



ESRB opinion on ESMA's report

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

The General Board of the European Systemic Risk Board (ESRB) welcomes the consultation paper of the European Securities and Markets Authority (ESMA) on post trade reduction services (PTRRS) with regards to the clearing obligation. Under Article 85(3a) European Market Infrastructure Regulation (EMIR) the ESRB is required to cooperate with ESMA in delivering a report exploring whether, and under which conditions, trades that directly result from PTRRS, including portfolio compression and counterparty rebalancing (where applicable), should be exempted from the clearing obligation referred to in Article 4(1) of the same regulation. The ESRB welcomes the opportunity to provide ESMA with this preliminary response to the consultation paper and stands ready to cooperate further with ESMA in the finalisation of the report. The ESRB also stands ready to revise its views once the new evidence from the consultation is made available.

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, this response focuses on the implications of PTRRS in non-centrally cleared OTC markets for preventing and mitigating systemic risk and promoting the smooth functioning of the internal market. The ESRB is fully supportive of the G20 Pittsburgh agenda, and in particular of the benefits of the centralised clearing of OTC standardised derivatives as an effective tool to mitigate the systemic risks arising from the web of credit exposures in the bilateral OTC market. The establishment of a clearing obligation for liquid and standardised OTC derivatives markets is an essential component of this agenda. Therefore, 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. The Pittsburgh agenda also included measures to reduce risk in the non-centrally cleared space, through the exchange of margins and other risk mitigation techniques such as PTRRS. Both EMIR¹ and MiFIR² recognise the role of PTRRS³ (especially portfolio compression) in mitigating systemic risk. In addition, it is noted that trades resulting from portfolio compression currently benefit from a series of exemptions (e.g. best execution, transparency requirements, trading obligations) under MiFIR.⁴ In principle, from a financial stability perspective

¹ See Recital 30 and Article 14 of Commission Delegated Regulation (EU) No 149/2013.

² See Recital 27 and Article 31 of Regulation (EU) No 600/2014.

³ The ESRB acknowledges, however, that the term is not a defined term under EMIR or MiFID/MiFIR and that this may cause misunderstandings.

⁴ Although no similar exemptions are available for the same sets of trades under EMIR.

and without prejudice to the overarching objective of promoting central clearing, exemptions from the clearing obligation of trades resulting from PTRRS could be allowed where they demonstrably reduce systemic risk compared to a scenario where such exemptions are not granted.

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.

While PTRRS reduce risks, residual and emerging risks must be duly understood, disclosed and addressed. Except in trivial cases – such as the compression of exchange traded derivatives where contracts are offset by identical but opposite positions, leaving no residual risk – PTRRS generally operate on the principle of equivalence: a portfolio of contracts is replaced by another, different portfolio which is equivalent, but not identical, to the original one. PTRRS can therefore be defined as a transaction in which two (or more) counterparties exchange a portfolio of pre-existing derivative contracts for a new portfolio, at a price. The driver of PTRRS transactions, which are also beneficial for financial stability, should be the perceived reduced riskiness of the new portfolio compared to the old one, all at little or no monetary cost. The equivalence between and preference for portfolios are counterparty-specific assessments based on future expectations, estimates of correlation and assessments of counterparty credit risk. While it would be inappropriate to try to define too strictly what constitutes an improvement for a given counterparty when accepting the results of PTRRS, the inevitable reliance on estimates of past price performance and risk may introduce imbalances into the system. Crucially, the perceived equivalence of portfolios would depend on correlations which could suddenly no longer apply, exposing the CCP and bilateral counterparties to unexpected and therefore unhedged price risk action. For this reason, particular attention should be given when performing PTRRS on portfolios of transactions that include centrally cleared trades.

The assessment of risk-reduction benefits is counterparty-specific. While an idiosyncratic assessment of risk is a vital component of well-functioning markets, issues can emerge when different counterparties have different risk metrics, in particular in terms of what is deemed equivalent. This assessment can in particular diverge for non-market risks such as counterparty, liquidity or operational risks attached to the portfolio of contracts. For example, two counterparties may have very different assessments of a third counterparty's credit standing, or of their appetite for bilateral exposure. Therefore, exchanging one counterparty for another on the same contract can be perceived as a benefit and should not be discouraged. On the other hand, since CCPs are in principle considered to be the most preferable counterparties from the perspective of credit risk, central clearing should be encouraged as a more beneficial outcome from a systemic point of view.

From a macroprudential perspective, PTRRS are beneficial if they reduce the overall systemic risk. It is difficult to provide a general metric to forecast how PTRRS transactions will impact the aggregate risk in the system. In this context it may be best to rely on the ad hoc assessments made by counterparties in accepting the results of the PTRRS proposals. However, the ESRB identifies two potential risks in this reliance on counterparties' own assessments. On the one hand, there is a potential risk of procyclicality in cases where the main driver for PTRRS is a reduction in margins which is not commensurate with the corresponding reduction in aggregate exposures. This is due to the potential misalignment between the counterparties' incentives to mutually reduce the costs of maintaining the derivative portfolios. The ESRB notes that one safe and effective way to ensure a more resilient calibration of margins would be to increase the centrally cleared portion of the contracts. On the other hand, the risks of misuse and deliberate avoidance of regulations when counterparties trade risks rather than offsetting them when replacing portfolios through the use of PTRRS would remain.

In conclusion, while the use of PTRRS in non-centrally cleared OTC markets can help to reduce aggregate risk exposures, exempting their use from the clearing obligation may introduce the risk of regulatory arbitrage and circumvention. Given the financial stability benefits of the clearing obligation, it is the ESRB's view that preventing it from being circumvented should take priority over lifting the clearing obligation to facilitate the use of PTRRS. Central clearing not only reduces bilateral exposures through multilateral netting, but also provides more transparency and simplicity in the network of exposures, loss mutualisation for extreme losses and, crucially, a more resilient centralised default management process that minimises loss and disruption. Moreover, these benefits display significant network effects which become more tangible the larger the share of centrally cleared transactions in a given market. In this respect PTRRS are less effective in delivering the range of benefits to financial stability brought about by central clearing. Therefore, 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. The following conditions, outlined in the ESMA consultation paper, appear particularly necessary.

- The exemption should be limited to PTRRS which demonstrably reduce risk. Since the policy justification for the exemption is to allow limited exceptions to promote the use of PTRRS where they can contribute to reducing counterparty credit risk in non-centrally cleared OTC derivatives markets, it should be a minimum requirement for PTRRS to reduce risk to benefit from the exemption. ESMA might wish to consider adequate metrics for this assessment.
- The exemption should be limited to multilateral portfolio compression and to other specific types of PTRRS insofar as the systemic risk reduction benefits could be of a magnitude sufficient to justify it.
- The exemption should be limited to market risk neutral, non-price forming transactions which must not offer a means to take on new market trading positions, but rather only to reduce risks.
- The exemption should be limited exclusively to non-centrally cleared 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.

12 June 2020

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- Finally, PTRRS 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.