esma European Securities and Markets Authority

Response form for the Consultation Paper on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a))

27 March 2020

European Securities and Markets Authority

Date: 27 March 2020

Responding to this paper

ESMA invites responses to the questions set out throughout its Consultation Paper on the Report on post trade risk reduction services with regards to the clearing obligation that ESMA is drafting under Article 85(3a) of the Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR, as amended by Refit).

Responses are most helpful if they:

- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all responses received by **15 June 2020**.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Consultation Paper in the present response form.
- Please do not remove tags of the type <ESMA_QUESTION_PTRR_1>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your response, name your response form according to the following convention: ESMA_PTRR_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PTRR_ABCD_RESPONSEFORM.
    - Upload the form containing your responses, **in Word format**, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation Paper on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a))".

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. **Please clearly indicate by ticking the appropriate checkbox on the website submission page if you do not wish your contribution to be publicly disclosed.** A confidential

response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection
Information on data protection can be found at www.esma.europa.eu under the heading “Data protection”.

Who should read the Consultation Paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivative transactions as well as central counterparties (CCPs) and clearing members.

General information about respondent

Name of the company / organisation	CME Group Inc.
Activity	Other Financial service providers
Are you representing an association?	☐
Country/Region	Sweden

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_PTRR_1>
CME Group Inc. ("CME")[1] appreciates the opportunity to provide the European Securities and Markets Authority ("ESMA") with comments regarding the Consultation Paper on the Report on post trade risk reduction services with regards to the clearing obligation that ESMA is drafting under Article 85(3a) of the Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR, as amended by REFIT).

TriOptima and RESET have over 16 years experience in delivering risk mitigation and risk elimination services for bilateral over-the-counter ("OTC") derivatives to capital markets institutions. TriOptima has significantly contributed to the promotion of better and safer bilateral derivatives markets, notably through inventing the methodology and the process for portfolio compression, "triReduce", among multiple counterparties for bilateral derivatives. TriOptima has also innovated a service for portfolio risk rebalancing, "triBalance", which can reduce significant risk in bilateral and centrally cleared derivatives portfolios of market participants using the service. RESET introduced a service for reducing the basis risk from positional or exposure mismatches in interest rate derivatives portfolios.
<ESMA_COMMENT_PTRR_1>

[1] CME Group is the ultimate parent company of TriOptima AB which operates the triReduce portfolio compression service and the triBalance portfolio rebalancing service ("TriOptima") and BrokerTec Europe Limited which operates the RESET basis risk mitigation service ("RESET").

Q1 : Would you agree with the description of the benefits (i.e. reduced risks) derived from PTRR services? Are there any missing? Could PTRR services instead increase any of those risks? Are there any other risks you see involved in using PTRR services?

<ESMA_QUESTION_PTRR_1>
Yes, the description of the benefits of post-trade risk reduction ("PTRR") services is broadly correct. While the value of compression services has been recognized by EU policymakers,[2] other PTRR services have not, meaning that these services are subject to regulation more applicable to bilateral trades among counterparties. Defining clear safeguards and criteria for PTRR service providers and encouraging the use of such services will contribute to significant risk reduction.

PTRR services play a crucial role in reducing post-trade risks in *existing* derivatives portfolios. PTRR services have developed organically across derivatives markets and existed pre-crisis. Beginning with basis risk reduction services in 1999 and portfolio compression services in 2002 and followed by counterparty rebalancing services that were first introduced in 2012. Generally, the post-crisis regulatory reform agenda has accelerated the markets' focus on risk reduction and with it PTRR services. Both bilateral and cleared derivatives portfolios are optimized to minimise the build-up of notional amounts, basis risk, trade count and counterparty risk, which reduces systemic risk.

PTRR services often involve the creation of new administrative transactions as a result of the service – albeit, the administrative transactions are not trading transactions (i.e. non-price forming). There is a risk these non-trading administrative transactions are captured by the EMIR clearing obligation – which in turn prevents PTRR services from being able to perform their risk reduction functions efficiently.
In terms of additional benefits, we believe that PTRR services, including portfolio compression, can play an important role in the migration from legacy reference rates and benchmarks ("IBORs") to risk free rates.

A modified version of portfolio compression, called, "benchmark conversion", can support the industry's transition from IBORs to the updated reformed benchmarks by offering compression of trade portfolios referencing the legacy rates and replacing the risk with replacement transactions on the reformed benchmarks. The use of such services should not be disincentivized by subjecting resulting administrative transaction to an obligation to clear such transactions.
<ESMA_QUESTION_PTRR_1>

Q2 : Would you agree with this description of portfolio compression? Please explain the different compression services that are offered and how they may differ from the description above. Are there today viable alternatives to using PTRR services to achieve a similar outcome?

<ESMA_QUESTION_PTRR_2>
The description of portfolio compression is broadly accurate. It is a post-trade mechanism that aims to reduce the number of transactions, the gross notional or some other measure of risk without materially affecting the market risk of the portfolio. These risk reduction exercises can be run bilaterally, multilaterally or within a CCP by a PTRR service provider. CCPs also run separate bilateral compression/netting exercises as described in the document.

Trades can be wholly or partially terminated and the notional on an individual partial termination can either increase or decrease, although the overall gross notional of the portfolio will decrease. In some asset classes, those with a high degree of standardisation, it is possible to run portfolio compression using full market risk neutrality, although for others, accepting nearly matching trades is essential to achieve the optimal result.

[2] *See* Article 14 of 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.

The amended or replacement administrative transactions mentioned above would be subject to the clearing obligation, where applicable, even though these transactions are not price forming – the transactions take place away from the market on stale curves. For example, requirements relating to pre- and/or post-trade transparency are typically applicable to trading venues but ill-suited to PTRR services, such as portfolio compression. While by their nature, these services operate among multiple counterparties, no buying and selling interests interact when clients use these services. Instead these services are used to reduce second order risks emerging from *existing* positions and at a portfolio level. Consequently, these services are not based on bids and offers, meaning that no price discovery takes place, making price transparency irrelevant in this context and making it impossible to have compound transaction PTRR services executed on a trading venue's central limit order book. Administrative transactions resulting from PTRR services should be clearly identified and reported as a non-addressable liquidity and separate from trading transactions in price and transaction reporting. Otherwise market participants would be misled into assuming that such PTRR transactions represented price forming addressable market liquidity. <ESMA_QUESTION_PTRR_2>

Q3 : Without changing the market risk of the portfolios, how different can the transactions included in the portfolio compression exercise be? Would the market risk be changed at all by the applied tolerances and if yes, how can the portfolio remain market neutral? What tolerance levels are often applied and could/should restrictions be placed on tolerances?

<ESMA_QUESTION_PTRR_3>
Compression algorithms identify a set of trades that can be terminated early or replaced within the market risk tolerances established by the participant. Primary market risk tolerances for compression of interest rate products are expressed in DV01. As explained further below, given the natural alignment of interests across participants and PTRR service providers to apply tight tolerances, it is unnecessary for regulatory imposed restrictions to be applied to market risk tolerance levels.

It is in the common interest for both participants in the PTRR exercise and for the service provider to have tight tolerances applied. The unwind proposal is typically based on "stale" valuations from the close of business the day before acceptance. These factors are controlled by the fact that market curves and prices fluctuate in real time and only a near market risk neutral unwind proposal would be acceptable to participants.

Market risk will always be symmetrical among participants in the compression cycle so if market risk tolerances are widened, half of the participants would on average see a negative value and would thus reject the proposal, while the other half of the participants would be very keen to complete the compression. Only with very tight tolerances (and a near market risk neutral proposal) would all participants accept the proposal given the potential for market moves during the time it takes for proposal generation, verification and acceptance (i.e. Live Acceptance).

Typically, tolerances are set to levels so tight that participants are entirely indifferent to the direction the market takes during Live Acceptance. Tolerances are commonly set as a fraction of the risk of one average ticket trade. For example, a common tolerance level for Interest Rate Swap compressions is to apply a restriction on present value impact of +/- 5,000 USD per basis points, and this can be applied on several levels to protect from curve shifts in different parts of the yield curve:

1. Total across the curve, to prevent a parallel curve shift of 1 basis point to result in more than +/- $5,000 impact;
2. Above and below 5 years, each separately limited to +/- $5,000 per basis point;
3. Curve segments like: < 1 year, 1-5 years, 5- 10 years, and >10 years. Total DV01 impact per curve segment restricted to +/- $5,000 per basis point;
4. Individual curve points like 1, 2, 3, 6, 9 months, 1, 2, 3, 5, 7, 10, 12, 15, 20, 30 years. Net impact for each individual point net impact on portfolio DV01 limited to +/- $5,000.

Combined, the above tolerance levels protect the portfolio from market risk shifts as a result of the compression. No matter how the market rates move, the aggregated present value of the terminated trades is very stable. In an example scenario, where curves have moved 3 basis points during the hours before acceptance some firms may see a valuation gain and others a loss of about $15,000 in relation to total compressed notional of about $1 trillion for large participants in large cycles.

The reason why market risk tolerances cannot be set to zero for compression, and why participants are willing to accept the present value fluctuations caused by non-zero tolerances, is that for non-standardised products there would be little to no potential for compression, given the different maturity dates and trade details in the portfolio. It is a trade-off where slightly wider tolerances increase compression efficiency, while at the same time generating this present value fluctuations. In addition to interest rate curve tolerances discussed above, participants typically apply additional tolerances, depending on type of compression cycle, including fixing, cross currency basis, and FX delta tolerances. <ESMA_QUESTION_PTRR_3>

Q4 : Should there be a clearing exemption for PTRR trades that are a direct result from a portfolio compression? If not, why? Is there a difference between bilateral and multilateral portfolio compression for the sake of an exemption?

<ESMA_QUESTION_PTRR_4>
While a clearing exemption is primarily relevant for portfolio rebalancing, for compression services there are still benefits to introducing a clearing exemption for some PTRR trades.

Most compressions that TriOptima and other service providers operate target cleared trades only. In this context it is desirable that any replacement trades or new trades (including partial trades) are also cleared, and the clearing obligation presents no challenges in this regard.

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 that requirement is needed. However, in the event there could be a change in the product scope mandated for clearing, it would be beneficial to have a clearing exemption applicable for any replacement or new trades (including partial trades) resulting from compression of legacy portfolios.

Currently, Credit Default Swaps on indices is the only product type for which TriOptima performs compressions of uncleared trades which is now subject to a clearing obligation. As a result, when operating unwind 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 unwind efficiency and operational simplicity. A clearing exemption would be beneficial to market participants.<ESMA_QUESTION_PTRR_4>

Q5 : Would you agree with this description of PTRR Services? What other forms of PTRR services exist? What do they do? How do they work? Are there any other viable alternatives to PTRR services, if yes, why are they not sufficient?

<ESMA_QUESTION_PTRR_5>
PTRR services include portfolio compression, portfolio rebalancing and other types of services such as basis risk mitigation. Portfolio compression was addressed in the preceding questions. The description of portfolio rebalancing is broadly accurate. The primary consideration for understanding portfolio rebalancing is that a portfolio of transactions among counterparties consists of many transactions across different product types, which may be highly customized. Despite the complexity and breadth of transactions in a given portfolio, the risk in such portfolio can be expressed using a small number of risk measures. Portfolio rebalancing reduces the risks of these portfolios by injecting standardized transactions into existing portfolios. Because rebalancing leverages new transactions, market risk neutrality can be ensured by inserting equal amounts of buy and sell exposures, facing different counterparties.

In addition, other PTRR services, such as those offered by RESET, provide risk mitigation solutions to efficiently offset and manage various types of basis risk within participant portfolios. Basis risk is a second order risk within interest rate derivative portfolios resulting from the structure of the instruments traded and a mismatch of exposures over time. This type of PTRR service focuses on the second order risks that result from the structure of the instruments traded by identifying large scale multilateral packages of transactions for each participant which will reduce or remove their underlying basis risk exposures.

RESET does not address bilateral counterparty risk, and as such the service is not negatively impacted by the current clearing obligation. The choice of counterparty for the resulting administrative transactions is not determinative of achieving the objective of the service. However, a clearing exemption is relevant for PTRR services other than RESET, such as portfolio rebalancing.

Some of the risks addressed by PTRR services can be managed unilaterally or bilaterally among counterparties, but this typically requires time consuming negotiations and will ultimately deliver very low efficiency compared to the multilateral optimization provided by PTRR service providers.<ESMA_QUESTION_PTRR_5>

Q6 : Without changing the market risk of the portfolios, how different can the transactions included in the PTRR exercise be? What tolerance levels are often applied and what restrictions could/should restrictions be placed on tolerances (if applies)?

<ESMA_QUESTION_PTRR_6>
Trades resulting from a rebalancing exercise are based on risk sensitivities from the portfolio and not on underlying trade details, meaning that the resulting trades will be different from the original trades which contribute to the underlying risk exposure. 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. <ESMA_QUESTION_PTRR_6>

Q7 : Is the requirement under EMIR of portfolio compression sufficient to mitigate the risk of build-up of transactions and how is the market managing this risk today?

<ESMA_QUESTION_PTRR_7>
Compression has become increasingly common as a risk management tool in derivatives markets. EU and other regulators have recognised the value of compression. We encourage regulators to support regulatory frameworks that foster the effective use of compression and other PTRR services in allowing market participants to effectively manage their risks.

Specific to portfolio rebalancing, new administrative transactions from rebalancing have very short maturities or have mandatory break dates or are subject to regular compressions. This ensures that no excess notional or trade count is outstanding at any point in time and that new transactions from PTRR exercises only offset risk exposures from firms' regular trading activity (not offsetting previously introduced PTRR transactions). Portfolio rebalancing transactions therefore will not contribute to significant build-up of inventory.<ESMA_QUESTION_PTRR_7>

Q8 : Based on all of the above, how would you define (algorithm based, second order risk, market neutral) PTRR services that cover all of the relevant aspects?

<ESMA_QUESTION_PTRR_8>
PTRR services include portfolio compression, portfolio rebalancing and other types of services such as basis risk mitigation.

A suitable definition of qualifying portfolio compression exercises would be:
"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 void."

A suitable definition of qualifying portfolio rebalancing exercises would be:
"*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."*

A definition is not proposed for basis risk reduction services because this type of PTRR service does not address bilateral counterparty risk, and as such the service is not negatively impacted by the current clearing obligation.

Characteristics that could be used to define qualifying PTRR exercises are:

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/ secondary order risks and a limited set of tolerances to be respected (e.g. counterparty credit limits and portfolio risk tolerances).
Non-price forming	PTRR exercises' participants are not able to post bids or offers, no price negotiation takes place and market risk neutrality within defined thresholds, where applicable, means transactions are recorded away from market prices on stale curves.
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-continuous and non-real-time	PTRR exercises "runs" or "cycles" 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 "all or nothing" basis across all exercise participants.

<ESMA_QUESTION_PTRR_8>

Q9 : Should there be an exemption from the clearing obligation for PTRR trades (other than portfolio compression) that are a direct result from a PTRR exercise? If not, why?

<ESMA_QUESTION_PTRR_9>
Yes, but only for those administrative transactions that are negatively impacted by the clearing obligation. A clearing exemption is primarily relevant for portfolio rebalancing. However, for compression services there are still benefits to introducing a clearing exemption for some PTRR transactions. PTRR services focused on basis risk mitigations, such as RESET, do not address bilateral counterparty risk, and as such the services are not negatively impacted by the current clearing obligation.

Portfolio rebalancing requires that new administrative transactions be inserted among two predefined counterparties. Allowing plain vanilla products, that are captured by the clearing obligation would allow, for example, bilateral interest rate DV01 risk among market participants to be mitigated with a relatively simple bilateral derivatives product. This will improve the efficiency of portfolio rebalancing and allow less sophisticated firms to leverage these services. <ESMA_QUESTION_PTRR_9>

Q10 : Is there a PTRR service today including offsetting transactions with a CCP?

<ESMA_QUESTION_PTRR_10>
Yes, TriOptima's triBalance service allows participants to include CCP counterparties in their portfolio rebalancing exercises. The risk exposures in a participant's portfolio facing a CCP are treated in a manner like a portfolio facing another bilateral counterparty. Including CCPs in portfolio rebalancing improves the efficiency of the service and allows for additional risk to be reduced, e.g. by transferring residual bilateral risk to face a robust and highly regulated CCP.
<ESMA_QUESTION_PTRR_10>

Q11 : Assuming there would be an exemption to the clearing obligation:

(i) Could PTRR services conduct offsetting opposite trades in the counterparty's cleared portfolio and if yes, should it be mandatory to enter into such offsetting transactions?

(ii) Would the PTRR transaction in the non-cleared portfolio then remain between the counterparties or be terminated (netted)?

<ESMA_QUESTION_PTRR_11>
(i) For non-compression PTRR services, while technically possible to generate a CCP facing trade for each new bilateral trade, this would generate unnecessary gross notional and transaction volume. Typically, there is a lot of risk netting possible across bilateral counterparties. Only remaining net risk could be booked facing the CCP to ensure full market risk neutrality and the effective migration of net risk from bilateral to cleared portfolios.

(ii) For non-compression PTRR services the administrative transactions entered into as the result of a PTRR exercise will stay on the bilateral books to maturity or may be subject to a subsequent compression exercise by which they may be terminated early. The compression opportunities may not exist at the time the administrative transaction is created, and in cases when such opportunities do exist there are often operational advantages to separate risk rebalancing from compression exercises.<ESMA_QUESTION_PTRR_11>

Q12 : Please provide data (number of trades and notional compressed, amount of initial margin reduction, number of counterparties regularly using PTRR services, other metrics) per type of PTRR service, with as much granularity as possible (per entity, per asset class/currency, per run, over the years and over the past year, etc.) and the related explanations on how PTRR services are used.

<ESMA_QUESTION_PTRR_12>

- 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 counterparty risk exposure among multiple CCPs and bilateral relationships while leaving net market exposure unchanged. Estimated risk reduction to date: > €10.5 billion.

PTRR services play 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. 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 bilateral and cleared derivatives portfolios are optimized to minimise the build-up of basis risk, notional amounts, trade count and counterparty risk, which reduces systemic risk.
<ESMA_QUESTION_PTRR_12>

Q13 : Please also, where possible, provide data whether those numbers would be expected to change if there was an exemption to the clearing obligation.

<ESMA_QUESTION_PTRR_13>
The simpler the instruments that can be used for administrative transactions to rebalance counterparty risk, e.g., a plain vanilla Interest Rate Swap to rebalance Interest Rate DV01, the more likely market participants will take part. Since portfolio rebalancing is a multilateral optimization service, the number of participants using the service is one of the main attributes defining its potential as the efficiency of the service grows considerably with the number of participants. <ESMA_QUESTION_PTRR_13>

Q14 : Do you think an exemption from the clearing obligation for transactions resulting from PTRR services would increase the use of PTRR services? Please explain.

<ESMA_QUESTION_PTRR_14>
Yes, as mentioned above, less sophisticated firms will be more inclined to use portfolio rebalancing if simpler (vanilla) products are eligible as administrative transactions. The larger number of participants using the service, the more risks can be proactively managed and ultimately mitigated resulting in a greater benefit for individual counterparties, as well as the wider financial markets and overall financial stability.
<ESMA_QUESTION_PTRR_14>

Q15 : Do you think an exemption from the clearing obligation is not needed for legacy portfolios and PTRR services generally? To what extent can the use of plain vanilla transactions in PTRR services be replaced with the use of non-plain vanilla transactions, or should this be avoided? Please explain.

<ESMA_QUESTION_PTRR_15>
An exemption from the clearing obligation for qualifying PTRR exercises would help to accelerate the reduction of legacy portfolios as participants could include them in PTRR exercises but only for those administrative transactions that are negatively impacted by the clearing obligation. As noted, a clearing exemption is primarily relevant for portfolio rebalancing. However, for compression services there are still benefits to introducing a clearing exemption for some PTRR administrative transactions. RESET does not address bilateral counterparty risk, and as such, the service is not negatively impacted by the current clearing obligation.

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. 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. In particular, the use of swaptions is complex and may detract certain participants that would otherwise be inclined to take part in an PTRR exercise. These synthetic workarounds for avoiding the clearing obligation 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. It is important from the perspective of optimal risk management and financial stability that market participants be 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. The best outcome is to facilitate the proper use of PTRR services by providing an exemption from the clearing obligation.

Multilateral portfolio compression, portfolio rebalancing, and basis risk reduction services offer the potential for considerable benefits by helping market participants reduce risk and manage their derivatives portfolios in a responsible manner. <ESMA_QUESTION_PTRR_15>

Q16 : Would an exemption to the clearing obligation contradict the G20 commitments? Please explain.

<ESMA_QUESTION_PTRR_16>
No, the administrative transactions resulting from PTRR services are not trading activities. The significant difference is that --unlike trading activities-- administrative transactions do not result from two counterparties meeting in the market with the intention of changing their respective market positions. This important disparity illustrates that regulatory frameworks established by the G20 for trading activities are ill-suited for PTRR services.

Rather PTRR services are meant to reduce risk in bilateral derivatives portfolios, which is consistent with the overarching objective of the G20. Even after application of the G20 commitments, significant residual risks remain in portfolios, such as counterparty exposures from split netting sets and operational and counterparty risks from gross and opposite outstanding positions. PTRR services accord with the G20 policy aims by mitigating these risks in the OTC derivatives markets.

The distinction from trading activities can be summarised as follows:

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

<ESMA_QUESTION_PTRR_16>

Q17 : How could an exemption to the clearing obligation for PTRR trades lead to a circumvention of the clearing obligation? Please explain.

<ESMA_QUESTION_PTRR_17>
Provided that certain conditions of qualifying PTRR exercises are a requirement for an exemption to the clearing obligation and the definitions are acceptable, an exemption for such exercises' administrative transactions will not lead to a circumvention of a clearing obligation by participants.

Characteristics of qualifying PTRR exercises that could be used to define conditions for an exemption from the clearing obligation are:

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/ secondary order risks and a limited set of tolerances to be respected (e.g. counterparty credit limits and portfolio risk tolerances).
Non-price forming	PTRR exercises' participants are not able to post bids or offers, no price negotiation takes place and market risk neutrality within defined thresholds, where applicable, means transactions are recorded away from market prices on stale curves.
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 services do not offer a vehicle for taking market positions – their purpose is risk reduction.
Non-continuous and non-real-time	PTRR exercises' "runs" or "cycles" 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 "all or nothing" basis across all exercise participants.

The changes ESMA has proposed to regulatory reporting related to PTRR exercises will facilitate transparency and aid in regulatory supervision and oversight.[3]
<ESMA_QUESTION_PTRR_17>

Q18 : Would you consider introducing an exemption to the clearing obligation as an incentive not to clear transactions that technically are covered by the clearing obligation. If yes, why?

<ESMA_QUESTION_PTRR_18>
Only administrative transactions entered into among the participants in a qualifying PTRR exercise, and which result from risk reduction proposals of the PTRR service provider should benefit from the exemption to the clearing obligation. Therefore, any such exemption would not act as an incentive not to clear the primary underlying trades. <ESMA_QUESTION_PTRR_18>

[3] Consultation Paper on Technical standards on reporting, data quality, data access and registration of Trade Repositories under EMIR REFIT, 26 March 2020 | ESMA74-362-47.

Q19 : Are there risks with reducing collateral? Even if complying with regulatory requirements, could this lead to such capital being used to increase risks, possibly systemic risks?

<ESMA_QUESTION_PTRR_19>
The G20's commitments following the financial crisis are designed to ensure that the risks of bilateral derivatives portfolios are appropriately managed and as such, collateralised. PTRR services are supportive of this commitment. Qualifying 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.<ESMA_QUESTION_PTRR_19>

Q20 : Are there other jurisdictions where PTRR trades have been exempted from the clearing obligation? Please explain the features of any such exemption. Do you use any of those exemptions, and for what type of trades?

<ESMA_QUESTION_PTRR_20>
Currently, we are not aware of any other jurisdictions that exempt PTRR trades from their clearing obligation. <ESMA_QUESTION_PTRR_20>

Q21 : Should conditions, similar to the ones as outlined above, apply to a possible exemption under EMIR for PTRR transactions? Should other conditions apply? Would the answer depend on the type of PTRR service? Please explain.

<ESMA_QUESTION_PTRR_21>
The proposed conditions broadly align with the conditions and definitions we have proposed in the course of this response, although there may be occasions when they differ. For instance:

- It may be beneficial to include both bilateral and cleared transactions in the same PTRR exercise rather than a purely bilateral one.
- In this event, the inclusion of a CCP in the PTRR exercise would result in the exercise being deemed a multilateral exercise since there would be more than two parties, excluding the PTRR service provider.
- The compression exercise should result in reduced risk/notional and include only the trades among the counterparties taking part.
- The PTRR service provider should be independent of the participants and PTRR transactions should be generated in accordance with the PTRR service provider's established rules and parameters.

Additional characteristics to be considered are:

- **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/ secondary order risks and a limited set of tolerances to be respected (e.g. counterparty credit limits and portfolio risk tolerances);
- **Non-price forming** – while the PTRR exercise may involve a new administrative transaction in order to achieve the identified risk reduction result, participants are not able to post bids or offers, no price negotiation takes place and market risk neutrality within defined thresholds, where applicable, means transactions are recorded away from market prices on stale curves;
- **All or nothing**– the PTRR exercise is binding on an "all or nothing" basis across all exercise participants**;**

- **Second order portfolio risks** – the PTRR exercise does not offer a vehicle for taking market positions or trading transactions – their purpose is the reduction of operational, counterparty, basis risks for *existing* derivative contracts, which ultimately reduces systemic risk; and
- **Non-continuous and non-real-time** – the PTRR exercise's runs – the assessment of risk reduction "runs" or "cycles" takes place intra-day/over-night according to pre-published schedules (participants cannot unilaterally select timing), the service provider's non-discretionary methodology determines overall risk reduction opportunities.

We note the conditions are all directed towards portfolio compression, but several align with conditions and definitions we have proposed for portfolio rebalancing, as discussed below.

Regarding suggested drafting for the conditions identified above, see the definitions for portfolio compression and portfolio rebalancing proposed at question 8.
Furthermore, see our response to question 18.
<ESMA_QUESTION_PTRR_21>

Q22 : Is there a difference between bilateral and multilateral portfolio compression justifying an exemption to the clearing obligation only to apply for multilateral portfolio compression?

<ESMA_QUESTION_PTRR_22>
Bilateral compression can be utilised in one of two ways. As a result of bilateral negotiation without the use of a PTRR service provider or by using a PTRR service provider to identify the optimal compression package for both parties.

An exemption should be available without any distinction for the number of participants involved. The exemption should be predicated on the use of a PTRR service provider independent to the counterparties and on the counterparties accepting in full the risk reduction proposal of the PTRR service provider.
<ESMA_QUESTION_PTRR_22>

Q23 : Should only uncleared transactions be included in portfolio compression in order to qualify for the clearing exemption? How would a possible limitation to uncleared transactions limit the effectiveness?

<ESMA_QUESTION_PTRR_23>
A compression exercise in a cleared environment will typically only result in new cleared transactions, for which there is no need for an exemption from the clearing obligation.

As mentioned previously, PTRR exercises may include both cleared and uncleared transactions in the same exercise which requires that both types of trade be afforded the exemption.<ESMA_QUESTION_PTRR_23>

Q24 : To benefit from an exemption to the clearing obligation, should PTRR trades be strict risk neutral or should there be tolerances for small changes in the risk of portfolios? How would you define what is an acceptably small change in risk?

<ESMA_QUESTION_PTRR_24>
For risk rebalancing services, a strict market risk neutral requirement could apply, and have no material impact on the service efficiency since this is the preferred method for most risk rebalancing services. Compression services however, only function when provided with small permitted changes in market risk, as outlined in question 3.

We do not consider the change in risk needs to be defined, because as outlined in the response to question 3, the incentives for pre-defined tolerance levels to be small are well aligned among PTRR participants and PTRR service providers. However, if the change in risk does require definition it should be considered on a product and asset class basis. Bearing in mind the concept is relative and what is small for one product might be large for another.<ESMA_QUESTION_PTRR_24>

Q25 : To benefit from an exemption to the clearing obligation, to what extent should parties to a PTRR exercise be able to be changed, i.e. not limited to the original counterparties? Would the answer depend on the type of PTRR service? Please explain.

<ESMA_QUESTION_PTRR_25>
Qualifying PTRR exercises mitigate outstanding risk by compressing existing transactions or by introducing new risk reducing administrative transactions. For compression, both parties to a trade must agree to compress the trade, this applies to both trades among two bank participants as well as among a clearing member and a CCP.

For risk rebalancing to have the desired outcome on outstanding risk exposure it must be possible to predefine the counterparties to each administrative transaction. This must be the case where an exemption from the clearing obligation is leveraged, e.g. by using Interest Rate Swaps to reduce bilateral Interest Rate DV01 risk. Exposure will however only be rebalanced among non-CCP participants that have actively decided to take part in a rebalancing exercise. Given the role of CCPs and structure of central clearing, in a risk rebalancing exercise, the inclusion of a CCP allows for residual exposures to be transferred from exposures borne in uncleared netting-sets to the cleared environment. <ESMA_QUESTION_PTRR_25>

Q26 : Should there be a requirement for PTRR services to reduce risk for a clearing exemption to apply? Should it apply to all PTRR services? If not, please explain why. How would a successful PTRR exercise be measured?

<ESMA_QUESTION_PTRR_26>
Yes, a qualifying PTRR exercise should be required to reduce the specific risk exposure targeted, for example, compression should be required to reduce outstanding notional and rebalancing should be required to reduce the outstanding counterparty risk exposures, e.g. initial margin. A successful PTRR exercise would be measured by achievement of a reduction in the specific risk exposure targeted. Note however, PTRR service providers cannot assume any responsibility for the accuracy of input data provided by participants as that is outside of the PTRR service providers' control. <ESMA_QUESTION_PTRR_26>

Q27 : Could PTRR services increase exposure or risk on a participant basis? Would the answer depend on the type of PTRR service provided? How should the PTRR service provider limit any possible increase in notional amount or risk? Please explain.

<ESMA_QUESTION_PTRR_27>
No, a qualifying PTRR exercise would not increase the specific risk exposure targeted, for example, compression will reduce the outstanding notional and rebalancing will reduce the outstanding counterparty risk exposures.

It is, however, important to note that to achieve the best possible risk reduction for both the market and the individual participants it is sometimes beneficial to allow a small number of bilateral risk exposures to mar-

ginally increase for individual participants where that improves the mitigation of risk for the overall exercise. Where exposures facing CCPs are included, the same restrictions should not apply as that may prevent a potential redistribution of risk exposure from uncleared to cleared netting sets.

That being said, both PTRR services providers and their participants limit the increase in outstanding notional for PTRR exercises that use new administrative transactions to mitigate risk. TriOptima's triBalance service systematically uses two- or three-week FX Non-Deliverable Forwards to continuously rebalance outstanding FX delta risk, and equity delta exposure is mitigated using four-week equity swaps, and Interest Rate DV01 exposures are mitigated using swaptions which are compressed in coordination with the next rebalancing exercise. This is designed to ensure that a minimum amount of notional is used to mitigate outstanding risk exposures. Allowing vanilla Interest Rate Swaps to address bilateral Interest Rate DV01 risk would further improve this relationship by effectively cutting the amount of notional required in half. <ESMA_QUESTION_PTRR_27>

Q28 : How could a limitation like "no participant worse off" be defined?

<ESMA_QUESTION_PTRR_28>
PTRR service providers should not increase the targeted risk for any participating party in a PTRR exercise based on the input data provided by participants. This is designed to ensure that a participant will never be "worse off" compared to not participating. <ESMA_QUESTION_PTRR_28>

Q29 : How should it be ensured that PTRR service providers are independent in their assessment? Should the conditions imposed on the providers of PTRR services include requirements on governance of the algorithms to ensure the definition and the setting of parameters takes place with minimum influence from market participants? Should algorithms run with minimum manual intervention? Any other conditions or structural requirements that should apply?

<ESMA_QUESTION_PTRR_29>
We have always promoted the integrity, efficiency and transparency of global financial markets and supported the technological and other infrastructure advancements that have characterised the evolution of markets in recent years. TriOptima services operate as regulated businesses under the existing MiFID II regulatory framework.

Qualifying PTRR exercises should be those operated by MiFID investment firms or those PTRR service providers regulated in a third country. This would provide appropriate transparency for regulators to facilitate supervisory oversight and to ensure that no circumvention of the clearing obligation takes place. Such regulatory frameworks already contain appropriate requirements regarding governance, independence, product development and conflicts of interest. Regarding manual intervention, the PTRR services operated by TriOptima apply a high level of automation to achieve a low-touch process.

As with new and developing market-related technology, it is critical that prospective regulation is prudent and measured. It should allow enough room for innovation and new technologies to develop, whilst ensuring financial market integrity and safety. At this stage, PTRR services remain in a state of development and we advocate an approach to prospective regulation that encourages prudent innovation and fosters international collaboration. It is also important that policy makers and regulators work in a coordinated manner across jurisdictions in order to facilitate approaches of regulatory deference and to promote a principles-based approach to the regulatory treatment of these services, which recognises the need to allow for exemptions from clearing obligations.

It is also important to consider that PTRR services are fundamentally a technology applied to financial activities and services, rather than a financial activity or service itself, and therefore the existing regulatory framework is appropriate for addressing the operation of these services. <ESMA_QUESTION_PTRR_29>

Q30 : Do you consider that a PTRR service provider should be specifically licenced or authorised? Would this depend on the remits of the services provided? Would it be sufficient to provide requirements on the service provided, i.e. on transaction level rather than entity level? What do you see as the benefits of regulating PTRR services? Would this create any impediment or barriers?

<ESMA_QUESTION_PTRR_30>
Please refer to question 29. Qualifying PTRR exercises should be those provided by MiFID investment firms or those PTRR service providers regulated in a third country. It is important to consider that PTRR services are fundamentally a technology applied to financial activities and services, rather than a financial activity or service itself, and therefore the existing regulatory framework is appropriate for addressing the operation of these services.

The changes ESMA has proposed to regulatory reporting related to PTRR exercises will facilitate transparency and aid in regulatory supervision and oversight.[4]
<ESMA_QUESTION_PTRR_30>

Q31 : What would be the cost-benefit of exempting PTRR transactions (replacement and risk mitigation services through offsetting trades such as rebalancing) from the clearing obligation?

<ESMA_QUESTION_PTRR_31>
The benefits of exempting PTRR transactions are those identified by ESMA in its Consultation Paper:

- Portfolio compression helps reduce risks such as counterparty, operational and ultimately systemic risks, by reducing the number of trades and/or notional exposure among 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[5]".

- For other PTRR services, such as rebalancing, new transactions are entered into to reduce counterparty risk by reducing the exposure among two counterparties as a way to reduce systemic risk by decreasing the overall exposure in the market among counterparties. To further reduce systemic risk, this may be done by involving a CCP (where possible) to reduce counterparty risk. Operational risk is also reduced by the reduction in exposure and by managing risk by improving the efficiency and transparency of portfolios. Basis risk is second order risk within interest rate derivative portfolios that can also be efficiently offset and managed using basis risk reduction services.

- Overall, increased use of PTRR services would lead to increased mitigation of risk and a more robust financial system. Exempting PTRR services reduces the operational risks associated with current synthetic workarounds. These workarounds require participants to resort to increasingly complex structures that introduce new risks to be managed.

There are no costs to providing the exemption provided the correct safeguards are in place (such as those discussed in response to Question 21).

There should not be additional costs or externalities from exempting administrative transactions that result from a PTRR exercise because only administrative transactions entered into among the participants in a

[4] Consultation Paper on Technical standards on reporting, data quality, data access and registration of Trade Repositories under EMIR REFIT, 26 March 2020 | ESMA74-362-47
[5] Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives, Consultation Report, September 2014, CR06/2014

qualifying portfolio compression or rebalancing or other qualifying PTRR exercise should benefit from the exemption. Therefore, any such exemption to the clearing obligation would not act as an incentive not to clear the primary underlying trades.
<ESMA_QUESTION_PTRR_31>