

ESRB REPORT ON ISSUES TO BE CONSIDERED IN THE EMIR REVISION OTHER THAN THE EFFICIENCY OF MARGINING REQUIREMENTS

Executive summary

The European Commission is under the obligation to review the European Market Infrastructure Regulation¹ (EMIR) by 17 August 2015. The European Systemic Risk Board (ESRB) is mandated to provide its views on the pro-cyclicality of margining requirements and on the need to consider additional intervention capacity in this area.

The ESRB is taking this opportunity to provide its views on topics other than the efficiency of margining requirements for the European Commission's consideration in preparing its report to the European Parliament and the Council.

The ESRB recommends that the European Commission consider for the EMIR review:

- **A swift process for the removal or suspension of mandatory clearing obligations.** The EMIR provisions should also include the possibility of and the conditions to be fulfilled for a swift removal or suspension of the clearing obligation for certain classes of over-the-counter (OTC) derivatives if the relevant market situation so requires. This will ensure that central counterparty (CCP) exposures on financial instruments that have turned illiquid will not continue to increase as fast or are reduced and limit the potentially pro-cyclical implications that follow from such exposures.
- **The evaluation of systemic risks for mandatory clearing purposes.** For the sake of clarity and consistency with the legislation establishing the ESRB as well as of financial stability, it should be clear that the evaluation of systemic risk for mandatory clearing purposes should be conducted by the European Securities and Markets Authority (ESMA) both at the EU and national level.
- **Replenishment of default funds and the skin-in-the-game design.** "Skin-in-the-game" (SIG) plays the fundamental role of providing effective incentives to manage risk prudently, and the ESRB would encourage the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (CPMI/IOSCO) to publish international standards in this area. The ESRB also believes that the EMIR calibration could be further enhanced by aligning the amount of SIG held by a CCP with the level of the CCP's clearing activity in order to ensure that these incentives are in some way proportionate to the quantitative dimension of the risks it manages. In particular, it should not be possible to reduce the amount of SIG where a CCP materially increases the volume

¹ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

of transactions it clears. This may require the existing SIG calibration to also include a link to the level of margins/default funds managed by the CCP. Its main purpose should, however, not be loss absorbency. With regard to the default fund provisions, the ESRB believes the legislation could provide further clarity on the timing and procedures to be followed for the replenishment of the fund(s) in order to make potential collateral calls by CCPs more predictable and thus diminish the possible pro-cyclical impact. From a pro-cyclicality perspective, a key issue is the predictability of a measure in order to enable clearing members and their clients to embed these potential collateral demands in their decisions on portfolio allocation. These options could be considered in the context of the forthcoming legislation on the CCP recovery and resolution framework, taking into account the outcome of international discussions currently being held.

- **Transparency requirements consistent with guidance developed at the international level.** The ESRB notes that at the international level, with the implementation of EMIR, a much more detailed transparency framework for CCPs has been developed, with a view to providing clearing members and the public in general with a broad range of quantitative and qualitative information. The ESRB recommends that CCPs be legally obligated to publish quantitative and qualitative requirements consistent with the CPMI-IOSCO disclosure framework.
- **Publication of a list of approved interoperability arrangements by ESMA.** To improve the transparency for regulators and market participants about existing interlinkages between financial market infrastructures, Article 88 of EMIR should be amended to require ESMA to make public on its website a list of all approved interoperability arrangements between CCPs and the financial instruments for which these links are allowed to be used. This will allow regulators to better understand and analyse the interconnectedness of CCPs.
- **Access to trade repository data.** In order to enable national authorities to perform an effective systemic risk analysis, access rights to trade repository data should be broadened to allow access to data of all subsidiaries of entities within their respective jurisdictions, regardless of where the subsidiaries are domiciled or headquartered.

1 Introduction

The European Commission is under the obligation to review EMIR² by 17 August 2015 and, in particular, assess – in cooperation with ESMA and the ESRB – the efficiency of margining requirements in limiting pro-cyclicality and the need to define additional intervention capacity in this area.

This is also an opportunity for the ESRB to evaluate whether other issues falling within the scope of EMIR warrant a rethink, also taking into account international and European developments during the implementation of the EMIR provisions.

This report presents the ESRB's views on topics other than the efficiency of margining requirements. The ESRB's recommendations are offered for the European Commission's consideration in preparing its report to the European Parliament and the Council.

2 Policy proposals

From a macroprudential point of view, the overall regulatory framework introduced in the EU with EMIR and the delegated legislation represents a big step forward in comparison with the previous situation. Mandatory central clearing requirements for standardised OTC derivatives, bilateral collateralisation requirements for bespoke contracts, reporting obligations, a harmonised regulatory framework, as well as prudential and organisational requirements for CCPs and trade repositories, are all elements of a general design which the ESRB fully supports.

Nevertheless, the ESRB believes that there are some areas of EMIR where interventions could contribute to further enhancing the general framework. As explained below, some of these interventions are presented for potential consideration in the context of the forthcoming legislation on CCP recovery and resolution despite being linked to the current EMIR provisions.

2.1 Clearing obligation procedure

2.1.1 Procedure for lifting the clearing obligation. Concerning the clearing obligation procedure, the ESRB reiterates what was already expressed in the context of the previous ESMA consultation on the proposals for mandatory clearing of non-deliverable forwards and for other (non-G4) OTC interest rate derivatives. The legal provisions should include the conditions to be fulfilled for a swift removal or suspension of the clearing obligation for certain classes of OTC derivatives if the relevant market situation so requires.

Market conditions for financial instruments can change dramatically in a very short period of time. From a macroprudential standpoint, the mandatory use of central counterparties for contracts which no longer have the characteristics qualifying for compulsory central clearing can lead to unintended consequences in terms of CCP exposures on potentially illiquid financial instruments and significant changes in margin requirements, possibly leading to pro-cyclical implications.

2.1.2 EU-wide and national perspective on systemic risk evaluation. It is the ESRB's opinion that systemic risks should be evaluated by ESMA at both the EU and national levels, while taking into

² Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

account the fact that some risks may seem small from an aggregated perspective, but can be concentrated in individual financial institutions that are systemically important at domestic or global level. National systemic risk may also be of broader concern to the extent that the financial sector in a given country is systemically important as defined by the IMF.

EMIR does not exclude evaluation of systemic risks by ESMA, in particular when determining the classes of OTC derivative contracts to be subject to the clearing obligation, also on a basis narrower than EU-wide. However, for the sake of clarity, it is suggested that the European Commission consider making it clear that the evaluation of systemic risk, for mandatory clearing purposes, is also relevant at national level. This would be in line with the legislation establishing the ESRB, which makes it clear that systemic risks need to be considered at all levels: “(...) *systemic risks include risks of disruption to financial services caused by significant impairment of all or parts of the Union’s financial system that have the potential to have serious negative consequences for the internal market and the real economy*”.³ This mandate underlies the approach taken by the ESRB. Two examples are the recommendations of the ESRB on lending in foreign currencies (ESRB/2011/1) and on money market funds (ESRB/2012/1), which addressed issues that were not systemic for the EU as a whole, but were systemic at the level of some individual Member States and did have the potential to spread through interconnectedness.

2.2 Requirements on CCPs

2.2.1 Prudential requirements. The ESRB believes that, from a macroprudential standpoint, in the context of the evolution of the European legislation concerning CCPs, the provisions concerning the so-called skin-in-the-game (SIG) and the default fund replenishment might deserve further attention. At international level, the Principles for Financial Market Infrastructures are currently silent on SIG and the ESRB would encourage CPMI/IOSCO to publish international standards in this area.

As far as SIG is concerned, EMIR legislation currently links the amount of SIG to the regulatory capital requirement and to some extent therefore to the CCP’s efficiency.⁴ Everything else being equal, a lower cost base would reduce the amount of regulatory capital a CCP has to hold and therefore also the amount of SIG. In principle, given the parameters of calibration, a CCP’s SIG could decrease even in the presence of a stable increase of the CCP’s margins/default fund(s), hence of the size of the credit counterparty risks it handles. Against this background, the ESRB believes that CCPs may not have a sufficiently powerful incentive to adopt rigorous risk management practices. The EMIR calibration could be further enhanced to ensure that the amount of SIG held by a CCP is not independent of the level of the CCP’s clearing activity. This may require the existing SIG calibration to also include a link with the margins and default fund(s) managed by a CCP. However, changing the methodology for setting SIG should not significantly affect the current balance of contributions to the default waterfall, as defined under EMIR articles 41, 42 and 43; the ESRB believes that a CCP’s SIG should maintain its fundamental function of providing effective and proportionate incentives for prudent risk management. Its main purpose should however not be loss absorbency.

³ Recital 27 of Regulation (EU) No 1092/2010; OJ L 331, 15.12.2010, p. 1.

⁴ Article 35 of the regulatory technical standards (RTS) No 153/2013.

With regard to the default fund provisions, the ESRB believes that the legislation could provide further clarity on the timing and procedure to be followed for the replenishment of the fund(s) should it prove insufficient in the event of a default of a major clearing member. In the ESRB's view, this is one of the key aspects in the overall functioning of CCPs as the replenishment of default funds by definition will occur in stressed market conditions. In fact, from a pro-cyclicality perspective, a key issue is the predictability of a measure in order to enable financial intermediaries and their clients to embed these potential collateral demands in their decisions in terms of portfolio allocation.

These issues can be considered either in the context of the EMIR revision or in the context of the forthcoming legislation on the CCP recovery and resolution framework. While recognising the importance of both, the ESRB believes that the latter possibility seems more appropriate as SIG and default fund replenishment can be seen as closer to situations where CCPs find themselves in recovery.

2.2.2 Transparency requirements. The transparency of central risk management facilities such as CCPs is a key concern from a macroprudential perspective as it sets the stage for the predictability of risk management measures. In this respect, the ESRB notes that EMIR already envisages a number of transparency requirements for CCPs and their clearing members. The ESRB notes as well that at international level, with the implementation of EMIR, a much more detailed transparency framework for CCPs has been developed, with a view to providing clearing members and the public with a broad range of quantitative and qualitative information.⁵

Against this background the ESRB recommends, for the European Commission's consideration, the possibility of CCPs being legally obligated to publish quantitative and qualitative requirements consistent with the CPMI-IOSCO disclosure framework.

Furthermore, the ESRB proposes to amend Article 88 of EMIR in order to make it obligatory for ESMA to make publicly available a list of all authorised interoperability arrangements and the respective covered financial instruments for the authorised CCP. This would complement the existing list of authorised CCPs and would enhance transparency towards market participants and regulators. For regulators, the information will be valuable to better understand and analyse possible contagion channels and interconnectedness.

2.3 Access to trade repository data

The ESRB believes that in order to enable national authorities to perform effective systemic risk analysis, access rights to trade repository data should be broadened.

It should be clarified that "the necessary information [...] to enable them to fulfil their respective responsibilities and mandates" (Article 81 of EMIR) may include transactions concluded by counterparties not domiciled or headquartered in the national authority's jurisdictions as long as a counterparty in the transaction is a subsidiary of an entity in the national authority's jurisdictions.

⁵ CPMI-IOSCO disclosure framework.

Currently, under Article 2.9 (a) of EMIR RTS 151/2013, national authorities are allowed to access transaction-level data for all counterparties within their respective jurisdictions. However, there could be a need for prudential supervisors or resolution authorities of a financial group to have access to transaction-level data of all members of that financial group, even if some members are outside the authority's jurisdictions. This would allow for a consolidated view of the positions of the financial group and thereby assist the authority in fulfilling its financial stability or macroprudential mandate.