

ESRB RESPONSE TO THE ESMA CONSULTATION PAPER ON MANDATORY CENTRAL CLEARING FOR OTC CREDIT DERIVATIVES

1. Introduction

This response sets forth the view of the European Systemic Risk Board (ESRB) on the proposal of the European Securities and Markets Authority (ESMA) to subjecting certain over the counter (OTC) credit derivatives to mandatory clearing by central counterparties (CCPs)¹.

It follows up on the first response published by the ESRB² on 18 August 2014 regarding a prior consultation launched by ESMA on the introduction of the clearing obligation for some classes of OTC interest rate derivatives (IRD). As they share a number of features, the two responses ought to be read together.

The ESRB remains fully convinced of the merits of applying the clearing obligation to a broad range of OTC derivatives, in order to reduce systemic risk as agreed by the G20. As a consequence, the ESRB expresses its overall support for subjecting the classes of OTC credit derivatives proposed by ESMA to the clearing obligation (CO).

At the same time, and in line with the conclusions reached in respect of OTC interest rate derivatives, the ESRB suggests that further elements should be considered when assessing the classes of credit derivatives that are deemed eligible for central clearing, or when setting the deadlines for the entry into force of the CO. Those elements may underpin a revision of the current proposal in the near future to extend the scope of application of the CO to OTC credit derivatives.

In developing this response, the ESRB was mindful of its mandate to monitor and assess potential systemic risks, including disruption to financial services caused by a significant impairment of all or parts of the Union financial system. At the same time, the

¹ On 11 July 2014 ESMA launched two consultations on draft regulatory technical standards (RTS) subjecting the following to the clearing obligation under the European Market Infrastructure Regulation (Regulation (EU) No 648/2012):

i) some OTC interest rate derivatives classes (<http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no1-IRS>), with the deadline for the consultation on 18 August 2014, and

ii) certain OTC credit derivatives classes (<http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no2-CDS>), with the deadline for the consultation on 18 September 2014.

Article 5(2) of EMIR requires the ESRB to be consulted through the preparation of those regulatory technical standards.

² See https://www.esrb.europa.eu/pub/pdf/other/140820_ESRB-response.pdf?84e2adaae5f830f6a07cd0ac017e29a4.

ESRB also carefully considered the importance of ensuring consistency with decisions made in other jurisdictions (e.g. the USA³ and Japan), given that regulatory arbitrage can be a major source of concern from a macro-prudential perspective.

The following section of this response briefly summarises the terms and scope of the CO proposed by ESMA in its second consultation paper. Section 3 continues with an analysis of the liquidity of OTC credit derivatives, and Section 4 details the macro-prudential implications of establishing the CO for certain OTC credit derivatives classes in relation to the structure and concentration of their markets. The last section contains the ESRB's concluding remarks on ESMA's proposal to subject OTC credit derivatives to the CO

2. The CO proposal regarding OTC credit derivatives

Both consultations launched by ESMA were initiated on the basis of the authorisations already granted to CCPs by the relevant national competent authorities to clear OTC interest rate or credit derivative contracts, and therefore followed the bottom-up approach set out in Article 5(2) of EMIR.

In particular, the second consultation refers to the OTC credit derivative classes cleared by ICE Clear Europe (UK) and LCH Clearnet SA (France), which include untranch index credit default swaps (CDS) on European corporate credits. These are as follows: the iTraxx Europe Main, the iTraxx Europe Crossover, the iTraxx Europe High Volatility and the iTraxx Europe Senior Financials, and single name CDS on both corporates (financial and non-financial) and sovereigns. The ESRB's response is based on ESMA's expectation that, after the authorisation of LCH Clearnet SA in May 2014, ICE Clear Europe will also be authorised under the European Market Infrastructure Regulation (EMIR) before the entry into force of the regulatory technical standards (RTS) on credit derivatives proposed in the consultation.

Following a review of the criteria set by EMIR and Regulation (EU) No 149/2013⁴, ESMA proposes applying the CO to the following OTC credit derivative contracts:

- CDS on the iTraxx Europe Main index with 5-year maturity, and
- CDS on the iTraxx Europe Crossover index with 5-year maturity.

³ The CFTC is considering further extending its CO for CDS contracts (the first batch was introduced in Q1 2013). The current US CO is already broader as it covers both CDX and iTraxx contracts and at multiple tenors (3, 5, 7 and 10 years).

⁴ 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 (OJ L 52, 23.2.2013, p. 11–24).

Since older versions of both indices show appreciably less liquidity than the newer on-the-run series, ESMA envisages that the CO shall apply to the series from 11 onwards.

ESMA has suggested that subjecting financials as well as sovereign single names to the CO should be considered with care, since they can bear wrong-way risk or introduce correlated risks with the clearing members of the CCPs. As a consequence, these contracts are not seen as a priority for this first determination of the CO for credit derivatives. For similar reasons and on grounds of its liquidity, it is also proposed to exclude at this stage the iTraxx Europe Senior Financials index from the scope of application of the CO.

In respect of the date of application of the CO, ESMA has repeated the approach proposed for the counterparties of OTC interest rate derivatives, which is as follows:

- category 1 (clearing members): 6 months after entry into force of the RTS;
- category 2 (non-clearing members): 18 months after entry into force of the RTS;
- category 3 (non-financials): 3 years after entry into force of the RTS.

As pointed out in the response to the related (first) consultation paper, the ESRB is not completely convinced by the argument that such long delays are necessary for categories 2 and 3. In particular, the later the clearing obligation comes into effect, the longer the period during which counterparty risk may not be adequately managed; and the bilateral margining to be gradually introduced from December 2015 may mitigate this risk only to some extent.

The approach adopted for IRD is also used in respect of the frontloading of credit derivatives: ESMA proposes entirely exempting non-financial counterparties from frontloading and excluding de facto from its application contracts concluded between the date of notification of the relevant class to ESMA and the publication in the Official Journal of the RTS imposing the CO (Period A). As a consequence, only 'Phase B' OTC derivatives (concluded between financial counterparties in the period between the publication of the RTS and the actual entry into force of the CO) would remain subject to frontloading.

3. Analysis of the suitability of OTC credit derivatives for the CO: liquidity and pricing

As with IRD, the ESRB has considered a number of metrics in addition to those used by ESMA in assessing the eligibility of credit derivatives for the CO against the criteria laid down in Regulation (EU) No 149/2013. Those included measures such as:

- the average daily traded aggregate notional amounts;
- the number of business days (in a year) during which no trading has occurred;
- the period required to close out large net long or short positions;
- the number and composition of dealers available to trade with;

- the concentration of outstanding exposures at the top five dealers;
- the price impact from trading large volumes (measured through the price change as a function of the same day's trading);
- the risk from adverse marked-to-market changes in the value of the contract over a predetermined (e.g. five-day) close-out period.

The internal analysis conducted by the ESRB generally supports ESMA's view regarding the suitability for central clearing of the CDS on iTraxx Europe Main and iTraxx Europe Crossover indices. Compared with other OTC credit derivatives, these contracts appear to be traded more regularly, require fewer days to close out large positions (fewer than five days), and have an adequate number of active traders, lower price impact of trading and smaller adverse changes in value over the close-out period. The liquidity and availability of reliable prices may be affected by the introduction of the clearing obligation for certain classes of derivative contracts. However, in this regard the ESRB concurs with ESMA's expectation that "as more trades are brought to central clearing, more pricing data should be generated"⁵.

The ESRB has examined⁶ the most common iTraxx contracts considered by ESMA, but has also tried to assess the occurrence of the conditions – with a macro-prudential view of liquidity- for the possible extension of the CO to other classes of credit derivatives, such as contracts on CDX indices series, or also on sovereigns and single name corporates. In doing so, the ESRB has noted that certain CDX contracts (e.g. CDX NAIG and NAHY), which are excluded from the CO proposal since no authorised CCPs is currently clearing them, may be considered suitable for central clearing. These contracts might be therefore considered for a possible application of the top-down approach in the future, although on the overall the ESRB concurs with ESMA on the opportunity to focus on the bottom up approach during the first stages of introducing the CO.

Moreover, on the basis of the liquidity of the contracts, the CO might conceivably be extended at some point in the future to some of the most liquid sovereign CDS. Although there appears to be evidence that, as opposed to index contracts, it may also take longer than five days to close out large positions in sovereign CDS for frequently traded names (such as Italy, Spain, France), the dealer concentration is lower than for index contracts and the price impact from trading also remains modest when this reaches the highest figures (Greece).

On the other hand, CDS on single corporates do not show convincing evidence supporting eligibility for the CO. The ESRB has noted that even for the most liquid of such derivatives,

⁵ See paragraph 77 of ESMA's Consultation Paper.

⁶ The findings presented in this section refer to an internal study conducted at the working level by the Expert Group of the ESRB that is tasked with macro-prudential analysis of central clearing.

trade counts and notional values are relatively modest compared with either indices or sovereigns. The average number of dealers available to trade is also smaller (three or four), and both position concentration and the price impact of trading are quite high. Finally, a fairly broad range of potential losses may arise from adverse price movements during the estimated close-out periods.

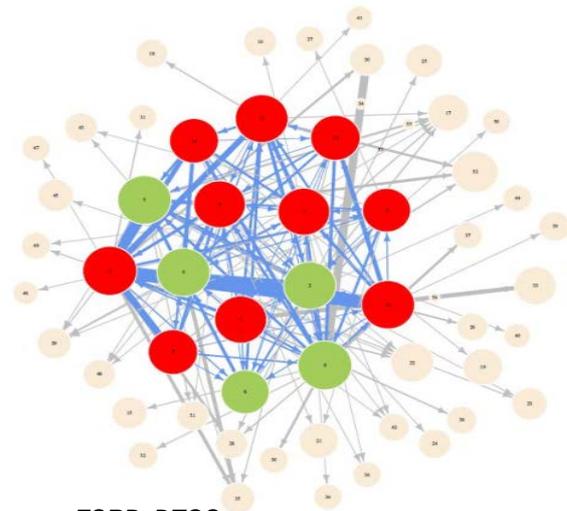
That said, the ESRB acknowledges that, with some exceptions, the majority of single name CDS on sovereigns and on corporates in particular, are traded quite infrequently⁷. Overall, this statement is also likely to hold good in respect of the entirety of the OTC credit derivatives sector when compared with that of IRD. It might therefore be prudent to share the approach taken by ESMA by introducing the CO for credit derivatives cautiously to the system, limiting its scope to iTraxx Europe Main and iTraxx Europe Crossover index contracts in the first instance.

4. Structure and concentration of OTC credit derivatives markets

The ESRB first examined the structure of CDS markets in 2012, when it set up a dedicated Expert Group tasked with assessing the potential systemic risk arising from credit events affecting major CDS reference entities or from the default of a key player in the CDS market. On the basis of that study⁸, the ESRB concluded that the Union CDS market structure is characterised by two main features, as discussed below.

- i) The network is large, complex and at the same time sparse, with an average of around 800 market participants⁹ each typically directly exposed to few other firms: in 2012 most market participants held net positions vis-à-vis only three or four other entities.

Figure 1: Network Structure of CDS Market



Source: ESRB, DTCC

⁷ As further explained later in this response, and also pointed in ESMA's consultation paper, the CDS market is rather highly concentrated at the level of the counterparties, but less so on the level of reference entities. The top-ten single names, in fact, account for less than half of the aggregate exposure.

⁸ The results of the work of the Expert Group were published in the ESRB Occasional Paper No. 4 of September 2013, on "Assessing contagion risks from the CDS market", available at <https://www.esrb.europa.eu/pub/op/html/index.en.html>. The main findings there are consistent with those of a more recent study (Working Paper No.1, 2014) conducted by ESMA on a comparable dataset (weekly DTCC data on bilateral single name CDS exposures for European reference entities); ESMA's study can be accessed at <http://www.esma.europa.eu/page/CEMA-Documents>.

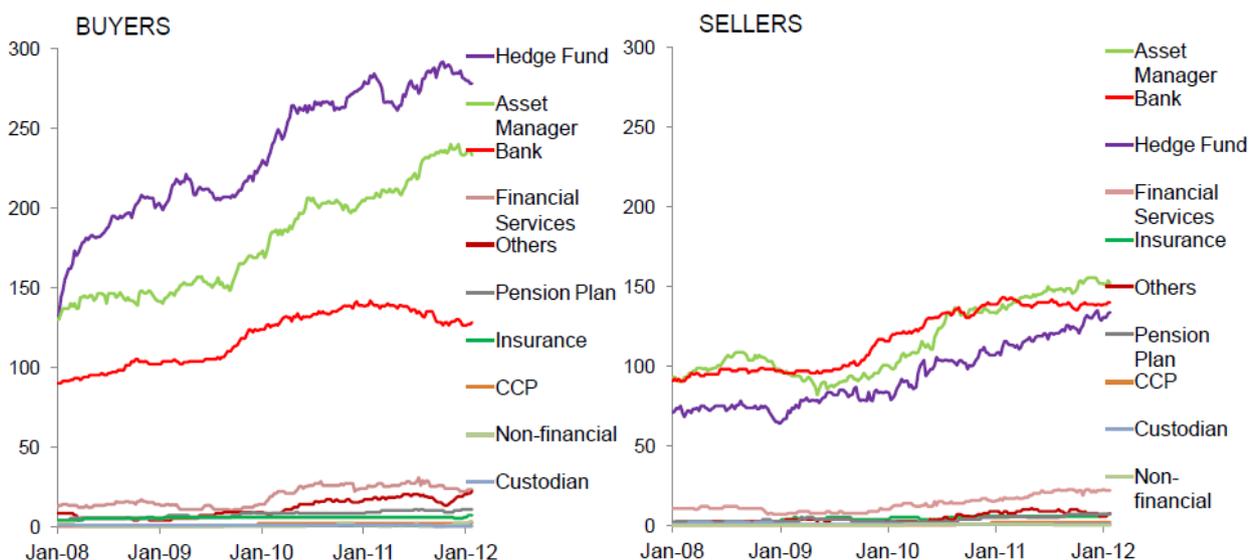
⁹ This figure refers to Q1 of 2012. According to the ESRB's estimates, the institutions participating in the EU CDS market increased from an average of 480 in 2008, to more than 800 at the beginning of 2012. Since September 2008 the trend has been mostly driven by CDS on sovereigns, whose growth accelerated after November 2009.

ii) CDS trading in the market is concentrated around 15 global derivatives dealers¹⁰, which have the highest number of counterparties and account for the largest aggregate net bilateral (selling or buying) positions¹¹. These are the most interconnected nodes in the network and are, therefore, the ones that can channel possible contagion in the system ('super-spreaders') by transmitting or amplifying shocks.

In aggregate, the CDS network has a 'hubs-and-spokes' structure (figure 1), with major counterparties selling and smaller traders buying (net) CDS protection. This is consistent with the finding, which has also been verified in respect of some national interbank markets, that smaller banks tend to lend to bigger, 'money-centre' banks.

The largest CDS dealers can be found in the Financial Stability Board's list of global systematically important banks (G-SIBs). However, non-bank institutions, in particular hedge funds and asset managers, also play an important role in the network (chart 1) by bearing 'super-spreader' potential¹².

Chart 1: EU CDS market participants: number by type (buy & sell side)



Source: ESRB OP No.4/2013

In terms of systemic risk, the role of non-bank super-spreaders may be problematic: on the one hand the diversity of market participants should improve the resilience of the system; on the other hand little is known about non-banks' trading strategies and capacity to resist

¹⁰ These are referred to as the G14 (G15) or "fourteen (fifteen) families", as first used in 2005 during a meeting at the Federal Reserve Bank of New York. See: http://www.newyorkfed.org/markets/otc_derivatives_supervisors_group.html.

¹¹ The ESRB estimated that the top-ten dealers sold more than 70% of gross CDS notional outstanding in Q1 2012, and were active in more than half of sovereign and financial reference entities. In contrast, the average market participant trades less than 20 reference entities against a maximum of around 10 counterparties.

¹² The importance of some non-dealer/ non-bank market participants for the resilience of the whole system can be better recognised by examining the indirect links in the network, and in particular the exposures to other sellers of the large sellers of CDS.

stress, and on whether those may add to systemic vulnerability. In any case, in its 2012 study the ESRB noted that the average bilateral exposures of the most interconnected non-bank firms were higher than those of many bank-dealers, although it was not possible to gauge the soundness (i.e. amount of capital) of these non-bank firms in relation to such exposures.

In fact, the ESRB has observed that, among banking institutions with comparable balance sheet indicators, the largest CDS dealers, while on average perceived as safer in the CDS market, tend to be less well capitalised than non-dealer banks. In this respect, the 2012 study confirmed that several banks had net CDS bilateral exposures far exceeding 30% of their core common equity.

While the relevant macro-financial conditions have clearly changed since the 2012 study, the ESRB remains convinced that the high concentration of trading volumes at the largest 15 dealers, and the allegedly large amount of gross and net CDS exposures relative to their capital, indicate that if stressed financial conditions exist the CDS market may end up exacerbating systemic risk, possibly by triggering domino-type contagion or indirect spillover effects (e.g. price-wealth loss spirals, fire-sales, funding effects, herding).

Against this background, the ESRB views the widespread use of CCPs, pursued through the establishment of the CO, as a crucial step in mitigating counterparty credit risk and thereby as a contribution to systemic risk reduction in OTC credit derivatives markets.

Once again, the ESRB stresses that the vital role played by CCPs as shock absorbers requires particular effort to ensure the quality of CCPs' risk modelling and collateral management. It is therefore essential that CCPs are fully authorised under EMIR before a CO for the products they clear comes into force. Where CCPs are properly managed and effectively supervised, the introduction of the CO can constitute a very effective policy tool to mitigate systemic risk, as central clearing allows the reduction of counterparty credit risk, improves the efficiency of multilateral netting, decreases uncertainty over participants' exposures, and improves overall market transparency, so that systemic resilience is increased. The ESRB is fully convinced that the implementation of EMIR, of the relevant delegated legislation at European level, and of the CPSS-IOSCO Principles for financial market infrastructures at global level, can achieve these objectives. At the same time, the ESRB reiterates that it is necessary to put in place as soon as possible an appropriate legislative framework for the recovery and resolution of CCPs¹³, whose systemic relevance will certainly increase as a consequence of the implementation of the CO.

¹³ The Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions (CPSS-IOSCO) issued a Consultative Report on the "*Recovery of financial market infrastructures*", in August 2013. The Report can be found at <http://www.bis.org/publ/cpss109.pdf>

In line with the above, the ESRB intends to draw attention to the potential benefits associated with the extension of the CO to certain classes of OTC contracts that are currently excluded by ESMA. These include, in particular, those liquid CDS on sovereigns or corporate indices and single names that, although currently cleared by ICE Clear Europe and LCH Clearnet, have been exempted from the CO on the basis of the existence of wrong-way risk or other risks correlated with the clearing members. The ESRB concurs with this prudent approach but at the same time is aware that the occurrence of credit events in relation to such reference entities (i.e. sovereigns and financials) may have an impact on the overall financial stability, funding conditions and quality of collateral of a number of counterparties, and ultimately potentially impair the system of CCPs. Restricting the CO on CDS indices might not entirely limit the wrong-way risk, as the CCPs would remain highly interconnected, both between each other and with the rest of the system (and thus exposed to the abovementioned sovereign or other idiosyncratic correlated risks) via the large and overlapping presence within their clearing members of the abovementioned 15 super-spreaders. Therefore, while a “narrow” CO is consistent with a prudent approach to be pursued in the initial steps of implementation of the CO, from a broader perspective it may prevent taking full advantage of the benefits arising from the mitigation of counterparty risk in the system¹⁴ while potentially not fully shielding CCPs from the impact of certain types of correlated risks between sovereigns and financials¹⁵.

When looking at the concentration in OTC credit derivatives markets, ESMA concluded that ‘the profile and number of the clearing members involved with these two CCPs would ensure that market dispersion remains sufficient in the event of the default of one of them’. However, this statement seems to refer to the overall degree of dealer concentration in CDS markets, while there is evidence of a significant heterogeneity in the structure of the network per classes of CDS reference entities. In particular, CDS on indices appear to have a more concentrated market structure than single name contracts, reflecting increasing specialisation and economies of scale, capacity issues and key information asymmetries. As a consequence, if market dispersion is regarded as appropriate in order to ensure continuity of trading (and clearing) in the index CDS segment, this should also be reassuring in relation to a scenario where one of few members clearing single name CDS are af-

¹⁴ However, it can be expected that, in spite of the absence of the clearing obligation, the implementation of bilateral margining and the higher capital cost for non-centrally cleared derivatives will incentivise the use of CCPs for those CDS on a voluntary basis, as long as CCPs cover them in their clearing services.

¹⁵ Indeed, the Greek credit event may provide some insight into the functioning of the EU sovereign CDS market: the credit event did not have a large impact on the Union financial system as there was widespread clarity about exposures of major banks, particularly thanks to EBA disclosures on banks’ exposures to sovereign CDS and the underlying debt. From a macro-prudential perspective, the transparency on CDS positions mitigated concerns about fragile players (i.e. ‘new AIG’) and subsequent contagion. It can be assumed that CCPs would also operate this kind of orderly and transparent procedure, so that the benefits mentioned above could be more permanently secured in the system if liquid sovereign CDS were also subject to the CO.

ected by financial distress. After all, these are the circumstances where central clearing is needed the most and in which most of the benefits of the CO will be realised¹⁶; whereas it should be to a certain extent possible to reduce the impact of wrong-way risk by ensuring appropriate collateral and default management from CCPs.

The ESRB is not yet in a position to draw firm conclusions from the reasoning outlined above, but wishes to investigate the issues further while cooperating with the regulators concerned. In particular, authorities may be interested in monitoring the participation of key counterparties across CCPs, which is likely to evolve as a result of market dynamics and regulatory reform; while wrong-way and correlated risks regarding the clearing of CDS on single names may need to be further assessed within appropriate stress-test frameworks. Furthermore, it will be necessary to acquire a better understanding of the nature of risk transfer via OTC credit derivatives, and the risk-bearing capacity of the relevant counterparties. This may require cross checking information regarding the characteristics of key market participants, their business model and role in the financial system, and whether CDS exposures originate from proprietary trading, market-making or hedging activities.

As much information as possible will be required in order to undertake the assessments described above, preferably by making extensive use of the data reported to trade repositories. Nonetheless, the ESRB understands how problematic it will be to collect detailed quantitative information at this early stage of the implementation of EMIR. These constraints may eventually prompt the adoption of a more cautious approach at the current juncture, as proposed by ESMA, regarding the determination of which credit derivatives classes should fall under the CO.

The ESRB therefore suggests that ESMA should explain in greater detail the impact of the current limitation of data on stakeholders, in a manner consistent with what has been proposed for IRD, along with the need to observe the outcomes and test the results of this first phase of implementation of the CO for credit derivatives. The ESRB also suggests that ESMA should announce a forthcoming review, covering the possible extension of the CO to other eligible OTC credit derivatives classes, together with an indicative timeline for that review. In the absence of these steps, stakeholders may find it difficult to plan or to allocate resources for any necessary future adjustment. In parallel, the implementation without difficulty of the first phase of the CO appears as a necessary condition for the ESRB before considering extending the CO to cover other indices. This seems even more appropriate in relation to the developments concerning the scope of the CO for OTC credit derivatives that are expected in other G20 jurisdictions. Although the ESRB appreciates that considering the CO for CDS on sovereigns would most likely require a full impact study

¹⁶ Contagion from sovereign credit events works in the first place through banks' sovereign bond exposures: domestic banks typically have very sizeable direct sovereign bond exposures. While foreign banks, including other EU banks, generally suffer losses from sources correlated to other sovereign bond exposures, and can therefore benefit substantially from reliable and resilient forms of hedging.

taking into account the pro-cyclical effects of concentration, sovereign and wrong-way risk within CCPs.

5. Concluding remarks

In the light of the reasoning presented in this response, the ESRB reiterates its general support for subjecting the classes of OTC credit derivatives proposed by ESMA to the CO.

At the same time, consistent with the remarks made in its response to the IRD consultation, the ESRB intends to draw ESMA's attention to the following issues.

A. Possible extension of the CO to other OTC credit derivatives

The ESRB identifies the need to conduct a more accurate analysis of the risks and benefits potentially associated with extending the CO to certain liquid OTC credit derivatives which, although currently cleared by ICE Clear Europe and LCH Clearnet, are currently excluded by ESMA.

At this stage, the ESRB believes that the implementation of the first phase of the CO without any particular difficulties or unexpected risk is a necessary condition to then consider a possible extension of the CO to other indices.

In this regard, and consistent with what has been proposed for IRD, the ESRB recommends that ESMA should explain further the impact of the current limitation of data on stakeholders, clarifying in more detail the reasons for the preference for a more cautious and gradual approach in introducing the CO for certain classes of OTC credit derivatives. At the same time, the ESRB suggests that ESMA should announce a forthcoming review, including the possible extension of the CO to other eligible OTC contracts, along with an indicative timeline for that review.

B. Timing and phasing-in of the CO

As is the case for IRD, the ESRB is not completely convinced by the argument that long delays are necessary before applying the CO to the counterparties in categories 2 and 3. Experience with other long-dated policy reforms reveals that most market participants defer work on implementation until the deadline is nearly reached. Moreover, other jurisdictions, such as the USA, had much tighter deadlines for the application of the CO to different groups of counterparties.

The later the clearing obligation comes into effect, the longer the period during which the counterparty risk might not be managed adequately. The bilateral margining requirements that are expected to enter gradually into force over a period of four years, starting from December 2015 (with respect to the largest market participants), can mitigate this risk only to some extent.

As a consequence, the ESRB reiterates its proposal to set the date of application for category 2 at 12 months and for category 3 at 18 months after the entry into force of the RTS. ESMA might therefore wish to reconsider the deadlines included in the draft RTS.

The ESRB does not see particular risk where counterparties are required to frontload OTC credit derivatives contracts on a strict basis. The overall effect of a mispricing on the trade date can be expected to be negligible. However, the ESRB's priority is the quick and comprehensive introduction of the CO as appropriate, as it is the most effective tool to mitigate systemic risk in the OTC derivatives markets. The ESRB appreciates ESMA's pragmatic proposal in respect of this goal to only require frontloading for 'Phase B' derivatives, in order to minimise uncertainties for the market participants. This is preferable to a prolonged discussion that risks postponing the introduction of the CO for a longer period.

C. Top-down approach

Finally, with regard to future action by the authorities, the ESRB's view is that the 'bottom-up' approach, under which the CO has been laid down, is a preliminary step. For the future, provided that a comprehensive and reliable set of data is available from trade repositories, the ESRB encourages ESMA also to consider the adoption of a 'top-down' approach as provided for in EMIR, thus making the G20's original reform more effective.