



## ESRB response to ESMA Consultation Paper No. 4 on the clearing obligation for other OTC interest rate derivatives

### 1. Introduction

Article 5(2) of the European Market Infrastructure Regulation (EMIR)<sup>1</sup> 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 over-the-counter (OTC) derivatives that should be subject to a clearing obligation under the Regulation.

On 11 May 2015 ESMA released Consultation Paper (CP) No. 4, which proposes introducing a clearing obligation for other OTC interest rate derivatives (IRD) that were not included in the first CP on the clearing obligation for OTC IRD (CP No. 1).<sup>2</sup> Subsequent to the first paper, a final report was submitted to the European Commission for endorsement on 1 October 2014 and is expected to enter into force in mid-2016.<sup>3</sup> The clearing obligation set down in the final report covers a set of OTC IRD denominated in euro, pounds sterling, yen and US dollars (G4 currencies). ESMA indicated that it would carry out further analysis of OTC IRD denominated in other currencies, as requested by the ESRB in its response to CP No. 1.<sup>4</sup> ESMA's current proposal (CP No. 4) is the result of this work.

This response summarises the ESRB's opinion on CP No. 4. First of all, 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 by the G20 in 2009 with a view to reducing systemic risk.<sup>5</sup> In this respect, the ESRB expresses its overall support for introducing a clearing obligation for the classes of OTC derivatives proposed by ESMA.

In developing its response, the ESRB has been mindful of its mandate to monitor and assess potential systemic risks including risks of disruption to financial services caused by a significant impairment of all or parts of the EU financial system – be they groups of Member States or even individual Member States – that have the potential to have serious negative consequences for

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<sup>1</sup> 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).

<sup>2</sup> ESMA (2015), *Consultation Paper. Clearing Obligation under EMIR (No. 4)*, ESMA/2015/807. ESMA's first consultation paper, *Clearing Obligation under EMIR (No. 1)*, published on 11 July 2014, contains a draft RTS on the clearing obligation for OTC IRD denominated in EUR, GBP, JPY and USD (2014/ESMA/799, as amended).

<sup>3</sup> ESMA (2014), *Final Report. Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives*, ESMA/2014/1184. See also *First steps in the review of EMIR, the European derivatives regulation*, speech by European Commissioner Jonathan Hill, 29 May 2015. [http://europa.eu/rapid/press-release\\_SPEECH-15-5080\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-15-5080_en.htm)

<sup>4</sup> ESRB (2014), *ESRB response to the ESMA Consultation Paper on mandatory central clearing for OTC interest rate derivatives*, 18 August.

[http://www.esrb.europa.eu/pub/pdf/other/140820\\_ESRB-response.pdf?0791e553608b26d1850f34bf23cad8ec](http://www.esrb.europa.eu/pub/pdf/other/140820_ESRB-response.pdf?0791e553608b26d1850f34bf23cad8ec)

<sup>5</sup> Leaders' Statement, The Pittsburgh Summit, September 2009.

[https://q20.org/wp-content/uploads/2014/12/Pittsburgh\\_Declaration\\_0.pdf](https://q20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf)

the internal market and the real economy.<sup>6</sup> The ESRB has also been mindful of the importance of consistency with the decisions on mandatory central clearing taken in other G20 jurisdictions (e.g. Japan, South Korea and the United States), considering that regulatory arbitrage can be a major source of concern from a macroprudential perspective.

Section 2 below provides more detail about the ESRB's stance on central clearing. Section 3 assesses the analysis presented in CP No. 4 and presents the ESRB's view on the draft RTS proposed by ESMA, supported by some additional data and the key findings of internal ESRB studies. The conclusions and proposals are summarised in Section 4.

## **2. ESRB stance on the use of central counterparties**

The 2008 crisis showed that large counterparty exposures through OTC derivatives were not appropriately managed in terms of risk. The exposures also increased the potential for contagion, knock-on effects and liquidity spirals, as the default of a single large counterparty could rapidly propagate across the financial system and across jurisdictions. These effects materialised in some instances with significant consequences, owing in particular to the limited use of central counterparties (CCPs) and the lack of widely accepted and sound collateral practices on a bilateral basis.

Against this background, the recourse to central clearing has been identified at the international level as one of the important tools to mitigate systemic risk. The ESRB shares this view. Central clearing redistributes counterparty credit risk – replacing the network of bilateral exposures between market participants with a structure in which each participant has a single exposure to a properly managed and effectively supervised and overseen CCP. Systemic risk is mitigated by improved counterparty credit risk management, the widespread use of multilateral netting, reduced uncertainty about participants' exposures and increased transparency of market activity.

Provided that the risk management of CCPs is sound and capable of effectively withstanding the default of a clearing member even in stressed circumstances, central clearing can act as a “circuit-breaker” should a market participant default on its obligations. Without central clearing, such defaults could trigger a chain of credit-related losses having severe systemic consequences. By means of central clearing, exposures are lowered through multilateral netting and collateralisation. 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.

Moreover, it is likely that the failure of a major OTC derivatives dealer would generate widespread uncertainty as to who is exposed to that failing counterparty which, in turn, might cause markets to become illiquid. The use of CCPs contributes to reducing this uncertainty in the market and helps to provide regulators with a clearer picture of market participants' exposures.

The obvious precondition 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 CPMI-IOSCO Principles for Financial Market Infrastructures<sup>7</sup> at

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<sup>6</sup> See also 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 establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1).

<sup>7</sup> The Committee on Payment and Settlement Systems (CPSS) was renamed the Committee on Payments and Market Infrastructures (CPMI) in September 2014.

the international level, and EMIR at the European level, provide overall the necessary reference framework for CCPs' functioning, regulation and supervision.

At the same time, the ESRB stresses the importance of introducing, without undue delay, a comprehensive regulatory framework for the recovery and resolution of CCPs to provide for the unlikely, but not impossible, event that a CCP finds itself in a distressed situation. This is important because CCPs concentrate significant credit and operational risk and will do to an even greater extent once the clearing obligations under EMIR enter into force. While their fully matched books shield CCPs from market risk, they remain exposed to the potential default of one or multiple clearing members. Once certain classes of OTC derivatives become CCP-eligible and a critical mass of contracts is cleared through CCPs, moral hazard may increase if an implicit government guarantee is assumed. The ESRB therefore looks forward to progress in developing an EU framework for CCPs' recovery and resolution.<sup>8</sup>

On the clearing obligation procedure, the ESRB reiterates what it stated in the context of the previous ESMA consultation on the proposal of mandatory clearing for non-deliverable forwards (CP No. 3)<sup>9</sup>. The legal provisions should determine the conditions to be fulfilled for a swift removal or suspension of the clearing obligation for certain classes of OTC derivatives where the market situation so requires. Indeed, market conditions for financial instruments can change dramatically in a very short period of time. From a macroprudential standpoint, the mandatory use of CCPs for contracts which are no longer eligible for the clearing obligation can have unintended consequences in terms of CCPs' exposures to potentially illiquid financial instruments and/or lead to significant changes in margin requirements, possibly with pro-cyclical implications.

### 3. Assessment of ESMA's analysis and additional data/information

The ESRB welcomes the approach adopted by ESMA for the purpose of CP No. 4. The interpretation of systemic risk proposed in Section 5.1 is fully in line with that of the ESRB. The ESRB confirms that, in the context of the clearing obligation, systemic risk should be considered not only at the aggregated EU level, but also at national or even institutional level, whenever risks of disruption to financial services caused by a significant impairment of all or parts of the EU financial system have the potential to have serious negative consequences for the internal market and the real economy.<sup>10</sup> There are multiple jurisdictions with systemically important financial sectors within the EU, also with local currencies other than the euro or pound sterling, which could transmit financial shocks across borders via, inter alia, capital relations between and within large European banking groups or active participation in the global financial markets and the derivatives market in particular.

On the basis of the criteria set out in EMIR and the RTS on OTC derivatives,<sup>11</sup> ESMA proposes in CP No. 4 that the following classes of OTC IRD, which were not included in the final report on the clearing obligation for OTC IRD denominated in G4 currencies, should be subject to the clearing obligation:

<sup>8</sup> EC (2015), *Framework for resolution of financial institutions other than banks*, 04-2015.

[http://ec.europa.eu/smart-regulation/impact/planned\\_ia/docs/2015\\_fisma\\_029\\_cwp\\_ccp\\_resolution\\_of\\_non\\_bank\\_resolution\\_en.pdf](http://ec.europa.eu/smart-regulation/impact/planned_ia/docs/2015_fisma_029_cwp_ccp_resolution_of_non_bank_resolution_en.pdf)

<sup>9</sup> ESMA (2014), *Consultation Paper. Clearing Obligation under EMIR (No. 3)*, ESMA/2014/1185.

<sup>10</sup> See footnote 6.

<sup>11</sup> 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).

- fixed-to-float interest rate swaps (IRS) denominated in CZK, DKK, HUF, NOK and PLN in tenors of 28 days to five years, and fixed-to-float IRS denominated in SEK in tenors of 28 days to 15 years;<sup>12</sup>
- forward rate agreements (FRA) denominated in NOK and PLN in tenors of three days to one year, and FRA denominated in SEK in tenors of three days to two years.

All classes of OTC IRD proposed to be subject to the clearing obligation in CP No. 4 are cleared by two or three CCPs.

With reference to the criteria in Article 5(4) of EMIR, the ESRB considers that the proposed set of classes, together with the set of classes proposed in CP No. 1, is appropriate to address the systemic risk for the EU market associated with OTC IRD for the time being. In the light of the broad G20 agreement of 2009 which recommended applying the clearing obligation to all standardised OTC derivatives, the extended set of classes of OTC IRD, as proposed by ESMA, is a step in the right direction.

The ESRB also welcomes the holistic approach adopted by ESMA for the purpose of the analysis. The assessment of market liquidity, e.g. with respect to market size and depth, is conducted not only in absolute terms, but also relative to other OTC derivatives asset classes. Markets for OTC IRD denominated in some non-G4 currencies may be smaller than those for IRS or FRA contracts denominated in G4 currencies. However, these non-G4 markets are still larger than the markets for some classes of OTC foreign exchange and credit derivatives (e.g. the credit default swap index) which were proposed to be subject to the clearing obligation in the previous consultation papers. IRD as an asset class constitute over 80% of the overall OTC derivatives market, as measured by outstanding notional value.

From a different angle, the ESRB would like to highlight the (abovementioned) importance of maintaining consistency with the decisions taken in other G20 jurisdictions in order to ensure the equal treatment of OTC derivatives denominated in currencies whose markets are of similar liquidity. Notably, the mandatory central clearing of CNY-denominated<sup>13</sup> OTC IRD was launched back in mid-2014, as was mandatory central clearing of standardised (“plain vanilla”) fixed-to-float KRW-denominated<sup>14</sup> IRS. The share of OTC IRD denominated in those currencies in the global OTC single currency IRD market in April 2013 (on a “net-net” basis, Bank for International Settlements (BIS) data) amounted to 0.62% and 0.52% respectively. At the same time, the equivalent shares in the global turnover of OTC IRD denominated in, e.g. SEK, NOK or PLN, accounted for 1.54%, 0.40% and 0.32% respectively, which is a similar order of magnitude.

The analysis conducted by ESMA is far more comprehensive and substantive than in the previous consultation papers and, in the ESRB’s view, sufficiently covers all of the criteria listed in Article 7 of the RTS on OTC derivatives. It has benefited from the use of additional data, including from the European trade repositories. This extended dataset has enabled ESMA to establish additional metrics, enhancing the breakdown of activity from a geographical

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<sup>12</sup> The Czech koruna (CZK), Danish krone (DKK), Hungarian forint (HUF), Norwegian krone (NOK), Polish zloty (PLN) and Swedish krona (SEK).

<sup>13</sup> Chinese renminbi (CNY).

<sup>14</sup> South Korean won (KRW).

perspective and allowing a more granular analysis. As a result, the adopted approach has produced, in the ESRB's opinion, a more thorough and EU-focused analysis.

In order to further enhance the EU perspective, the analysis provided by ESMA in Table 4 of the paper could be extended to cover OTC IRD denominated in the European currencies other than the G4 currencies currently proposed to be subject to the clearing obligation. Based on available BIS data, it is possible to calculate the turnover of transactions in those instruments executed in any of the EU Member States (jointly for all OTC single currency IRD denominated in a given currency, on a "net-gross" basis) and the share of EU-executed transactions in the global turnover (see the table below). Given that the clearing obligation defined in EMIR pertains to transactions in which at least one counterparty is an EU resident, this exercise would provide a more relevant indicator of their systemic significance for the EU. For example, there is a notable difference between transactions denominated in SEK and JPY in terms of their EU-wide importance.

**Daily average "net-gross" turnover in OTC single currency interest rate derivatives by currency, April 2013**

Currency of denomination	Transactions executed in the EU (USD; millions)	Share of EU-executed transactions in the global turnover (percentages)
EUR	1,277,744	95.6
GBP	201,284	97.4
USD	180,866	23.3
<b>SEK</b>	<b>43,362</b>	<b>98.0</b>
JPY	15,758	18.7
<b>PLN</b>	<b>9,093</b>	<b>98.4</b>
<b>NOK</b>	<b>6,804</b>	<b>58.1</b>
<b>DKK</b>	<b>4,389</b>	<b>96.1</b>
<b>HUF</b>	<b>2,975</b>	<b>96.0</b>
<b>CZK</b>	<b>804</b>	<b>86.5</b>

Sources: ESRB calculations based on the Triennial Central Bank Survey, Interest rate derivatives market turnover in 2013, BIS, December 2013, Tables 3.1-3.6, pp. 8-13.

In addition, for most of the countries with currencies proposed to be subject to the clearing obligation (CP No. 4), the vast majority of turnover in their domestic OTC IRD markets pertains to instruments denominated in the respective local currencies. This may make those derivatives systemically important at the level of individual EU Member States. Also, as most of the turnover in these local markets relates to transactions with non-residents, predominantly EU-based, the resulting web of bilateral exposures links multiple financial sectors together, posing a potential EU-wide systemic threat.

The ESRB has compared the classes of OTC IRD proposed for the clearing obligation in CPs No. 1 and No. 4, in terms of market liquidity. A wide set of metrics was used for this purpose, including, inter alia, the largest net long and short positions; average daily trade volume and trade count; number of days without any trades concluded; large long and short positions' close-out periods; average number of active dealers; market concentration (top five and top three positions, as measured by the Herfindahl index); and the price impact of trading. Compared with

some of the less liquid classes of IRD proposed for the clearing obligation in CP No. 1, in particular GBP- and USD-denominated IRS with maturities of over 30 years, trading in the classes of IRS denominated in non-G4 currencies proposed for the clearing obligation in CP No. 4 exhibits similar liquidity characteristics. This is especially true with respect to the time it takes to close out large long and short positions, the number of available active dealers, as well as the price impact of trading and the scale of adverse changes in value over a given close-out period. The same conclusion, with respect to virtually all of the examined metrics, can be drawn from the comparison of EUR-, GBP- and USD-denominated FRA contracts with maturities longer than 18 months with FRA contracts denominated in non-G4 currencies, proposed for the clearing obligation in CP No. 4. In the case of some characteristics – such as the number of days without any trades concluded, large long and short positions' close-out periods, market concentration measured by the Herfindahl index and the price impact of trading – NOK-, PLN- and SEK-denominated FRA seem to perform significantly better in terms of market liquidity.

The analysis also leads to another important conclusion, namely that the choice of maturities for each type of OTC derivatives contract denominated in a given currency crucially determines whether it is eligible for the clearing obligation. In this respect, the ESRB's findings presented above corroborate the results of ESMA's analysis and subsequent proposal, presented in CP No. 4. For each of the non-G4 currencies in which OTC IRD are denominated, the contracts whose maturities fall within the range proposed by ESMA for the clearing obligation to apply, in comparison with such OTC IRD with longer maturities, tend to be traded more regularly and by a greater number of active dealers, in a more liquid and less concentrated market, require fewer days to close out large long and short positions, and exhibit lower price impact of trading and smaller adverse changes in value over a given close-out period.

All in all, the classes proposed to be subject to the clearing obligation seem to meet the criteria listed in the RTS on OTC derivatives in a similar manner as some of the classes of OTC IRD included in the final report on the clearing obligation for OTC IRD denominated in G4 currencies. This significantly mitigates any risks arising from the introduction of the clearing obligation set down in CP No. 4.

Nevertheless, in order to avoid a situation in which market participants try to evade regulation by switching to transactions with maturities slightly longer than those falling within the proposed scope of the clearing obligation, the ESRB identifies a clear need, after the clearing obligation is introduced, to monitor activity in individual market segments with regard to transaction maturities and to act promptly when the market situation so requires.

The ESRB considers that ESMA's proposal on the definition of counterparty categories is appropriate in the light of the criteria set out in EMIR. In particular, it is reasonable to frame the definition of Category 1 in such a way that it encompasses only the counterparties which have existing clearing arrangements for at least one of the classes of OTC IRD denominated in non-G4 currencies proposed for the clearing obligation in CP No. 4.

Furthermore, the ESRB agrees with the proposal to use the same phase-in periods for the four categories of counterparties as those put forward in the final report on the clearing obligation for OTC IRD denominated in G4 currencies, namely six months for Category 1, 12 months for Category 2, 18 months for Category 3 and three years for Category 4. Recommending that all RTS on the clearing obligation are adopted as soon as possible, the ESRB nevertheless has some doubts concerning the need for an extra period to be added to the phase-in periods should the RTS for OTC IRD denominated in non-G4 currencies be adopted within three

months of the adoption of the RTS on OTC IRD denominated in G4 currencies. Granting an additional three-month phase-in period may be justified with respect to counterparties falling into Category 1, and perhaps Category 2, but extending the already very long grace periods for Categories 3 and 4 seems unnecessary. Much of the organisational work resulting from the need to prepare for the clearing obligation exists whatever the currency of denomination of OTC IRD proposed for central clearing. A large share of the counterparties that conclude transactions in OTC IRD denominated in one or several non-G4 currencies proposed for the clearing obligation will in any case have to prepare adequate procedures for the purpose of the mandatory clearing of transactions in OTC IRD denominated in G4 currencies.

#### **4. Conclusions and proposals**

The ESRB reiterates its appreciation for ESMA's analysis and notes that its results are broadly in line with the outcome of the ESRB's internal studies. The ESRB supports the proposal to apply the clearing obligation to the classes of OTC IRD set out in CP No. 4, i.e.:

- fixed-to-float IRS denominated in CZK, DKK, HUF, NOK and PLN in tenors of 28 days to five years, and fixed-to-float IRS denominated in SEK in tenors of 28 days to 15 years;
- FRA denominated in NOK and PLN in tenors of three days to one year, and FRA denominated in SEK in tenors of three days to two years.

In view of the criteria in Article 5(4) of EMIR, the ESRB considers that the proposed set of classes, together with the set of classes proposed in ESMA's first consultation paper on the clearing obligation, is appropriate to address the systemic risk for the EU market associated with OTC IRD for the time being.

Although there are clear differences in terms of the characteristics of individual classes of OTC IRD denominated in different currencies, in particular with regard to market liquidity, any risks arising from the application of a clearing obligation are minimised given the relatively conservative range of contract maturities detailed in the proposal. Even so, the ESRB stresses the need, after the introduction of the clearing obligation, to monitor activity in individual market segments with regard to transaction maturities. Market participants may try to avoid regulation by switching to transactions with maturities slightly longer than those falling within the proposed scope of the clearing obligation.

The ESRB considers that the definitions of the categories of counterparties are appropriate and welcomes the use of the proposed phase-in periods for each of those categories. The ESRB recommends that all RTS on the clearing obligation are adopted as soon as possible. Furthermore, it suggests that the additional three-month phase-in period – should the two RTS for OTC IRD denominated in G4 and in non-G4 currencies be adopted within three months of one another – be granted only with respect to counterparties falling into Category 1, and possibly Category 2.