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ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB RESPONSE TO ESMA CONSULTATION PAPER ON MANDATORY CENTRAL CLEARING FOR FOREIGN-EXCHANGE NON-DELIVERABLE FORWARD OTC 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 1 October 2014 ESMA released a consultation paper (CP) on the clearing obligation (CO) for foreign-exchange non-deliverable forward OTC derivatives (FX NDF).

This response summarises the ESRB's opinion on ESMA's proposal; it follows the opinions recently delivered by the ESRB on the proposal of clearing obligation for certain classes of OTC Interest Rates Derivatives (IRD) and Credit Default Swaps (CDS).

In line with these previous consultations the ESRB wishes to reaffirm the merits of a wide application of mandatory central clearing to a number of OTC derivatives classes, consistent with the policy agreed in 2009 by the G20 with a view to reducing systemic risk.

The ESRB wishes to reaffirm as well that, in developing this opinion, it has been mindful of its mandate to monitor and assess potential systemic risks, which 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].

The ESRB has been also mindful of the importance of ensuring consistency with the decisions currently being made in other jurisdictions (in particular the USA, where the competent authorities are considering the possibility to impose the clearing obligation on FX NDF), given that regulatory arbitrage can also be a major source of concern from a macroprudential perspective. The ESRB considers that close coordination with the competent foreign authorities will prove to be particularly useful in this kind of decision process.

The following Section of this response elaborates on the ESMA CO proposal; Section 3 continues with an analysis of liquidity of FX NDF and of the structure and concentration in this market. The response closes with some concluding remarks. For the general assess-

[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 macroprudential oversight of the financial system and on establishing a European Systemic Risk Board; OJ L 331, 15.12.2010, p. 1.

ment of macro prudential aspects of central clearing, the ESRB wishes to confirm what it already expressed in its opinion on the CO for IRD and CDS.

2. *The CO proposal regarding FX NDF OTC derivatives*

FX NDF are cash-settled forward contracts on a certain currency pair whereby the difference between an exchange rate agreed at the inception and the spot rate at maturity is cash-settled in a previously agreed upon currency. Predominantly, FX NDF are quoted and settled in US dollars (USD); these contracts are commonly used to hedge currency risks (for investment or commercial purposes) or to speculate on currencies that are not internationally traded because of domestic restrictions on capital flows or to enter into arbitrage strategies between bonds and currency pairs.

As with the two previous consultations launched by ESMA on OTC interest rate and credit derivative contracts, this consultation was initiated on the basis of the authorisation granted to CCPs by the relevant national competent authorities, and therefore it follows the bottom-up approach described in Article 5(2) of EMIR.

In particular, the consultation refers to the FX NDF OTC derivative classes cleared by LCH.Clearnet Ltd (UK) and proposes to subject the following eleven currency pairs on the full range of maturities (3 days to 2 years) to the clearing obligation:

- Brazilian Real / USD
- Chinese Yuan / USD
- Indonesian Rupiah / USD
- Korean Won / USD
- Philippine Peso / USD
- Taiwan Dollar / USD
- Chilean Peso / USD
- Colombian Peso / USD
- Indian Rupee / USD
- Malaysian Ringgit / USD
- Russian Ruble / USD

In addition, LCH.Clearnet Ltd is also currently clearing the Peruvian Nuevo Sol / USD pair, which is not part of the CO proposal by ESMA.

According to the ESMA consultation paper, the landscape of CCPs clearing this type of OTC contracts is supposed to include a variety of CCPs; other European CCPs – some of them already authorised, others in the course of being authorised – are expected to clear some or all of these currency pairs in the near future: CME Clearing Europe Ltd, ICE Clear Europe Ltd and Nasdaq OMX Clearing AB. In addition, three third-country CCPs also currently clear FX NDF and have already applied to be recognised in Europe.

In respect of the date of application of the CO, ESMA has followed the same approach developed in the final report on the CO for IRD and adopted also for the consultation paper on credit derivatives, which is as follows:

- Category 1 (clearing members): 6 months after entry into force of the RTS;
- Category 2 (large financials , i.e. non-clearing members above the 8 bln threshold adopted for bilateral clearing): 12 months after entry into force of the RTS;
- Category 3 (small financials, i.e. non-clearing members below the 8 bln threshold adopted for bilateral clearing): 18 months after entry into force of the RTS;
- Category 4 (non-financials): 33 months after entry into force of the RTS.

With regard to the frontloading requirement and the minimum remaining maturity, for consistency reasons ESMA decided to follow the same approach presented in the final report to the Commission on the CO for IRD. However, the length of the minimum remaining maturities is shorter than that foreseen for IRD, given that the maximum maturity of FX NDF contracts is shorter than the maximum maturity of the IRD class.

3. Analysis of market structure, liquidity and pricing

The ESMA consultation paper reports that FX markets, and in particular the FX NDF market, have experienced significant growth in the past five years; according to a BIS study, published in April 2013 “the NDF turnover globally accounted for $127 billion, representing 19% of all forward trading globally and 2.4% of all currency turnover”. A similar conclusion could also be drawn from the Bank of England data, which exhibit a significant increase in daily turnover in the UK FX NDF market (from $22.5 billion in April 2008 to $54.6 billion in April 2014)[3], which translated into an increase of NDF share in the overall value of forward transactions concluded in the UK market (from 11.3% in April 2008 to 23.3% in April 2014), and in the total turnover in the UK FX market (from 1.2% in April 2008 to 2.3% in April 2014).

However, it should be noted that while the above mentioned figures show a dynamic growth of the FX NDF market which occurred over the last years, some factors could raise doubts about the sustainability of this trend in the foreseeable future.

Given that, as explained in Section 2, traditionally the demand for FX NDF products has been associated with restrictions imposed on foreign investors to invest in certain currencies, one could reasonably assume that once these constraints are removed or relaxed, the demand and therefore the liquidity of such products could fade away. However, the past experience with certain currencies shows that the displacement of the FX NDF market can take years; the example of the Korean won shows that, also with continuing restrictions, when trading moves to multilateral trading facilities and clearing to CCPs, markets can have significant improvements and become more transparent and liquid. Hence, the ESRB concurs with ESMA’s view that the future FX NDF market growth and liquidity is difficult to foresee.

[3] *Semi-annual Foreign Exchange Turnover Surveys* of the Foreign Exchange Joint Standing Committee, Tables 1.B in Excel “*…data tables.xls*” files, http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx.

In this respect, and in particular in light of potentially fast fading liquidity of contracts belonging to this asset class, the ESRB wishes to add that the ability of swiftly removing the clearing obligation is important; the process currently foreseen in the EU legislation for this removal may not be as swift as needed. Further, the ESRB wishes to add that the particular features of this asset class might lead to circumstances in which contract prices are not reliable or, simply, not available; the ESRB understands that, given that this possibility has already been tackled in the CCPs' regulatory framework, the relevant risk mitigation measures have been properly evaluated.

In terms of concentration of clearing at CCPs, as already stated in the previous paragraph, currently only one European CCP is authorised to clear all eleven currency pairs up for consideration; of course, where products have relatively lower volumes, it is more likely that market volume will concentrate in a single or few CCPs. During the initial stages of product clearing, such an approach may have market benefits, in that it may provide a catalyst for more clearing and may enable the CCP and market participants to better understand the risk characteristics of the product. Nevertheless, the ESRB concurs with ESMA's view that it is expected that the CO actually will take effect in a clearing "ecosystem" where more CCPs handle the same asset class and which thereby contributes to avoid that some potential effects of a monopoly situation occur[4]. Having said that the ESRB wishes to reiterate nonetheless its concerns related to the concentration of clearing services at very few CCPs already expressed in previous consultations, given that a CCP distress in such circumstance could exacerbate the inherently systemic consequences of a CCP default. In light of this the ESRB reiterates the urgency of having in place a comprehensive legislative and regulatory framework for the recovery and resolution of CCPs in the EU.

As in the IRD and CDS markets the establishment of the clearing obligation and the potential increase in client clearing activity could lead to changes in the network of systemic clearing members in FX NDF OTC derivatives markets. Therefore, the ESRB encourages regulators to continuously monitor the participation of key market counterparties across CCPs, which may evolve as a result of market dynamics.

4. Assessment from a macroprudential perspective – concluding remarks

From a macroprudential perspective, the proposal to submit certain classes of FX NDF to a clearing obligation presents a number of positive implications.

In general, one should consider the enhancement of the transparency and stability of the relevant markets, which is expected from the application of the clearing obligation.

Further, in terms of regulatory consistency it should be recalled that the FX market is intrinsically global in nature and the NDF segment does not constitute an exception. In this

[4] See paragraph 42 of the consultation paper.

respect, the ESMA proposal appears substantially coherent with the decisions which are being made also in the USA on the same asset classes, and thus able in principle to limit significantly, if not to avoid, room for potential regulatory arbitrage. Having said that, there are still differences in the proposed contract maturities between the European and USA proposals and ESMA should consider the consultation responses carefully in this area.

Finally, although this is not specific to FX NDF, the ESRB confirms its favour for a wide application of the mandatory clearing requirement; as expressed in previous opinions on mandatory clearing for other asset classes, properly managed and supervised CCPs can act as effective backstops in case of crisis.

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

However there are also some caveats which the ESRB wishes to highlight, for ESMA's consideration.

Firstly, the ESRB encourages ESMA to more deeply characterise the EU perspective in the assessment of the systemic risk implications of the FX NDF market, through a wider use of EU data.

The ESMA consultation paper is transparent in explaining that the data set used for analysis does not include information applying specifically to the European FX NDF market. The primary sources thereof are: DTCC Global Trade Repository and the global results of the BIS Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Market Activity. Hence ESMA primarily builds on and exhibits trends in the USA and global FX NDF markets (as it is recalled in paragraph 62 of the CP). Moreover, in order to combine information from these data sources and draw conclusions with respect to the FX NDF market in the EU, in some cases ESMA had to make strong assumptions.

In this respect the ESRB encourages the use of EU data, in order to yield more robust results, as applied to Europe.

Information obtained from trade repositories might provide a more accurate outlook. However, the ESRB acknowledges that the difficulties with the retrieval thereof (signalled in the *Final Report on Draft technical standards on the Clearing Obligation – Interest Rate Derivatives*)[5], may make data from trade repositories unavailable, at least in the short term. Other sources of seemingly relevant data include the national results of the *BIS Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Market Activity*, in particular on the UK market[6], which is by far the largest in the EU. Also, the Bank of England publishes twice a year the results of *Semi-annual Foreign Exchange Turnover Surveys* con-

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[5] *Final Report on Draft technical standards on the Clearing Obligation – Interest Rate Derivatives*, ESMA/2014/1184, 1 October 2014.
[6] The results of the survey are publicly available under http://www.bankofengland.co.uk/statistics/Pages/bis-survey/survey071013.aspx.

ducted by the Foreign Exchange Joint Standing Committee which include, *inter alia*, data on turnover in the London-based NDF market.[7]

Secondly, the limitations in the availability of EU data might raise a problem in terms of consistency of the application of the CO across asset classes. For instance, based on the above mentioned data on the UK market the level of average daily net turnover with respect to some of the currency pairs intended to be subject to the clearing obligation seems to be lower than the value of transactions concluded daily in the EU market for IRD denominated in some European currencies that are currently not proposed for mandatory central clearing[8]. The ESRB acknowledges that despite a relatively low turnover in markets for FX NDF denominated in some currencies intended for mandatory central clearing, the estimated number of trades in these markets is probably relatively high, which may, to some extent, compensate for this seemingly heterogeneous approach across asset classes. However, taken the above mentioned into account, the ESRB would encourage ESMA to supplement the analysis, to the extent possible, with data more adequately reflecting the size and structure of individual segments of the EU market. Furthermore, in terms of consistency of the initiatives taken across asset classes to reduce systemic risks, the ESRB stresses the importance of launching a new consultation on IRD denominated in the Nordic region currencies as well as PLN by ESMA shortly, as envisaged in the above mentioned *Final Report on Draft technical standards on the Clearing Obligation – Interest Rate Derivatives*[9].

Finally, in terms of clarity and in view of the forthcoming technical standards for future CCP-eligible classes of instruments the ESRB encourages ESMA to enhance the coherence of the whole process from the point of view of stakeholders. FX NDF or some of the FX NDF classes might seem not to be really relevant under a systemic risk containment perspective in terms of volume/size compared, for example, to the OTC IRD market. Further, an overall timetable for the assessment of a clearing obligation for the different OTC derivatives classes could be helpful for the clarity of the ESMA approach across these classes.

In confirming its support for the ESMA proposal for CO the ESRB, as already put forward in the consultations on IRD and CDS, wishes to also suggest implementation periods shorter than those proposed; in this respect the ESRB encourages ESMA to consider that over time market participants and end-users can leverage on the experience progressively gained in accessing central clearing facilities and therefore a progressive shortening of these periods can be evaluated.

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[7] Tables 1.B in Excel "…data tables.xls" files, available at http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx.

[8] Sources: *Results of the Semi-Annual FX Turnover Surveys*, April 2013 revised data tables, Table 1.B, http://www.bankofengland.co.uk/markets/Documents/forex/fxjsc/fxturndata140728_apr13.xls; *Survey of Foreign Exchange and OTC Derivatives turnover - Results 2013 to 2007*, Breakdown of the 2013 BIS triennial survey for the UK, Table Single-currency IR, http://www.bankofengland.co.uk/statistics/Pages/bis-survey/survey071013.aspx.

[9] Paragraph 80 of the Report.

In line with what has been expressed in previous opinions, the ESRB wishes to add, with regard to future action by the authorities, 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 EMIR, thus making the G20’s original reform programme more effective.