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| 27 March 2020 |

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

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| --- | --- |
| Name of the company / organisation | FRENCH BANKING FEDERATION |
| Activity | Banking sector |
| Are you representing an association? |[x]
| Country/Region | France |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_PTRR\_1>

French banks are active users of PTRR services offered by several independent service providers. PTRR services are useful to reduce counterparty risks and systemic risk. PTRR services are all the more important because if the exposure on a given counterparty is high, and this counterparty defaults, the market participants could be competing with the CCPs to hedge their positions. PTRR services also have a benefit for liquidity management because they reduce the amounts of margin that need to be transferred – in fact, the recent Covid-19 related market stresses have highlighted this issue, while the net amounts of variation margin paid/received remained broadly of the same order of magnitude as before, the gross amounts paid/received increased by the order of 5 to 7 times.

The clearing obligation, which in itself is a good concept, that we do not wish to undermine, has had an unwanted and probably unforeseen effect : it has become impossible to use vanilla trades, which are subject to the clearing obligation, for bilateral portfolio rebalancing. Paradoxically, the clearing obligation has made sophisticated PTRR services more necessary than before, because of the loss of flexibility in bilateral portfolio management.

We note the recent (2nd June 2020) publication of a paper by Acadiasoft - <https://acadiasoft.com/smooth-sailing-through-the-perfect-storm/>

Acadiasoft is a market infrastructure central to the margin process across the industry. Their observation that Variation Margin exchanged increased from around USD1.6tryn per month to USD5.6tryn during March as the Covid-19 crisis hit the markets. The large scale of offsetting bilateral credit risks – that PTRRS seek to address – is a significant cause of this.

<ESMA\_COMMENT\_PTRR\_1>

1. : 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>

We agree that PTRR services reduce systemic risk, and operational risk. By definition, they have no (or nearly no) effect on market risk. They will reduce counterparty risk in bilateral portfolios. It can happen that they increase the exposure facing a CCP when cleared transactions are put in place in the PTRR services.

We fully acknowledge that certain risk mitigation procedures (such as Bilateral Uncleared Initial Margin) are in place to reduce the impactfulness of these risks. However we strongly assert that the mitigation of a risk is a poor substitute for the outright removal of that risk – as once removed, participants are no longer exposed to Black Swan type events that would break through the level of mitigation that has been implemented.

We believe the risk reduction possibilities offered by PTRR services are, therefore, preferable when it comes to the overall systemic risk profile.

<ESMA\_QUESTION\_PTRR\_1>

1. : 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>

Yes, the description in the consultation paper is broadly accurate.

<ESMA\_QUESTION\_PTRR\_2>

1. : 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>

We believe there must be a slight tolerance to facilitate the portfolio compression, but there should also be control over any misuse of the service. Portfolio compression is normally currently carried out through partial or total unwinds of trade. New trades are not put in place because they would be subject to the clearing obligation.

<ESMA\_QUESTION\_PTRR\_3>

1. : 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>

Yes, in our opinion there should be a clearing exemption for trades resulting from a portfolio compression, whatever the tool used (bilateral or multilateral, as both will aim to reduce systemic risks).

However, regarding the clearing obligation, we do not think there is a will in the market to undermine it. Cleared trading is less costly which is an incentive to clear.

<ESMA\_QUESTION\_PTRR\_4>

1. : 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>

In our experience, we currently do not see any build-up of uncleared trades resulting from PTRR services.

Furthermore, each bank taking part in a multilateral PTRR needs to reduce its counterparty risk. This can sometimes be difficult to achieve and will then require to include a CCP in the optimisation exercise.

<ESMA\_QUESTION\_PTRR\_5>

1. : 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>

For existing PTRR services, the trades included in a specific compression exercise tend to be reasonably similar in nature, giving rise to similar risks.

Where non-vanilla trades are booked to offset the existing risks (ie portfolio rebalancing), these can be quite different to the original trades – eg swaptions can be used to offset risk arising from non-cleared Swaps and/or other non-vanilla transactions.

Tolerances are small and, importantly, are bi-directional. In other words, a firm does not know, ex-ante, a) how much, if any, of the tolerance might be used, and b) in which direction the tolerances might be applied. Thus it is not possible to use tolerances to add price forming risk to the portfolio.

We understand that existing service providers in this space are regulated, so their approach to tolerances is under the purview of their National Competent Authority.

<ESMA\_QUESTION\_PTRR\_6>

1. : 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>

Yes. The EMIR requirement to carry out portfolio compression is positive. Some of our members carry out the PTRR more often than the EMIR requirement, because there is a counterparty risk benefit and a prudential benefit. It also has a positive effect on the banks’ liquidity profile.

<ESMA\_QUESTION\_PTRR\_7>

1. : 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>

We think PTRR services are very useful and of systemic importance. They should be carried out by an independent third party, under appropriate supervision. They should always be risk reducing. In a multilateral exercise, the risks cannot always be reduced everywhere, but the PTRR leads to a general reduction. It is market neutral and post trade by nature. Given the existing agenda, we cannot propose some type of tender offers to third parties for PTRR.

<ESMA\_QUESTION\_PTRR\_8>

1. : 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, in our opinion there should be a clearing exemption for trades resulting from PTRR services.

Specifically we believe:

1. Any such exercise should be carried out by a regulated party independent of the participating firms,
2. To the extent trades are booked into a bilateral portfolio that would normally be required to be cleared, such trades should reduce the risk in that bilateral portfolio; and
3. For every trade exempted from the Clearing Obligation, and equal an opposite trade should be booked between the two counterparties but given up to a CCP. (Note, for technical reasons, the trades facing the CCP should be able to be compressed prior to ensure efficient booking)

<ESMA\_QUESTION\_PTRR\_9>

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

<ESMA\_QUESTION\_PTRR\_10>

Yes there are PTRR services today with offsetting transactions with a CCP.

<ESMA\_QUESTION\_PTRR\_10>

1. : Assuming there would be an exemption to the clearing obligation:
2. 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?
3. Would the PTRR transaction in the non-cleared portfolio then remain between the counterparties or be terminated (netted)?

<ESMA\_QUESTION\_PTRR\_11>

 With respect to question (i) Yes PTRR services could include offsetting trades in the counterparty’s cleared portfolio. But we do not think it should be mandatory. The decision could be left to the PTRR service provider. It would make sense to run a portfolio compression before clearing.

In regard to part ii) this would depend on whether the PTRR transaction exactly offsets the precise details of an existing bilateral trade – in which case it might be compressed – but more likely it will be more akin to a macro-hedge in the portfolio and, thus, would not have an exactly offsetting existing trade to compress against.

<ESMA\_QUESTION\_PTRR\_11>

1. : 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>

Trades resulting from existing compression and PTRR services are reported under MiFID and can be clearly identified in those reports.

Our members do not have access to statistics covering the overall use of PTRR and Compression services.

We would also note that any reduction in Initial Margin is the direct result of a reduction in risk. There is no change to the Initial Margin algorithm implied by PTRR services, as such the Initial Margin per unit of risk will not be changed. A reduction in IM should be welcomed as evidence as a reduction in the underlying risk. Recent events under Covid-19 have clearly highlighted the risks inherent in having multiple offsetting (but not nettable or hedgeable) offsetting bilateral exposures.

<ESMA\_QUESTION\_PTRR\_12>

1. : 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>

We expect the exemption from the clearing exemption for vanilla trades resulting from PTRR services would expand the customer base for PTRR services, especially regarding less sophisticated market participants.

In addition, due to the ready inclusion of CCP(s) in the scope of such services, we expect greater efficiency to be achieved for existing participants.

<ESMA\_QUESTION\_PTRR\_13>

1. : 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, we believe an exemption from the clearing obligation for transactions resulting from PTRR services would increase the use of PTRR services, especially for less sophisticated actors.

<ESMA\_QUESTION\_PTRR\_14>

1. : 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>

Yes we think an exemption from the clearing obligation for legacy portfolios and corresponding PTRR services would be useful.

PTRR services can be delivered with non-vanilla transactions, it is already done today by some service providers. However vanilla products reduce the operational risk compared to complex products, and for certain market participants the systems and processes are only able to manage vanilla products. For this reason we are in favour of an exemption from the clearing obligation in the context of PTRR services.

Transactions in non-centrally cleared bilateral portfolios are generally there for a good reason, for example historic trades where one counterparty wants the trade to be booked in its banking book and have accrued accounting or where the transaction is not clearable due to its specific characteristics – eg Swaptions, Caps, Floors, Cross-Currency Swaps, Structured Derivatives.

<ESMA\_QUESTION\_PTRR\_15>

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

<ESMA\_QUESTION\_PTRR\_16>

In our view, an exemption to the clearing obligation would NOT contradict the G20 commitments, because PTRR services reduce the size of the bilateral (uncleared) portfolios, and hence increase proportionally the size of the cleared portfolio. In other words, the percentage of cleared trades in the total portfolio increases.

<ESMA\_QUESTION\_PTRR\_16>

1. : 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>

PTRR services are used only for credit risk management and must have no impact on market risk. Rules should be sufficiently clear so that traders have no discretion on which trade is cleared and which is not. The exemption from the clearing obligation should indeed be carefully controlled to avoid any abuse. As such, PTRR services represent an additional step over and above what is available today – and none of the existing processes and scope are changed. Suitably controlled, as previously described in our answer, such services have the potential to add value, while maintaining the existing clearing obligation and increasing the proportion of the market risk that is cleared.

<ESMA\_QUESTION\_PTRR\_17>

1. : 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>

No, in our opinion an exemption from the clearing obligation would NOT be an incentive not to clear transactions that technically are covered by the clearing obligation, because PTRR are a separate post-trade activity. There must be a clear separation between trading and PTRR services.

<ESMA\_QUESTION\_PTRR\_18>

1. : 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>

In our view it is not a problem that the collateral is reduced if the counterparty risk is reduced. We do not see any systemic risk in that.

<ESMA\_QUESTION\_PTRR\_19>

1. : 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>

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<ESMA\_QUESTION\_PTRR\_20>

1. : 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>

As discussed in Q9,

1. Any such exercise should be carried out by a regulated party independent of the participating firms,
2. To the extent trades are booked into a bilateral portfolio that would normally be required to be cleared, such trades should reduce the risk in that bilateral portfolio; and
3. For every trade exempted from the Clearing Obligation, and equal and opposite trade should be booked between the two counterparties but given up to a CCP. (Note, for technical reasons, the trades facing the CCP should be able to be compressed prior to ensure efficient booking)

<ESMA\_QUESTION\_PTRR\_21>

1. : 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>

By including the risk transfer to CCPs in the process, we do not believe it is necessary to distinguish between bilateral and multilateral compressions. Whatever the case, the process should be run by a party independent of the market participants seeking to manage their risks.

<ESMA\_QUESTION\_PTRR\_22>

1. : 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>

Generally it should be possible to include both bilateral and cleared transactions in the same compression run. However such a limitation should not limit effectiveness – but by including both the process would be more efficient.

<ESMA\_QUESTION\_PTRR\_23>

1. : 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>

In the proposed approach whereby all bilateral trades should have an equal and opposite cleared trade, no tolerances are explicitly required. However existing compression and PTRR services use tolerances to improve efficiency and it is possible to see how a hybrid service might be developed to yet further improve efficiency. Therefore we believe the existing tolerance regime should remain. Furthermore, as we transition from LIBOR to Risk Free Rates, some degree of tolerance would be helpful due to the basis risks present.

<ESMA\_QUESTION\_PTRR\_24>

1. : 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>

A Compression or PTRR service should only impact the risk of those firms participating in it. We do not see a reason why parties should be able to be changed. As such we would agree with such a restriction.

<ESMA\_QUESTION\_PTRR\_25>

1. : 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, in line with our proposed conditions specified in Q9.

All regulated participants have agreed measures of risk with their supervisors. We believe it should be incumbent upon the firm utilising such an exemption to be able to demonstrate such a reduction in line with the approach agreed with supervisors.

<ESMA\_QUESTION\_PTRR\_26>

1. : 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>

As PTRR services overlay trades into existing bilateral portfolios, there will be some increase in gross notional of trades, though (per Q9) the risk in the portfolio must be reduced so the Net exposure must be reduced. We believe that Net exposure is the correct measure (as it is with CCPs and other risk/margin calculations.

In addition, firms might include the trades resulting from a previous PTRR service run in the next run, to compress or otherwise amend them accordingly. As such, we do not expect to see significant increases in gross notional arise.

<ESMA\_QUESTION\_PTRR\_27>

1. : How could a limitation like “no participant worse off” be defined?

<ESMA\_QUESTION\_PTRR\_28>

Per Q9, we believe the requirement that the risk is reduced in each and every bilateral portfolio that takes advantage of such an exemption means that all participants will benefit and none can have their position worsened.

<ESMA\_QUESTION\_PTRR\_28>

1. : 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 believe that the existing regulation of such service providers has been effective and feel that it should be continued. In particular, the algorithms used should be under the purview of supervisors

Additionally, it is vital to the commercial success of a PTRR service provider for the market to have confidence in their algorithm and their confidentiality. Robust governance should be helpful.

<ESMA\_QUESTION\_PTRR\_29>

1. : 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>

Existing PTRR service providers are already regulated. They should be able to operate globally.

<ESMA\_QUESTION\_PTRR\_30>

1. : 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>

As previously stated, we believe that the current Clearing Obligation has been extremely useful but, as the market has moved to an increasingly cleared model, the strict delineation of cleared vs non-cleared has given rise to new emergent risks. We have already seen the C-19 market stress cause significantly increased gross margin flows during a period of intense liquidity shortages. Had there been a major dealer default, it is likely that the competition for hedges could have caused material difficulties.

We believe the mitigation of these risks is a valuable outcome, and a general reduction in systemic risk will ensue.

There are few costs, except additional transaction costs arising from more trades being created by the PTRR service providers.

<ESMA\_QUESTION\_PTRR\_31>