ECB-PUBLIC

18 August 2014

ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB RESPONSE TO ESMA CONSULTATION PAPER ON MANDATORY CENTRAL CLEARING FOR OTC INTEREST RATE DERIVATIVES

1. Introduction

Article 5(2) of the European Market Infrastructure Regulation[1] (EMIR) requires the European Securities and Markets Authority (ESMA) to consult the European Systemic Risk Board (ESRB) when preparing draft regulatory technical standards (RTS) on the classes of OTC derivatives that should be subject to the clearing obligation.

On 11 July 2014 ESMA released a consultation paper (CP) on the clearing obligation for OTC interest rate derivatives (IRD); the consultation was initiated on the basis of the authorisation granted to four European central counterparties (CCPs) by the relevant national competent authorities to clear OTC IRD contracts.

This response summarises the ESRB's opinion on ESMA's proposal.

As a general and introductory remark the ESRB wishes to reaffirm that it is fully convinced of the merits of a broad application of mandatory central clearing to a number of OTC derivatives classes, in line with the policy agreed in 2009 by the G20 with a view to reducing systemic risk.

In this respect, the ESRB expresses its general support for subjecting the classes of OTC derivatives proposed by ESMA to the clearing obligation (CO).

At the same time the ESRB suggests that further issues be considered when defining the classes of CCP-eligible contracts and the deadline by which the CO will come into force.

In developing its opinion, the ESRB has been mindful of its mandate to monitor and assess potential systemic risks that include risks of disruption to financial services caused by a significant impairment of all or parts of the EU financial system – be they groups of or even individual Member States – that have the potential to have serious negative consequences for the internal market and the real economy[2].

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; OJ L 201, 27.7.2012, p. 1-59.

2 Recital 27 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board; OJ L 331, 15.12.2010, p. 1

The ESRB has been also mindful of the importance of ensuring consistency with the decisions made in other jurisdictions (e.g. the USA, Japan and South Korea), considering that regulatory arbitrage can also be a major source of concern from a macro-prudential perspective.

The following section of this response elaborates on the macro-prudential view of central clearing; the subsequent ones continue with an analysis of liquidity of OTC IRD and of the structure and concentration in their market. Before the concluding remarks, another section provides a macro-prudential analysis of possibly imposing the CO on IRD denominated in currencies other than USD, EUR, JPY and GBP. In the last section, the ESRB stance is reiterated with particular attention drawn to suggestions regarding the contracts to be submitted to the CO, as well as the date of application of the CO.

2. *ESRB assessment of macro-prudential aspects of central clearing*

The 2008 crisis showed that, regarding OTC derivatives, large counterparty exposures between market participants were not appropriately risk-managed and increased the potential for contagion/knock-on effects. In some circumstances, these effects materialised with significant implications, due to the limited intervention of CCPs and the lack of widely accepted and sound collateral practices on a bilateral basis.

Against this background, the recourse to central clearing via properly managed and effectively supervised/overseen CCPs has been identified at international level as one of the most important tools to mitigate systemic risk, by improving counterparty credit risk management, allowing multilateral netting, reducing uncertainty about participants' exposures, and increasing transparency of market activity.

The ESRB completely shares this view.

Provided that the risk management of CCPs is sound and capable of effectively withstanding the defaults of clearing members even in stressed circumstances, central clearing can act as a circuit-breaker when some market participants default on their obligations.

Without the intervention of CCPs, these defaults could trigger a chain of credit-related losses that could have severe systemic consequences. The failure of a major OTC derivatives dealer could in fact spread uncertainty regarding who is linked to such a failing counterparty, which in turn could cause markets to become illiquid.

By means of CCPs, exposures are lowered through multilateral netting and collateralised. Furthermore, in stressed circumstances (i.e. when the losses stemming from a default exceed the margins posted by the defaulting member) CCPs mutualise the impact of counterparty risk by using pre-funded default funds. Therefore, the use of CCPs can reduce uncertainty in the market and help in providing regulators with a clearer picture of market participants' exposures.

The obvious pre-condition for these benefits to materialise is that CCPs are properly designed and managed, and closely supervised and overseen by competent authorities. In this respect, the ESRB is fully convinced that the CPSS-IOSCO Principles for Financial Market Infrastructures[3] at the international level, and the EMIR at the European level, provide the necessary reference framework for CCPs' functioning, regulation and supervision. At the same time the ESRB stresses the importance of putting in place soon a comprehensive regulatory framework for the recovery and resolution of CCPs to cater for the unlikely, but not impossible, event that a CCP enters into a distressed situation[4]. Considering that, once certain classes of OTC derivatives become CCP-eligible and a critical mass of contracts is cleared through CCPs, moral hazard may increase, the ESRB looks forward to the expected progress in the legislation on CCPs' recovery and resolution both at international and European level.

3. *The OTC IRD proposed for the clearing obligation; analysis of liquidity (and pricing)*

On the basis of the criteria set by the EMIR and Commission Delegated Regulation (EU) No 149/2013[5], ESMA has proposed that the following OTC contracts should be subject to the CO:

- fixed-to-float (plain vanilla) interest rate swaps (IRS) and basis swap contracts in EUR, GBP and USD in tenors of 28 days-50 years,
- IRS and basis swap contracts in JPY in tenors of 28 days-30 years;
- Forward Rate Agreement (FRA) contracts in EUR, GBP, USD in tenors of 3 days-3 years;
- Overnight-Index-Swap (OIS) contracts in EUR, GBP and USD in tenors of 7 days-3 years.

While concurring with the analysis conducted by ESMA, the ESRB would like to stress that additional metrics could be considered in order to assess the suitability of classes of OTC IRD instruments for the clearing obligation. Those metrics may include measures such as: the percentage of business days (in the reference period) during which no trading occurred; the number of days required to close out large outstanding long and short positions; the population of dealers available to trade with on days when trading took place; the concentration of outstanding positions held by the top five dealers; the price impact of trading, as measured by the change in contract price as a function of the same day's trading; the scope for adverse marked-to-market changes in the value of the contract over a five-

3 April 2012, published on http://www.bis.org/publ/cpss101a.pdf.

4 See the CPSS-IOSCO consultative report on the recovery of financial market infrastructures, August 2013.

5 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).

day close-out period; and the trading volume per outstanding position of clearing members. The analysis of those metrics may complete or facilitate the assessment of the criteria set out in Article 7 of Regulation (EU) No 149/2013.

The available data generally supports the proposal set forth by ESMA regarding the suitability of IRD for mandatory central clearing. Based on an internal analysis, the ERSB has concluded that, compared with other contracts, the contracts proposed for central clearing tend to be traded more regularly, require fewer days to close out large positions, and have a higher number of active traders, lower dealer concentration, lower price impact of trading and smaller adverse changes in value over a five-day close-out period.

Available data in relation to 30-50 year plain vanilla IRS is limited. However, the analysis confirms that long-dated contracts appear to be suitable for central clearing, as trading volumes per outstanding position of clearing members appear to be as high as for some shorter-maturity contracts. In addition, a 50-year swap may be considered as equivalent to a 30-year swap plus a 20-year swap that starts in 30 years' time, and the price volatility of the second component might be close to zero. As a consequence, if CCPs can risk manage the volatility of 30-year swaps, they may be able to manage the similar volatility of 50-year swaps.

Basis swaps appear to be less liquid (beyond 10 years for USD and GBP contracts), with fewer trading days, longer close-out periods, and higher market concentration. However, it seems reasonable to assume that there can be benefits in terms of systemic risk containment by subjecting longer term basis swaps to the CO, considering that the price impact of trading these contracts is deemed to be low, and it could be problematic to treat these contracts differently from IRS contracts of the same currency and maturity.

Based on the abovementioned data, it seems premature to draw unambiguous conclusions relating to OTC IRD contracts denominated in European currencies other than EUR and GBP. On the one hand, they appear to be less liquid and usually account for only a very small proportion of global outstanding notional amounts. On the other hand, trading volumes per outstanding position of clearing members may be sufficiently high and hence they might be suitable for the clearing obligation. The final determination of the eligibility of such contracts for the clearing obligation might require calculating the abovementioned metrics using a broader set of data, possibly from trade repositories. This would allow the number of direct clearing members to be established, and also active market participants, which is important in terms of CCPs' ability to close positions inherited from defaulting clearing members. With respect to IRD denominated in less liquid currencies it may be crucial to take into account other factors, described in more detail in Section 5.

4. *Structure (e.g. number of CCPs and market participants) and concentration in OTC IRD markets*

Overall, the introduction of a clearing obligation for the products identified in ESMA's consultation paper would undoubtedly be positive for reducing systemic risk.

Nonetheless, mandatory clearing of these OTC IRD could have certain macro-prudential implications, in terms of market structure and concentration, which regulators may wish to monitor going forward.

In this respect, the ESRB wishes to highlight the following issues which, at this time, do not suggest modifications for the draft RTS; however, in the ESRB view the market structure of the OTC derivatives clearing deserves full attention from both micro and macro regulators.

Introducing a clearing obligation for EU counterparties for IRD should increase the volume of transactions cleared at EU CCPs, and may lead to risk concentration within CCPs and within clearing members. The concerns raised by this concentration of risk could be made worse as a result of the specific structural features of the OTC IRD market.

One relevant issue regarding the structure of the OTC IRD market is whether the CCP landscape is diverse enough to offer to counterparties a degree of substitutability. Although there is no consensus within the academic or regulatory community on the optimal structure of the CCP landscape, it can be argued that the existence of several CCPs clearing the same products could have favourable consequences in terms of mitigating systemic risk, by providing potential alternative options in the event that one CCP was not able to process new or existing trades[6]. Four CCPs currently clear some or all of the OTC IRD classes proposed by ESMA to be subject to the CO. The diverse landscape of CCPs offering clearing services for OTC IRD could in theory guarantee substitutability in the event that one CCP was no longer able to process transactions, either as a result of an operational failure, or of the default of the CCP (as already mentioned, the default of a CCP can be considered an extremely unlikely event, but cannot entirely be ruled out). However, according to ESMA's consultation paper, of the trades cleared by the four EU CCPs, one CCP is currently responsible for clearing approximately 95% of total cleared OTC IRD trades.

The current market structure reflects the fact that only one CCP was available for clearing of OTC derivatives for much of the past 15 years, and it is possible that the introduction of the CO and the entry of additional clearing providers will cause the market structure to evolve. In this respect the ESRB is of the opinion that the 'market share' of CCPs clearing

[6] The ESRB acknowledges, however, that also where two or more CCPs clear the same product, the establishment of operational links between those CCPs which would facilitate substitutability in the clearing process, and thus bring the indicated benefits, may encounter some practical difficulties.

transactions in instruments subject to the CO should be closely monitored, particularly from the perspective of their potential substitutability in circumstances of distress. The ESRB is confident that the expected forthcoming legislation on recovery and resolution of CCPs will provide the relevant authorities with the appropriate tools to intervene in circumstances of distress.

Another relevant issue which regulators may wish to have in mind when monitoring the implementation of the clearing obligation for IRD is the systemic importance of the counterparties active in the market. The OTC IRD market appears particularly systemic in terms of exposures to EU-based entities. Indeed, data collected by the European Central Bank through the European System of Central Banks suggests that a significant number of the most systemic EU-based financial institutions (in terms of cross-participation in financial market infrastructures) are general clearing members in the IRD branch of at least one of the four CCPs currently authorised to clear these products.

One potential implication of establishing a clearing obligation is that the volume of transactions cleared through these general clearing members could increase significantly (providing the market structure does not fundamentally change), making them even more systemically relevant. Therefore, a default event, or chain of defaults, of clearing members active in this market could have even greater consequences from a systemic risk point of view once the clearing obligation is in place. Although this should not deter regulators from establishing a clearing obligation, it is a factor that should be analysed both when assessing CCPs' risk mitigation arrangements, and when monitoring systemic risk in the future.

Another topic which may warrant future attention from supervisors from a systemic risk perspective is the degree of concentration of clearing members across CCPs. A large degree of overlap of clearing membership across the various CCPs active in the market could potentially facilitate the porting of client positions in the event that one CCP was no longer able to process transactions. However, it should be pointed out that porting of positions between CCPs is a complex process which faces many fundamental challenges beyond overlapping membership, notably legal restrictions, differing insolvency regimes, and operational constraints.

A rather low degree of overlap in clearing membership exists between the four CCPs currently clearing the classes of IRD designated by ESMA, which means that, in respect of this particular criteria and in addition to the other issues mentioned above, porting of positions from one CCP to another could prove challenging in the event of a CCP default. However, it is not clear if more overlap, i.e. increasing interconnectedness between CCPs via their members, will reduce systemic risk.

It is difficult at this stage to draw any firm conclusions from the above reasoning, but regulators may wish to investigate the issue further. Furthermore, the establishment of the clearing obligation for OTC IRD and the potential increase in client clearing activity could lead to changes in the network of systemic clearing members: regulators may therefore wish to continuously monitor the participation across CCPs of key market counterparties, which may evolve as a result of market dynamics.

Lastly, supervisors may wish to continuously monitor the concentration of open positions within the various CCPs authorised to clear these products, although the concentration of positions within CCPs does not appear to be a source of concern at present.

5. *Macro-prudential analysis of possible imposition of the clearing obligation on IRD denominated in currencies other than USD, EUR, JPY and GBP*

While in support of imposing the CO to the classes of OTC derivatives proposed by ESMA, the ESRB suggests further elements to be considered from a macro-prudential perspective.

Reducing systemic risk is the overarching objective of the obligation to clear certain classes of OTC derivatives via CCPs that have been authorised or recognised under the EMIR framework. Ensuring that the clearing obligation reduces systemic risk requires the identification of classes of derivatives that should be subject to mandatory clearing (Article 5(4) of EMIR). Taking into account the EMIR provisions, it seems that systemic risk in this context should not be assessed from a global perspective only, and the share in global market liquidity should not be the decisive factor in the assessment of CCP-eligibility of individual classes of OTC IRD. Approximating the size of the global market may be important for assessing market liquidity. However, the analysis should also distinguish between the locations of counterparties, which is crucial for assessing the size and distribution of risk EU-wide, as well as risk exposures of EU-based entities.

For example, the data presented in the CP are taken from the DTCC Global Trade Repository, as well as from the Bank for International Settlements (BIS), and show global trends in the OTC IRD market. The comparison of these data with the BIS Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Market Activity, on turnover in April 2013 for the UK, reveals severe discrepancies between the currency structure of the average daily turnover in the global market vis-à-vis the largest market in the EU, not only with respect to the most heavily traded currencies (Table 1).

Indeed, in the ESRB's view a European perspective is much more relevant, especially given that the abovementioned CO basically pertains to transactions in which at least one counterparty is an EU resident (Article 4(1)(a) of EMIR). What is more, within the EU there may be multiple jurisdictions with systemically important financial sectors which use local currencies other than EUR or GBP[7]. In many such financial sectors, the transactions in

[7] For example, the International Monetary Fund (IMF) identifies 25 jurisdictions worldwide whose financial sectors are deemed to be systemically important, including inter alia Denmark, Poland, Sweden and the United Kingdom, along with 10 euro area countries. Also, the ESRB is responsible for monitoring and assessment of potential systemic risks

OTC IRD denominated in local currencies constitute the vast majority of turnover in the local markets (see for instance the Polish market in Table 1), and of banks' off-balance-sheet positions, concentrating the bulk of the associated risk.

Table 1: Currency structure of turnover in the OTC IRD markets in April 2013 (in %)

Currency	Global	UK	Poland
EUR	50.4	68.9	0.7
USD	28.9	8.2	0.0
GBP	8.2	14.1	0.0
AUD	3.3	1.9	0.0
JPY	3.1	1.0	0.0
SEK	1.6	1.8	0.0
CHF	0.6	0.9	2.1
KRW	0.5	0.0	0.0
PLN	0.3	0.4	96.9
CZK	0.0	0.0	0.3
Other currencies*	3.1	2.8	0

Source: BIS, Bank of England (http://www.bankofengland.co.uk/statistics/Pages/bis-survey/survey071013.aspx), Narodowy Bank Polski (http://www.nbp.pl/homen.aspx?f=/en/systemfinansowy/obroty.html). *Calculated as residual.

In the ESRB's view this is a crucial point. The justification for choosing certain classes of OTC IRD while leaving out others, e.g. those denominated in currencies other than USD, EUR, GBP and JPY, would require some further elaboration as the analysis conducted by ESMA seems to focus on the number and value of transactions (e.g. only with respect to this criterion does the distinction between different currencies appear). ESMA could clearly indicate the factors that were decisive for establishing the proposed set of classes of OTC IRD to be mandatorily cleared in CCPs.

Ideally, the final draft of the RTS to the European Commission should be underpinned by a more comprehensive analysis with respect to OTC IRD denominated in currencies other than USD, EUR, GBP and JPY, including all of the criteria enumerated in Article 7(2) of Regulation (EU) No 149/2013 in order to determine the classes of OTC derivatives which optimally – given the European focus of EMIR – ought to be subject to the CO. For this purpose it would be vital to acquire as much information as possible, preferably making extensive use of trade repositories data on OTC derivative transactions.

Should such comprehensive analysis justify any extension of the set of CCP-eligible classes of OTC IRD proposed in the CP, it may be necessary to modify the initial draft of the RTS published by ESMA.

The ESRB is nevertheless mindful of the problems regarding the acquisition of sufficient quantitative input to allow the unambiguous determination, before the EMIR deadline, of

that include risks of disruption to financial services caused by significant impairment of all or parts of the EU financial system – be they groups of or even individual member states – that have the potential to have serious negative consequences for the internal market and the real economy (Recital 27 of Regulation (EU) No 1092/2010).

the final list of IRD that should optimally fall under the CO. Therefore, it may be inevitable to adopt a ‘narrow’, rather than a “broad”, approach at this stage. This would allow a critical mass of contracts whose clearing could be moved to CCPs to be promptly obtained. In such a case, however, the ESRB suggests that ESMA clearly explains the current limitations in data availability and announces a forthcoming review, including the possible enlargement of the proposed set of CCP-eligible classes of OTC IRD, together with an indicative timeline. Otherwise stakeholders might find it difficult to plan or to allocate resources to any necessary future adjustments.

The comprehensive analysis concerning the scope of the CO with respect to OTC IRD needs to take into account the developments in other G20 jurisdictions, in order to ensure equal treatment of OTC derivatives denominated in currencies whose markets are of similar liquidity. This pertains in particular to currencies other than the top ones in terms of global turnover (USD, EUR, GBP etc.). For example, South Korea has already introduced mandatory CCP-clearing of standardised (plain vanilla) fixed-to-float KRW-denominated IRS, effective since 30 June 2014[8].

Also, it should take note of the proposed rules regarding the collateralisation of bilateral exposures resulting from transactions in OTC derivatives not cleared by a CCP[9], as they significantly affect the scale and distribution of systemic risk across domestic markets in individual countries.

In this context it may be worthwhile to analyse the overall effect of leaving out from mandatory CCP-clearing certain classes of OTC IRD, denominated in European currencies other than EUR and GBP, while taking into account the abovementioned rules concerning counterparty credit risk management in bilaterally-cleared transactions.

It may turn out that for some EU countries the actual impact of the OTC derivatives market reform only consists of reporting to trade repositories, which represents a significant cost/burden for all OTC derivatives market participants, but is unlikely to be satisfactory in terms of reducing systemic risk.

6. Concluding remarks

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

At the same time, the ESRB wishes to highlight the following elements for ESMA’s consideration.

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8 In April 2013, the turnover in the global OTC IRD market with respect to instruments denominated in KRW amounted to USD 12 billion, whereas OTC IRD denominated in SEK amounted to USD 36 billion.

9 *Consultation paper: draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*. [whose consultation paper? add date?]

A. Possible extension of the CO to other OTC derivatives

The ESRB points out a need to conduct a more comprehensive analysis with respect to OTC IRD denominated in currencies other than USD, EUR, GBP and JPY which would assess in detail, using the suggested metrics (ideally based on trade repositories data), all criteria enumerated in Article 7(2) of Regulation (EU) No 149/2013.

The ESRB also wishes to point out that the need for a more comprehensive analysis also seems to arise in respect of other contracts currently not proposed for the CO, such as equity derivatives and interest rate futures and options.

Should such comprehensive analyses justify any extension of the set of CO eligible classes of derivatives proposed in the CP, it may be necessary to modify the draft RTS published by ESMA.

However, as pointed out earlier on in this ESRB response, should these further analytical underpinnings not be available at the time that the draft RTS has to be submitted to the European Commission, the ESRB suggests that ESMA clearly announces a forthcoming review including possible enlargement of the proposed set of CO eligible classes of OTC derivatives, together with an indicative timeline thereof.

B. Other issues regarding the timing and phasing-in of the CO

In terms of dates of application of the CO, the ESRB is not completely convinced by the argument that extensive delays are necessary for category 2 and 3. As experience with other long-dated implementation deadlines has shown (e.g. the Single Euro Payments Area, where the migration end date had to be eventually delayed by further six months) most market participants defer work on implementation until the deadline is nearly reached. Other jurisdictions, such as the USA, had much closer deadlines for the application of the CO to different groups of counterparties, although the situation is not completely comparable with that in the EU.

The later the clearing obligation comes into effect, the longer the counterparty risk might not be managed adequately. The bilateral margining requirements that are expected to gradually come 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. Therefore, the ESRB proposes 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 wish to reconsider accordingly the deadlines included in the draft RTS.

With regard to the issue of frontloading, the ESRB would like to reiterate that a quick and comprehensive introduction of the CO is the most effective tool to tackle systemic risk in the OTC derivatives markets. In this respect, the ESRB does not see an excessive market risk if the frontloading was required on a strict basis; it can be expected that the overall effect due to a mispricing on the trade date would be negligible.

However, the ESRB appreciates ESMA's pragmatic proposal to only – request frontloading of the 'Phase B derivatives' to minimize the uncertainties for the market participants. This is preferable to a prolonged discussion that might lead to a further postponement of the introduction of the clearing obligation for a longer period.

D. Top-down approach

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