



ESRB response to the ESMA Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity

1. Introduction

Article 5(2) of the European Market Infrastructure Regulation (EMIR)¹ 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 EMIR.

On 13 July 2016 ESMA released a Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity (“the CP”). The CP proposes modifying the phase-in period applicable to Category 3 counterparties, by extending the current compliance deadlines related to the clearing obligation that are set out in the three Commission Delegated Regulations by two years.²

This response summarises the ESRB’s opinion on this CP; it follows the opinions delivered by the ESRB on the proposals for clearing obligations for OTC interest rate derivatives (IRD) denominated in G4 currencies,³ OTC credit derivatives,⁴ and OTC IRD denominated in Norwegian kroner (NOK), Polish zlotys (PLN) and Swedish kronor (SEK) (“non-G4 currencies”).⁵

In line with the previous consultations, the ESRB reaffirms that it is fully convinced of the merits of a wide application of mandatory central clearing to a large number of OTC derivative classes, consistent with the policy agreed by the G20 in 2009 with a view to reducing systemic risk.⁶ As in previous consultations, the ESRB expresses concerns in relation to long phase-in periods.

In developing its response, the ESRB has been mindful of its mandate to monitor and assess potential systemic risks. This includes in particular risks of a disruption to financial services caused by a significant impairment of all or parts of the EU financial system that – regardless of whether this occurs in groups of Member States or only in individual Member States - could potentially have serious negative consequences for the internal market and the real economy.⁷

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).

² Commission Delegated Regulation (EU) 2015/2205 (RTS on G4 IRD transactions, first RTS), Commission Delegated Regulation (EU) 2016/592 (RTS on CDS transactions, second RTS) and Commission Delegated Regulation (EU) 2016/1178 (RTS on non-G4 IRD transactions, third RTS)

³ See https://www.esrb.europa.eu/pub/pdf/other/140820_ESRB_response.pdf?9dc93c838d7ccf80000c61a23675f565

⁴ See https://www.esrb.europa.eu/pub/pdf/other/140925_ESRB_response.pdf?f68c6037c58c2bb081a0b01ca76a6a0a

⁵ See https://www.esrb.europa.eu/pub/pdf/other/150713_ESRB_response.pdf?c3d988073074797c2012b32d2c08fcd

⁶ Leaders’ Statement, The Pittsburgh Summit, September 2009

(<http://www.g20.org/English/Documents/PastPresidency/201512/P020151225615583055801.pdf>)

⁷ 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).

The ESRB has also borne in mind the importance of consistency with the decisions on mandatory central clearing taken in other G20 jurisdictions, considering that regulatory arbitrage can be a major source of concern from a macroprudential perspective.

Section 2 below assesses the analysis presented in the CP and presents the ESRB's view on the draft RTS proposed by ESMA. The conclusions and proposals are summarised in Section 3.

2. Assessment of ESMA's proposal

The compliance deadlines for the clearing obligation stemming from the three RTS are summarised in the table below; the new deadlines proposed in the CP are provided in brackets. The clearing obligation for Category 1 counterparties under the first RTS has only recently come into operation, unlike in other jurisdictions, such as the US, which had tighter deadlines for applying the clearing obligation to different groups of counterparties. In this respect, the ESRB would like to reiterate that a quick and comprehensive introduction of the clearing obligation is one of the most effective tools in tackling systemic risk in the OTC derivatives markets, along with the margining obligation for bilaterally cleared transactions and with reporting requirements.

Table: Compliance deadlines for the clearing obligation in the EU

	RTS on G4 IRD transactions	RTS on CDS transactions	RTS on non-G4 IRD transactions⁸
Category 1	21 June 2016	9 February 2017	9 February 2017
Category 2	21 December 2016	9 August 2017	9 August 2017
Category 3	21 June 2017	9 February 2018	9 February 2018
	(21 June 2019)	(9 February 2020)	(9 February 2020)
Category 4	21 December 2018	9 May 2019	9 August 2019

Note: ESMA's proposal with respect to Category 3 is provided in brackets.

The ESRB acknowledges that the scope of the clearing obligation in the European Union is particularly wide, contrary to the situation in other non-EU jurisdictions, which have introduced exemptions for entities entering into derivatives transactions on an occasional and/or non-significant basis. The ESRB also acknowledges that ESMA's CP addresses issues that some Category 3 counterparties might be faced with when trying to connect to a central counterparty (CCP). Such issues include, for example, the limited appetite of clearing members, and the amount of time needed to incorporate new clients as well as the lack of experience in offering client clearing in some jurisdictions. Although the ESRB welcomes ESMA's efforts to analyse the issue further, it is of the opinion that the deadlines set out in the three RTS should be respected, for the reasons explained below. At the same time, the ESRB encourages ESMA, the national competent authorities of Category 3 counterparties and the industry to work closer with small financial entities, with a view to finding a solution that is acceptable to all and that would allow clearing for these entities.

ESMA argues that the extension of the phase-in period for small market players (Category 3) is expected not to compromise the primary objective of the clearing obligation, namely reducing systemic risk. ESMA bases its argument primarily on the fact, that across the European Union, the

⁸ Deadlines in the Table reflect the deadlines provided in the third RTS and the related corrigendum.

bulk of the volume is traded by only a small number of counterparties, with clearing members (Category 1) accounting for almost 95% of the volume in interest rate derivatives and 86% in credit derivatives. At the same time, it is estimated that Category 3 counterparties account for the vast majority of the counterparties (more than 90%) at the aggregated EU -level, but represent only 1.1% and 5.1% respectively of the volume of the two derivative classes.

It should however be noted that in some EU Member States, all counterparties are classified in the estimated Category 3. According to ESMA's findings, there are eight such EU Member States for interest rate derivatives⁹ and four for credit derivatives.¹⁰ As the postponement of the clearing obligation relates to any transaction where a Category 3 counterparty is involved, under ESMA's proposals the clearing obligation in these cases would be delayed for all transactions in each of these EU Member States.

Furthermore, there are several EU Member States where the aggregate volume for estimated Category 3 adds up to the majority of the volume in those countries.¹¹ In this respect, the ESRB would like to reiterate 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; this applies in particular whenever risks of disruption to financial services caused by a significant impairment of all or parts of the EU financial system could potentially have serious negative consequences for the internal market and the real economy.¹² Many jurisdictions have financial sectors that are systemically important at national level. Nevertheless, the financial sectors of these jurisdictions could transmit financial shocks across borders within the EU, for example via their participation in the global financial markets, and more particularly, the derivatives market.

Another point is that given the strong interconnectedness, shocks stemming from other parts of Europe could also pose difficulties in these jurisdictions. Across the entire European Union, the aggregated amounts of Category 3 counterparties are comparably small. However, it is unclear how important derivatives transactions are to the business models of these entities, for example in terms of the share of derivatives in their respective balance sheets. Postponing the clearing obligation for Category 3 would also involve delaying the clearing obligation for their transactions with Category 1 and Category 2 counterparties. As such, any postponement would leave Category 3 counterparties exposed longer than necessary to the potential failure of their counterparties, including possibly major market participants in the OTC derivatives markets.

The ESRB would like to reiterate that the EMIR framework already provides for several exemptions, in particular for intra-group and pension funds transactions. The ESRB is of the view that when considering the postponement of mandatory clearing for Category 3 counterparties, it would be necessary to take into account the cumulative effect of the exemptions and new phase-in periods. The new deadlines proposed in the CP would further narrow the scope of the Regulation, very likely leaving some jurisdictions in the EU without a clearing obligation at all for an extended period of time, thus undermining the overarching objective of EMIR.

Against this background, the longer it takes for the clearing obligation to come into effect, the longer the counterparty risk and the risk of cross-border contagion might not be managed adequately in these jurisdictions.

⁹ Bulgaria, Estonia, Croatia, Latvia, Lithuania, Romania, Slovenia and Slovakia.

¹⁰ Croatia, Malta, Poland and Slovakia.

¹¹ In particular, Croatia and Ireland for interest rate derivatives and Ireland and Luxembourg for credit derivatives.

¹² See also footnote 7.

ESMA notes in the CP that the quantitative elements provided in the analysis do not allow it to ascertain whether counterparties are actively preparing for the clearing obligation. The ESRB would like to reiterate that, as experience with long deadlines has shown, most market participants defer their work on implementation until the deadline is very close. This was the case with the Single Euro Payments Area, for example, where the migration end date eventually had to be delayed by six months. In addition, other non-EU jurisdictions have had much shorter deadlines for the application of the clearing obligation to different groups of counterparties, although admittedly the situation is not entirely comparable to that in the European Union (in particular given the de-minimis exemptions in other jurisdictions).

In this context, the ESRB would like to highlight that there are examples of counterparties, which due to the small size of their activities would fall into Category 3, but in the past applied a prudent and forward-looking approach to the forthcoming clearing obligation and have become direct clearing members of a CCP. Some of them now even fall into Category 1 as they obtained the status of a clearing member prior to the date of entry into force of the relevant RTS. Moreover it cannot be ruled out that other counterparties are in the process of becoming direct clearing members of a CCP or are making all the necessary arrangements for indirect access to a CCP. Postponing now the clearing obligation for Category 3 counterparties would appear to further favour entities that are less “counterparty risk-sensitive” which could create conditions conducive to moral hazard insofar as it would ultimately result in incentives to not apply in a timely manner a cautious approach with respect to any future regulation.

The ESRB considers that the rationale for extending the deadline for the three RTSs by the same length is not fully explained in the CP. First, the relevant regulatory developments are foreseen to be implemented in the coming year; this is the case in particular for the RTS on indirect clearing arrangements (which is expected to facilitate indirect access for small financial counterparties to CCPs) and the finalisation of the leverage ratio framework (which will provide more clarity to clearing members on client clearing). However, the CP proposes postponing the clearing obligation for Category 3 in the second and the third RTS until 2020. Moreover, market participants can leverage, over time, on the experience progressively gained in accessing central clearing facilities; therefore a progressive shortening of these periods could be considered. In particular, a large share of the counterparties that conclude OTC IRD transactions denominated in at least one non-G4 currency that is subject to the clearing obligation under the third RTS will have to prepare adequate procedures for the purpose of the mandatory clearing of OTC IRD transactions denominated in G4 currencies (stemming from the first RTS). The ESRB notes that the same rationale was followed in defining the categories of counterparties in the third RTS, where Category 1 counterparties were defined as counterparties having a clearing member status stemming from either the third RTS or the first RTS with respect to at least one of the defined classes of OTC derivatives.

3. Conclusions and proposals

As already put forward in previous consultations, the ESRB would like to reiterate its concerns in relation to long phase-in periods. Moreover, it would like to reiterate that a quick and comprehensive introduction of the clearing obligation is the most effective way of tackling systemic risk in the OTC derivatives markets, along with the margining obligation for bilaterally cleared transactions and with reporting requirements.

The ESRB acknowledges that the scope of the clearing obligation in EMIR is particularly broad. Moreover, it acknowledges that some small financial counterparties might face difficulties in gaining access to a CCP and that the means by which those counterparties access the CCP bring their own risks. However, the ESRB is of the view that extending the deadlines might not be an appropriate solution as it would provide ambiguous incentives. Postponing now the clearing obligation for Category 3 counterparties would, in fact, not bring advantages for the 'small' counterparties which preferred to act in a timely manner and managed to become or are in the process of becoming clearing members or clients of clearing members; this postponement could instead send the wrong signal since it would further favour entities which were less "counterparty risk-sensitive" which might result in incentives to not apply in a timely manner a cautious approach with respect to any future regulation. The ESRB therefore encourages ESMA, the national competent authorities of Category 3 counterparties and the industry to work more closely with those entities in order to find solutions that would allow them to make use of clearing as quickly and with as little risk as possible before the deadlines set in the three RTS.

Moreover, the ESRB would like to emphasise that systemic risk should be considered not only at the aggregated EU level, but also at national level, whenever the internal market and the real economy of the EU or of an individual Member State, are at risk. In this respect, the ESRB considers it inappropriate from a systemic risk containment perspective that the clearing obligation might be delayed for all, or the majority of, the volume of OTC derivatives transactions in several EU Member States.

Finally, bearing in mind that the new regulatory framework has been designed to facilitate access for Category 3 counterparties to indirect clearing; it ought to be implemented in the coming months. Also, previous experience shows that distant deadlines may lead to delays in the implementation by market participants. Therefore, if the deadlines applicable to Category 3 counterparties were to be modified, the ESRB suggests that the proposed grace period for the central clearing obligation for Category 3 counterparties, be substantially shortened, particularly with regard to the second and third RTS. ESMA might therefore wish to reconsider the new deadlines proposed in the CP, at least by shortening the new grace period in the second and the third RTS. A possible solution could be to adopt the same deadlines for Category 3 counterparties in all three RTS, in line with the new deadline of 21 June 2019 provided in the CP for the first RTS. This could meet ESMA concerns about compliance risks due to the uncertainties surrounding the entry into force of the new RTS on indirect clearing arrangements, while avoiding further delays in the implementation of clearing obligation for the asset classes referred to in the second and the third RTS.