose of the bilateral clearing obligation, which is based on international standards, funds are counted separately for the purpose of the 8 billion threshold. Thus the proposal would also imply that certain funds would be classified differently for two EMIR obligations.
74. Finally, some stakeholders reported that the assessment of counterparties' level of activity should be based on turnover rather than on outstanding volumes, as this would mirror more precisely the criteria used by clearing members to determine whether or not they wish to on-board a specific client.
75. Without discarding the merits of this proposal, ESMA considers again that for the purpose of establishing an exemption of temporary nature, it would be too complex and costly to build a new classification mechanism at this stage.

¹² According to Article 2(3) of the Delegated Regulations on the clearing obligation, where counterparties are alternative investment funds or UCITS, the EUR 8 billion threshold used to define Category 2 and Category 3 applies individually at fund level.

76. In view of the above, ESMA is proposing not to change the approach presented in the consultation paper regarding the identification of counterparties with a limited volume of activity, i.e. to consider that they are the ones in Category 3 as currently defined in the Delegated Regulations on the clearing obligation.

4.3 Duration of the delay and timing between Categories 3 and 4

77. In the consultation paper, ESMA proposed a two-year postponement of the date of application of the clearing obligation for Category 3, compared to the dates that are currently set out in the Delegated Regulations.

78. There were a few proposals to make this postponement longer or shorter, but the main feedback on this point, made by an important number of stakeholders, is the inconsistency in the resulting compliance calendar for the various groups of counterparties.

79. Indeed, delaying the application of the clearing obligation by 2 years for counterparties in Category 3 means that the deadline for this category of counterparties would come after that of Category 4 (comprising non-financial counterparties above the clearing threshold).

80. Many cited this outcome as inconsistent with the principle of proportionality and with the recitals of the Delegated Regulation on the clearing obligation: those explain that the counterparties (and resulting phased-in period) are defined on the basis of the “levels of legal and operational capacity regarding OTC derivatives” and the “experience and operational capacity with OTC derivatives and central clearing”.

81. Such assessment of the degree of sophistication of counterparties has initially led to the definition of four categories of counterparties, with a date of application for Category 3 being set 6 months before that for Category 4 (for the two Delegated Regulations on IRS) and 9 months before that for Category 4 (for the Delegated Regulation on CDS)¹³.

82. ESMA understands why its proposal may have been perceived as an inconsistency and would like to clarify that, since the moment when the categories of counterparties were defined, new evidence suggests that the level of sophistication of non-financial counterparties above the clearing threshold (NFC+) may actually be higher than that of many small financial counterparties.

83. Indeed, in August 2015 ESMA published a report on the use of OTC derivatives by non-financial counterparties¹⁴. This report constituted one part of ESMA’s contribution to the general report on EMIR that the European Commission is required to prepare.

¹³ There is a difference between the Delegated Regulation on CDS and the others because for the former, counterparties were given an additional 3-month period to take into account the fact that only one CCP was authorised for CDS at that time, and this extra 3-month period was not provided to Category 4.

¹⁴ EMIR Review Report no.1 – The use of OTC derivatives by non-financial counterparties. ESMA/2015/1251, 13 August 2015



84. This report based on data coming from European Trade Repositories (TRs) showed inter alia that, although at global level the systemic relevance of NFC was significantly smaller than that of FCs, a disaggregated view of the numbers provided a different picture.
85. For example, it was shown that the level of exposure of NFC+ and large non-financial counterparties below the clearing threshold (NFC-) to their counterparties is significant and much closer to those of FCs than to those of small NFC-¹⁵.
86. The report also compared (in Figure 9) the individual portfolio sizes of NFC+ and large NFC- to those of financial counterparties, and concluded that there are many groups of NFCs among the biggest market participants, and that those groups of NFCs appeared relatively high when counterparties were ranked by portfolio sizes (this being particularly true in the Commodity and FX asset class, and to a lesser extent in the Interest rate asset class).
87. The important conclusion of this analysis is that there are massive differences in the level of experience with OTC derivatives between the smallest and the largest NFCs, up to the point that NFC+ and large NFC- are actually more active than many FCs.
88. As a result, ESMA considers appropriate that the group of NFC+ (composed of a small number¹⁶ of relatively sophisticated counterparties) is required to start clearing a few months before the group of FCs with a limited volume of activity (composed of a large number¹⁷ of relatively less sophisticated counterparties). A recital has been added to the draft RTS presented in Annex 3 to explain this.

4.4 Scope of the proposed amendments

89. In the last section of the consultation paper, counterparties were asked their views on the proposal to modify the phase-in period for Category 3 in the three Delegated Regulations on the clearing obligation at the same time, and to add a period of 2 years to each compliance deadline. Hence the proposal was to shift by 2 years the dates on which the clearing obligation would apply to counterparties in Category 3.
90. Again with this question, the large majority of respondents were in agreement with the proposal. They noted in particular that it was important to provide legal certainty as soon as possible, hence modifying the three Delegated Regulations at the same time was the preferred approach.
91. Nevertheless, the responses from the ESRB and several CCPs provided suggestions departing from this approach.

¹⁵ See Table 5 of the report: with regard to the level of exposure, NFC+ and large NFC- have around 500 to 600 trades on average versus 872 for FCs and 20 for small NFC-; and the average notional value of trades for NFC+ and large NFC- is around 4 to 5 billion EUR on average versus 21 for FCs and 0.1 for NFCs.

¹⁶ In the EMIR Review report No.1 on the activity of NFCs, the estimated number of NFC+ in Europe was 424, see e.g. Table 4, whereas the number of counterparties with a notification, as per Article 10 of EMIR, was about half of this number, 218.

¹⁷ In the consultation paper corresponding to this final report, the number of counterparties classified as "Estimated Category 3" was above 5,500 in the Interest asset class and above 2,400 in the Credit asset class.

Difference between IRS and CDS markets

92. A first proposal is that the compliance date for Category 3 in the Delegated Regulation on CDS should either not be modified at all or, as a minimum, not be deferred by the same amount of time as the one in the Delegated Regulation on IRS (i.e. 2 years).
93. The justifications for such proposal lie in the structural differences between the IRS and CDS market. The CDS market is smaller in size and has fewer active counterparties (although the majority of the activity is concentrated in a few large counterparties, in a similar way to the IRS market), therefore the smaller counterparties are responsible for a bigger share of the activity in the CDS market in relative terms than in the case of the IRS market. This can be derived from the analysis provided in the Consultation Paper, showing that the estimated Category 3 counterparties represent 5.1% of the volume on the CDS market versus 1.1% of the volume in the IRS market (see paragraphs 58 and 59, and Figures 5 and 6 of the Consultation Paper).
94. It was found that there are about twice as many active counterparties in the IRS as in the CDS market (see Table 1 of the Consultation Paper). Hence, counterparties in Category 3 represent a higher share of the volume in the CDS market, compared to the IRS market.
95. It has been argued that the delay provided to Category 3 for CDS clearing could have a negative impact on the liquidity of the CDS market, and could lead to the development of a price basis between cleared and non-cleared CDS trades.
96. ESMA is sympathetic to those arguments, however the challenges experienced by smaller counterparties to access clearing are similar for IRS and CDS contracts.
97. Taking into consideration all of the above, ESMA is proposing not to treat the phase-in relative to the CDS classes differently from how the phase-in relative to IRS classes is addressed.

Use the same date for Category 3 in the three Delegated Regulations on IRS and CDS

98. A second proposal is that the dates of application for Category 3 should not be shifted by the same amount of time in the three Delegated Regulations, but that instead they should be aligned or, at least, that the length of the delay should progressively decrease.
99. This proposal is based on the idea that once the first clearing arrangements have been established, counterparties should be able to leverage on that first experience to establish the consecutive ones.
100. Taking into account this justification, ESMA concurs with the ESRB's view that it is not necessary to delay all the dates of application by the same amount of time. ESMA is thus proposing to align the three compliance dates for Category 3 in the three Delegated Regulations on IRS and CDS.
101. As a result, compared to the proposal of the consultation paper, ESMA has modified in the draft RTS presented in Annex 3 the compliance date for Category 3 in the Delegated



Regulation on IRS denominated in NOK, PLN and SEK and in the Delegated Regulation on CDS. This compliance date is now 21 June 2019, i.e. the same date as the one proposed for IRS denominated in the G4 currencies.



5 Annexes

5.1 Annex 1 Legislative mandate to develop technical standards

Article 5 of Regulation (EU) No 648/2012

Clearing obligation procedure

2. Within six months of receiving notification in accordance with paragraph 1 [of Article 5] or accomplishing a procedure for recognition set out in Article 25, ESMA shall, after conducting a public consultation and after consulting the ESRB and, where appropriate, the competent authorities of third countries, develop and submit to the Commission for endorsement draft regulatory technical standards specifying the following:

- (a) the class of OTC derivatives that should be subject to the clearing obligation referred to in Article 4;
- (b) 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
- (c) the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii).

Power is delegated to the Commission to adopt regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

5.2 Annex 2: Cost Benefit Analysis

1. This cost-benefit analysis was conducted by ESMA while developing the amendments to the delegated regulations on the clearing obligation.
2. The scope of the cost-benefit analysis is strictly limited to the elements of the delegated regulations on the clearing obligation which are proposed to be amended, i.e. the phase-in period for counterparties with a limited volume of activity in OTC derivatives.

Policy Objective	Determine the categories of counterparties in respect of which the date of application of the clearing obligation should be postponed
Option 1	Rely on the existing classification of counterparties (defined in the delegated regulations on the clearing obligation) and postpone the date of application for the counterparties in Category 3.
Option 2	Define a new system of counterparty classification to replace the existing one, and postpone the date of application for one of the new categories.
Preferred Option	Option 1

Option 1	Rely on the existing classification of counterparties (defined in the delegated regulations on the clearing obligation) and postpone the date of application for the counterparties in Category 3.
	Qualitative description
<i>Benefits</i>	The option is simple as it fully relies on an existing system of counterparty classification. This existing system is based on the level of activity in OTC derivatives of counterparties at group level. Therefore, it is linked, to some extent, to the level of legal and operational capacity of counterparties regarding OTC derivatives, but in an imperfect way. Indeed, even when the degrees of sophistication of two counterparties belonging to the same group are different, they will be classified in the same category of counterparties and be subject to the clearing obligation at the same time.
<i>Costs to regulator</i> One-off ¹⁸	This option is the baseline scenario and does not add any compliance costs compared to the existing framework. Counterparties are already required to perform this counterparty classification under the delegated regulations on the clearing obligation. It should however be noted that for the regulators monitoring the activity of financial counterparties at
<i>Compliance costs</i>	

¹⁸ On-going costs are irrelevant with respect to phase-in.

One-off	group level is not immediate and not possible through the data collected by trade repositories.
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Option 2	Define a new system of counterparty classification to replace the existing one, and postpone the date of application for one of the new categories.
	Qualitative description
<i>Benefits</i>	<p>This option provides more flexibility to design an ad hoc framework, with the specific purpose of identifying the counterparties that are facing the most difficulties in setting up their clearing arrangements.</p> <p>For example, several thresholds could be set at asset class level, and the clearing obligation would be postponed only for the counterparties with individual portfolio size below the threshold, in each asset class. With such a framework, the differences in the absolute sizes of each asset class would be addressed more appropriately than with Option 1.</p> <p>With this option it would be possible to target more precisely the counterparties with a limited volume of activity, hence to postpone the clearing obligation for a more limited share of OTC derivative markets, which in turn is positive for the global reduction of systemic risk.</p>
<i>Costs to regulator</i> One-off ¹⁹	The costs would be proportionate to the level of complexity of the adopted classification system. In the example taken above, regulators would need to check the classification at individual level, which is expected to be less costly for regulators than Option 1.
<i>Compliance costs</i> One-off	<p>The costs would be proportionate to the level of complexity of the adopted classification system. In all cases, the overall costs are expected to be significant as it would require several thousands of counterparties to perform, once more, a self-classification based on quantitative elements, and to communicate this information to all their counterparties.</p> <p>Furthermore, a new classification system would introduce uncertainty for entities classified in different categories than category 3 and this uncertainty would remain until the publication in the official journal of the amended technical standards. This uncertainty would further exacerbate the compliance cost.</p>

¹⁹ On-going costs are irrelevant with respect to phase-in.

5.3 Annex 3: Draft technical standards

COMMISSION DELEGATED REGULATION (EU) No .../...

of [.]

amending Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015, Commission Delegated Regulation (EU) 2016/592 of 1 March 2016 and Commission Delegated Regulation (EU) 2016/1178 of 10 June 2016, supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ⁽²⁰⁾, and in particular Article 5(2) thereof,

Whereas:

- (1) To ensure a timely and orderly application of the clearing obligation, different phase-in periods apply to different categories of counterparties.
- (2) The categories of counterparties are defined in Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) No 648/2012 ⁽²¹⁾, Commission Delegated Regulation (EU) 2016/592 of 1 March 2016 supplementing Regulation (EU) No 648/2012 ⁽²²⁾ and Commission Delegated Regulation (EU) 2016/1178 supplementing Regulation (EU) No 648/2012 ⁽²³⁾ (the Delegated Regulations on the clearing obligation) for the purposes of the respective clearing obligations. In those categories, counterparties are grouped according to their levels of legal and operational capacity regarding OTC derivatives, which is related to their levels of activity in OTC derivatives.
- (3) The date on which the clearing obligation takes effect for counterparties in Categories 2 and 3 takes into account the fact that most of them can only get access to a CCP by becoming a client or an indirect client of a clearing member.
- (4) However, counterparties with the smallest level of activity in OTC derivatives (i.e. those in Category 3) are facing important difficulties in preparing the arrangements with clearing members that are necessary for clearing the contracts, due to complexities affecting both types of access, client clearing and indirect client clearing, which were not foreseen at the time the proposals related to the clearing obligation were developed.

⁽²⁰⁾ OJ L 201, 27.7.2012, p. 1.

⁽²¹⁾ OJ L 314, 1.12.2015, p. 13.

⁽²²⁾ OJ L 103, 19.4.2016, p. 5.

⁽²³⁾ OJ L195, 20.7.2016, p. 3.

- (5) First, in relation to client clearing, recent evidence suggests that clearing members find little incentives to develop extensively their client clearing offering because of cost issues, and even more so for clients with a limited volume of activity in OTC derivatives. In addition, the final regulatory framework on the capital requirements applicable in relation to exposure from client clearing activity has not been finalised yet, and this creates uncertainties that act as an impediment to a broad development by clearing members of their client clearing offerings.
- (6) Second, in relation to indirect clearing arrangements, counterparties are currently unable to access CCPs by becoming an indirect client of a clearing member, because of the scarcity of the offer. ESMA has reviewed the rules set out in Commission Delegated Regulation (EU) No 149/2013 ⁽²⁴⁾ and has submitted amending draft technical standards to the Commission on 26 May 2016. One objective of these new draft rules is to promote and simplify this type of access for counterparties, with the expectation that the indirect clearing offering could increase.
- (7) To take those difficulties and regulatory developments into account, it is necessary to modify the dates on which the clearing obligation takes effect for counterparties in Category 3 in the Delegated Regulations on the clearing obligation and to provide those counterparties with an additional period of time to finalise the necessary clearing arrangements.
- (8) The regulatory framework influencing the capacity of counterparties to access CCPs via client or indirect client clearing arrangements is still evolving and is not expected to be fully implemented in the short to medium term. The dates on which the clearing obligation takes effect for counterparties in Category 3 should therefore be set in accordance with this timing uncertainty.
- (9) New evidence suggests that non-financial counterparties in Category 4 do not necessarily have a more limited experience and operational capacity with OTC derivatives and central clearing than financial counterparties in Category 3. Therefore, it is not necessary to amend the dates on which the clearing obligation takes effect for counterparties in Category 4, nor to align those dates for Category 3 and Category 4. Given that counterparties in Category 3 account for a relatively limited share of the global volume in OTC derivative market, the modification of the dates of application for this category does not compromise the overarching objective of the clearing obligation, which is the reduction of systemic risk.
- (10) This Regulation is based on draft regulatory technical standards submitted by the European Securities and Markets Authority (ESMA) to the Commission.
- (11) ESMA has conducted an open public consultation on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits, requested the opinion of the Securities and Markets Stakeholder Group established by Article 37 of Regulation (EU) No 1095/2010, and consulted the European Systemic Risk Board.

HAS ADOPTED THIS REGULATION:

Article 1

Amendment to Commission Delegated Regulation (EU) 2015/2205

Point (c) to Article 3(1) of Commission Delegated Regulation (EU) 2015/2205 is replaced by the following:

⁽²⁴⁾ OJ L 52, 23.2.2013, p. 11.



'(c) 21 June 2019 for counterparties in Category 3;'

Article 2

Amendment to Commission Delegated Regulation (EU) 2016/592

Point (c) to Article 3(1) of Commission Delegated Regulation (EU) 2016/592 is replaced by the following:

'(c) 21 June 2019 for counterparties in Category 3;'

Article 3

Amendment to Commission Delegated Regulation (EU) 2016/1178

Point (c) to Article 3(1) of Commission Delegated Regulation (EU) 2016/1178 is replaced by the following:

'(c) 21 June 2019 for counterparties in Category 3;'

Article 4

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, [.]

For the Commission
The President