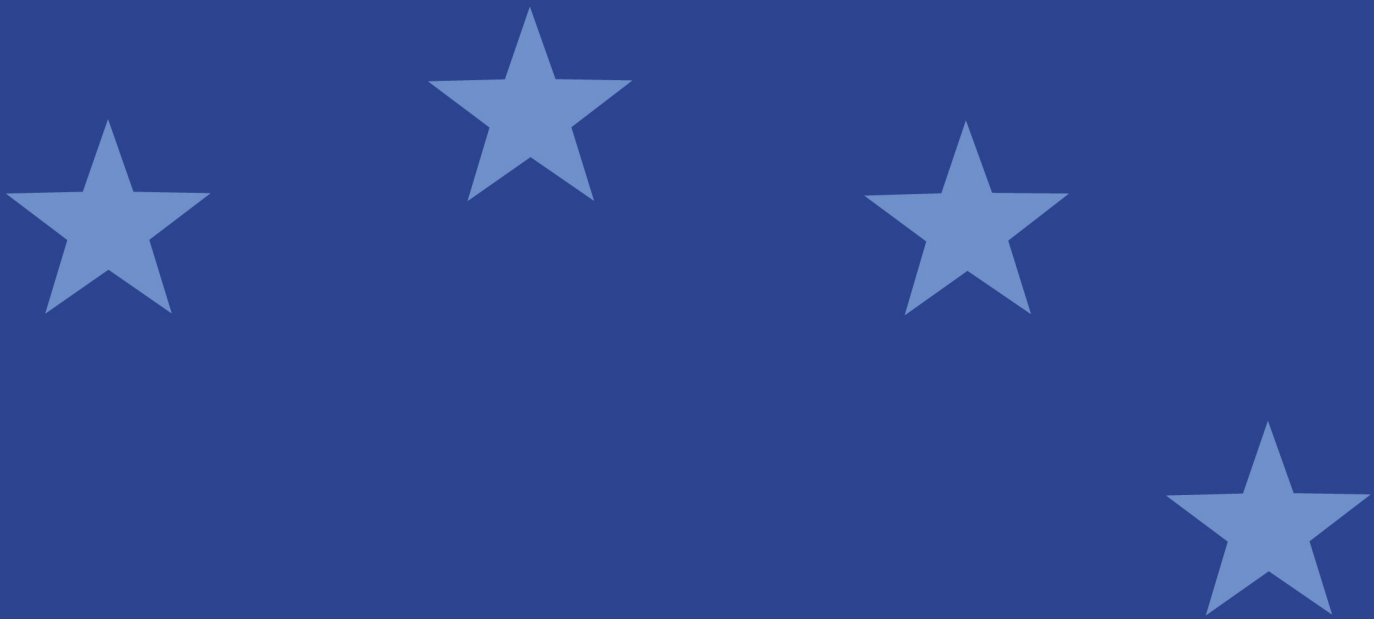




European Securities and  
Markets Authority

# Report to the European Commission

**Report on post trade risk reduction services with regards to the clearing  
obligation (EMIR Article 85(3a))**



# Table of Contents

- 1 Executive Summary ..... 3
- 2 Introduction ..... 6
- 3 Background..... 7
- PART 1 ..... 8
- 4 Regulatory framework and characteristics of PTRR services ..... 8
  - 4.1 Portfolio compression under EMIR..... 8
  - 4.2 The clearing obligation under EMIR ..... 9
  - 4.3 The trading obligation and portfolio compression under MiFIR..... 10
  - 4.4 Reporting of PTRR transactions under EMIR..... 12
  - 4.5 Exemption from margin requirements for PTRR transactions..... 13
  - 4.6 A definition of PTRR services..... 13
  - 4.7 Characteristics of PTRR Services ..... 14
  - 4.8 Administrative transactions ..... 15
  - 4.9 Introduction to portfolio compression..... 15
  - 4.10 Introduction to portfolio rebalancing ..... 16
  - 4.11 Other PTRR Services..... 18
  - 4.12 Market use of PTRR services today ..... 18
  - 4.13 PTRR service providers ..... 20
- 5 Noteworthy aspects of PTRR services ..... 24
  - 5.1 List of possible conditions or requirements established in the consultation paper... 25
  - 5.2 General aspects of the PTRR services and feedback received ..... 25
  - 5.3 Use of Portfolio Compression..... 43
  - 5.4 Use of Portfolio Rebalancing ..... 45
- PART 2 ..... 47
- 6 Exemption to the clearing obligation for certain PTRR transactions ..... 47
  - 6.1 Limiting factors for PTRR services ..... 48
  - 6.2 PTRR services today ..... 48
  - 6.3 Need for an exemption to the clearing obligation for PTRR services ..... 49
  - 6.4 Respondents critical to the need for an exemption to the clearing obligation..... 50
  - 6.5 Respondents supporting the need for an exemption to the clearing obligation ..... 51
  - 6.6 Weakening the incentive to clear..... 53
  - 6.7 Would an exemption challenge the clearing mandate? ..... 55

6.8	The clearing obligation .....	56
6.9	Optimising collateral use .....	57
6.10	Circumvention of the clearing obligation.....	60
6.11	Conclusion .....	61
PART 3	.....	65
7	Possible requirements for the provision of PTRR services .....	65
7.1	PTRR service providers acting independently .....	65
7.2	Build-up of transactions.....	67
8	Summary of key features and requirements.....	68
8.1	Proposed requirements for the provision of PTRR services to benefit from an exemption to the clearing obligation.....	68
8.2	Conditions to benefit from the clearing exemption on trades resulting from portfolio compression .....	69
8.3	Conditions to benefit from the clearing exemption on trades resulting from portfolio rebalancing.....	69
Annex 1:	Portfolio rebalancing.....	71
Annex 2:	Cost Benefit Assessment .....	72
8.4	Cost .....	72
8.5	Benefits.....	73
8.6	Liquidity.....	73
Annex 3:	High-level matrix over exemptions for portfolio compression in other jurisdictions.	75

---

# 1 Executive Summary

## Reasons for publication

The European Securities and Markets Authority (ESMA) is mandated to provide a report to the European Commission, in cooperation with the European Systemic Risk Board (ESRB), on whether any trades that directly result from post-trade risk reduction services (PTRR services), including portfolio compression, should be exempted from the clearing obligation referred to in Article 4(1) of EMIR.

ESMA published a Consultation Paper on 26 March 2020 containing several questions on PTRR services. The consultation ended on 15 June 2020. ESMA received 13 public responses and a few confidential responses. This final report to the European Commission takes into account the feedback provided by the respondents to the consultation. In addition, ESMA has worked with the ESRB to integrate their input in the final report.

In this report, ESMA is looking into the different types of PTRR services being offered, their purpose and whether there is a need for the new trades, that these may generate, to be exempted from the clearing obligation, and if such an exemption could lead to the risk of some counterparties circumventing the clearing obligation.

## Conclusions

The 2008 financial crisis has underlined the importance of central clearing as an effective risk mitigation tool. Central clearing has an important role to play in reducing systemic risk in the OTC derivatives markets and remains a cornerstone of safe and transparent markets. The respondents to the consultation have confirmed that they fundamentally support central clearing and a majority of financial institutions are now centrally clearing significant shares of their OTC derivative transaction portfolios, thereby reducing systemic risk in line with the G20 commitments.

ESMA notes that PTRR services complement the clearing obligation in bringing systemic risk reduction to the financial market and PTRR transactions are successfully undertaken today and have reduced a considerable amount of risks in the market. However, the use of PTRR services today are subject to some noteworthy considerations. PTRR transactions cannot be clearable if the portfolio they derive from consists of uncleared transactions as it would detach the replacement or rebalancing trade from the risk it is designed to reduce, for example in principle legacy trades cannot be compressed today without an exemption. The market, to some extent, may use other instruments, not subject to the clearing obligation, to execute PTRR transactions in uncleared portfolios, however such PTRR services become more complex and the products used are less standardised, to avoid the clearing obligation. Also, by using more complex transactions PTRR services become less accessible for all markets participants either due to regulatory concerns or due to less advanced internal management systems. ESMA therefore notes that without an exemption to the clearing

---

---

obligation PTRR transactions in uncleared portfolios will either not be undertaken today or would be using PTRR transactions not subject to the clearing obligation.

Hence, if certain compression or rebalancing trades would benefit from an exemption from the clearing obligation, this would enable market participants to further reduce risk in non-cleared (and to some extent cleared) portfolios. This reduction in risk on the individual level would also result in an overall reduction of systemic risk.

ESMA concludes that the benefits of allowing certain PTRR transactions to be exempted from the clearing obligation would reduce risk in the market, allow for legacy trades to be compressed, increase participation in PTRR services of counterparties less interested to participate today (due to complex structures) and overall reduce complexity in the market by using simpler trades for rebalancing. ESMA is of the view that, in the absence of compelling evidence or reasoning to the contrary, those positive effects outweigh, inter alia, the increased operational burden on market participants and regulators and the increase in gross risk in the non-cleared netting sets (in case of portfolio rebalancing).

ESMA further notes that the mere function of allowing PTRR transactions to be exempted from the clearing obligation when related to uncleared portfolios of transactions would not reduce the amount of transactions cleared with the CCP. Indeed, currently the risk in portfolios is offset with the use of uncleared instruments. An exemption from the clearing obligation would allow risk to be offset with standardised contracts. Moreover, regarding bilateral outstanding risk, an exemption would allow the booking of one uncleared trade (that would remain in the uncleared portfolio) to offset the bilateral risk between these two counterparties, and in addition, counterparties could book a mirroring cleared trade facing a CCP shifting the overall risk exposures of each counterparty to a CCP. ESMA finally concludes that any such exemption should be limited and subject to certain requirements, to reduce any risk of circumvention of the clearing obligation.

## **Contents**

This report is divided into 3 Parts and 8 Sections. Section 2 provides an introduction to this consultation paper and section 3 provides a background.

In Part 1, Section 4 covers the types of post trade risk reduction services, including what they are, how they function, the risks they aim to reduce, why and to what extent market participants use them and their regulatory framework. Section 5 refers to noteworthy aspects of PTRR services.

In Part 2, Section 6 assesses how the current clearing obligation may affect those services and the need to clear or to exempt the new trades that might be generated by PTRR services (PTRR transactions) from the clearing obligation and assesses the risks with an exemption from the clearing obligation.

In Part 3, Section 7 considers possible conditions or requirements for the provision of PTRR services. Section 8 provides key features and proposed requirements for PTRR services.

---

---

Finally, Annex 1 provides a description of rebalancing, Annex 2 provides for a cost and benefit analysis and Annex 3 presents a high-level matrix over the exemptions for portfolio compression in other jurisdictions.

With this report ESMA, in cooperation with the ESRB, aims to contribute to the assessment of the European Commission, in their consideration of post-trade risk reduction services, and to the extent any exemption should be provided to the clearing obligation.

### **Next Steps**

ESMA has submitted this final report to the European Commission. The European Commission is mandated under EMIR to prepare a report assessing whether any trades that directly result from post-trade risk reduction services should be exempted from the clearing obligation.

---

## 2 Introduction

1. On 20 May 2019, the European Parliament and the Council adopted Regulation (EU) 2019/834, EMIR Refit, amending Regulation (EU) 648/2012, EMIR, as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories. EMIR Refit was published in the Official Journal on 28 May 2019<sup>1</sup>.
2. Under Article 85(3a) of EMIR<sup>2</sup>, the European Securities and Markets Authority (ESMA) is mandated to provide, by 18 May 2020<sup>3</sup>, a report to the European Commission (EC or Commission), in cooperation with the European Systemic Risk Board (ESRB), on whether trades that directly result from post-trade risk reduction services, including portfolio compression (PTRR services) should be exempted from the clearing obligation referred to in Article 4(1) of EMIR. For ESMA to provide its determination, ESMA shall investigate PTRR services, explain the purpose and functioning of PTRR services and the need for the trades directly resulting from PTRR services (PTRR trades or PTRR transactions) to be exempted from the clearing obligation and, if exempted, whether this could lead to a circumvention of the clearing obligation.
3. ESMA published a Consultation Paper on 26 March 2020 containing several questions on PTRR services. The consultation ended on 15 June 2020. ESMA received 13 public responses and a few confidential responses. ESMA also consulted the ESMA Securities and Markets Stakeholders Group. This final report to the Commission takes into account the feedback provided by the respondents to the consultation.
4. In addition, ESMA worked with the ESRB in order to integrate their input into the final report.
5. Following the submission of the report from ESMA, the EC is mandated to prepare, by 18 December 2020, a report assessing whether any trades that directly result from PTRR services, should be exempted from the clearing obligation referred to in Article 4(1) of EMIR. The EC is mandated to submit the report to the European Parliament and to the Council, together with any appropriate proposals<sup>4</sup>.
6. Extract from Article 85(3a) of EMIR (as amended by EMIR REFIT).

3a. By 18 May 2020, ESMA shall submit a report to the Commission. That report shall assess: [...]

(d) in cooperation with the ESRB, whether any trades that directly result from post-trade risk reduction services, including portfolio compression, should be exempted from the clearing obligation referred to in Article 4(1); that report shall:

---

<sup>1</sup>OJ L 141, 28.5.2019, p.42. The text can be found following this link: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834&from=EN>

<sup>2</sup> EMIR 648/2012 as amended including by EMIR Refit.

<sup>3</sup> Due to the difficult circumstances during which ESMA was developing and published its consultation paper, as a consequence of the COVID-19 pandemic, a longer consultation period had been provided that initially envisaged.

<sup>4</sup> Article 85(3) of EMIR.

- (i) investigate portfolio compression and other available non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios without changing the market risk of the portfolios, such as rebalancing transactions;
- (ii) explain the purposes and functioning of such post-trade risk reduction services, the extent to which they mitigate risk, in particular counterparty credit risk and operational risk, and assess the need to clear such trades or to exempt them from clearing, in order to manage systemic risk; and
- (iii) assess to what extent any exemption from the clearing obligation for such services discourages central clearing and may lead to counterparties circumventing the clearing obligation;

### 3 Background

7. The main objective of the final report is to consider whether a special regime, in the form of an exemption to the clearing obligation for transactions directly resulting from the use of PTRR services, should be included under EMIR.
8. The first part of this report investigates portfolio compression and other available non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios without changing the market risk of the portfolios, such as rebalancing transactions<sup>5</sup>. It aims at explaining the purposes and functioning of such PTRR services and the extent to which they mitigate risks, and in particular counterparty credit risk, operational risk and systemic risk.
9. The second part of this report considers a possible exemption to the clearing obligation for trades that directly result from PTRR services and provides references to the responses received under the consultation. It provides for ESMA's conclusion on an exemption from the clearing obligation for trades that directly result from PTRR services.
10. The third part of the final report assesses the need for possible conditions that should apply when using the exemption to the clearing obligation for trades that directly result from PTRR services and provides for key features of PTRR services.
11. The term *portfolio compression* is used in EMIR Level 2 regulation (Commission Delegated Act on Risk Mitigation<sup>6</sup>) in relation to the risk mitigation techniques for OTC derivative contracts not cleared by a CCP and is a defined term in MiFIR<sup>7</sup> <sup>8</sup>. The term

---

<sup>5</sup> Rebalancing/optimisation is used in this paper to refer to risk mitigation techniques using offsetting trades to achieve its risk reduction.

<sup>6</sup> Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP.

<sup>7</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, OJ L 173, 12.6.2014, p. 84–148.

<sup>8</sup> Article 2(47) of MiFIR “‘portfolio compression’ means a risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with another derivative whose combined notional value is less than the combined notional value of the terminated derivatives.”



PTRR services is not a defined term under EMIR or MiFID II<sup>9</sup>/MiFIR but is referred to in Recital 27 of MiFIR<sup>10</sup>. Although this is not a definition and it is inserted in a recital rather than in an enacting provision, this seems to indicate that the slightly more limiting definition is not intending to prevent the use of such other PTRR services beside the specific regulated portfolio compression. A PTRR transaction could be described as a non-price forming transaction which reduces non-market risks in derivatives portfolios without materially affecting or changing the market risk of the portfolios.

12. This report uses the term PTRR services to refer both to portfolio compression services as well as to other available non-price forming PTRR services, primarily referring to the current services of portfolio optimisation services and rebalancing services (risk rebalancing services).

## **PART 1**

### **4 Regulatory framework and characteristics of PTRR services**

#### **4.1 Portfolio compression under EMIR**

13. EMIR Article 11(1) requires that counterparties that enter into an OTC derivative contract not cleared by a CCP must have appropriate procedures and arrangements to measure, monitor and mitigate operational risk and counterparty credit risk.
14. Pursuant to EMIR regulatory technical standards (Article 14 of the Delegated Act on Risk Mitigation), financial counterparties and non-financial counterparties with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared, must have in place procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk. If counterparties do not conduct portfolio compression, they should be able to provide a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise was not appropriate.
15. The scope of portfolio compression is further explained in an EMIR Q&A<sup>11</sup> with the conclusion that portfolio compression does not prevent an offsetting transaction to be

---

<sup>9</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, p. 349–496.

<sup>10</sup> Recital 27 of MiFIR: “The obligation to conclude transactions in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation on a regulated market, MTF, OTF or third country trading venue should not apply to the components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios including existing OTC derivatives portfolios in accordance with Regulation (EU) No 648/2012 without changing the market risk of the portfolios. In addition, while it is appropriate to make specific provision for portfolio compression, this Regulation is not intended to prevent the use of other post-trade risk reduction services.”

<sup>11</sup> [https://www.esma.europa.eu/sites/default/files/library/esma70-1861941480-52\\_qa\\_on\\_emir\\_implementation.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-1861941480-52_qa_on_emir_implementation.pdf)

concluded with a counterparty different from the counterparty to the initial transaction. The Q&A further clarifies some justifications for not undertaking a portfolio compression.

**EMIR Article 11(1)**

1. Financial counterparties and non-financial counterparties that enter into an OTC derivative contract not cleared by a CCP, shall ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least:

- (a) the timely confirmation, where available, by electronic means, of the terms of the relevant OTC derivative contract;
- (b) formalised processes which are robust, resilient and auditable in order to reconcile portfolios, to manage the associated risk and to identify disputes between parties early and resolve the, and to monitor the value of outstanding contracts.

**Delegated Regulation 149/2013**

**Recital**

*Portfolio compression may also be an efficient tool for risk mitigation purposes depending on circumstances such as the size of the portfolio with a counterparty, the maturity, purpose and degree of standardisation of OTC derivative contracts. Financial counterparties and non-financial counterparties that have a portfolio of OTC derivative contracts not cleared by a CCP above the level determined in this Regulation should have procedures in place in order to analyse the possibility to use portfolio compression that would allow them to reduce their counterparty credit risk.*

**Article 14 Portfolio compression**

Financial counterparties and non-financial counterparties with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared shall have in place procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise.

Financial counterparties and non-financial counterparties shall ensure that they are able to provide a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise is not appropriate.

**OTC Question 10 [last update 4 June 2013]**

Article 14 of Regulation (EU) 149/2013: Portfolio Compression

- (a) When financial and non-financial counterparties conclude that a portfolio compression exercise is not appropriate, they need to be able to provide a "reasonable and valid explanation". What is considered as a "reasonable and valid explanation"?
- (b) Does the requirement on portfolio compression prevent an offsetting transaction to be concluded with a counterparty different from the counterparty to the initial transaction?

**OTC Answer 10**

- (a) The explanation the counterparty needs to be able to provide to the competent authority when they are requested to do so should adequately demonstrate that portfolio compression was not appropriate under the prevailing circumstances. Depending on the circumstances, the justification could include that:
  - 1. the portfolio is purely directional and does not allow any offsetting transactions;
  - 2. multilateral compression services are not available in the relevant markets, for the relevant products, or to the relevant participants and that compression on a bilateral basis would not be feasible;
  - 3. compression would materially compromise effectiveness of the firm's internal risk management or accounting processes.
- (b) No. The requirement on portfolio compression does not prevent an offsetting transaction to be concluded with a counterparty different from the counterparty to the initial transaction.

## 4.2 The clearing obligation under EMIR

- 16. EMIR requires that all OTC derivative contracts subject to mandatory clearing (entered into or novated on or after the relevant clearing obligation start date) must be cleared in an authorised or recognised CCP. The clearing obligation covers standardised transactions that are considered suitable for clearing. Yet, whilst clearing has improved

efficiency and reduced counterparty risk and thereby strengthened the stability of the market in line with the G20 commitments, clearing is not suitable for all types of trades. For instance, more complex transactions, such as exotic derivatives are not considered suitable for clearing and would instead be subject to specific risk mitigation requirements, such as margin requirements and portfolio reconciliation. As a result, financial institutions continue to have large uncleared portfolios of trades in addition to their cleared portfolios.

17. When responding to previous ESMA consultations on the clearing obligation, several respondents mentioned PTRR services and commented on the need to exempt a range of trades concluded in certain scenarios, including trades generated as part of post-trade risk reducing initiatives such as multiportfolio compression runs or counterparty risk rebalancing<sup>12</sup>. However, due to the wording in EMIR, ESMA did not, at that time, have a mandate to consider conditions leading to a different treatment for such transactions.

### 4.3 The trading obligation and portfolio compression under MiFIR

18. MiFIR<sup>13</sup> specifically excludes transactions that derive from portfolio compression from best execution requirements and from the derivatives trading obligation. The consultation paper noted the interlinkage with MiFIR. Although the paper did not assess possible effects of linking an exemption to the clearing obligation with the exemption to the trading obligation. Hence this final report will not assess in any great details if and how a possible exemption under EMIR could be affected by the current exemption under MiFIR.
19. MiFIR<sup>14</sup> and the related delegated regulation with regard to portfolio compression (Delegated Act on Compression)<sup>15</sup> contain a number of provisions that relate to the provision of, and participation in, portfolio compression services by investment firms and market operators.

Article 2(47) of MiFIR “‘portfolio compression’ means a risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with another derivative whose combined notional value is less than the combined notional value of the terminated derivatives.”

Recital 27 of MiFIR: “The obligation to conclude transactions in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation on a regulated market, MTF, OTF or third country trading venue should not apply to the components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios including existing OTC derivatives portfolios in accordance with Regulation (EU) No 648/2012 without changing the market risk of the portfolios. In addition, while it is appropriate to make specific provision for portfolio compression, this Regulation is not intended to prevent the use of other post-trade risk reduction services.”

Article 31 Portfolio Compression

1. When providing portfolio compression, investment firms and market operators shall not be subject to the best execution obligation in Article 27 of Directive 2014/65/EU, the transparency obligations in Articles 8, 10, 18 and 21 of

<sup>12</sup> See ESMA Final Report Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives, 1 October 2014. [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184\\_final\\_report\\_clearing\\_obligation\\_irs.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184_final_report_clearing_obligation_irs.pdf)

<sup>13</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02014R0600-20160701>

<sup>14</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (“MiFIR”).

<sup>15</sup> Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions. ESMA provided a technical advice to the EC.

[https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569\\_final\\_report\\_-\\_esmas\\_technical\\_advice\\_to\\_the\\_commission\\_on\\_mifid\\_ii\\_and\\_mifir.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf)

this Regulation and the obligation in Article 1(6) of Directive 2014/65/EU. The termination or replacement of the component derivatives in the portfolio compression shall not be subject to Article 28 of this Regulation.

2. Investment firms and market operators providing portfolio compression shall make public through an APA the volumes of transactions subject to portfolio compressions and the time they were concluded within the time limits specified in Article 10.

3. Investment firms and market operators providing portfolio compressions shall keep complete and accurate records of all portfolio compressions which they organise or participate in. Those records shall be made available promptly to the relevant competent authority or ESMA upon request.

4. The Commission may adopt by means of delegated acts in accordance with Article 50, measures specifying the following:

(a) the elements of portfolio compression,

(b) the information to be published pursuant to paragraph 2,

in such a way as to make use as far as possible of any existing record keeping, reporting or publication requirements.

20. Based on a technical advice prepared by ESMA<sup>16</sup>, Article 17 of the Delegated Act on Compression sets out the elements of portfolio compression. It could also be mentioned that in 2017 ISDA developed a Portfolio Compression Agreement with the objective to help certain market participants in fulfilling the requirement set in Article 17(2) of the delegated act<sup>17</sup>.

**Commission delegated regulation (EU) 2017/567**

**Article 17 Elements of Portfolio compression**

(Article 31(4) of Regulation (EU) No 600/2014)

1. For the purposes of Article 31(1) of Regulation (EU) No 600/2014, investment firms and market operators providing portfolio compression shall fulfil the conditions in paragraphs 2 to 6.

2. Investment firms and market operators shall conclude an agreement with the participants to the portfolio compression providing for the compression process and its legal effects, including identifying the point in time at which each portfolio compression becomes legally binding.

3. The agreement referred to in paragraph 2 shall include all relevant legal documentation describing how derivatives submitted for inclusion in the portfolio compression are terminated and how they are replaced by other derivatives.

4. Before each compression process is initiated, investment firms and market operators providing portfolio compression shall:

(a) require each participant to the portfolio compression to specify the participant's risk tolerance including specifying a limit for counterparty risk, a limit for market risk and a cash payment tolerance. Investment firms and market operators shall respect the risk tolerance specified by the participants in the portfolio compression;

(b) link the derivatives submitted for portfolio compression and submit to each participant a portfolio compression proposal that includes the following information:

(i) the identification of the counterparties affected by the compression,

(ii) the related change to the combined notional value of the derivatives,

(iii) the variation of the combined notional amount compared to the risk tolerance specified.

5. In order to adjust the compression to the risk tolerance set by the participants to the portfolio compression and in order to maximise the efficiency of the portfolio compression, investment firms and market operators may grant participants additional time to add derivatives eligible for termination or reduction.

<sup>16</sup>[https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569\\_final\\_report\\_-\\_esmas\\_technical\\_advice\\_to\\_the\\_commission\\_on\\_mifid\\_ii\\_and\\_mifir.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf)

<sup>17</sup><https://www.isda.org/2017/11/28/isda-2017-portfolio-compression-agreement/>

6. Investment firms and market operators shall only perform the portfolio compression once all participants to the portfolio compression have agreed to the portfolio compression proposal.

## 4.4 Reporting of PTRR transactions under EMIR

21. Although ESMA's mandate to produce this report does not mention the reporting obligation, it seems important to note that EMIR contains requirements to report all derivatives entered into under EMIR, including derivatives that would be generated as a result of running PTRR services on portfolios. The reporting requirements under EMIR may be found in the RTS on the minimum details of the data to be reported to trade repositories<sup>18</sup> and the ITS on the format and frequency of trade reports to trade repositories, where the "compression" flag was populated initially in the Field 11 of the Table 2 (Common data)<sup>19</sup> but has been moved to Field 16<sup>20</sup>.
22. Following the amendments to EMIR introduced by Refit, ESMA is in the process of amending the technical standards on reporting, including the reporting of derivatives that derive from PTRR services and a consultation paper was published in March<sup>21</sup>. The responses to the consultation are being assessed and the final report on the technical standards on reporting will likely be published later this year. The updates are two-fold. Firstly, to adapt the reporting templates to the increasing number of PTRR services that are provided. Furthermore, having regard to the fact that the ability to link reports of different derivatives related to the same business events is currently limited, changes to require reporting of an identifier univocally linking the derivatives either terminated or established through the PTRR event, will be a key improvement. Including information concerning the nature of a business event will be crucial to understand the relationship between the derivatives resulting from PTRR services not only in the event of compression, but also where any derivatives are terminated or created due to a PTRR event. The consultation responses noted that administrative transactions resulting from PTRR services should be clearly identified and reported as a non-addressable liquidity (non-price forming) and separate from trading transactions in price and transaction reporting. Otherwise market participants might be misled into assuming that such PTRR transactions represented price forming addressable market liquidity.

---

<sup>18</sup> Commission Delegated Regulation (EU) No 148/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0148&from=GA>

<sup>19</sup> Commission Implementing Regulation No 1247/2012 of 19 December 2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories.

11 Compression: Y = if the contract results from compression; N= if the contract does not result from compression.

<https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:352:0020:0029:EN:PDF>

<sup>20</sup> Commission Implementing Regulation (EU) 2017/105 of 19 October 2016 amending Implementing Regulation (EU) No 1247/2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories requires the compression flag to be indicated in Field 16.

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0105&from=EN>

<sup>21</sup> Technical standards on reporting, data quality, data access and registration of Trade Repositories under EMIR REFIT (ESMA74-362-47).

## 4.5 Exemption from margin requirements for PTRR transactions

23. This report, in line with the consultation paper, does not elaborate on a possible exemption from the margin requirements for PTRR transactions as this aspect is not within the mandate provided to ESMA. This also means that where this paper considers the benefits and risks of an exemption from the clearing obligation for certain trades generated from PTRR services, it does not affect the application of the risk mitigation techniques requirements under Article 11 of EMIR, in particular that bilateral margining would apply to OTC derivatives not cleared by a CCP (provided that the counterparties and contracts are in scope of the relevant requirements).

## 4.6 A definition of PTRR services

24. ESMA raised the question in the consultation what a reasonable definition would be for PTRR services and received some valuable feedback from respondents. All respondents (except one) in principle agreed with ESMA's descriptions of PTRR services.

25. One respondent provided the following definition of **portfolio compression** exercises:

*“Portfolio compression is a post-trade mechanism that aims to reduce the number of contracts, the notional amounts of derivatives contracts or some other measure of risk exposure without materially changing the market risk of the portfolios.”*

*Portfolio compression can be carried out bilaterally (among parties in relation to their portfolio with each other) or multilaterally among multiple entities in relation to their portfolios with all the other counterparties taking part in the compression. A compression proposal must be accepted by all participants to the proposal (the PTRR service provider is not party to the proposal) or the proposal will be void.”*

26. The same respondent provided the following definition of qualifying **portfolio rebalancing** exercises:

*“Portfolio rebalancing is a non-continuous risk reduction service that generates a market risk neutral proposal based on original risk exposures submitted by participants (two or more) and propose new risk reducing administrative transactions among two or more participants (the PTRR service provider not being a party to any of those transactions) which will reduce second order risks for participants.”*

*Portfolio rebalancing exercises are scheduled to take place at a certain time and proposed new risk reducing administrative transactions must be agreed to by all participants (or the whole exercise will be void and no new administrative transactions will be executed). A portfolio rebalancing exercise must reduce the risk it aims to reduce both across all participants and for each participant individually, based on the input data provided by all participants.”*

27. ESMA generally agrees with the two definitions provided and have summarised the characteristics of the services below based on the responses received.

	Portfolio <b>Compression</b>	Portfolio <b>Rebalancing</b>
Main purpose	In principle to reduce notional amount outstanding and the number of transactions.	Reduce counterparty risk.
Mechanism	Wholly or partially terminate trades and (eventually) replace the terminated derivatives with new trades often with reduced notional.	Injecting new trades to reduce the risk of the portfolio. No trades are terminated and replaced and the notional is increased rather than decreased.
Underlying Portfolio	Cleared or uncleared portfolio.	Uncleared or mixed portfolios.
Market neutrality	Transactions executed applying symmetric tolerances to all participants.	Market neutrality is ensured by inserting equal amounts of buy and sell exposures.

## 4.7 Characteristics of PTRR Services

28. Before assessing PTRR services, such as compression and rebalancing/optimisation services in detail, some general features of the services were listed in one consultation response, and inserted below, in order to try to provide some general characteristics of qualifying PTRR transactions and exercises.

**Market risk neutral:** The exercise does not change the directional market risk of the portfolios concerned, but rather reduces counterparty, operational, basis risk and systemic risk in respect of existing derivatives transactions. Participants submit their portfolio and a limited set of tolerances to be respected (e.g. counterparty credit limits and portfolio risk tolerances).

**Second order portfolio risks:** PTRR exercises reduce second order risks such as operational and counterparty risks for existing derivative portfolios, which ultimately reduces systemic risk. PTRR exercises do not offer a vehicle for taking market positions – their purpose is risk reduction.

**Non-price forming as non-continuous and non-real-time:** PTRR exercises' participants are not able to post bids or offers prices and no price negotiation takes place. PTRR exercises are "runs" or "cycles" that take place intra-day/over-night according to pre-published schedules; the service provider's non-discretionary methodology determines overall risk reduction opportunities.

**All or nothing:** PTRR exercises are binding on an "basis across all exercise participants.

### 4.8 Administrative transactions

- 29. The trades resulting from PTRR services do not result from a trading activity and are referred to as **administrative transactions**. A significant difference is that, to qualify as a PTRR transaction and, unlike with trading activity, administrative transactions do not result from two counterparties meeting in the market with the intention of changing their respective market positions.
- 30. One respondent provided the following illustrative description of the distinction between trading activity and PTRR’s administrative trades and summarised it as follows.

	Trading platforms	PTRR Services
<b>Price determination</b>	<b>Price forming:</b> bids and offers submitted	<b>Non-price forming:</b> market risk neutral within defined thresholds, where applicable, means transactions can take place on predetermined prices
<b>Organization</b>	<b>Continuous market</b>	<b>Periodic</b> scheduling of cycles/events
<b>Input</b>	<b>Individual trading interest:</b> comprising bids or offers	<b>Portfolio level risk positions</b>
<b>Transactions determination</b>	<b>Trader driven execution</b>	PTRR <b>service provider determined</b> calculation
<b>Impact on portfolio’s market risk</b>	<b>Trading activity:</b> individual transaction changes portfolio’s market risk	<b>Risk mitigation:</b> multilateral compound transaction either does not change market risk or negligibly changes market risk of the portfolio within predefined thresholds

### 4.9 Introduction to portfolio compression

- 31. Portfolio compression is a post-trade mechanism which aims to reduce the number of contracts, the gross notional or some other measure of risk without materially affecting the market risk of the portfolio. Although the term “without materially affecting” is not defined, it implies a restriction on how little the market risk could change following a compression trade. It is a fundamental component of the symmetric outcome between counterparties in the compression and relates to the unpredictability for participants regarding the outcome of the compression when applying tolerances.
- 32. Where portfolio compression services were initially only used to terminate trades, either in full or in part, full market risk neutrality was achieved, as only trades with matching characteristics and in asset classes with a high degree of standardisation could be included, as the transactions were not amended but merely the notional was reduced.



Hence, portfolio compression created a way to terminate trades without changing the original risk profile of the participants and compression worked on this basis for many years. Compression conducted in this way is not so much affected by the clearing obligation as trades are merely terminated.

33. Under a compression exercise, where it is not possible to find matching transactions or no efficient solution can be found by just terminating trades, accepting nearly matching trades in the compression cycle is essential to achieve the best result. Unlike trade termination, *risk replacement trades* are new trades replacing one or more compressed trades. To undertake such risk replacement trades, the PTRR service provider uses tolerances with the aim to enhance the efficiency of the compression. How efficient a compression will be depends on the level of participation and on the tolerances applied as, in essence, the PTRR service provider uses risk replacement transactions to rebuild the original risk profile with standardised transactions by replacing old slightly different transactions with standardised transactions in relation to e.g. maturity dates, rates or coupons. By undertaking portfolio compression, the counterparties can terminate large portfolios of transactions without materially changing the original risk profile that those trades represent. Recently, service providers may also capture counterparty risk under a compression exercise.
34. Such replacement trades, even if originated as part of the compression cycle, are subject to regulatory requirements in force at such point in time, and such trades become subject to the clearing obligation if applicable.
35. The definition under MiFIR<sup>22</sup> notes the need to replace the compressed transaction rather than only cancelling fully or partially trades against each other. Portfolio compression can therefore be sub-divided into two main types, the *riskless compression* and the *risk constrained compression*. The first type is characterised by exact matching cash-flow and no market risk change in the portfolio and the second type is characterised by a minimal and constrained market risk change to the portfolio.

#### 4.10 Introduction to portfolio rebalancing

36. Beside compression, other types of PTRR services are primarily rebalancing and risk optimisation services, i.e. services using offsetting transactions to reduce risk in the portfolio but there may be other established PTRR services either structured similarly or differently providing reduced risk in designated portfolios.
37. ESMA understands that rebalancing has been developed to manage risks across cleared and non-cleared portfolios as today (after the clearing obligation was introduced) parties may no longer offset their risks in the non-cleared part of the market and the cleared part of the market i.e. the credit exposure of cleared trades can no longer be netted against bilateral trades across different asset classes that are not eligible for clearing. This split

---

<sup>22</sup> In the definition of portfolio compression under Article 2(47) of MiFIR portfolio compression means a risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with another derivative whose combined notional value is less than the combined notional value of the terminated derivatives.

of the market creates imbalances within the portfolios and in the end increases IM and VM requirements. The use of rebalancing transactions aims to reduce those imbalances by reducing different risks of the portfolios, e.g. interest rate risks (delta risks) across portfolios with different counterparties and systemic risk. However, to achieve the envisaged risk reduction, the rebalancing transaction needs to remain in the portfolio it manages the risk, hence to manage risk in the uncleared portfolio the rebalancing trade would need to remain in the uncleared portfolio, i.e. it cannot be cleared and novated to the CCP.

38. Portfolios of transactions among counterparties consist of many transactions across different product types which may be highly customized. Any derivative contract with a future cash-flow has some sort of interest risk built into it (including interest rate products but also commodity swaps and equity swaps) as future cash flows come with a certain interest rate risk. Even if the complexity and breadth of transactions in a given portfolio is extensive, the risk in such portfolio can be expressed using a small number of risk measures such as delta, vega and gamma. The rebalancing transaction off-sets the identified risk i.e. the interest rate risk exposure meaning the cost to cover a change of one basis point to the interest rate of the portfolio at hand.
39. Rebalancing trades rebalance a certain risk of a portfolio, hence it is important to consider the portfolios a party has with several counterparties, i.e. Party A's portfolio with Party B and Party C are two sub-portfolios in Party A's total portfolio. The object of a rebalancing cycle is to change (increase or decrease) the non-market risk in each sub-portfolio while the overall risk within Party's A portfolio is reduced. The rebalancing transaction offsets part of the risk between the parties but rebalancing does not close out or terminate any trade in the underlying portfolio, which remains unchanged. Instead, rebalancing adds new transactions that reduces the identified risk from the existing portfolio of trades. Hence, trades resulting from a rebalancing exercise are based on the identified risk sensitivities of the portfolio and not the risk sensitivities of each of the trades, i.e. the underlying trade details. The resulting trades will be different from the original trades which contribute to the underlying risk exposure.
40. Rebalancing services are run on a multilateral basis where each participating firm provides the sensitivities<sup>23</sup> of their portfolio to the PTRR service provider. Typically, only one product type is used in a rebalancing exercise which will apply identical terms for buy and sell transactions facing different counterparties to ensure full market risk neutrality. The resulting trades will be market risk neutral across the exercise for each participant (please, see Annex 1).

---

<sup>23</sup> For example, a party has several bilateral portfolios with a few counterparties and sensitivity is often measured in relation to a change, i.e. the EUR 5yr swap rate increases by 1 basis point ("1bp"). The effect of 1bp change results in changes in Party X's exposure to a given counterparty and this would be referred to the portfolios' sensitivity to change.

## 4.11 Other PTRR Services

41. While most PTRR Services concentrate on the reduction of counterparty credit risk, other services are emerging on other risk aspects, i.e. legal and contract differences.
42. One response to the consultation notes that basis risk reduction services would not naturally fall within PTRR services as this type of PTRR service does not address bilateral counterparty risk, and as such is not negatively impacted by the current clearing obligation.

## 4.12 Market use of PTRR services today

43. ESMA notes that the recent CCP12 report<sup>24</sup> provides some noteworthy data on the use of derivatives and compression. It references to the BIS Triennial Survey and notes that this survey shows substantial growth in trading volumes of Interest Rates Derivatives (IRDs) between 2016-2019. Average daily volumes (ADV) have increased to \$6.5trn, an increase of 2.4 times since April 2016. The \$3.8trn increase in daily volumes is made up of four components:
  - a) Cleared volumes have increased by \$1.36trn.
  - b) Intra-group (aka “related party” trading) has increased by \$1.15trn per day.
  - c) Compression volumes increased by \$0.74trn.
  - d) Uncleared volumes have increased by \$0.48trn.
44. Compression and intra-group trades therefore accounted for \$1.9trn (49%) of the increase. This is significant because neither type of trade is risk-generating or market-facing.
45. As cleared volumes have continued to grow, and crucially as more participants join the clearing ecosystem, more risk becomes “compressible”. This is because more multilateral netting is possible to reduce gross notional exposures closer to the net notional outstanding. In April 2019, LCH compressed \$37trn in notional (\$1.66trn ADV). This has continued to grow, hitting \$47trn in a single month in September 2019 (\$2.24trn ADV). The BIS has estimated that compression activity alone accounted for 25% (\$0.96trn) of the overall increase in activity reported in the Triennial survey. Cleared compression volumes are “an order of magnitude greater than uncleared compression”.
46. The CCP12 report also notes that the gross amount of risk traded has increased substantially. In the past 3.5 years, the DV01 cleared has increased from around \$11bn per month to nearly \$25bn.
47. The CCP12 report also considers the uncleared market and notes that on interest rate options “trading has grown from \$30bn ADV in Q2-2016 to \$55bn ADV in Q2-2019, according to US SDR data. This increase in volume is significantly below the increases

---

<sup>24</sup> [https://ccp12.org/wp-content/uploads/2020/02/Progress\\_and\\_Initiatives\\_in\\_OTC\\_Derivatives-A\\_CCP12\\_Report.pdf](https://ccp12.org/wp-content/uploads/2020/02/Progress_and_Initiatives_in_OTC_Derivatives-A_CCP12_Report.pdf)

reported by the BIS for the global market. This may be because there is now regular compression activity in Swaptions. This portfolio maintenance activity can account for 40% of on-SEF Swaption volumes.”

48. On FX Options trading the CCP12 report notes that “IM optimisation strategies are popular. Monthly volumes in G3 NDFs, as reported to SDRs, have continued at a pace of \$130bn per month in 2019. Whether these NDFs are being transacted purely as optimisation trades or at the time of trading the FX Option is difficult to pin down. Nonetheless, the motivation for them is clear – to bring FX delta into the realm of uncleared margin rules to compensate against Options delta.”
49. In relation to legacy trades the CCP12 report note that nearly 80% of outstanding positions in IRDs are now cleared, which has accelerated in the past twelve months. FX continues to see a very small uptake of clearing at around 2%. The report also questions why more of these legacy positions are not being moved to clearing. Understanding the split of these trades into clearable and non-clearable products would help explain, for example, why so much of current Credit trades are cleared, whilst legacy risk remains bilateral.
50. ESMA notes that there has been an increase in both cleared derivatives and in compression services, that could be a sign that PTRR services so far has not cannibalised on the incentives to use CCP clearing.
51. ESMA encouraged respondents to the consultation to provide data (if possible) to assess the scope of PTRR services provided and the future of such services with or without an exemption to the clearing obligation. Some of the data received by ESMA is referenced below.
52. It is noted in the responses that PTRR services played a crucial role in reducing post-trade risks in existing derivatives portfolios, beginning with basis risk reduction in 1999, portfolio compression in 2002, and counterparty rebalancing services in 2012. It is noted that generally, the post-crisis regulatory reform agenda has accelerated the markets’ focus on risk reduction, and with it PTRR services. A key benefit to these services is the reduction of risk in the financial system. Both uncleared and cleared derivatives portfolios are optimized to minimise the build-up of basis risk, notional amounts, trade count and counterparty risk, which reduce systemic risk.

TriOptima provided the following numbers:

- TriOptima’s triReduce service results in counterparties wholly or partially terminating or replacing some or all the derivatives submitted while leaving net market exposure unchanged. Estimated risk reduction to date: > €1,500 trillion.
- TriOptima’s triBalance service results in counterparty risk management that rebalances counter-party risk exposure among multiple CCPs and bilateral relationships while leaving net market exposure unchanged. Estimated risk reduction to date: > €10.5 billion.

London Stock Exchange provided the following numbers:

Between January 2016 to October 2019, LCH has compressed approx. 13 million trades with a total notional of \$2.4 quadrillion<sup>25</sup>. In 2018, SwapClear compressed the equivalent of 72% of the total notional it cleared. The effects of compression on outstanding notional increased only by \$17 trillion while producing combined reductions in notional of over 1\$ quadrillion.

## 4.13 PTRR service providers

### 4.13.1 Supervision and authorisation of PTRR service providers and market participants

53. In view of the role PTRR service providers are playing and the size of the cycles that are being run, one consideration is whether PTRR services are also becoming, or already are, systemically important for the financial stability and should be supervised accordingly.
54. A PTRR service provider is not comparable to a CCP as the latter is regulated under EMIR in terms of risk management and systemic risk prevention. A CCP also assumes counterparty risks as it becomes the counterparty to the trades, whilst a PTRR service provider provides a package of transactions to be executed by the counterparties to the PTRR exercise to achieve the intended risk reduction. Hence, depending on the level of involvement of the PTRR service provider in the designation, application and execution of PTRR transactions, different rules and regulations may be relevant to apply to such PTRR service providers.
55. Today some PTRR service providers in the Union are authorised under MiFID II as "Investment firms" meaning "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis<sup>26</sup>". Hence, these PTRR service providers are authorised for the provision of investment services and there is no specific authorisation for providing PTRR services.
56. It is understood from the feedback received that there are still unclear aspects regarding the status of PTRR service providers and also, to some extent, of market participants using their services. This report will not address questions raised on MiFID II/MiFIR but some aspects on MiFIDII and MiFIR are included below to reflect some questions raised in the feedback to the consultation.
57. For instance, one response noted that it is not clear whether a market participant offering offsetting trades into a portfolio compression service or submitting transactions for other PTRR services would be considered to deal on own account when executing client orders which would be subject to MiFID II Art. 2(1)(d)(iv).

---

<sup>25</sup> [https://www.lch.com/sites/default/files/media/files/Compression%20Watch%20Factsheet\\_0.pdf](https://www.lch.com/sites/default/files/media/files/Compression%20Watch%20Factsheet_0.pdf) - SwapClear Compression Watch Factsheet

<sup>26</sup> Article 4(1) of MiFID II.

58. In addition, as some PTRR service providers offer their services on platforms or through systems, that technically and legally raise the question if they might be considered MTFs, regulated markets or direct electronic access to a trading venue; a respondent pointed out this should be clarified. This uncertainty, according to the feedback received, has an impact on financial institutions that are not investment firms, and that benefit from a MiFID II-exemption. The question asked is if the use of certain (or any) PTRR system could be considered as a membership or participation that would disqualify such entity from this MiFID II-exemption under Art. 2(1)(d)(ii) of MiFID II, and hence would such entity then have to apply for authorization under MiFID II.
59. It is further noted that this lack of legal certainty about the scope of the provisions of MiFID II and MiFIR with respect to the set-up of various PTRR services and the process to access PTRR services gets unnecessarily costly and consumes an unreasonable amount of time, effort and money and still potentially leaves significant legal uncertainty.

#### 4.13.2 New authorisation regime for PTRR service providers

60. The aim of the report is to investigate PTRR services and if an exemption to the clearing obligation would be useful or even necessary for PTRR services to be offered effectively in the market. The oversight and supervision of PTRR service providers is not expressly mentioned under the mandate to ESMA, however, it is an important aspect in particular where the intervention of a PTRR service provider becomes compulsory for benefiting from the clearing exemption.
61. ESMA in its consultation paper asked whether participants consider that a PTRR service provider should be specifically licensed or authorised and if so, how and what would be the benefits of such an authorisation regime.
62. The feedback received noted that some market participants considered it important to regulate this service, moreover if an exemption to the clearing obligation requires the intervention of a service provider in the compression or rebalancing exercise.
63. The ESRB noted that PTRR service providers should be subject to proportionate regulatory requirements to ensure that they act independently and according to established rules and parameters which have been reviewed by a competent authority, in particular to avoid any use that aims to circumvent the clearing obligation.
64. In terms of the supervisory surveillance that could be applied to PTRR service providers, one of the comments received is that PTRR services is an area that is still a relatively new market and for that reason, the regulatory approach to it should strike the right balance between the need to preserve financial stability and preserve innovation so that new technologies can be developed to increase efficiency in the methodologies for risk-reduction. At the current stage, respondents advocate for a regulatory approach that encourages prudent innovation and fosters international collaboration among regulators. It is also highlighted that this is a technology-based business applied to finance, rather than a financial activity itself and that this is to be taken into account when looking at the regulatory framework surrounding PTRR service providers' activities.
65. According to the feedback received, many consider that the current regulation under MiFID II which authorises some PTRR service providers as investment firms already

contains appropriate requirements regarding governance, independence, product development and conflicts of interest or under an equivalent third-country regime. In addition, respondents note the importance of having governance frameworks that ensure automatic analyses of portfolios and treatment of the outputs or proposals to the point that there is no or de minimis manual intervention to ensure independence.

66. Another aspect noted was the algorithms or methodologies used by PTRR service providers when analysing the portfolios submitted by market participants and how the provider presents the proposal for trades that will achieve the risk reduction. The question here was whether these methodologies and algorithms should be subject to a specific governance regime and if so, on which criteria would this regime be based. A respondent indicated that the algorithm used has to be subject to supervision and that this is a crucial part for the commercial success of the business model for providers as this would also enhance the confidence of market participants in the service. In addition, it is also mentioned that a robust governance would also help in building trust. However, another respondent also noted that the current regulatory status is working effectively and that it is important to preserve the confidentiality of the data managed by service providers.
67. A response noted that the independence of service providers can be assessed on an outcome basis, such as it is envisaged in MiFIR and that the tolerances and parameters under which the compression or the rebalance exercise is undertaken are not only checked by the service provider but also by the relevant participants.
68. Data sensitivity has also been noted in the consultation as PTRR service providers receive a significant amount of commercially sensitive data on portfolios of market participants. Hence, service providers' data management processes must be robust to ensure the safekeeping of the data.
69. An aspect raised in the responses, is that PTRR services are conducted globally and that most participants are large banks located in the EU, the US, Canada, UK and Japan. In order to achieve the highest levels of efficiency, PTRR exercises benefit from a big pool of participants, if the population of participants is reduced, less risk is reduced. Therefore, it is mentioned in the responses that there should be no location requirement for PTRR service providers, as any location requirement would automatically reduce the pool of eligible transactions and that having an equivalence regime for third countries is also crucial.
70. Bearing in mind PTRR services are performed across global market participants which are in different jurisdictions, the responses highlighted that policy makers and regulators should work in a coordinated manner across jurisdictions to facilitate regulatory cohesion and promote a common understanding and treatment for these services, in particular regarding exemption from the clearing obligation.
71. ESMA notes that MiFIR and the Delegated Act on Compression state that investment firms and market operators providing portfolio compression shall fulfil certain conditions to ensure the portfolio compression follows certain established rules.
72. Based on this, ESMA concludes, in line with this mandate and assessment, that ESMA may consider and propose requirements that should apply to both the service provider and the participants, to qualify the use or application of the clearing exemption.

Regulators would need to be able to access the information kept by the service providers (record keeping) and participants, including the linkages of trades that need to be reported under the EMIR reporting framework and also, if needed, to the algorithm used for the compression or rebalance cycle.

73. To generally regulate the service providers, i.e. to introduce an authorisation scheme or authorisation requirements on service providers offering PTRR services generally, would likely not fall under the mandate, as such an authorisation regime would apply to the PTRR service provider rather than being linked to the use of the clearing exemption for trades directly generated by a PTRR exercise. Also, to ensure a level playing field it would likely be beneficial for the international workstreams to assess the question of if and how to regulate service providers as a first step.
74. However, in light of the important role PTRR service providers are playing it may, depending on the level of involvement of the PTRR service provider in the designation, application and execution of PTRR transactions, be relevant to consider if such service providers should be regulated accordingly. This is in ESMA's view an important aspect, in particular where the intervention of a PTRR service provider becomes compulsory for benefiting from the clearing exemption and the amounts compressed or risks rebalanced continue to increase. ESMA will continue to assess the need to regulate service providers and stand ready to undertake any further assessments if asked to by the EC or the legislative parties.

#### 4.13.3 Participation in PTRR services

75. It is noted in the responses that a full participation of market participants to existing compression and optimisation exercises is crucial to improve the services.
76. As noted above, EMIR requires counterparties with 500 or more OTC derivative contracts outstanding to have in place procedures to analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk. This requirement is not a mandatory requirement hence ESMA's understanding is that currently the PTRR compression services are dominated by some large derivative counterparties, primarily banks, where other types of counterparties are less represented. Adding a variety of counterparties such as the buy side to a greater extent would be beneficial to the marketplace, which would be covering a wider section of the overall market for greater overall efficiencies. ESMA agrees with the respondents that a good representation in PTRR services is fundamental.
77. ESMA has considered if requiring certain behaviour, such as making it mandatory to use a service provider in order to take advantage of the clearing exemption would be advisable., however, this would create a new obligation on the market participants. Also, to strengthen the current obligation to consider using compression services with an obligation to use PTRR services or to clearly evidence why such services have not been used to reduce certain risks of the portfolio, is also creating a new obligation on the market participants. A draw-back with the use of any obligations established by law is that there is a risk that where the service providers would be providing their services voluntarily, such constructions may result in competition, access and pricing issues. ESMA anticipates that where limiting an exception to the clearing obligation to the



situation where the PTRR exercise is managed by a service provider is probably less likely to create a problem as the use of PTRR services is not strictly mandated and to use the exemption to the clearing obligation is voluntary.

78. As noted earlier in the report, accessibility to service providers is very important. Today, the accessibility has not yet been identified as a potential issue as the PTRR market has been developed mainly by the major derivatives counterparties, such as banks. However, given the aim to achieve a wider participation in PTRR services, ESMA would like to note some aspects.
79. Any limitations applied by PTRR service providers on accessibility of PTRR services could result in a reduced ability to use such PTRR services with reduced possibility to manage relevant risks. Hence any formal requirements on how to access such services by the service providers should be fair, reasonable and transparent. It is noted that the first compression may be quite resource intensive, but it is also envisaged that the following compressions should be easier to manage. In principle, it is very important that PTRR services are provided in a fair, reasonable and non-discriminatory manner.
80. Based on above, ESMA would suggest that participation in PTRR services is encouraged rather than forced at this stage and is hoping that if there is an exemption to the clearing obligation, market participants would become more inclined to participate in PTRR exercises. ESMA is considering if other “soft” engagements could be regulated, such as a requirement for counterparties to take in a quote or test portfolio compression under the existing requirement for compression under EMIR. However, such requirements are not pursued at this stage.

## 5 Noteworthy aspects of PTRR services

81. As noted above, this report aims to *investigate* portfolio compression and other available non-price forming post-trade risk reduction services which reduce non-market risks such as counterparty, credit, operational and systemic risks in derivatives portfolios without changing the market risk of the portfolios, such as rebalancing transactions. This report also aims to *explain* the purposes and functioning of such post-trade risk reduction services and if there is merit for an exemption from the clearing obligation, what conditions should apply.
82. ESMA has worked with the ESRB to investigate and explain PTRR services, and finally to assess an exemption from the clearing obligation for PTRR services. The ESRB is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. In the light of this, their contribution focuses on the implications of PTRR services in non-centrally cleared OTC markets for preventing and mitigating systemic risk and promoting the smooth functioning of the internal market.

## 5.1 List of possible conditions or requirements established in the consultation paper

83. ESMA's consultation paper included a list of possible conditions or requirements applied in other jurisdictions that provide an exemption to the clearing obligation for PTRR portfolio compression. The list was non-exhaustive and included the following aspects:
- Only PTRR transactions deriving from multilateral compressions can be exempted, i.e. more participants than 2 excluding the service provider;
  - Only uncleared transactions should be included in the portfolio for compression;
  - The compression exercise should result in reduced notional and/or risk;
  - The compression exercise should involve the same counterparties as the original transactions being compressed; and
  - The PTRR service provider should be acting independently and PTRR transactions shall be generated in accordance with a multilateral portfolio compression service provider's established rules and parameters for multilateral portfolio compression exercises.
84. ESMA asked feedback on whether these requirements were considered suitable in relation to a potential exemption from the clearing obligation under EMIR for trades resulting from portfolio compression and if the same conditions could also be applied to other PTRR services. For that purpose, the Consultation Paper included specific questions on how different potential requirements could be applied for PTRR services in the EU.
85. The feedback received shows support for the application of conditions to benefit from a clearing exemption, and in some cases ESMA has had to reconsider its initial proposal to accommodate the views of respondents. Additional conditions were suggested besides the elements listed by ESMA, such as a condition on periodicity, where a respondent suggested to include a condition to perform PTRR exercises on cycle basis with cycles of at least one trading day but not shorter. Other proposals received included the possibility to require the booking of an equal and opposite trade facing a CCP, after (or where possible within) the PTRR exercise. Some of those proposed conditions are analysed in more detail below and the conditions on PTRR services provider providing PTRR services are considered under Section 8, Summary of key features and requirements.
86. However, there are also some respondents that do not agree with the conditions because they do not support the underlying idea of considering any exemption from the clearing obligation for trades resulting from PTRR exercises.

## 5.2 General aspects of the PTRR services and feedback received

### 5.2.1 Bilateral vs multilateral PTRR services

87. Portfolio compression can be carried out bilaterally (between two parties in relation to their portfolio with each other) or multilaterally between multiple entities in relation to their

portfolios with all the other counterparties taking part in the compression. Although bilateral and multilateral compressions are similar in their approach, multilateral compressions offer increased opportunities for efficiency, as more trades across multiple parties involved can be offset. It is noted that many jurisdictions only provide for an exemption to the clearing obligation in relation to multilateral compression, possibly due to different risk profiles or due to different justifications for an exemption.

88. Portfolio compression is generally understood as a service provided by a third party (i.e. not a party to the transactions compressed). It is though important to note that the process of portfolio compression, and primarily on a bilateral basis, is something that counterparties to a derivative contract can and currently do themselves.
89. Multilateral portfolio compression of uncleared transactions is a PTRR service similar to the multilateral compression undertaken by a CCP but without a central counterparty such as a CCP at the core of the compression. Portfolio compression is today undertaken both within CCPs and between counterparties with bilateral portfolios mainly uncleared.
90. A CCP may participate in multilateral portfolio compression as a participant to the compression or the parties may after the replacement trade is identified enter into an equal and opposite trade with a CCP to shift risk to a CCP. A CCP may today also undertake separate bilateral or multilateral compression exercises within the CCP, with or without a service provider assisting the compression. One aspect to note is that compression within a CCP has the benefit of already applying standardised contract terms hence the need to use rebalancing to harmonise contract terms is less relevant.
91. In the consultation paper ESMA asked if there is any difference between bilateral and multilateral portfolio compression that would justify an exemption to the clearing obligation to apply only for multilateral portfolio compression.

#### 5.2.1.1 Feedback

92. A majority of respondents would not see a reason to limit the exemption only to multilateral compression and a minority of respondents were in favour of limiting it to multilateral exercises. In addition, two respondents would not consider the exemption necessary because it could favour a deviation from cleared to uncleared portfolios.

#### Arguments for a limitation

93. The ESRB notes that preventing the clearing obligation from being circumvented should take priority over lifting the clearing obligation to facilitate the use of PTRR services, hence exemptions from the clearing obligation should be subject to appropriate conditions to ensure that they are granted only when they bring clear financial stability benefits while also reducing the risk of misuse. On this basis, the ESRB notes that an exemption from the clearing obligation, for example, should be limited to multilateral portfolio compression.
94. One respondent argued that a multilateral only approach could avoid a loophole to the clearing obligation as an individual firm could essentially no longer determine itself whether or not its trades should be cleared and could arguably avoid market participants structuring transactions specifically to avoid the clearing obligation. It was further noted by one respondent that the more participants involved, the more the sensitivity threshold

of the service would be set to the best common denominator. It was also noted that a pure bilateral ability to exempt from the clearing obligation would mean that an individual firm could select which trades to clear or not.

95. One respondent noted in their consultation response that, theoretically, the smaller the number of participants the higher the probability that an individual firm could essentially determine itself whether or not its trades should be cleared. A reservation was also noted, i.e. if the safeguards (as suggested) would be effective to prevent circumvention where only two counterparties are involved, notwithstanding the independence of third-party PTRR service provider.
96. This is a crucial aspect, if and then how much participants can steer the outcome of the compression exercise and if this is depending on the number of participants in the compression.

Arguments against a limitation:

97. Several respondents supported and would deem it appropriate not to limit an exemption from the clearing obligation to multilateral compression and to extend it to bilateral compression as both services will aim to reduce systemic risk. Some market participants are not convinced that such a limitation would be an effective way to prevent circumvention (if at all possible) as it is difficult to assess a difference between two and three participants.
98. A respondent critical to an exemption mentioned that they do not believe that differentiating bilateral and multilateral portfolio compression would help limit the risk of regulatory arbitrage and that having a higher number of participants involved does not in itself manage the risk of having vanilla trades moved back to the uncleared space as such risk remains the same if two or more participants are involved.
99. A PTRR service provider indicated that a bilateral compression can be the result of bilateral negotiation between the counterparties without the intervention of a PTRR service provider or by using a PTRR service provider to identify the optimal compression package for both parties. Respondents point out that an exemption should be granted where the parties use the services of a PTRR provider to conduct the PTRR exercise regardless of the number of participants involved in the exercise and where the reduction proposal presented by such provider is accepted in full.
100. Several respondents supporting an exemption without any distinction for the number of participants involved instead focus on the use of an independent service provider and on the counterparties accepting in full the risk reduction proposal by the service provider to ensure control over the exercise by the provider and to avoid any possible circumvention. Hence, whether a compression exercise is bilateral, or multilateral, should make no difference as long as it is performed by an independent third-party provider with controlled tolerances and non-price forming trades as part of a bona fide compression exercise.

101. A market association mentions that the process they suggest, introducing an equal and opposite cleared transactions for each technical risk reducing transaction<sup>27</sup>, would work for multilateral compressions as well as for bilateral compression. It is noted by one respondent that a bilateral exercise would theoretically become 'multilateral' if it includes a subsequent trade shifting risk to a CCP. ESMA is of the view that undertaking equal and opposite trades with a CCP cannot transform the bilateral PTRR exercise into a multilateral, as the CCP in this scenario did not submit a portfolio for compression.

#### 5.2.1.2 Considerations

102. First ESMA has assumed that the compression is undertaken by a service provider, i.e. there will always be at least two market participants submitting their portfolios and one service provider applying the algorithm on the submitted portfolios to provide for the trades to be entered into by the parties to achieve the optimal compression based on the portfolios and tolerances set. Then ESMA has considered the arguments supporting a limitation that only PTRR transactions deriving from multilateral compression may benefit from an exemption, and the arguments against such an exemption.
103. Today, compression may be undertaken freely as the parties can agree to compress transactions and such an action would be within their contractual freedom, hence as long as the replacement transaction is not a transaction subject to the clearing obligation there would be no reason to restrict the freedom of agreement between the parties. The aspects to be further assessed are where the replacement transaction is a clearable transaction and where the parties would apply the clearing exemption (as a result, such clearable transaction would remain in the bilateral portfolio) and if a potential exemption is depending on if the compression is undertaken on a bilateral or multilateral basis.
104. ESMA notes that the most efficient compression is done on a multilateral basis, however ESMA also notes that this question is mainly limited to the compression of legacy trades and where such compression could be undertaken on a bilateral basis. Those legacy transactions, to ESMA's understanding, are located in different types of counterparties in the market. The consultation responses noted there is no difference between bilateral and multilateral portfolio compression. On this aspect ESMA notes that there is an interest among the participants to also undertake bilateral compression. The question is how big this group is.
105. ESMA notes the reservation made by the ESRB, that does not believe that exemptions should apply to the bilateral space but should be limited to the multilateral space. The main reason is that whilst the ESRB appreciates the safeguards included in the report, the ESRB still has reservations that these safeguards would not be effective enough to prevent circumvention where only two counterparties are involved, notwithstanding the independence of third-party PTRR service provider as agreements between just two counterparties are possible, even without the knowledge of the third-party PTRR service provider.

---

<sup>27</sup> This is further explained in Section 5.2.6.

106. The question is then if the number of participants can have an impact on the possibility of using the compression service to circumvent the clearing obligation. The answer could be yes, if you define circumvention as a possibility to effect the outcome of compression by submitting a limited selection of legacy trades and limit participation to a very few number of participants, and then compress the legacy trades into an exempted transaction that would be different than if more transactions were submitted to clearing. And the answer could be no, if you define circumvention as evading the clearing obligation either by not submitting transactions that used to be cleared to clearing, or that cleared trades are withdrawn from the CCP. This is based on ESMA's understanding that compression of i.e. legacy trades is not undertaken today, hence the CCP is unaffected at this level.
107. ESMA concludes that the participants do control the transactions submitted to compression but not the outcome of the compression exercise where the compression is undertaken by an independent service provider. ESMA further concludes that it is difficult to identify a reason not to allow PTRR transactions directly deriving from bilateral and multilateral compression services to apply the exemption. ESMA notes that to provide an exemption, a market need for an exemption, including for bilateral compression of portfolios, should be evidenced. As no data or numbers were provided by the market participants this makes it difficult for ESMA to assess the additional risk reduction that could be achieved if also allowing bilateral compression to use the clearing exemption.
108. Can a limitation to only multilateral compression be justified? Multilateral compression should be defined as involving more than two market participants beside the service provider. Whilst it is not clear how risks increase going from two to three participants, ESMA notes that increasing the number of participants would ensure the efficiency of a compression cycle. ESMA however has not been able to verify that allowing compression between two parties would be more prone to misuse than if three parties were to be involved.
109. Considering the feedback received, ESMA is of the view that the most important aspect when deciding on an exemption from the clearing obligation is how the compression is undertaken and the underlying principle of increased efficiency where several parties participate and the principle underlying PTRR services generally, that they are undertaken in processes involving several market participants. Based on this, ESMA does not find the arguments presented overall convincing enough to allow bilateral compression to benefit from a possible clearing exemption.

### 5.2.2 Tolerances

110. To increase the efficiency of PTRR services, tolerances are used. Tolerances are a key feature for portfolio compression (replacement transactions) but are less relevant for portfolio rebalancing, as it is further elaborated on under the section on rebalancing.
111. Under MiFIR, the compression requirements include tolerances such as including a limit for counterparty risk, a limit for market risk and a cash payment tolerance. Such tolerances should be specified before the compression and should be respected by the service provider (i.e. investment firms and market operators under MiFIR).

112. Generally, risk tolerances address how much a participant would accept as a cost in a change (sensitivity) per basis point of interest rate movement. Tolerances for compression of interest rate products are expressed in DV01<sup>28</sup>.
113. Risk tolerances are used to allow the termination or replacement of trades, particularly in portfolio compression cycles, which do not perfectly match but broadly offset in terms of risk. This is of particular importance in OTC markets with non-standardised trades, as without risk tolerances applied trade compression would be reduced to the pure netting of perfectly offsetting transactions.
114. Tolerances are also used to manage the risk of using “old” valuations to establish the replacement trades to ensure the proposals of a PTRR exercise are immune to the changes over the “acceptance period”. Typically, and as noted above, tolerances are set to levels so tight that participants are entirely indifferent to the direction the market takes during the period of the compression exercise. The participants would not know if, due to the shift in prices, they would see a valuation gain or loss in relation to total compressed notional. If the PTRR exercise have winners and losers, then only the winning participants would participate in the proposal.
115. One respondent describes tolerances in its response: “Without the application of basic risk tolerances as part of compression or risk rebalancing cycles, such exercises would either result in strongly impaired results or in uncontrolled risk exposures post-exercise. Risk tolerances therefore form an essential part of these processes. They are typically applied to a variety of market risks such as outright/first-order risks to the underlying risk factor, curve and discounting sensitivities, but equally to counterparty credit risk measures. Without such tolerances, the risk profile of an existing portfolio of derivative transactions would not be maintained, nor could counterparty credit risk exposures be kept within a stable boundary or moved to offsetting counterparty exposures. Some risk tolerances are driven by the need to accommodate different trade and collateralisation terms, both between uncleared counterparties and CCPs. [...] A prescriptive framework would not be able to accommodate counterparty-specific risk considerations, as counterparties may want to accommodate idiosyncratic risk profiles specific to their institution. An example of firm specific risk considerations are existing counterparty and market risks over and above the specific compression portfolio: the counterparty credit risk sensitivity to exchange-rate movements, which will only be partly driven by a subset of trades included (e.g. in a cross-currency compression cycle).”
116. There is a trade-off between the efficiency of the compression and the size of the tolerances of the compression, however both participants and providers have aligned interest to apply very limited tolerances and importantly the algorithm should not allow individual risk taking and it should apply small and symmetrical tolerances.

---

<sup>28</sup> Dollar Value of a Basis Point Move (“DV01”). This is a maturity-agnostic measure of risk, converting the notional traded into the change in valuation of the derivative for each one basis point (0.01%) move in interest rates.

117. ESMA notes that in cases of uncertainty and volatility there is a natural incentive to reduce the risk tolerances to a minimum in order not to be exposed to an unforeseen risk change which may adversely affect the participant.
118. It is noted that there seems to be occasions when small increases in counterparty risk may occur towards a few participants in order to facilitate greater counterparty risk reduction against other counterparties but where the overall counterparty risk is reduced. However, any result of the compression would need to be within the pre-agreed tolerances.

#### 5.2.2.1 Feedback

119. A respondent notes that there is no need for ESMA to define the tolerances as it is in the interest of both the PTRR service provider and market participants to keep the pre-defined tolerances small. However, for the case in which ESMA considers that changes in risk need to be defined, they propose to set tolerances on a product and asset class basis because what represents a small change in one product may be significant for another product.
120. Another respondent argues that market participants do not use PTRR services to take on new risks and that it is an established standard to use risk-constrained compression cycles that are non-price forming trades with the standard risk measures around +/- 5,000 USD per basis point of interest rate movement. For this reason, they do not see a need for limiting the use of a potential exemption to the clearing obligation to risk neutral PTRR exercises.
121. Another issue raised in the feedback received is that a regime of tolerances in risk would allow some flexibility that could be useful for the transition from IBORs to the new risk-free rates (see Section 5.3.3 on Standardisation and Risk-free Reference Rates).
122. Another question is if service providers themselves could see benefit in wider tolerances (as this increases the amount of trades that can be compressed within an exercise). It is noted in one of the responses that PTRR service providers should not be able to steer tolerances nor be able to manage the tolerances after being set by the participants.

#### 5.2.2.2 Considerations

123. Generally, the tolerances accepted by a participant are measured in how much change the participant would accept as a cost in a change (sensitivity) per basis point of interest rate movement. Since the idea behind a compression is not to introduce new risks or to completely change a portfolio, tolerances are usually set to very tight sensitivity for the benefit of both counterparties.
124. It seems that nearly all (if not all) respondents support some moderate tolerances to facilitate portfolio compression, but there should also be control over any misuse of the service. One respondent noted that converting IBOR based transactions/portfolios into portfolios with a higher ratio of RFR based transactions would be near impossible without using tolerances. However, ESMA notes the tolerances should be applied on each curve and not on the portfolio of trades being changed from i.e. Eonia to Ester (or any other



RFR); the change of curve is a basis trade which is price forming and should not be a usage of PTRRs.

125. ESMA also notes that participants are today motivated to put in place a framework for such tolerances as part of the derivative compression exercises. Noting that risk tolerances constantly evolve, there is a risk that a prescriptive regulated framework on tolerances would not be flexible enough to be able to accommodate for market risks and counterparty-specific risk considerations, as such tolerances of a participant would be depending on the participants internal rules and models and legal requirements (if any). For example, some participants may be very sensitive to certain risks such as FX risks whilst others are less so. Overall, there is little support from respondents to define the tolerances that can be used as incentives for predefined tolerance levels.
126. ESMA also notes that tolerances are conceptually within the contractual framework as they are used by the participants in the compression exercise to mitigate and manage risks (i.e. counterparty risk). Hence, specifying tolerances could challenge the contractual freedom as the parties to a contract may amend and terminate contracts as they wish, and counterparties must be able to manage their risks when participating in a PTRR exercise. ESMA also notes that entering into an off-setting transaction with a CCP to shift bilateral risk to CCP risk, would not require specific tolerances.
127. ESMA considers after taking into account the feedback received, that running a PTRR exercise should reduce counterparty, operational and systemic risks in respect of existing derivatives transactions and should not increase exposure on any bilateral uncleared portfolio by more than the pre-agreed tolerances (market risk). In addition, a PTRR exercise is not a vehicle for taking market positions or trading transactions. Therefore, replacement transactions need to be non-price forming, based on prices that are not updated and without entering into price negotiations.
128. In rebalancing portfolios, ESMA notes that tolerances do not play a significant role on the efficiency of the rebalancing outcome as typically, only one product type is used in a rebalancing exercise which will apply identical terms for buy and sell transactions facing different counterparties in order to ensure full market risk neutrality.
129. ESMA considers that tolerances are necessary to achieve efficiency in compression cycles. ESMA notes that there is no identified reason to limit a possible exemption to the clearing obligation to only strictly risk neutral compression and tolerances could be used to increase the efficiency of the compression.
130. ESMA does not consider it necessary to be prescriptive regarding these parameters as it is in the interest of counterparties to keep them as tight as possible while allowing room for efficiency in the compression process. Tolerances are applied symmetrically, and the compression outcome can go in both directions, i.e. either reducing its exposure or increasing it without any control about its direction by market participants. ESMA concludes that defining tolerances would not be useful as the participants are better placed to decide on the risk-level they are comfortable with.

### 5.2.3 Separating cleared and uncleared portfolios and the risk for circumvention

131. Some jurisdictions grant an exemption to a trade resulting from compression only when the original portfolio is exclusively composed of uncleared trades (including legacy transactions). ESMA asked for feedback regarding whether an exemption for clearing should only be available for portfolios of uncleared trades in relation to portfolio compression.

#### 5.2.3.1 Feedback

132. A PTRR **compression exercise** of a cleared portfolio will typically result in new cleared transactions, for which there would be no need for an exemption from the clearing obligation because the initial transactions were already in the cleared space and the PTRR would involve the CCP since the beginning. Therefore, cleared portfolios could continue to be compressed but would not need a clearing exemption and the relevant replacement trades could also be cleared without compromising “netting sets”.
133. Respondents expressed their preference for allowing an exemption for portfolios including both cleared and uncleared transactions, as it would allow for more flexibility and could encourage innovation towards new and more efficient PTRR services in the future.
134. On the other hand, two respondents acknowledged the possibility of using PTRR exercises for portfolios containing both cleared and uncleared transactions, but noted that it is reasonable to only consider an exemption for portfolios with only uncleared transactions and adds that limiting the exemption only to the uncleared sphere would not hinder the effectiveness of the PTRR exercise outcome.
135. Another point raised by respondents, with a preference for limiting the exemption only to portfolios of uncleared trades, is that this requirement, also applied by other jurisdictions, would reduce any risk of using PTRR exercises to deviate risk from CCPs to the bilateral sphere, which undermines the spirit of G-20 reforms.
136. The sceptics regarding the possibility of granting an exemption from the clearing obligation observed that limiting PTRR exercises only to uncleared portfolios would only highlight that G-20 reforms have not achieved the goal of effectively transferring vanilla risks from the bilateral portfolios to CCPs.
137. ESMA understands that the position is different for **rebalancing** as it has been developed to manage risks across cleared and non-cleared portfolios. The use of rebalancing transactions aims to reduce those imbalances by reducing different risks of the portfolios i.e. interest rate risks (delta risks) across portfolios with different counterparties and systemic risk. However, to achieve the envisaged risk reduction, the rebalancing transaction would need to be in the portfolio it manages the risk. To manage risk in an uncleared portfolio the rebalancing trade would need to remain in the uncleared portfolio, i.e. remain uncleared and not novated to the CCP and similarly to manage risk in a cleared portfolio the rebalancing trade would need to be cleared to remain in the cleared portfolio.

138. There is a strong support among respondents in favour of a potential exemption to allow rebalancing exercises to contain both cleared and uncleared portfolios.
139. Whilst the ESRB is sceptical of commingling cleared and uncleared trades, the ESRB also notes that PTRR services reduce several risks and that such benefits also materialise when these services are applied to mixed portfolios, commingling cleared and non-centrally cleared trades. Nevertheless, the ESRB notes that there could be benefits to limit the exemption to uncleared transactions to minimise the risk of it being used as a technique to circumvent the clearing obligation by creating a loophole to reverse cleared trades and that the risks of circumvention outweigh the benefits in terms of improved risk reduction from increased use of PTRR services.

### 5.2.3.2 Considerations

#### a) Cleared and uncleared in compression

140. Whilst there is support to combine cleared and uncleared portfolios in PTRR services, there is a concern expressed in the consultation responses that by applying tolerances theoretically an unlimited combination of transactions could be included in a compression cycles, without changing the market risk of the portfolio. In other words, the more different the trades, the higher the tolerance level to facilitate matching.
141. This could create an issue where compression is undertaken on a combined set of portfolios, containing both cleared and uncleared trades. A scenario identified, where an issue could potentially materialise, would be where the CCP participates in a multilateral portfolio compression as a counterparty to the compression exercise but where the replacement trades arguably could be a transaction not subject to the clearing obligation, either because this transaction is not mandated to be cleared or because it is exempted from clearing (this is not the case today), i.e. compression of swaps and swaptions. ESMA understands that it is not common today to mix cleared and uncleared portfolios in a compression exercise, nevertheless this scenario does require some further considerations.
142. For example, whilst it seems possible to compress interest rate options alongside interest rate swaps, FX options alongside FX forwards or swaps alongside swaptions in a compression this would have to fall within the applied tolerances. It would be difficult to compress different types of trades as the tolerances would not accommodate for such a compression to take place due to the fundamentals of symmetry and uncertainty. Also, there is no market incentive to widen the tolerances to accommodate compression of different types of trades. The outcome of a compression exercise depends on factors outside of the control of the individual participant, such as the trades submitted to the compression exercise by other participants and the optimisation model applied by the service provider to reach an efficient compression based on the submitted trades.
143. It is noted that no participant would know in advance in which direction the tolerances will be applied and therefore it does not seem likely that the participants could use these tolerances (even if they were wider) to steer the replacement transactions. No market participant would enter into a compression with a blank card, i.e. that the risk (and aligned costs) are unlimited. On the contrary, market participants are careful to control the outcome of the compression. It is also noted that the PTRR trades should be market risk

neutral, i.e. to replace existing transactions with a new replacement transaction would possibly result in a priceable trade in the market, i.e. where the resulting position, completely different, would have the same market risk as in a number to the original compressed transaction, the change from one trade to the other would generate a price in the market and be price driving and hence not allowed as a PTRR transaction.

144. All replacement trades should in addition be non-price forming, hence to compress swaptions with swaps would result in a cost and a new replacement transaction different from the original transaction, and such transaction would not be considered as non-price forming trade while this is one of the requirements.
145. ESMA concludes on the risk of circumvention that compression involving different types of transactions would firstly have to be within the risk parameters, i.e. the tolerances, established for the compression, and secondly meet the requirement to be a “administrative transaction”, i.e. a not price forming transaction. If it is possible to meet those requirements and still compress transactions in a portfolio consisting of both cleared and uncleared transactions, ESMA has considered other restrictions that would apply.
146. One option to manage the risk of extracting transactions from a CCP would be to restrict participation of CCPs in multilateral compression exercises, as this would eliminate the possibility for trades to be “extracted” from a CCP in a compression exercise. However this could be seen as an unfounded limitation as it would reduce the trades eligible to be included in the compression and the scope of transactions that are crucial in achieving an efficient compression.
147. Another option would be to ensure that no participant in the compression sees an increase by more than the tolerance of any risk factor in the sum of its bilateral transactions when a CCP is participating to the exercise and that all PTRR transactions must not increase by more than the tolerance in the bilateral risk in the portfolio into which it is booked.
148. ESMA, in cooperation with the ESRB, concludes that to not allow both cleared and uncleared portfolios in PTRR compression exercises would be the easiest way to manage this risk of possible circumvention, and such a restriction would be clear to the market.
149. ESMA notes that based on the feedback received in relation to compression, ESMA would recommend limiting the use of an exemption to the clearing obligation to trades resulting from a PTRR exercise that only involve a portfolio of uncleared trades. This would, reading the responses, not impact the effectiveness of such PTRR service in reducing risks.

#### b) Cleared and uncleared portfolios in Rebalancing

150. ESMA understands that today rebalancing exercises include both cleared and uncleared portfolios of transactions as one drive behind rebalancing is to allow risk to be managed across portfolios. The underlying portfolios of transactions are not changed, as rebalancing contains the function of adding transactions to be entered into between the parties to the exercise to manage and reduce identified risks, such as IR risks.

151. ESMA notes that the ESRB does not share the view that commingling of cleared and uncleared trades is advisable as the ESRB is of the view that the risks of circumvention outweigh the benefits in terms of improved risk reduction from increased use of PTRR services and their argument is that existing trades facing the CCP may be modified or cancelled. The general risk of circumvention is a concern to ESMA and therefore ESMA agrees with the ESRB that such risk should be avoided. However, ESMA has not been able to identify how circumvention would occur in the scenario envisaged of mixing cleared and uncleared portfolios in a rebalancing exercise as no transactions in the portfolios are modified or cancelled. In other words, it is not clear to ESMA how such a technique to circumvent the clearing obligation could be established and to create a loophole with the aim to *reverse cleared trades*, as the underlying portfolio of trades remains unchanged and the rebalancing trades entered into are additional trades to manage risks. In addition, such rebalancing trades are currently not cleared where managing risk in an uncleared portfolio (as this would break the netting sets).
152. Another way of seeing it is that if we allow rebalancing between cleared and uncleared portfolios, this would allow decomposing (i.e. managing) the risk in a standardised part that will be cleared and in a non-standardised part that cannot be cleared. So potentially increasing rather than decreasing the uncleared risk component. While not allowing for this to happen, would result in all the risk being non-standardised and therefore uncleared.
153. An exemption to the clearing obligation would allow the same simple process today used for FX to be also used for IR (i.e. the same product in the cleared and uncleared netting sets) and this would allow the market to move exposure from currently bilateral uncleared netting sets to cleared netting sets.
154. Based on this reasoning, ESMA considers that to be able to use the same type of transactions both in the uncleared and the cleared netting sets would limit any risk of using mis-matching transactions and limit complexity.
155. ESMA concludes that based on the feedback received on rebalancing, ESMA does not see a need to apply a similar limitation on rebalancing transactions. PTRR exercises on rebalancing are often undertaken simultaneously on cleared and uncleared portfolios and one of the main differences is that the underlying portfolios in rebalancing remains between the parties and the rebalancing exercises only adds risk-offsetting trades between the parties in the exercises, hence rebalancing is a risk management tool, and no transactions are cancelled or adjusted in the underlying portfolio within the rebalancing exercise.

#### 5.2.4 Reducing market and non-market risk of portfolios

##### 5.2.4.1 Overall risk reduction by PTRR services

156. PTRR services should reduce the risk in the overall portfolio and all risk-reducing transactions must reduce the bilateral risk in the portfolio into which it is booked.
157. **Portfolio compression** helps reducing risks such as counterparty, operational and ultimately systemic risks, by reducing the number of trades, line items and/or notional exposure between counterparties. In its report “Risk Mitigating Standards for Non-

centrally Cleared Derivatives”, IOSCO described the outcome of compression as: “*diminished operational risk for individual market participants which may, in turn, lessen systemic risk and enhance overall financial market stability*”<sup>29</sup>.

158. **Portfolio Rebalancing** is based on new trades being entered into to reduce counterparty risk by reducing a certain risk (i.e. interest rate or currency risks) identified between two counterparties without changing the trades in the underlying portfolio. This is viewed by market participants as a way to reduce systemic risk by decreasing the overall exposure in the market between counterparties.
159. The general view of the respondents is that operational risk is reduced by the reduction in exposure and by managing risk through improving the efficiency and transparency of portfolios under all PTRR services. However, some respondents noted in the responses that rebalancing exercises would in effect not reduce operational risks as the new trades entered into between the parties (and allowed with an exemption to remain in the bilateral sphere, even if subject to a clearing obligation though exempted), would create operational risks due to the fundamental issue of visibility. Transparency would be lost as such administrative PTRR transactions would be comingled with bilateral trades not subject to clearing and increase operational risks as difficult to manage and possible prone to mistakes in a stressed situation.

#### 5.2.4.2 MiFIR

160. Under MiFIR the requirement for portfolio compression is to “replace the terminated derivatives with another derivative whose combined notional value is less than the combined notional value of the terminated derivatives.” This “definition” was challenged already in the consultation response to ESMA’s Technical Advice to the Commission on MiFID II and MiFIR. Some respondents noted to this consultation that compression is sometimes performed without a reduction in the notional value of the portfolio but for the purpose of simplification as for example portfolio compression can be used to aggregate contracts into fewer contracts without reduction of the notional amount. The purpose of this exercise could be to standardise the coupons and coupons period, to make them eligible for clearing or to facilitate the management of the contract. ESMA noted in the report that the mandate by the Commission granted to ESMA referred explicitly to the compression as a mean to reduce the notional value of portfolio hence other results that could be achieved by applying portfolio compression may bring an economic benefit to the party that will reduce time and cost to manage the contracts resulting from compression however such compression exercises were not considered.
161. ESMA would agree with the remarks made at this time and based on above ESMA is hesitant to this description for PTRR services, ESMA notes that the notional should be equal or reduced on a portfolio basis for compression exercises, however if equal, other risks should then be reduced.

---

<sup>29</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD450.pdf>

162. For portfolio rebalancing the position is different and this wording would not be a suitable description of portfolio rebalancing as no trades are terminated and replaced and the notional is increased rather than decreased as new trades are added though the rebalancing exercise however the bilateral counterparty risks should be reduced.

#### 5.2.4.3 Reducing risk under MiFIR

163. In Recital 27 of MiFIR it is further stated that the obligation to trade derivatives that have been declared subject to the trading obligation on eligible trading venues should not apply to the components of non-price forming post-trade risk reduction services **which reduce non-market risks in derivatives portfolios including existing OTC derivatives portfolios in accordance with Regulation (EU) No 648/2012 without changing the market risk of the portfolios**. ESMA notes that the broad reference to post-trade risk reduction services was not included under Article 31 as further noted in Section 3, Background.
164. One definition of portfolio compression provided in the consultation responses is “a practice by which market participants transfer their exposure allocation – without changing it substantially – between existing or new counterparties in order to adjust exposures between their counterparties, either to reduce risk held against a particular counterparty or to bring overall exposures down”<sup>30</sup>.
165. The non-market risk of a portfolio is for example operational, counterparty, and systemic risk, also referred to as second order risks. The Recital in MiFIR requires for a transaction to fall under the exemption under MiFIR *that the non-market risks should be reduced overall in the portfolios*. The Recital also notes that the **market risk should however not be changed**.

#### 5.2.4.4 Feedback

166. The question is whether all counterparties whose portfolios in which PTRR transactions are booked need to demonstrate a reduction in notional amount and/or risk and whether there should be a requirement for this to be documented by the PTRR service provider and/or by the participants in the PTRR exercise.
167. Regarding compression, respondents indicated that the total net notional output after the exercise should be lower than the net notional input and that ideally, this should be the case for each and every participant. However, it is also mentioned that in some cases (described as rare in frequency), a given counterparty could see its notional unchanged or risk slightly increased while the overall notional in the portfolio is reduced. This would report a higher benefit for the rest of the participants leaving one party “worse-off”.
168. Another respondent noted that in order to benefit from a clearing exemption, the PTRR exercise should comply with three criteria that are interconnected, the first being to

---

<sup>30</sup> ESMA notes the reference to new counterparties and would not agree to allow for an extension of the parties to a portfolio compression exercise beside the possible involvement of a CCP that may be involved in the process of shifting bilateral risk to the CCP, but the parties submitting portfolio of trades for compression should remain the same.

reduce counterparty credit risk, operational and basis risks of the derivatives portfolio submitted to the PTRR exercise. The second, to be systemic risk neutral, and third, be credit risk neutral so the outstanding derivatives are not impacted by the failure of the provider of the PTRR services.

169. In order to introduce a requirement to reduce risk in portfolios submitted to a PTRR exercise, one suggestion from the feedback received points at requiring PTRR services to reduce the specific risk exposure targeted in the exercise.

(a) In a compression, the service provider should be required to reduce (or leave unchanged) the outstanding notional, number of trades or any other identified risk in the portfolio.

(b) In a rebalancing, the service provider should be required to reduce the outstanding counterparty risk exposure, reducing the initial margin. Another respondent also indicated that in addition to ESMA's proposal the total bilateral margin calculated according to independent models such as the Standard Initial Margin Model ("SIMM") should also be included as a metric.

170. To supervise the risk reductions, a suggestion is for the service providers to do a list of risk reducing transactions to be applied to the overall risk in the portfolios submitted and to introduce the requirement to demonstrate that the risk has been reduced accordingly after the running the PTRR cycle. In addition, as the service providers have no knowledge of the full portfolios of their clients and of the local clearing obligations, it is in the interest of the banks involved to show that the risk of their bilateral portfolios has been reduced and that, if applicable, for all risk reducing or replacement transactions that are exempt from the clearing mandate, equal and opposite trades on a net basis have been booked at a CCP to shift residual risk to the CCP. ESMA also notes a suggestion raised by a respondent that the measures to determine if the risk has been adequately reduced should be developed by level 2 regulation.

#### 5.2.4.5 Considerations

171. The feedback received shows a broad support for including a condition on risk reduction as a requirement to benefit from a clearing exemption for trades resulting from a PTRR exercise. However, regarding the metrics to be considered, ESMA is of the view that it is more effective to focus on the risk exposure than on the notional amounts to determine when a PTRR service complies with the objective of reducing risk. Therefore, the condition to be applied to benefit from the exemption could be that the total risk exposure cannot increase on any bilateral portfolio more than the tolerance agreed with the participants. Respondents agree with the proposed approach.

172. Based on this reasoning, ESMA considers that where a compression exercise should not result in an increased non-market risk overall in the portfolios, some risks may remain unchanged or increased in the underlying portfolios (but only if the risk overall is not increased). However, in order not to change the market risks of the portfolios this means that the compressed transactions must perfectly match. This type of riskless compression severely limits the scope of the compression otherwise obtainable by risk constrained compression, i.e. allowing similar (but not identical) transactions to be



compressed against each other and replaced by new transactions with reduced non-market risk.

173. At the level of individual counterparties, ESMA considers that a PTRR exercise should not leave a given counterparty with a higher notional (in compression) or a higher risk exposure (in rebalance) than before the PTRR exercise, even when the overall notional or risk exposure has been reduced. To this end, ESMA notes that a counterparty could see its risk unchanged but not increased as a result. This limitation could affect the efficiency of the exercise but only in few cases as the situation where a counterparty increases its notional has been reported as rare in frequency. Therefore, ESMA considers it is in the interest of all participants to be protected against a worse-off outcome as it would not significantly impact the efficiency of the exercise.

### 5.2.5 Same Counterparties

174. One of the current requirements in other jurisdictions is that the PTRR exercise should involve the same counterparties as the original transactions being compressed. ESMA wanted to further understand if this practice also applies for the PTRR services offered today, or possibly to be offered in the future, and any risks with deviating from this principle. For example, ESMA wanted to know to which extent a CCP can be added to the PTRR exercise even if it is not a party to one of the original trades; or if other counterparties could be added to the PTRR exercise to achieve a higher compression or risk reduction output.

#### 5.2.5.1 Feedback

175. The majority of respondents agreed that only the original counterparties participating to a PTRR exercise can enter into the trades resulting from the PTRR exercise, the replacement trades or rebalancing trade. A respondent noted that this restriction would help avoid PTRR service providers from offering what could be seen as a new brokerage service. Only one respondent did not see a need to impose that limitation.
176. In a compression, the outstanding risk is reduced by compressing existing transactions or by introducing new risk reducing transactions. Both parties to a transaction need to agree to compress the transaction.
177. In a rebalancing exercise, counterparties to each replacing transaction have to be pre-defined, for example when counterparties enter into an Interest Rate Swaps to reduce bilateral Interest Rate DV01 risk leveraging on the exemption from the clearing obligation for such rebalancing trade. The exposure will only be rebalanced among participants (outside the CCP) that have actively decided to take part in a rebalancing exercise, which refers to the fact that the parties to the replacement trades have to be the same ones that initially submitted their portfolio for rebalancing.
178. A respondent highlights that given the role of CCPs and the mechanics of central clearing, the inclusion of a CCP allows for risk to be shifted to a CCP, this is assessed below under “An “equal and opposite” trade booked facing the CCP.

#### 5.2.5.2 Considerations

179. ESMA considers that the trades entered into as a result of a PTRR exercise can only be booked by the counterparties to the original trades in the portfolios submitted to the PTRR run. This requirement allows for the reduction of risk while preventing the possibility for market participants to be involved in the compression exercise and benefit from the exemption for a purpose unrelated to the PTRR exercise.
180. However, where in the case of compression and rebalancing, after the relevant PTRR transactions have been entered into, risk is shifted to a CCP (not participating in the PTRR exercises) this is not adding a new participant to the exercise, as this occurs after the PTRR compression and rebalancing has been computed.

#### 5.2.6 An “equal and opposite” trade booked facing a CCP

181. The consultation paper investigated whether participants to a PTRR service also enters into transactions with a CCP to replace bilateral credit risk with CCP risk and if this is undertaken today.

##### 5.2.6.1 Feedback

182. One of the proposals received from market participants and that seems to have support from a major group of users of PTRR services is the possibility of entering into equal and opposite trades with a CCP after a PTRR service, i.e. shifting the bilateral risk of a rebalancing transaction to a CCP or shifting residual risks in a rebalancing service (after booking the trades proposed by the service provider) to a CCP. By doing this, the participants to a PTRR exercise would book the trades proposed to optimise their portfolios and in a subsequent (in some cases almost simultaneous) also book an exactly offsetting opposite net trade into their cleared portfolios facing a CCP. This would on one side reduce the exposure of uncleared portfolios even further and on the other, increase the proportion cleared portfolios and of risk exposure towards the CCP.
183. Hence, the proposal received from an association representing market participants (users of the PTRR exercises) proposes that for each transaction booked by a counterparty resulting from a PTRR exercise, an equal and opposite transaction on netted basis should be booked facing the CCP. According to the proposal, the bilateral transactions would continue existing and both counterparties would book additional transactions facing the CCP, which would offset the bilateral risk exposure and shift risk from the bilateral uncleared portfolio to the CCP.
184. According to the proposal, this is an example of how this mechanism would work:

*If as a result of a PTRR exercise, counterparties A and B are proposed to enter in a risk reducing transaction, for instance an interest rate swap (assuming there is an exemption from the clearing obligation), and if both counterparties agree to the outcome proposed by the PTRR service provider, both would book the IRS in their bilateral portfolios. In addition, they would book a second trade, an equal and opposite risk reducing IRS, for which they would both face a CCP.*

185. In line with the concern described on the unnecessary accumulation of trades (build-up of transactions), the proposal also considers that to avoid unnecessary booking (and subsequent compression) of large numbers of offsetting technical risk reducing transactions, “PTRR service providers should pre-compress CCP-facing transactions such that the CCP facing risk is booked efficiently, while keeping records of the corresponding bilateral and cleared IRS to be able to trace compliance with this condition”.
186. In their view, when the scope of the clearing obligation expands, this future-proofed approach automatically expands with it. It would also automatically cover other asset classes, such as FX and Equities as and when the clearing obligation is extended in scope to cover those products.

#### 5.2.6.2 Considerations

187. ESMA sees value in this proposal as it shifts risk from bilateral portfolios to the CCP, in line with the policy objectives and G20 measures.
188. However, this is a transaction outside of the compression exercise and is merely ensuring the new **replacement transaction** (where an exempted transaction is used) is mirrored by an equal and opposite trade facing the CCP to mitigate the fact that the replacement trade is exempted from clearing but a clearable transaction.
189. Equally, ESMA further understands that once the **rebalancing transactions** have been identified in the exercise, the parties to the exercise may also consider if and how the net positions of the rebalancing transactions should be followed by offsetting or risk shifting transactions with a CCP. Hence any net bilateral exposure should be “managed” by an equal and opposite trade with a CCP and then in effect shifting risk to the CCP by using, for example, FX/NDFs transactions as such transactions can be used both for cleared and uncleared netting sets.
190. The aim would be to merely shift bilateral risk to the CCP. To ensure that this shift of risk is made in an adequate manner the net position of the new trades in the bilateral portfolio should be equal to the net position of the new trade(s) facing the CCP.
191. Those “equal and opposite” trades are additional to the rebalancing exercise and would hence increase the notional outstanding in the cleared portfolio but would be essential in achieving the aim of shifting risks to the CCP, where possible, and this is simplified by allowing cleared PTRR rebalancing transactions both in the uncleared and cleared portfolios as no basis risk remains between the two.
192. ESMA supports the principle that the participants of the PTRR exercise should shift bilateral risk to the CCP after a PTRR exercise (or where relevant within the rebalancing exercises if a CCP participates directly in the exercise) if the PTRR trades uses the exemption. Hence, compression and portfolio rebalancing (on a net basis) should be complemented (where this is not already achieved in the rebalancing exercise) by an equal and opposite trade with a CCP to shift the risk from the bilateral PTRR transactions to the CCP. It would be the obligation of the service provider to identify such risk shifting transactions to the CCP (where possible, i.e. where there is a risk outstanding after the PTRR service has been completed) and provide them to the participants to be executed

as a complementing trade to the PTRR exercise (where such trade is not part of the rebalancing exercises). ESMA though notes that this condition could have a limited impact due to the risk neutrality of the rebalancing exercise.

193. This proposal of “equal and opposite” however raises the issue regarding access to clearing, ESMA understands that there could be limitations as how to gain access to a CCP for the participants of the PTRR exercise. This could be the case where the compression or rebalancing is done on uncleared portfolios as all participants to such exercise may not have a relationship with a CCP and it may also be the case that the participants have relationships with different CCPs. ESMA therefore notes some possible restraints on the accessibility to CCPs by some entities. Based on this, a requirement to enter into “equal and opposite trades” may be too burdensome and disproportionate to apply to such entities. In the communication with the market this is not considered a problem. However, ESMA is cautious if to mandate certain behaviours as such requirements should not result in an accessibility issue of the PTRR services as this would be in contrast to the aim of an exemption, which is to facilitate access to PTRR services for all derivative counterparties in the market. It must be taken into account that where a participant to the PTRR exercise is not a clearing member of a CCP, it may face more obstacles accessing the CCP and it may impact its capacity to enter into an “equal and opposite” trade with the CCP. ESMA acknowledge that where a participant to the rebalancing exercise is not a clearing member of a CCP, and may have to access the CCP through a clearing member or through a client providing clearing services, this may have an impact on the possibility to enter into an “equal and opposite” trade with the CCP.
194. Finally, ESMA sees merit in allowing for traceability that links the equal and opposite cleared transactions to the trades resulting from the PTRR exercise by using the reporting mechanisms under EMIR.

### 5.3 Use of Portfolio Compression

195. To further assess PTRR services, ***this section aims to explain the purposes and use of portfolio compression.*** Multilateral portfolio compression operates both in the cleared and uncleared space. The main compression is across trades in a cleared portfolio at a CCP, however, compression is also used in the uncleared space. The focus of this report is on compression resulting in PTRR transactions subject to the clearing obligation. In cleared portfolios this is not a concern, however where the underlying portfolio consists of uncleared trades, such transactions resulting from the PTRR exercise will be allocated in the cleared portfolio (facing the CCP), rather than to the bilateral portfolio they originated from. Hence, the compression exercises will today (without an exemption to the clearing obligation) not be designed to result in a replacement transaction subject to the clearing obligation where the portfolio of compressed transactions are uncleared.

#### 5.3.1 Legacy trades

196. Today, the main reason for exempting certain clearable replacement trades focuses on compressions of legacy trades (i.e. trades that were entered into before the clearing

obligation was put in place) and hence, they were not subject to clearing obligation but if compressed today, the replacement trades would now be subject to the clearing obligation. Such replacement trades would lose the legacy derivative status if replaced through a portfolio compression exercise.

197. The scope of legacy trades subject to clearing obligation is today relatively small however CCP 12 concluded in its Report “Progress and initiatives in OTC derivatives” from February 2020 (the CCP12 Report)<sup>31</sup> that there still remains a stock of legacy trades that remain uncleared.
198. Based on this reasoning, ESMA concludes that there are still some types of legacy transactions that would benefit from compression if an exemption were to be in place. Some participants have not yet been able to compress such legacy transactions in other ways, using more complex solutions, which would not trigger the clearing obligation for these legacy transactions.

### 5.3.2 New clearing mandates

199. Another aspect is if new “legacy trades” would be created in the future where new clearing obligations may be established. It is noted that this aspect could possibly be managed when the clearing obligation is established but to envisage certain solutions at this point in time, for example staggered implementations or exemptions for such replacement trades, is very difficult. Also, such solutions would not likely be within ESMA’s mandate when expanding the clearing obligation, as per the experience with the assessments previously done in ESMA reports<sup>32</sup>.
200. Based on this reasoning, ESMA concludes that the better place to assess a possible exemption to manage future legacy trades is in this final report.

### 5.3.3 Standardisation and Risk-Free reference Rates (RFRs)

201. While most PTRR Services concentrate on the reduction of counterparty credit risk, other services are emerging on other risk aspects. The use of replacement trades in portfolio compression could allow the transition of a greater number of existing trades into new standardised terms. However, while the industry is engaged in a transition from IBORs to RFRs, one important aspect to note here is that PTRR transactions can only be non-price forming. Therefore, replacement trades cannot be used as a way to manage basis risks between different reference rates, since the basis risk have a price in the market.
202. One respondent noted the reference to IBOR replacement in the following explanatory text from the recent proposed rulemaking in the US: “One reason that the agencies are

---

<sup>31</sup> [https://ccp12.org/wp-content/uploads/2020/02/Progress\\_and\\_Initiatives\\_in\\_OTC\\_Derivatives-A\\_CCP12\\_Report.pdf](https://ccp12.org/wp-content/uploads/2020/02/Progress_and_Initiatives_in_OTC_Derivatives-A_CCP12_Report.pdf)

<sup>32</sup> See Classes of derivatives subject to the clearing obligation and the respective Final Reports on ESMA’s website: <https://www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation>

permitting amendments resulting from compression exercises is to reduce the operational burden associated with IBOR replacements. While protocols to amend non-cleared swaps that reference an IBOR or another discontinued rate are in development, there is a possibility that counterparties may choose to replace portfolios of IBOR-based, non-cleared swaps with replacement swaps generated through compression exercises.<sup>33</sup>

203. Some respondents noted that an exemption to the clearing obligation would ensure service providers to assist the market in the benchmark transition and that it is important to exclude such risk replacement trades from any clearing obligation, as the clearing obligation may create a disincentive to the use of such trade portfolio compression. Allowing for legacy trades to be exempted from a future clearing obligation could be valuable in support of the benchmark transition efforts over the next years but it is unclear how valuable it will be or if the market will be able to adjust to the new RFRs without legacy trades remaining.
204. ESMA provided in December 2019 a statement clarifying that the introduction of fallbacks to provide clarity in the event that benchmarks used in the relevant contracts change materially or cease to be provided and how this would impact OTC derivative contracts in relation to the requirement to exchange collateral<sup>34</sup>. The statement notes that amendments made to outstanding uncleared OTC derivative contracts (legacy contracts) for the sole purpose of introducing fall-backs should not create new obligations on these legacy contracts. In particular, margining requirements should not apply to these legacy contracts where they were not subject to those requirements before the introduction of the benchmark's fall-backs<sup>35</sup>.
205. Based on this reasoning, ESMA considers that the approach in the ESMA statement should cover the changes necessary to accommodate for the transition without creating new trades that could be subject to the clearing obligation. In addition, there is today no clearing obligation on RFRs and to establish a clearing obligation the requirements on liquidity and standardisation would need to be met. Hence, the need to provide an exemption for legacy trades in relation to the transition to RFRs seems to ESMA less relevant.

## 5.4 Use of Portfolio Rebalancing

206. To further assess PTRR services, this **section aims to explain the purposes and use of portfolio rebalancing**. As noted above, rebalancing has been developed to manage risks across cleared and non-cleared portfolios and the use of rebalancing transactions aims to reduce different risks such as interest rate risks (delta risks) across portfolios with different counterparties and systemic risk. However to achieve the envisaged risk

---

<sup>33</sup> <https://www.occ.treas.gov/news-issuances/federal-register/2019/84fr59970.pdf>

<sup>34</sup> [https://www.esma.europa.eu/sites/default/files/library/esas\\_2019\\_19\\_statement\\_on\\_the\\_introduction\\_of\\_fallbacks\\_in\\_otc\\_derivative\\_contracts\\_to\\_increase\\_contract\\_robustness.pdf](https://www.esma.europa.eu/sites/default/files/library/esas_2019_19_statement_on_the_introduction_of_fallbacks_in_otc_derivative_contracts_to_increase_contract_robustness.pdf)

<sup>35</sup> There is also a related provision regarding benchmarks, amending EMIR, in the political agreement on the CCP Recovery and Resolution legislative proposal.

reduction, the set-off transaction/rebalancing transaction would need to be in the portfolio it manages the risk, hence to manage risk in the uncleared portfolio the rebalancing trade would need to remain in the uncleared portfolio, remain uncleared and not novated to the CCP.

#### 5.4.1 Instruments to use for rebalancing

207. To use the right type of instrument to set off an identified risk in the portfolio is crucial as to use the most optimal type of instruments minimise complexity and maximise the ratio between risk reduction and added notional. A participant would use, for example, an IRS to set-off identified interest rate risks in a portfolio and FX NDFs to set-off FX risks identified in the portfolio.
208. As noted above, the most common risk is known as “interest rate delta risk” and it arises whenever you have a future cash flow. This delta or interest rate risk is best hedged with an interest rate swap hence the market would like to use IRS to manage an interest risk in an uncleared portfolio and this is today problematic as such a transaction would be novated to the CCP and not remain in the bilateral sphere off-setting the risk in the bilateral uncleared portfolio.
209. Therefore, whilst IRS would be the obvious choice for rebalancing bilateral uncleared IR delta exposures, they are not available as IRS cannot be inserted into uncleared bilateral netting sets as those transactions will eventually end up facing the CCP instead. To avoid using an instrument that is subject to the clearing obligation, other types of instruments can be used to offset simply interest rate exposures, such as swaptions<sup>36</sup> with the result that such trade results in increased amount of notional required to reduce risk and also introduces new risks and complexity. It is noted in the responses that enabling an IRS to hedge the “delta risk” and for such trade to remain in the same portfolio as it hedges (i.e. non-cleared) can reduce systemic risk.
210. There are also more complex risks such as vega, gamma and other curvature risks but such risk management transactions are often used by more sophisticated parties using more complex instruments not subject to the clearing obligation.
211. ESMA notes that whilst it is technically possible to undertake risk management of IR delta exposures with other rebalancing transactions not subject to the clearing obligation this generates increased complexity as the process gets more difficult to manage as, for example, swaptions involve an exercisable option.
212. As the underlying asset or risk factor fluctuates over time this will require the counterparty to rebalance on a regular basis adding yet more new trades to the portfolio. Ultimately, this would potentially lead to a build-up of non-cleared vanilla rebalancing trades. To mitigate this build-up of transactions, as it might add risk and complexity to the portfolio, these rebalancing transactions are short dated to limit any build-up of rebalancing

---

<sup>36</sup> Using call-put parity, one can use two European swaptions, a Payer and a Receiver, to replicate a swap.

transactions and compressed at a regular basis through the rebalancing exercise. Today EMIR requires portfolio compression to be undertaken at least twice a year.

#### 5.4.2 The role of a CCP in rebalancing

213. The role of a CCP participating in a rebalancing exercise can be two-fold. A CCP may participate in portfolio rebalancing and bring in its portfolio in the rebalancing exercise and hence to include the CCPs in the rebalancing would result in rebalancing containing both cleared and uncleared portfolios. A CCP can also assist in the rebalancing exercise for the sake of allowing transfer of risk from bilateral portfolios to the CCPs, this is further assessed under section 5.2.6 An “equal and opposite” trade booked facing a CCP.

## PART 2

### 6 Exemption to the clearing obligation for certain PTRR transactions

214. After considering what PTRR services are and why they are used in the market, this section is looking into whether the clearing obligation in some cases might limit the use of PTRR services. The second part of this final report assesses the need to clear PTRR transactions or if they should be exempted from clearing, in order to manage systemic risk.
215. This section also assesses to what extent any exemption from the clearing obligation for such services discourages central clearing and may lead to counterparties circumventing the clearing obligation.
216. The ESRB noted in their response that they, from a financial stability perspective, consider exemptions to the clearing obligation should be considered only when they contribute to reducing systemic risk, subject to appropriate safeguards to avoid the risk of regulatory arbitrage. In principle, from a financial stability perspective and without prejudice to the overarching objective of promoting central clearing, exemptions from the clearing obligation of trades resulting from PTRR services could be allowed where they demonstrably reduce systemic risk compared to a scenario where such exemptions are not granted. The ESRB notes the following in their response to the consultation.

*“Overall, PTRRS designed to reduce outstanding risk contribute to making the non-centrally cleared OTC markets safer and more resilient to shocks from the failure of market participants. The ESRB supports the widespread and frequent use of post trade risk reduction techniques. By reducing the number of contracts in bilateral OTC derivatives portfolios and the size of the aggregate gross notional exposures, as well as by shortening the intermediation chains, these services reduce the operational complexity of the risk intermediation network by making it more resilient to the possible defaults of single nodes, reducing interconnectedness and increasing the transparency of bilateral exposures. The benefits also materialise when these services are applied to mixed portfolios, commingling cleared and non-centrally cleared trades.”*



## 6.1 Limiting factors for PTRR services

217. As eluded to above, ESMA has identified the following limiting factors for the use of PTRR services today:

**Clearing obligation:** It is noted in the responses that the clearing obligation today limits the use of PTRR services due to the requirement to have the PTRR transactions located to the cleared netting set with a CCP rather than the bilateral uncleared netting set with the result that both the replacement transaction and rebalancing transaction would be detached from the original trades and portfolios.

**Participation:** Another aspect that effects the efficiency of PTRR services is the level of participation in the compression or rebalancing service. The greater the participation, the larger the network of trades and portfolios for compression and rebalances transactions to be identified. Hence the aspect of participation is important from an accessibility perspective and it is noted in the responses that the use of complex transactions (i.e. swaptions) in rebalancing to avoid transactions subject to the clearing obligation probably results in a lack of participation of less advanced market participants and this results in less efficiency of such exercises but also a reduced ability to manage certain risks by such less advanced counterparties.

**Amount of trades and the nominal amount:** Also, the amount of trades and the nominal amounts of the trades submitted to a PTRR exercise matters as an efficient PTRR exercise would be based on a high number of participants as well as every participant submitting as much transactions as they can within the set boundaries for the exercise. To reach an increased efficiency each of the participants should submit all possible trades as if only part of the trading books or portfolios are submitted then there are limitations effecting the outcome of the exercise as i.e. compression is a cash flow matter and works its best with a high number of trades submitted to the exercise and you can match as much as possible.

## 6.2 PTRR services today

218. As noted above, EMIR as currently in force, requires compression to be undertaken and that the trades resulting from portfolio compression are cleared if they fall under the clearing mandate and does not provide for any kind of exemption from the clearing obligation for PTRR transactions.

219. The question raised in the market is how market participants can be fully incentivized to perform portfolio compression (which is also a requirement under EMIR) without an exemption to the clearing obligation. It is noted that lack of exemption limits portfolio compression to operate in the most efficient way and does not appear perfectly aligned with the approach adopted by MiFIR.

220. It is also noted that other jurisdictions have exempted from the clearing obligation trades resulting from portfolio compression activities (provided that specific conditions identified at regulatory level are fulfilled).

221. It is also noted, and as referred to above, that the problems with treating PTRR transactions as normal trades and not providing an exemption from the clearing obligation is not a new issue and that it has been raised in the past<sup>37</sup> and to ESMA in particular, during the consultation process performed in 2014, where several respondents explicitly underlined the need to exempt, inter alia, trades generated as part of post trade risk reducing initiatives such as multi-portfolio compression runs or counterparty risk rebalancing.

## **6.3 Need for an exemption to the clearing obligation for PTRR services**

### **6.3.1 Portfolio compression**

222. Often, compression covers cleared trades only and any replacement trades or new trades (including partial trades) would also be cleared and the clearing obligation presents no challenges in this regard.
223. Most compressions for uncleared portfolios involve non-clearing eligible product types like cross currency swaps, FX forwards, Interest Rate Swaptions. Today, there is no clearing obligation for these product types and therefore, no exemption from the clearing obligation is needed.
224. Portfolio compression is also carried out through partial or total cancellation or unwinds of uncleared legacy trades where no new transactions are created, i.e. no replacement trades and therefore, no exemption from the clearing obligation is needed.
225. Where replacement trades are used in an uncleared portfolio, they would “break” the netting sets (if such transactions are subject to the clearing obligation), because mandatory clearing would allocate such replacement transaction to a cleared netting set i.e. with the CCP as the counterparty to the trade. This means that the PTRR trade would not end up replacing the positions it was supposed to within the uncleared portfolio following the compression. Hence, where replacement trades would require the use of a cleared product, such as an IRS to replace the portfolio, e.g. for legacy trades, they cannot be fully undertaken today.
226. An example of this is noted by one respondent in relation to compression of portfolios consisting of CDSs on indices undertaken today, i.e. compressions of uncleared trades which are subject to a clearing obligation. Currently, when operating unwinding proposals on any remaining legacy uncleared trades, the service does not generate any replacement trades but only full and partial terminations. The ability to include replacement trades or new trades to legacy portfolios would enhance the unwinding efficiency and operational simplicity. A clearing exemption would be beneficial to market participants.

---

<sup>37</sup> See ESMA Final Report Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives, 1 October 2014. [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184\\_final\\_report\\_clearing\\_obligation\\_irs.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184_final_report_clearing_obligation_irs.pdf)

### 6.3.2 Portfolio Rebalancing

227. For PTRR services such as rebalancing and optimisation services, where the offsetting trade is not subject to the clearing obligation, for instance if a swaption or a swap in a currency not in scope of the clearing obligation is used, the trade can remain within the uncleared portfolio. However, where the PTRR trade is subject to the clearing obligation, it will be allocated to the cleared portfolio. Therefore, the replacement trade will not be part of the uncleared portfolio and it will not reduce the risk in the underlying portfolio. Hence, under the current clearing mandate (not allowing exemptions for portfolio rebalancing), such rebalancing exercise would not be possible.
228. To address the issue of the allocation of PTRR transactions to cleared portfolios, i.e. “broken netting sets” or detached rebalancing transactions, it is argued that the replacement or rebalancing trades should not be subject to the clearing obligation as the transaction is only entered into as part of a PTRR exercise, i.e. the PTRR trade would not have occurred had the PTRR exercise (replacement or rebalancing transactions) not been undertaken.
229. Allowing this exemption enables market participants, to reduce the market risk in the uncleared netting sets, thereby reducing systemic risk.

## 6.4 Respondents critical to the need for an exemption to the clearing obligation

230. A few respondents are critical to a clearing exemption for transactions that are the direct result of a PTRR services and provides different reasons why an exemption would not improve the financial stability. Respondents note in their consultation responses that PTRR services have never been more used than today hence there would be little gains from such an exemption, however the respondents do not quantify this. Such respondents do not think that transactions resulting from PTRR services would need to be exempted to support the growth of those services and instead they see significant downsides with such an exemption.
231. It is noted that not granting an exemption was done intentionally to disentangle the highly standardized trades for central clearing from the more complex exotic trades to be dealt with under the bilateral margin rules as per the G20 Reforms and that with an exemption uncleared portfolios would always have a mix of ‘vanilla’ and ‘exotic’ trades going-forward, and thereby creating mixed portfolios in contradiction to the intentions of the G20 reforms which sought to shed light on overly complex OTC derivatives markets.
232. A reference is made, by a respondent, to the fact that a number of jurisdictions have decided to clarify that legacy trades prior to the clearing obligations are exempt but also that no major jurisdiction has yet opted for an outright exemption from the clearing obligation of new trades resulting from PTRR services. Hence the need for an exemption for legacy trades is challenged and it is noted that all trades concluded prior to the clearing obligation can already be compressed today and that new trades should not be used to change the nature of the exposure of portfolios composed of old trades.

233. The need for an exemption is also challenged by noting that delta hedges i.e. rebalancing transactions can also be done via complex exotic trades, primarily swaptions, rather than via simple vanilla trades to avoid the clearing obligation. While it is noted that such trades are indeed riskier than plain vanilla trades, it is noted that they are not riskier than the transaction they are hedging in the first place. On the same thought it is noted that if there are financial stability concerns it is recommended that the decision to undertake such trades are reconsidered and the real issue for participants using a complex trades to hedge an exotic trade is the overall capital and collateral requirements but it is noted that this was done intentionally to incentivize the use of less risky vanilla trades.
234. It is also noted that PTRR services have continued to expand their offerings without requiring an exemption to the clearing obligation hence such respondents recommend that ESMA obtain data regarding the current use of PTRR services, including total number of market participants that are using each such service and total notional volumes that have been processed by each such service.

## **6.5 Respondents supporting the need for an exemption to the clearing obligation**

235. Many respondents generally support a clearing exemption for PTRR transactions to increase the efficiency of compression and other PTRR services and an exemption would reduce the risks in non-cleared portfolios (and therefore reduce systemic risk) and promote regulatory objectives. Multilateral portfolio compression, portfolio rebalancing, and basis risk reduction services offer the potential for considerable benefits by helping market participants to reduce risk and manage their derivative portfolios in a responsible manner.
236. A majority of the respondents support a clearing exemption for legacy trades that are a direct result from multilateral compression, many also support an exemption for bilateral portfolio compression where run by a service provider conducted over a non-cleared portfolio, where compression is the sole objective of the exercise and where it manages to reduce overall risk (i.e. reduce notional amounts). The respondents note that they believe that an exemption is needed in respect of legacy transactions because changes in market prices can modify the exposure profiles of these legacy portfolios and create risks. Activities aimed at reducing risk in the market should be welcomed. Such respondents encourage ESMA to consider significant reductions in bilateral counterparty risk as well as improved efficiency in the transformation of IBOR trades to RFR-equivalent that can be derived from the use of PTRR services. The respondents strongly believe that an exemption from clearing obligation would represent a very strong incentive for portfolio compression regarding legacy derivatives, which should be encouraged.
237. A majority also support an exemption for rebalancing or risk optimisation based PTRR services. It is noted that one of the largest drivers of uncleared counterparty risk is IR delta risk. To allow for plain vanilla products to be used to rebalance for example, bilateral interest rate DV01 risk among market participants in a portfolio would result in a relatively simple bilateral derivatives product, such as IRS could be used. Plain vanilla transactions can, at times, be replaced by non-plain vanilla transactions in PTRR services, although

this may result in new risks being added to a portfolio that must subsequently be managed.

238. The respondents note that existing PTRR services rely on products that fall outside the clearing obligation which, by their nature, are often more complex and this naturally limits the usability of these services to those firms with less ability or mandate to manage such products. For example, bilateral interest rate delta reduction can be achieved by using swaptions although this introduces additional risk at expiry and requires up to twice the notional that plain vanilla swaps would require. These workarounds for avoiding the clearing obligation hence require the use of complex administrative transactions that introduce new risks to be managed and represent a more onerous approach and additional operational risk implications for the participants and service provider.
239. The respondents further highlight that the use of swaptions is complex and may hinder certain participants that would otherwise be inclined to take part in a PTRR exercise. It is important from the perspective of optimal risk management and financial stability that market participants are able to achieve portfolio risk reduction without having to resort to complex workaround solutions that not all holders of risk can or want to implement. It is noted that to be able to use a simple product, such as an IRS trade that is specifically intended to hedge risk, rather than using other more complex instruments, like swaptions, would greatly simplify the process.
240. Therefore, several respondents stress that the accessibility should not be ignored, as today participation in the compression and rebalancing exercises are mainly larger market entities and less advanced participants are disincentivised from participating due to the use of complex strategies for uncleared risk rebalancing services. To increase the industry participation, it is essential to allow PTRR services to be as efficient as possible in counterparty credit risk management via PTRR exercises. Hence, to allow simple products to be used for rebalancing would, at a minimum, remove barriers of entry for new participants and this would improve the efficiency for many portfolio rebalancing exercises by allowing less sophisticated firms to leverage these services. The best outcome is to facilitate the proper use of PTRR services by providing an exemption from the clearing obligation.
241. Based on that, respondents believe that an exemption from the clearing obligation for transactions directly resulting from PTRR services would increase the use of PTRR services for the following reasons:
- (i) less sophisticated firms might not be able to participate today to price and risk manage swaptions etc., but would be comfortable with using plain vanilla products, such as an IRS, hence the use of more vanilla products will make the compression and rebalancing more straightforward and therefore easier to manage for firms;
  - (ii) it would mitigate the concern in the market that complex products like swaptions are used for PTRR purposes just in order to avoid the clearing obligation;
  - (iii) ability to streamline the portfolios by eliminating line items and thereby making trading books smaller, cleaner and far more efficient from a margin and capital requirements standpoint to the benefit of other economic activities that can be undertaken by the same market participants;

- (iv) reduction in operational risk due to the number of trades is reduced in compression hence the potential operational risk linked to dealing with multiple transactions is reduced and equally a reduction in operational risks will occur if less complex type of trades could be used to rebalance portfolios;
  - (v) reduced counterparty risk, as trades across multiple counterparties could be offset reducing the open risk in bilateral relationships; and
  - (vi) enhanced financial stability as authorities should also consider the potential effects on financial stability due to the impact on default management, as a result of potentially smaller and 'cleaner' portfolios.
242. An exemption would enable parties to better manage their credit risk profiles while enabling a greater proportion of risk to be moved to face a CCP and therefore reduce systemic risk. To allow the parties to book trades into their non-cleared portfolios with an exact offsetting opposite trade in their cleared portfolio, rather than using different types of transactions as is the case today, would be supported.
243. A respondent noted that a potential exemption from the clearing obligation under EMIR subject to conditions should be aligned with a potential exemption from the trading obligation under MIFID. Introducing a clearing exemption for these transactions under EMIR would align EMIR and MIFID II/MIFIR as Article 31 MiFIR states, inter alia, that the termination or replacement of the component derivatives in the portfolio compression are exempted from the derivatives trading obligation under Article 28 MiFIR even if these derivatives belong to a class designated as subject to the trading obligation. To align EMIR with MiFIR would according to some market representatives also be consistent with the objective to align as much as possible the MiFIR and the EMIR regime (ESMA "Final Report-Alignment of MiFIR with the changes introduced by EMIR Refit" February 2020<sup>38</sup>).

## 6.6 Weakening the incentive to clear

244. There are strong incentives to clear transactions including margin requirements and capital requirements for non-centrally cleared transactions and the CCP12 Report notes that uncleared margin requirements have motivated increased activity in cleared markets. The G20's commitments following the financial crisis are designed to ensure that the risks of bilateral derivatives portfolios are appropriately managed and collateralised. The IOSCO report on "Incentives to centrally clear over-the-counter (OTC) derivatives"<sup>39</sup> clearly demonstrates the importance of uncleared initial margin requirements in assessing incentives to centrally clear. Dealers and client clearing service providers identified the uncleared margin requirements as incentivizing central clearing more than any other regulatory reform.<sup>40</sup>

---

<sup>38</sup> [https://www.esma.europa.eu/sites/default/files/library/esma70-156-2076\\_emir\\_final\\_report\\_on\\_alignment\\_clearing\\_and\\_trading\\_obligations.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-156-2076_emir_final_report_on_alignment_clearing_and_trading_obligations.pdf)

<sup>39</sup> <https://www.fsb.org/wp-content/uploads/R191118-1-1.pdf>.

<sup>40</sup> IOSCO Report at Figure D.1 (page 26).

245. One of the arguments made against the need to exempt trades resulting from PTRR services is that by exempting, for example, the delta hedge vanilla swap trade from the clearing obligation this would be weakening the clearing obligation itself (as de facto less exposure is covered by central clearing), but also the incentives to clear (as there will now be a cheaper option to hedge the portfolio or swaption in the bilateral space). ESMA considers this thinking to be incomplete, as the above mentioned 'delta hedge vanilla swap trade', without an exemption, would be entered into using an uncleared PTRR transaction and the transaction would never be cleared.
246. A respondent notes that the PTRR exercises are fundamentally designed to reduce the costs associated with trading uncleared OTC derivatives, both from a margin and capital perspective. To the extent the costs associated with trading uncleared OTC derivatives are materially reduced and market participants are able to enter into transactions that would normally be subject to the clearing obligation on an uncleared basis, then in many cases it may become more cost effective to transact on an uncleared basis, undermining the G-20 post-crisis reforms.
247. Statements like those are challenged by several other respondents stating that an exemption from the clearing obligation would not be an incentive not to clear transactions directly resulting from a PTRR services that technically are covered by the clearing obligation, because a PTRR service is a separate post-trade activity and they note that there must be a clear separation between trading and PTRR services. It is noted that the characteristics of PTRR services are very distinct, and they should rather be considered as tools that improve the accuracy of the counterparty risk management, and the collateral liquidity management.
248. In addition, it is mentioned in responses that PTRR exercises that would create a trade subject to clearing will not be entered into today as such trade would not be allocated to the right netting set, i.e. would be allocated to the cleared netting set rather than the uncleared and would not meet the requirement of reduced risk as the replacement trade or rebalancing trade would be detached from the original portfolio of trades subject to the PTRR service.
249. It is also noted that market participants clear those trades that can be cleared because of existing incentives and the willingness to clear is more driven by the benefits of clearing like multilateral netting, operational efficiency and reduced risk than by the cost of un-cleared portfolios.
250. Some respondents refer back to the aim of PTRR services as a tool and that an exemption could rather be seen as an incentive for participants to move some of the bilateral risk to a more strictly regulated and controlled environment while at the same time benefit from improved resource optimisation and from a reduction in operational risk. Consequentially, improved default management processes and smaller/'cleaner' portfolios would strengthen financial stability which has always been the core objective of EMIR.
251. PTRR transactions resulting from PTRR services are risk reducing tools and not trading activities as they require the existence of a portfolio of transactions traded between the parties to be able to manage the risk identified in such portfolio. ESMA does not see how an exemption for PTRR transactions resulting from a PTRR exercise would be

“emptying” trades from a CCP because today PTRR trades uses uncleared trades to ensure such transactions remain bilateral to avoid breaking the netting sets or detach the PTRR transaction from the original trades.

252. Following from this reasoning, ESMA has not seen any evidence that an exemption from the clearing obligation for PTRR trades would weaken the incentives to clear. In addition, ESMA does not see *prima facie* indications of any regulatory arbitrage opportunities (for example, to use PTRR services in the EU to avoid a clearing obligation in a third country because there has first to be an obligation to clear in the EU). However, there should be some monitoring to check that it is indeed not the case, such that if it proved to materialize, then this could be further addressed by regulation and/or supervisory measures.

## 6.7 Would an exemption challenge the clearing mandate?

253. Policy makers and regulators have mandated clearing in liquid, standardised products and introduced strict bilateral risk management practices in bilateral markets. This two-fold approach helps to foster a safer, simpler and fairer financial sector. PTRR service providers are supportive of this commitment.
254. Respondents note that PTRR exercises allow market participants to more efficiently manage their collateral obligations, but do not undermine the objectives of the G20 reforms, nor negate the requirements for market participants to appropriately collateralize their derivatives exposures. An exemption to the clearing obligation would not exempt trades from the framework applicable to non-cleared transactions and trades generated from PTRR services would be subject to the risk mitigation techniques requirements under Article 11 of EMIR (including bilateral margining).
255. A few respondents mention that an exemption to the clearing obligation reverses the logic of the G20 intention of risk mitigation for OTC derivatives. They argue that the core concept of such reforms was that standardised OTC markets would be cleared, and thus come under the multilateral netting and collateralisation imposed by CCPs and that more exotic OTC derivatives would come under heightened capital and collateralisation requirements, with the intention to better safeguard against their inherent risks and incentivise market participants to employ standardised contracts when possible. In sum, the purpose was to create more transparent markets, as well as to provide collateral and capital buffers to help insulate market participants from each other’s counterparty credit risk. One respondent noted that it was always understood that exotic or uncleared risk is offset or hedged by standard OTC contracts would be cleared but does not provide further details on how such a structure would look like.
256. It is further noted that several countries already have exempted PTRR transactions resulting from portfolio compression from the clearing obligation. Based on this, such respondents are of the view that the proposed exemption from the clearing obligation would not contradict the G20 commitments but that this could contribute to improving the way risk is managed. On one hand, central clearing was mandated for a set of standardized contracts, including forward rate agreements (FRAs), interest rate swaps (IRS) and CDS indices and on the other hand, uncleared contracts were to face higher



capital and margin requirements, primarily to better reflect their risk profiles but also to promote central clearing.

257. Hence, two reforms have been implemented and whilst regulatory reforms promote central clearing where possible, OTC bilateral portfolios still exist and are actively traded between firms, containing trades; i) that are not suitable for clearing as not fulfilling the eligibility CCP requirement for clearing, or ii) for which there is no widespread use of clearing, e.g. cross-currency swaps (with the exception of NDFs), interest rate swaptions and options (caps, collars, floors), single-name CDS and various types of equity and commodity swaps.
258. ESMA also notes the following in the CCP 12 report “OTC Options have been launched by CCPs, for example by the CME (Swaptions, FX Options) and recently LCH (FX Options). So far, the market has chosen to continue trading these products bilaterally. [...] In general, it remains a conundrum that large volumes continue to trade in exchange traded options across a variety of asset classes, and yet OTC options remain largely uncleared.” ESMA notes that this is an interesting aspect to investigate, it would however not be relevant to assess this further under this report as it does not have a bearing on the assessment of an exemption to the clearing obligation.
259. Based on this reasoning, ESMA considers in line with the view of market participants, that it seems realistic to think that, in the future, the uncleared OTC products will remain to be used and a large part of the derivatives market will remain bilateral. Today entities still have bilateral exposures but while facing different counterparties, they would need to use a service provider to compress their portfolios as multilateral compression and rebalancing offer better possibility to find matching trades. ESMA also notes the reflection in the CCP12 report that “Service providers who help to compress options activity concentrate on a number of metrics to improve the profitability of options trading. These include reducing gross notional, as well as lowering the gross amount of initial margin that must be posted under the UMRs<sup>41</sup>. These are significant innovations from the industry, but it remains the case that these activities would be more efficient in a cleared model, where all risks could be multilaterally netted.”

## 6.8 The clearing obligation

260. The central clearing provides unique and superior risk mitigation benefits and features are noted compared to bilateral trading, including the elimination of interconnected bilateral counterparty credit exposures, a centralized default management process, multilateral netting and compression opportunities, and transparent end-of-day pricing.
261. With regards to other viable alternatives to PTRR services, it is argued in the responses that extending the clearing obligation to encompass all products that are currently handled bilaterally would be an alternative.

---

<sup>41</sup> Uncleared Margin Rules

262. One respondent notes that this would be a more efficient option, to clear both the complex trade and its vanilla hedge into the same cleared netting set, which is less risky and the most efficient in terms of capital. There would be no need for an exemption to the clearing obligation as the clearing obligation itself makes this option the most risk reducing and supports the incentives to centrally clear. This would, in a respondent's view, be compliant with the G20 reforms, to support a shift towards central clearing, which is more cost/capital effective for the market participant.
263. This suggestion is though challenged by other respondents that note that extending the scope of clearing to complex trades, which are often non-standard and highly illiquid, will have significant impacts on the risk profile of a CCP which is why such trades were not included in the clearing obligation in the first place. Respondents note that the trading obligation and the clearing obligation are applicable *where suitable* and it is not a requirement to clear all transactions.
264. The industry actively supports the clearing of suitable products but do not believe it is appropriate to extend the scope of mandatory clearing to encompass all products that might be found in the bilateral portfolios between firms. Such respondents note that using an extended clearing obligation does not offer a full solution to increase the efficiency of PTRR services and notes that for suitable products, the industry supports the ongoing growth of clearing offerings as ultimately, the multilateral netting and risk management benefits of clearing offer an efficient answer for such suitable products but PTRR services play an important part in reducing risks in the bilateral markets by enabling firms to effectively manage that risk in the most efficient way.
265. The underlying requirement to clear certain trades under EMIR, where pursuant to Recital 21 of EMIR, ESMA, when determining whether a class of derivatives is subject to the clearing obligation, should consider whether the clearing determination would reduce systemic risk. ESMA, when identifying the classes of OTC derivative contracts which should be subject to the clearing obligation, should pay due regard to other relevant considerations and most importantly i) to the interconnectedness between counterparties using the relevant classes of OTC derivatives and ii) the impact on the levels of counterparty credit risk. It is noted in the responses that PTRR transactions do reduce interconnectedness and reduces counterparty risks. Hence it could be argued that PTRR transactions should not have been captured initially by the clearing obligation and more relevant, that this is another argument why such trades should be exempted.
266. Based on above ESMA would agree that where trades are suitable for clearing in accordance with the requirements provided under the regulations, clearing provides additional benefits such as risk allocation to the CCP. At the same time, ESMA notes that the clearing obligation should only apply to transactions that CCPs can effectively risk-manage.

## 6.9 Optimising collateral use

267. One respondent notes that in addition to the clear risk reduction benefits for the derivatives market, there is a not to be underestimated additional benefit of increase in collateral availability with PTRR services. It is noted that many of the regulatory changes since 2008 depend on collateral availability and despite the huge increase in government

and other types of bonds, availability of such high quality collateral is restrained for a number of reasons and this can be observed in particular at quarter-ends but also in stressed market conditions like the recent COVID-19 crisis. This aspect is discussed in the market and a respondent notes that i.e. ICMA ERCC continues to encourage industry wide discussions to optimise the use of collateral, avoiding a potential gridlock that would jeopardise the important reforms so far achieved.

268. It is noted in the responses that market participants are incentivised to optimise or reduce collateral as it is costly. The bilateral market has been calculating collateral on net basis and managed risks and exposures through amendments, terminations, etc. One aspect raised in relation to PTRR services is the concern that by using compression and risk mitigation through offsetting trades, the market might become “under collateralised”, this is according to many respondents not to be the case as the collateral would still be the correct amount required by regulation.
269. IOSCO notes that PTRR services aim to reduce “outstanding gross notional value of non-centrally cleared OTC derivatives transactions, allowing for increased capital liquidity and efficiency”. The CCP12 Report points out that the uncleared margin requirements are providing suitable incentives to clear as well as leading to innovations in reducing bilateral counterparty exposure using multilateral optimisation services to offset risk between uncleared and cleared. The report further notes that the BIS data shows that Gross Market Value (“GMV”) has consistently dropped in IRDs over the past few years and that the drop in GMV is due to innovations in clearing as compression reduces GMV by removing redundant, off-market and off-setting swaps, therefore reducing gross mark- to- markets.
270. In the responses it is mentioned that the trading activity in uncleared OTC derivatives would increase due to the proposed exemption and more trading activity would be uncollateralized because the uncleared initial margin requirements have yet to be implemented for the vast majority of the dealer-client relationships. There are two issues reducing the effectiveness of the uncleared initial requirements in incentivizing central clearing.
271. Firstly, the “quantitative data suggests that the difference between required cleared and uncleared initial margins is less than expected, with the CFTC research finding that the uncleared margin required for certain portfolios can even be lower than the corresponding cleared margins, specifically as low as “54% of the ‘all-risks’ cleared margin for the same portfolio.”<sup>42</sup> Secondly, the “uncleared initial margin requirements have yet to be implemented for the vast majority of the dealer-client relationships, meaning that it still may be less costly for dealers to transact with clients on an uncleared basis”. Such respondent note that in the absence of uncleared initial margin requirements for dealer-to-client trades, voluntary clearing rates, for many standardized

---

<sup>42</sup> The respondent notes that this research also found that 32% of dealer firms had higher cleared margin requirements (vs uncleared) when all initial margin costs were included. Roberson, M., “Cleared and uncleared margin comparison for Interest Rate Swaps,” CFTC staff paper (April 2018) at page 10, available at: [https://www.cftc.gov/sites/default/files/idc/groups/public/%40economicanalysis/documents/file/dcr\\_cleared\\_uncleared\\_margin.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/%40economicanalysis/documents/file/dcr_cleared_uncleared_margin.pdf).

OTC derivatives not yet subject to a clearing mandate, such as interest rate derivatives in non-mandated currencies, single-name CDS, CDS referencing non-mandated indices, and FX non-deliverable forwards, remain at low levels even though viable clearing offerings exist.

272. The respondent further notes that as a result, the clearing obligation remains critically important in ensuring that liquid and standardised derivatives are centrally cleared, as set forth in the G-20 reforms. While the uncleared trading activity and exposures of any given dealer-client relationship may not present systemic risk concerns in isolation, the number of bilateral exposures exempted from uncleared initial margin requirements can create systemic risk in aggregate. Therefore, any exemptions from the clearing obligation should be extremely limited in scope, and policymakers should clearly understand the impact of any exemption before allowing it.
273. Another respondent notes that the reduction of margin is a consequence of “risk reduction” services and notes that while a reduction of notional amounts would not lead to situations where the market is undercollateralized and vulnerable in times of stress, it does make the capital and collateral costs for the market participant cheaper. This results in a substantial shift of risk towards the bilateral space, and that PTRR services do not bring the financial stability benefits of central clearing.
274. Such respondent agrees that PTRR services clean up line-by-line items but do not evaluate and collect the appropriate collateral needed to face counterparty credit risk, nor do they have comprehensive default management processes to address eventual defaults and is therefore sceptical that such an exemption would help better to manage counterparty credit risk for the financial system as a whole. By exempting rebalancing trades will further reduce uncleared initial margin requirements while enabling market participants to circumvent the clearing obligation and significantly increase trading activity in uncleared OTC derivatives.
275. Those arguments are challenged by several respondents noting that it is not a problem that the collateral is reduced if the counterparty risk is reduced and no systemic risk can be identified in using PTRR services and as long as the regulatory requirements are met, no risks with reducing collateral is identified.
276. One respondent highlights that it is important to understand that, for the same risk model, an increase in collateral is indicative of an increase in risk. As collateral increases across bilateral portfolios, it is not safe to conclude that, in some way, the system is “better protected”. Instead, a safer conclusion is that risk increases. Under an exemption regime, collateral in bilateral portfolios would reduce because the counterparty risk in these portfolios would be smaller, representing a better systemic risk profile. In the end, it is mentioned, a reduction in collateral is only a reflection of lower collateral needed as shown by various regulatory metrics. Freed up collateral could be used to better service clients or reduce pressure on funding markets. The focus should therefore be on the reduction of the need for collateral, rather than concentrating on ever increasing collateral balances for increased risk exposures.
277. Based on this reasoning, ESMA considers that margin requirements are a separate question from the assessment to be undertaken under this final report, which focuses on

whether PTRR transactions should be exempted from the clearing obligation for reasons of risk reduction and risk optimisation in the market, simplicity and accessibility.

278. Whilst the margin requirements under EMIR are very important, ESMA does not find the argument that PTRR transactions should not be exempted as there would be too low margins on them as a valid argument for this report. That the margins are too low may be a valid conclusion but is not relevant in relation to the assessment at hand, whether an exemption or not will be provided.
279. Hence, to “cure” any identified lack of requirement to post collateral of uncleared trades through the position to not grant an exemption for PTRR transactions would not be the right means. It is important to keep the PTRR services and their aim separate from any identified lack of margin requirements under the relevant regulation.

## **6.10 Circumvention of the clearing obligation**

280. EMIR Refit requires that before granting any clearing exemption, regulators must assess if such exemption would lead to a circumvention of the clearing obligation. PTRR services resulting in transactions subject to the clearing obligation may today either be avoided by not undertaking the PTRR exercise or by using transactions not subject to the clearing obligation.
281. As vanilla trades resulting from PTRR services would be exempt from the clearing obligation, it is argued that less trades would be subject to the clearing mandate, thereby weakening the ‘obligation’ in itself and the G20 objectives and such exempted trades could be used to extract vanilla trades already in cleared portfolios, thereby reversing the shift towards central clearing.
282. To assess the risks of circumvention by allowing certain PTRR transactions to be exempted from the clearing obligation is difficult, mainly for the obvious reason that the PTRR transactions would most likely not have occurred at all today due to the clearing obligation. The question therefore is whether an exemption would incentivise market participants to use this technique as a way to avoid clearing.
283. One respondent noted that an exemption to the clearing obligation would open up significant possibilities for regulatory arbitrage and ‘clever’ trading to extract trades already present in cleared portfolios and to bring them back into the uncleared space. ESMA has noted in the responses this argument that cleared trades are reduced or shifted to the bilateral sphere, however ESMA is not clear on how this would be done. There is the possibility where a replacement trade (exempted from the clearing obligation) is used to replace cleared trades in a CCP, however this requires that the compression contains both cleared and uncleared portfolios in the same compression cycle hence suitably framed and calibrated exemptions should avoid such outcome. The scenario on how to extract cleared trades from a CCP is assessed above under Section 6.3.1.
284. One respondent noted that whilst it could imagine scenarios in which incentives to perform such circumventing activity might be created this would require PTRR services to be undertaken without an applied regime and requirements.

285. Many respondents are of the view that the likelihood of a circumvention of the clearing obligation will turn out to be, de facto, extremely low. One respondent found it extremely difficult to imagine a “real” scenario where what is mentioned above could materialise.
286. Many respondents support the use of conditions to avoid any risk of circumvention of the clearing obligation. Some requirements for PTRR services noted in the responses include such services (i) being market risk neutral, (ii) reducing the bilateral risk in the portfolio into which it is booked, and (iii) carried out by an independent service provider, i.e. none of the participants should be able to influence the outcome of the exercise and no pick and choose among the trades. Based on this the view is that, any such exemption of such trade would not act as an incentive not to clear the primary underlying trades.
287. One respondent critical to an exemption requests ESMA to provide the data for the current size of standardised risk that currently resides in bilateral portfolios as such respondents then envisage it possible to estimate the type of participant and scale of plain vanilla OTC derivatives that would be added to bilateral portfolios. It would also be incisive to consider how much capital and collateral such moves would free up.
288. ESMA considers that whilst relevant data generally should be used, ESMA would though note that collecting data as suggested by the respondent in relation to PTRR services is not possible for two reasons: how would “standardised risk in a bilateral portfolio” be defined when risk is based on counterparties sensitivities and secondly to assess the changes to collateral is again not possible as it would depend on the overall position of the counterparties and their risks preferences.
289. In addition, today PTRR services do not use cleared trades to mitigate risk in an uncleared portfolio as this would delink such trades from the risks they are managing. Hence, uncleared trades are used, arguably with some drawbacks in some cases. This would mean that there is no reduction in cleared trades as the trades were never entered into in the first place and there is no data to be provided of cleared transactions that would instead be uncleared (with an exemption).
290. ESMA notes that it is important to bear in mind the underlying contractual freedom of counterparties, i.e. bilateral counterparties may at all time trade bilateral trades and use uncleared trades to mitigate risks.
291. ESMA considers, in line with respondents, that the design of an exemption must take into account strict conditions to prevent any misuse of PTRR exercises.

## 6.11 Conclusion

292. ESMA has in cooperation with the ESRB and in accordance with the mandate, investigated portfolio compression and other available PTRR services, mainly rebalancing/optimisation services and provided explanations on the purposes and functioning of such PTRR services and the risks they mitigate. ESMA has also investigated to what extent any exemption from the clearing obligation for such services may discourage central clearing and may lead to counterparties circumventing the clearing obligation.
293. ESMA would, based on the assessment undertaken and the responses received, conclude that PTRR services, primarily compression and optimisation/rebalancing, are

very useful tools to manage risk in both cleared and uncleared portfolios. ESMA notes that such PTRR transactions are different from “ordinary” traded instruments, as PTRR transactions are a direct result of a PTRR exercise, established on “old” prices and not subject to negotiation between the parties but established by applying an algorithm to submitted portfolios of trades that the parties would like to compress or rebalance.

294. One of the arguments presented against an exemption to the clearing obligation in the responses is that PTRR services used by market participants have steadily increased without being negatively affected by the clearing obligation. ESMA agrees that PTRR services have successfully reduced a significant amount of risks in the market to date. However, whilst those numbers are significant, they do not provide any evidence on the question if they are hampered by the clearing obligation as the compression today is undertaken in accordance with the regulatory requirements of today. On the contrary, ESMA understands based on the evidence submitted in the consultation that the requirement to clear any PTRR trade subject to the clearing obligation hampers the use of PTRR services today.
295. ESMA notes that the G20 commitment to improve the OTC derivatives market include the reporting obligation, the trading obligation, the clearing obligation and the requirement to increase use of collateral and risk mitigation techniques. Hence, the G20 commitment does not prevent an exemption to the clearing obligation, as the requirement to clear applies in conjunction with the requirement to increase the use of risk mitigation requirements targeting the uncleared market and MiFIR already contains an exemption from the trading obligation for PTRR trades.
296. ESMA notes that PTRR services for compression today use termination (partial or full, no replacement trades are created) when compressing trades uncleared but subject to the clearing obligation (legacy trades such as CDS) and for rebalancing the service use uncleared trades (swaptions) to hedge the i.e. interest rate risk of the uncleared portfolio instead of the clearable instrument (IRS). This has two consequences, the participants effected by the use of more complex products (as not all market participants can manage such more complex trades) and participants that have concerns with the use of uncleared trades to avoid the clearing obligation, may opt not to use PTRR services today and this is in the end negatively effecting the risk management possibility of exiting portfolios of trades that would not be in line with the G-20 commitment.
297. ESMA has noted some scepticism on the possibility for exempting such PTRR transactions from the clearing obligation and further assessed the risks those respondents have raised regarding an exemption to the clearing obligation. One of the main arguments is that an exemption would reduce the amount of trades cleared today. ESMA did not find any evidence that introducing a clearing exemption for PTRR trades would have this effect. In fact, today the clearing obligation simply prevents such PTRR trades to be performed, as they would need to be cleared.
298. PTRR services are different to CCPs but have some common valuable features of aiming to reduce different risks in the market. However, ESMA notes that not all trades are suitable to be cleared due to liquidity or complexity and there are already procedures in place under other regulations regulating what type of trades are suitable to be subject to the clearing obligation. ESMA notes the opposing positions in the responses; on one side, allowing for a limited exemption to the clearing obligation in order to increase the

efficiency and accessibility of PTRR services; compared to the other side, suggesting moving more transactions (if not all) to clearing with CCPs as this would also increase efficiency and avoid the issue of today of having the cleared and uncleared netting sets sitting at counterparties. ESMA notes that to clear all trades at a CCP is not in line with the regulatory requirements and is not a viable way forward.

299. ESMA has also noted the concern on the reduction of margin and agrees that any reduction of margin should be in line with the regulatory requirements applying to the market today as uncleared trades are subject to specific margin requirements in line with the G20 commitment. ESMA is not convinced by the argument that because the bilateral margin requirements are not resulting in enough trades being collateralised due to phase-in provisions or that an exemption would limit PTRR transactions to fall under the margin requirement's regime for uncleared OTC derivatives. Any drawbacks or limitation in relation to the applicable margin requirements would need to be managed through any future review of the relevant regulations but cannot be considered in this assessment of a possible exemption to the clearing obligation.
300. One aspect raised in the responses is on legal certainty and the legal consequences related to replacement trades in the execution of the relevant transaction. ESMA agrees that legal certainty around the effectiveness and timing of the trades is essential and should, where needed, be considered as part of a regulated exemption.
301. ESMA also notes the concerns raised from a more fundamental point of view, that no exemption to the clearing obligation should be made, as it will by definition reduce the incentives to clear. It is noted that there already are difficulties to ensure all trades suitable for clearing are cleared and that all participants that are obligated to clear, have reasonable tools to access clearing and to meet its obligations to clear on a fair term. Whilst ESMA fully agree that there are remaining issues on ensuring clearing are accessed and used to the fullest extent possible (within the remits provided by law) ESMA would not like to use the assessment as to the reasonableness and need for an exemption to the clearing obligation in the assessment on overall issues with accessibility.
302. ESMA notes that on the contrary, an exemption to the clearing obligation would simplify and require the parties to enter into risk offsetting trades with the CCP to shift the risk of their uncleared portfolio into the CCP, and this would be simplified by using the same type of transactions in the uncleared and cleared portfolio.
303. Not allowing for an exemption will probably only provide a further split in the market between cleared and uncleared as the possibilities to risk mitigate between the both portfolios will be reduced for the majority of the markets participants and hence possibly rather incentivise the use of uncleared trades to ensure all trades are within the uncleared portfolio rather than managing both cleared and uncleared portfolios as not yet all trades may be cleared.
304. Another fundamental aspect raised by a respondent is that from a financial stability perspective, exemptions to the clearing obligation should only be considered when they contribute to reducing systemic risk, subject to appropriate safeguards to avoid the risk of regulatory arbitrage. ESMA agrees with this remark, and notes that PTRR services demonstrably reduce systemic risk compared to a scenario where an exemption to the



clearing obligation is not granted and that the proposed exemptions would be subject to requirements aimed to manage risks of circumvention.

305. To conclude ESMA notes the following aspects.
306. Exempting certain compression or rebalancing trades from the clearing obligation enables participants to reduce risk in the non-cleared netting sets. This reduction in risk on the individual level also results in an overall reduction of systemic risk. ESMA views this as a desirable feature.
307. PTRR compression services are successfully used today and have successfully compressed portfolios of uncleared or cleared trades, but legacy trades (and future legacy trades) cannot be compressed due to the clearing obligation.
308. PTRR rebalancing services are successfully used today, but that using complex products to reduce a simple, for example, interest rate risks, runs three risks, added complexity in the portfolios, reduced participation due to complexity service; and risk of circumventing the clearing obligation by using uncleared alternatives.
309. ESMA notes that some, including the ESRB, are of the view that preventing the clearing obligation from being circumvented should take priority over lifting the clearing obligation to facilitate the use of PTRR services. ESMA very much agrees that the clearing obligation is an important and fundamental cornerstone in ensuring financial stability but notes that also PTRR services results in ensuring financial stability. Hence, in the absence of compelling evidence or reasoning to the contrary, ESMA believes the benefits of reducing market risks in the non-cleared netting sets outweigh, inter alia, the increased potential operational burden on market participants and regulators, the increase in gross risk in the non-cleared netting sets (in case of portfolio rebalancing) and the remote risk of market participants possibly evading the clearing obligation via the exemption (gaming).
310. ESMA also notes that an exemption to the clearing obligation would ultimately result in an increase of the trades at the CCP, as the counterparties would be required, to the maximum extent possible, to voluntarily shift risk to a CCP after undertaking a PTRR exercise.
311. ESMA concludes that PTRR services are an important tool to manage risk and the respondents to the consultation have provided valid arguments of why an exemption would improve the use of PTRR services and increase its accessibility. At the same time, the fundamental starting point is contractual freedom and parties may compress and rebalance their portfolios as they would want to as long as the services do not generate a cleared trade (unless intended). Based on this, ESMA has formulated a core question, would it be preferable for the market to continue as it is now, i.e. with some limitations on compression (primarily for legacy trades), with only the most advanced market participants undertaking PTRR exercises and using more complex products (where possible), or not?
312. Based on above, ESMA supports an exemption to the clearing obligation for PTRR trades, as it would allow to treat legacy trades equally with other uncleared trades (including a possibility to compress them), and overall increase the accessibility of PTRR services for market participants.

313. ESMA would support data to be assessed once the new reporting RTSs have been adopted and implemented, to assess, if possible, how the exemption to the clearing obligation have increased access to PTRR services.
314. To ensure that an exemption would not be misused ESMA has assessed different types of conditions to apply to an exemption, they are set out in Part 3.

## **PART 3**

### **7 Possible requirements for the provision of PTRR services**

315. ESMA considers that there is merit in considering an exemption to the clearing obligation for trades resulting from PTRR exercises when they comply with certain restrictions and ESMA has thoroughly assessed the requirements that would be recommended to apply where PTRR service providers apply the exemption to the clearing obligation.

#### **7.1 PTRR service providers acting independently**

316. One of the questions identified is how to avoid inappropriate influence of the participants over the PTRR service provider. If the PTRR provider was not bound by conditions, there is the risk that participants could cherry-pick which transactions submitted to the PTRR service provider would eventually get executed (and which would not). Similarly, if there were no requirements on the PTRR exercise to reduce risk in portfolios, then there would be a risk that PTRR services could be used to add trades under the perception that they are exempted from the clearing obligation just by the fact of being part of a PTRR exercise. A way to mitigate these risks (and this is already noted under MiFIR) is to provide clear remits and requirements to PTRR services to ensure they are not used to avoid the clearing obligation.
317. The process today seems to be that the participating counterparties decide on the transactions to be included in the portfolio which is submitted to the PTRR exercise. Once the parties have submitted their portfolios, it is understood that they have no further influence over the exercise. With some PTRR services such as portfolio compression, the parties may set tolerance levels to provide the remits of the exercise, but the participants influence is expected to end with the submission of the portfolio, as then it is the PTRR service provider who applies its algorithm to complete the PTRR exercise. This means that after the PTRR service provider runs the PTRR exercise on such portfolio, the counterparties may or may not undertake the suggested resulting PTRR transactions, but they cannot influence or change the result of running the PTRR service provider's algorithms. The service provider analyses the portfolios of the participants and publishes the optimal solution. The outcome depends on which method the PTRR service provider will use.
318. The question is how to ensure that the PTRR service provider is independent in its assessment and that market participants cannot have an influence in the solution proposed by the provider.

### 7.1.1 Feedback

319. Respondents note that PTRR services should be carried out by an independent service provider to avoid participants, subject to the clearing obligation, deciding whether to clear a trade or not. Rather, PTRR exercises should be performed by PTRR service providers independently of the market participants.
320. Another point raised in the responses is that the outcome of the PTRR exercise should operate on an all-or-nothing basis. Market participants should submit their portfolio and the third-party service provider would then calculate the appropriate adjustments in the form of PTRR transactions needed to best manage the risk in the portfolios submitted and propose the adjustments to the market participant. Participants to the PTRR exercise should not have any influence in the designation of the adjustments proposed based on the algorithm and must either accept or reject in full the proposed adjustments. The tasks of the PTRR service provider should be limited to receiving the information regarding the participants' portfolios and tolerances, carry out calculations based on algorithms and submit the outcome of these calculations to the participants as a package (for them to accept or reject) without providing any advice. The exercise would be void if not all participants accept the proposed outcome. In the responses there is a proposal to suggest that a suitable initial governance framework is put in place that mandates the "automatic" treatment of outputs (i.e. no manual intervention or *de minimis*).
321. Another respondent noted that PTRR service providers should keep records of the transactions inserted into the bilateral portfolios, the risk of these portfolios before and after the exercise and the transactions to shift risk to the CCP. This information would be available for regulators to monitor whether conditions to benefit from the exemption are met. Trade linkages could also, where applicable, be reported as part of EMIR and MiFIR transaction reporting (the functionality to provide trade linkages already exists in middleware platforms such as MarkitWire and DSMatch).
322. Such data would also allow to review, after each PTRR exercise (where needed), that for each PTRR transaction inserted into the bilateral portfolios, an equal and opposite transaction has been booked into a CCP (on a net basis) and that the risk in each affected bilateral portfolio has been reduced.
323. Other respondents, sceptic to the exemption to the clearing obligation noted that requiring PTRR exercises to be performed by an independent service provider does not alter the commercial incentives that individual traders would have (leveraging on a clearing exemption) to enter into uncleared OTC derivatives in the first place, with full knowledge that they could later be hedged using uncleared vanilla instruments that are normally subject to the clearing obligation.

### 7.1.2 Considerations

324. After considering the feedback received, ESMA is of the view that in order to benefit from an exemption from the clearing obligation, a PTRR exercise needs to be conducted by an independent third party PTRR service provider.
325. Hence, one requirement for the provision of PTRR services could be that the transactions shall be (i) generated in accordance with a service provider's established rules and

parameters for compression exercises, (ii) the exercise shall be conducted independently by the PTRR service provider acting as a third-party, and (iii) the proposal can only be fully accepted or rejected without giving the possibility to market participants to choose which trades they agree to and which not, and if only one rejects it in part or in full, the entire exercise is void. The objective of such independent requirements would be to avoid any influence of any market participant on the direction or result of the proposed outcome in a PTRR exercise.

326. An aspect that is closely linked to the independence of the service provider is the conflict of interest aspect. It is noted in the responses that the independence of a service provider could be compromised in a system where clients who pay for the service set the tolerance levels that the service provider will apply to their portfolios. In addition, as a respondent noted, service providers can be part of a financial group or be owned by their customers and this could lead to a potential conflict of interest that should be taken into account if governance requirements would be assessed.

## 7.2 Build-up of transactions

327. ESMA identified in the consultation paper the possible concern regarding the build-up of non-cleared transactions booked as part of the optimisation process after the PTRR service provider has proposed a solution to reduce risk and the participants in the exercise have agreed to it. The concern is that the new transactions booked by market participants would increase the total number of transactions and that this needs to be prevented by mandating a compression after each rebalance exercise and before running the next cycle.
328. The consultation paper investigated whether there is the possibility that a PTRR rebalancing exercises could result in a build-up of transactions as a result of the need to constantly manage risks that are constantly subject to changes and if a condition to regulate this should be envisaged.

### 7.2.1 Feedback

329. ESMA notes that the market seems to self-regulate this concern as it is in the interest of the participants (particularly rebalancing conducted with more complex products that contain expiry features) to constantly compress such trades and in addition ESMA's understanding is that rebalancing transactions are often short dated to avoid a build-up of transactions. It is also in the interest of the providers to deliver efficient PTRR services and to continuously compress the rebalancing trades.

### 7.2.2 Considerations

330. ESMA is of the view that build-up of transactions should be limited and that after each rebalancing cycle and before the next, a compression exercise should be performed where needed. In addition, ESMA is aware that this is already a practice conducted by PTRR service providers and this condition should therefore not be too burdensome as it merely confirms the practice undertaken today.

## 8 Summary of key features and requirements

331. ESMA concluded above that an exemption to the clearing obligation is justified based on the assessment and analysis undertaken by ESMA. However, due to the development in the market ESMA also notes that some of the characteristics of the services may change due to developments in the provision of post-trade reduction services, hence the key features of compression and rebalancing are noted below providing the remits of the services assessed in this report.

### 8.1 Proposed requirements for the provision of PTRR services to benefit from an exemption to the clearing obligation

332. ESMA has, as noted above, thoroughly assessed the requirements that should apply to the provision of PTRR services, where PTRR service providers apply the exemption to the clearing obligation the following requirements apply on the provision of the PTRR service:

- a) PTRR exercises should be performed by service providers independent of the market participants, i.e. independent of in-house traders, to avoid gaming and to avoid any conflict of interest.
- b) The service provider shall ensure that the compression and rebalancing exercises are provided on fair, reasonable and non-discriminatory terms and conditions.
- c) The PTRR service providers should keep records of the transactions inserted into the bilateral portfolios, the risk of these portfolios before and after the exercise and the transactions to shift risk to the CCP (where used).
- d) The service providers shall monitor the services they provide to ensure (to the extent possible) to adhere to the purpose of the service, post-trade risk mitigation through compression and rebalancing and should not assist in any misuse or intended circumvention to the clearing obligation.
- e) The service provider shall only apply the clearing exemption to transactions that directly derive from PTRR services described as portfolio compression transactions and portfolio rebalancing transactions, and that comply with the conditions to benefit from the clearing exemption as listed below.
- f) The service provider should provide PTRR exercises under clear remits and in accordance with the provider's established rules, methods and algorithms; and participants, after submitting the portfolios they want to compress or rebalance, should have no influence in the result of the exercise.
- g) The proposed PTRR trades after the service provider has completed the compression or rebalancing cycle, can only be fully accepted or rejected (the "all or nothing approach"), without giving the possibility to market participants to choose which trades they agree to execute and which not.
- h) Counterparties entering into a PTRR transaction as a result of a compression or rebalancing exercise must be participants of the PTRR exercise. No third-party that

was not part of the PTRR exercise can enter into any of the resulting PTRR transactions.

## **8.2 Conditions to benefit from the clearing exemption on trades resulting from portfolio compression**

333. In a compression exercise, the exemption from the clearing obligation should only apply to PTRR trades directly resulting from compressions of uncleared transactions (primarily legacy transactions, i.e. trades that are uncleared today but would technically be subject to the clearing obligation (current and future ones) and rebalancing transactions).
334. A portfolio compression service should be run on a multilateral basis.
335. Compression should show that the risk in each affected bilateral portfolio has been reduced.
336. Compression is market-risk neutral in risk-free compression (no replacement trades), however where replacements trades are executed the market-risk is materially market risk neutral.
337. Each participating firm in a compression exercises provides its tolerances or sensitivities of their portfolio to the PTRR service provider which are then binding on participants. The tolerances provided by the participant should be applied equally to the participants in the rebalancing service except for tolerances derived from counterparty credit risk. In a compression exercise, the total risk exposure cannot increase by more than the pre-agreed tolerances (market risk) on any bilateral portfolio.
338. For each replacement transaction resulting from risk reduction exercises, an equal and opposite transaction must be booked facing a CCP, to the maximum extent possible<sup>43</sup>.

## **8.3 Conditions to benefit from the clearing exemption on trades resulting from portfolio rebalancing**

339. In a rebalancing exercise, the exemption from the clearing obligation should only apply to PTRR trades directly resulting from rebalancing of portfolios of only uncleared portfolios or mixed portfolios compounded of cleared and uncleared trades.
340. Portfolio rebalancing transactions offsets part of the risk between the parties but does not close out or terminate any trades in the underlying portfolio, those trades remain outstanding between the parties.
341. Portfolio rebalancing adds new transactions based on risk sensitivities of the underlying portfolio and not based on the individual transactions within the portfolio, meaning that

---

<sup>43</sup> ESMA notes some possible restraints on the accessibility to CCPs by some entities. Based on this a requirement to enter into "equal and opposite trades" may be too burdensome and unproportionate to apply to such entities, and in contradiction of the aim of increased use of PTRR services.

the rebalancing trade will be different from the original trades which contribute to the underlying risk exposure.

342. Rebalancing services are run on a multilateral basis.
343. Where a portfolio rebalancing contains both cleared and uncleared portfolios, a rebalancing transaction mitigating risks in a cleared portfolio, shall be cleared with a CCP to remain with the portfolio it manages the risk in.
344. Portfolio rebalancing need to demonstrate that the risk in each affected bilateral portfolio submitted has been reduced.
345. A portfolio rebalancing exercise is market risk neutral (this is ensured by inserting equal amounts of buy and sell exposures, facing different counterparties in the rebalancing exercise). Hence, in a rebalance exercise, for each participant to the exercise, the net risk of the new rebalancing trades must amount to zero.
346. In order to prevent a build-up of transactions in portfolios, after each rebalancing cycle and before the next, a compression exercise needs to be performed where a material amount of rebalancing remains outstanding between the participants from the previous exercise.
347. Rebalancing transactions must transfer risk (on a net basis) to a CCP to the maximum extent possible.

## Annex 1: Portfolio rebalancing<sup>44</sup>

How the portfolio rebalancing service works in terms of reduction in the **sum of “bilateral” net exposures within** a mixed portfolio, where the CCP is treated as the other bilateral counterparties. The example envisaged a mixed portfolio made up of three bilateral counterparties (A, B and C) and a CCP. The various counterparties have DV01 sensitivities with each other as reported in Table 1.

**Table 1 – Initial portfolio exposures**

	A	B	C	CCP	Net	Sum Abs
A	0	12	-10	6	8	28
B	-12	0	-6	14	-4	32
C	10	6	0	-3	13	19
CCP	-6	-14	3	0	-17	23
						<b>102</b>

For each counterparty the sum of “bilateral” net exposures (in absolute values) is much larger than the net one. In this scenario rebalancing transactions should be the ones reported in Table 2.

**Table 2 – Rebalancing transactions**

	A	B	C	CCP	Net
A	0	-3	5	-2	0
B	3	0	1	-4	0
C	-5	-1	0	6	0
CCP	2	4	-6	0	0

The rebalancing transactions are market neutral and each counterparty has an equal amount of buy and sell exposure facing the other counterparties. As a result of the injection of these rebalancing trades the new DV01 sensitivity of the mixed portfolio is the one shown in Table 3.

**Table 3 – Final portfolio exposures**

	A	B	C	CCP	Net	Sum Abs
A	0	9	-5	4	8	18
B	-9	0	-5	10	-4	24
C	5	5	0	3	13	13
CCP	-4	-10	-3	0	-17	17
						<b>72</b>

While the net exposures of each counterparty are unchanged, the sum of “bilateral” net exposures has decreased from 102 to 72 with a reduction of **29%**.

<sup>44</sup> Source of the data: TriOptima.



## Annex 2: Cost Benefit Assessment

In order to assess the effects of an exemption to the clearing obligation, ESMA requested (if possible) to receive data and other information on the possible costs or benefits of an exemption to the clearing obligation. Several responses were received and some aspects are referenced below.

ESMA received some interesting responses, however, less on data but more on the general assessment as to the costs and benefits of an exemption.

Regarding the benefits of an exemption from the clearing obligation, respondents highlight that on the one hand, compression helps to reduce risks such as counterparty, operational and ultimately systemic risks, by reducing the number of trades and/or notional exposure among counterparties and; on the other hand, it is challenged as limiting or disincentivising the clearing obligation.

To reduce systemic risk, this may be done by involving a CCP (where possible) to reduce counterparty risk (as it is further explained in Section 5.2.6 An “equal and opposite” trade booked facing a CCP).

Operational risk is also reduced by the reduction in exposure and by managing risk by improving the efficiency and transparency of portfolios.

### 8.4 Cost

One respondent notes that most costs they have identified will not be significant compared to benefits, with the potential exception of capital requirements for firms constrained by notional driven measures.

Such respondent notes that constraints driven by notional, for instance capital requirements, the leverage ratio, the GSIB surcharge and US stress tests might increase if the PTRR exercise adds many new trades to the uncleared portfolios. While this cost can be mitigated by careful design of the PTRR algorithms, these constraints might affect the extent to which firms will utilise PTRR services.

The cost of the services are noted, stating that there will be transaction cost to each PTRR service run and participants would likely not participate in a PTRR exercise where the benefits (saving in margin, capital requirements, gross notional and operational complexity) will not outweigh the cost.

The cost of the provider is an important aspect and ESMA notes that to increase access to compression services costs may be a limiting factor, as less advanced participants may contribute with smaller portfolios of trades but possible important trades bearing in mind different directional preferences in the market, but such participants may have less resources to participate in PTRR services and in particular if they are too expensive. Another angle to costs is that regulatory requirements bear a cost, hence any additional requirements and increased costs of complying with requirements and supervisory costs, will be reflected in the

fees of the services, hence whilst it is important that PTRR service providers are regulated appropriately, the common good of accessibility to such services are vital to achieve efficiency.

It is noted that an exemption to the clearing obligation might be seen as a “regulatory cost”. However, the exemption from the clearing obligation will support overall risk reduction. ESMA would be inclined not to view an exemption as a regulatory cost as such an exemption would be in line with the underlying G20 principles of reduction in risks and would only exempt certain non-price forming administrative trades.

## 8.5 Benefits

Several respondents consider that the benefits of an exemption materially outweigh the costs above:

- Overall risk reduction (counterparty risk, collateral risk, systemic risk);
- Reduction of default competition risk;
- Reduction of liquidity risk driven by margin payments;
- Reduced margin requirements, leading to reduced liquidity risk.

Should PTRR services manage to reduce the majority of the interest rate delta (assume 90%), SIMM margin would reduce by 15.3%. With margin being a proxy of risk, it could also be assumed about 15% of total risk has been reduced. Based on total margin of USD 82.1bn from the 2019 SIMM back-testing, this would result in a reduction of margin requirements of USD 12.6bn. Reduced margin requirements are also a proxy measure for reduced counterparty risk in the uncleared portfolios.

It is also noted that the overall proportion of risk warehoused at the CCP (rather than bilaterally) will be increased as the possibility to enter into equal and opposite trades (at least on a net basis) will be simplified which will also increase clearing volumes.

## 8.6 Liquidity

One respondent noted that under normal market conditions, gross payments and receipts would be between three or four times the net VM for bilateral portfolios but during the recent stressed period from mid-March, net VM changed only modestly (typically two to three times) however, gross VM paid and received increased from the order of three or four times to the order of ten to twelve times. The respondent highlights that significantly increased liquidity requirements exactly when funding markets might be less liquid. Acadiasoft, on 2nd June 2020, published a paper “Smooth Sailing Through the Perfect Storm”<sup>45</sup> -that sets out the significant increases in Variation Margin on bilateral trading that arose during the Covid-19 crisis in March 2020. The analysis shows how collateral flows increased to around 350% of their typical levels in prior months. Broadly, during March 2020, around USD 260bn of liquidity was being utilised

---

<sup>45</sup> <https://acadiasoft.com/smooth-sailing-through-the-perfect-storm/>

each and every day in settlement of these obligations. Large offsetting bilateral credit risks will have contributed materially to these amounts.

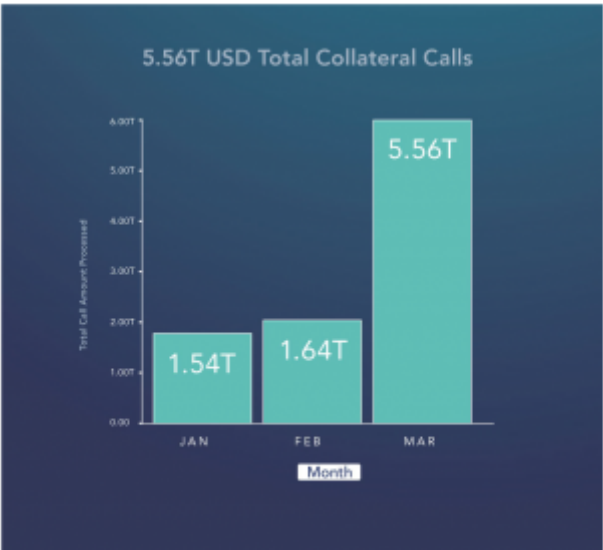


Illustration 5: Sourced by AcadiaSoft Analytics

Another point raised is the cost of not having a clearing exemption, which entails the use of more complex products (e.g. swaptions) instead of simpler vanilla products that are under the clearing mandate. These synthetic workarounds introduce new risks to be managed.

## Annex 3: High-level matrix over exemptions for portfolio compression in other jurisdictions

Country	Applied conditions and independent service provider	Portfolio of only uncleared transactions	Only multilateral compression	Same CPs	Reduce notional	Reduce risk
US	<p>Each amended swap(s) or replacement swap(s) generated by the multilateral portfolio compression exercise must:</p> <ul style="list-style-type: none"> <li>- be generated in accordance with a multilateral portfolio compression service provider's established rules and parameters for multilateral portfolio compression exercises; and</li> <li>- the "multilateral portfolio compression exercise" generating the amended and replacement swaps must meet the definition set forth in Commission regulation 23.500(h).</li> </ul> <p>Once the original swaps have been selected and submitted by market participants as part of the multilateral portfolio compression exercise, the multilateral portfolio compression methodology does not permit participants to specify which swaps may be amended or replaced.</p>	<p>2. No original swap submitted by market participants as part of the multilateral portfolio compression exercise shall include any swap that has been cleared by a DCO.</p> <p>3. No original swap submitted by market participants as part of the multilateral portfolio compression exercise shall include any swap that is required to be cleared under 2(h)(1)(A) of the CEA and part 50 of Commission regulations because it was executed on or after an applicable compliance date.</p>	<p>"[...] and must involve more than two market participants."</p>	<p>b. be entered into between the same counterparties as the original swap(s) that is amended or terminated;</p>	<p>c. with the exception of reducing the notional amount, have the same material terms as the original swap(s), as defined in part 45 of Commission regulations,<sup>10</sup> including the reference entity, the maximum maturity of the swap, and the average weighted maturity of the swap; and</p> <p>d. be entered into for the sole purpose of reducing operational or counterparty credit risk.</p>	<p>"replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise"</p>
Australia	<p>(a) the Clearing Transaction is entered into by the Clearing Entity as a result of the Clearing Entity modifying or terminating and replacing Derivatives under a Multilateral Portfolio Compression Cycle;</p> <p>(d) the Multilateral Portfolio Compression Cycle was</p>	<p>(b) for each of the Derivatives that was modified, or terminated and replaced—entry into the Derivative was not a Clearing Transaction that was required to be Cleared Through a Clearing Facility in accordance with Rule</p>	<p>"the Clearing Transaction is entered into by the Clearing Entity as a result of the Clearing Entity modifying or terminating and replacing Derivatives under a Multilateral Portfolio Compression Cycle;"</p>	<p>(c) the Clearing Transactions entered into by the Clearing Entity as a result of the Multilateral Portfolio Compression Cycle are only entered into with persons who were</p>	<p>Multilateral Portfolio Compression Cycle means a process under which portfolios of Derivatives between participants in the process are modified to reduce their notional value or terminated and replaced with new Derivatives providing for</p>	<p>"conducted for the purposes of reducing operational risk or counterparty credit risk for the participants. for reduced notional exposures between the participants, conducted for the purposes of reducing operational risk or</p>

	<p>conducted in accordance with the rules of a third-party operator of Multilateral Portfolio Compression Cycles and involved more than two participants, none of which was the operator;</p> <p>(e) the Multilateral Portfolio Compression Cycle was conducted in compliance with the counterparty credit risk tolerance levels set by the participants in the Multilateral Portfolio Compression Cycle.</p>	<p>2.1.1 or sub-rule 2.1.6(2); and</p>		<p>counterparties to those Derivatives; and</p>	<p>reduced notional exposures between the participants</p>	<p>counterparty credit risk for the participants.”</p>
Canada	<p>(e) the multilateral portfolio compression exercise is conducted by an independent third-party</p>	<p>(b) the existing derivatives do not include a mandatory clearable derivative entered into after the effective date on which the class of derivatives became a mandatory clearable derivative;</p> <p>(c) the existing derivatives were not cleared by a clearing agency or clearing house;</p>	<p>Multilateral portfolio compression exemption in National Instrument 94-101 and (a) the mandatory clearable derivative is entered into as a result of more than 2 counterparties changing or terminating and replacing existing derivatives;</p>	<p>(d) the mandatory clearable derivative is entered into by the same counterparties as the existing derivatives;</p>		
Hong Kong	<p>Exempted “if the transaction is entered into by the person (i) as a result of a multilateral portfolio compression cycle that meets the requirements referred to in subrule (2);</p> <p>(2) The requirements are that the multilateral portfolio compression cycle—</p> <p>(a) was conducted in accordance with the rules of an operator of multilateral portfolio compression cycles;</p> <p>(b) involved more than 2 participants, none of which was the operator of the cycle; and</p> <p>(c) was conducted in compliance with the counterparty credit risk</p>	<p>multilateral portfolio compression cycle means a process applied to portfolios of OTC derivative transactions.</p>	<p>b) the multilateral portfolio compression cycle [...] (ii) involves more than 2 participants and the operator cannot be a participant (i.e. a bilateral compression will not be able to benefit from the exemption);</p>	<p>Exempted “if the transaction is entered into by the person [...] (ii) with a participant in the multilateral portfolio compression cycle that was a counterparty to one or more of the compressed transactions;”</p>	<p>Multilateral portfolio compression cycle means a process applied to portfolios of OTC derivative transactions between participants in the process—</p> <p>(a) under which some or all of the transactions are</p> <p>(i) modified to reduce their notional value; or</p> <p>(ii) terminated and replaced with one or more new OTC derivative transactions which have the effect of reducing exposures between or among the participants;</p>	<p>Multilateral portfolio compression cycle means a process applied to portfolios of OTC derivative transactions between participants in the process [...]</p> <p>(b) that is conducted for the purposes of reducing operational risk or counterparty credit risk for the participants.</p>

	tolerance levels set by the participants in the cycle.					
Singapore	(d) that is conducted by an operator engaged by parties to derivatives contracts contained in the portfolio; and (f) that is conducted — (i) in accordance with rules set by the operator; and (ii) in compliance with a counterparty credit risk tolerance level set by all the participants”.		(e) in which there are at least 3 participants;”	(b) if the derivatives contract is entered into [...] (ii) with a participant in the portfolio compression cycle that was a party to one or more of the compressed derivatives contracts under the cycle.	The definition of multilateral portfolio compression cycle means a process: “(a) that is applied to a portfolio of derivatives contracts; (b) under which some or all of the derivatives contracts in the portfolio are — (i) modified to reduce their notional amount; or (ii) terminated and replaced with one or more new derivatives contracts which have the effect of reducing notional exposures between the participants;	The definition of multilateral portfolio compression cycle means a process: (c) that is conducted for the purposes of reducing counterparty risk or operational risk for the participants;