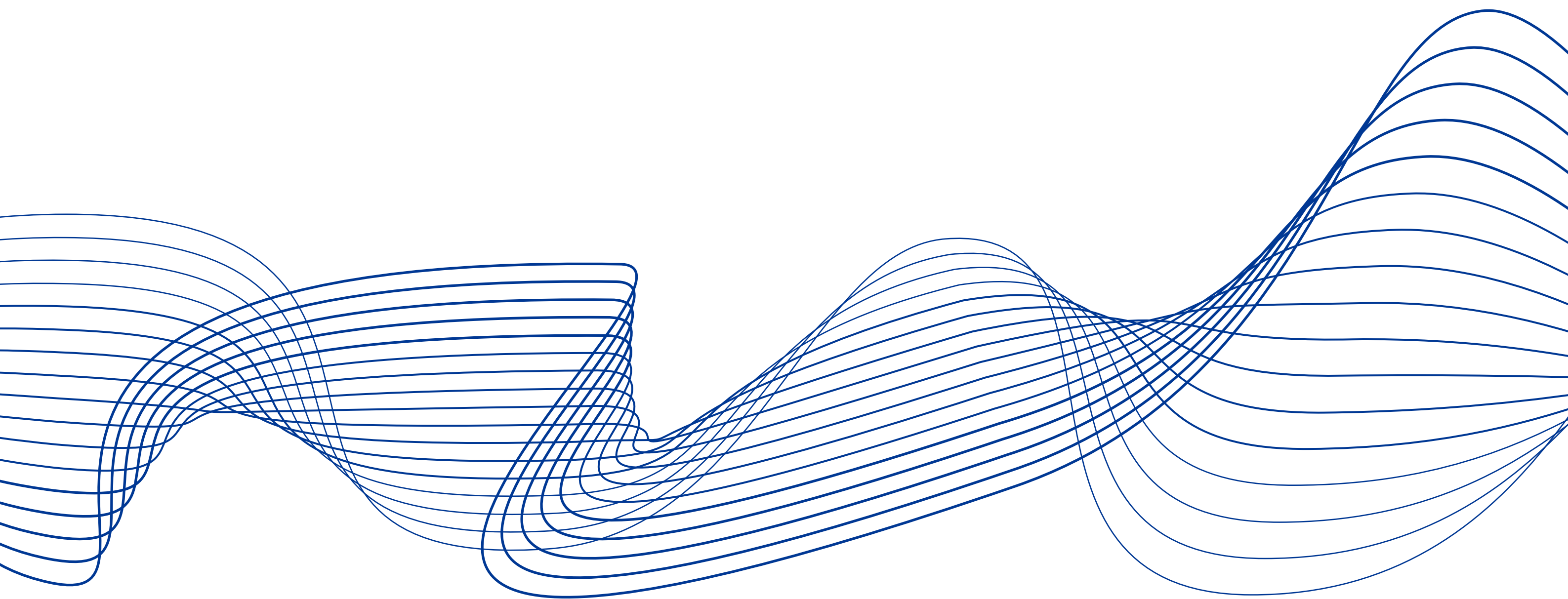
Revision of the European Market Infrastructure Regulation

April 2017



ESRB
European Systemic Risk Board
European System of Financial Supervision

Contents

Executive summary 2

Section 1 Introduction 5

Section 2 Clearing obligation and trade reporting 7

2.1 Introducing a mechanism to suspend the clearing obligation 7

2.2 Scope of the clearing obligation 8

2.3 Trade reporting 8

Section 3 Enhancing procyclicality-limiting tools within EMIR 11

3.1 Including a definition of procyclicality in the EMIR Level 1 text 11

3.2 Binding guidance on the operationalisation of the three options to limit the procyclicality of margins 12

3.3 Introducing a holistic approach to procyclicality for CCPs 14

3.4 Systemic implications of the procyclicality-limiting measures in EMIR for CCPs 15

3.5 Addressing procyclicality in bilateral margining 16

Section 4 Other issues 18

4.1 Evaluation of systemic risks for mandatory clearing purposes by ESMA 18

4.2 Consistency with internationally agreed regulations or standards 19

4.3 Previous ESRB proposals on dedicated resources of CCPs and interoperability arrangements 20

Imprint 21

Executive summary

Financial stability is a precondition for jobs and growth that can be threatened by a number of conditions. This includes highly leveraged and interconnected institutions from the bank and non-bank sector and failures in the functioning of financial markets. Unregulated, opaque over-the-counter (OTC) derivatives markets in which risks are not properly priced and/or mitigated were one of the fault lines that caused the global financial crisis.

The European Market Infrastructure Regulation (EMIR) is a milestone for making Europe's derivatives markets and the provision of central clearing services safer. It entered into force in 2012 and is designed to put into practice in the EU several of the commitments made by the G20 leaders to reform derivatives markets.[1] It promotes transparency in derivatives markets and aims to reduce systemic risk. EMIR mandates the central clearing of standardised and liquid OTC derivatives contracts and sets out prudential and operational requirements for derivatives transactions. Counterparties and central counterparties (CCPs) are required to report all details regarding their derivatives contracts to trade repositories. EMIR also requires CCPs and trade repositories to fulfil prudential minimum requirements; in doing so it follows the Principles for Financial Market Infrastructures issued in 2012 by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO)[2].

The ESRB issued two reports in 2015[3] containing proposals that it believes would further enhance the safety of derivatives clearing in the EU. In this context, the ESRB welcomes the report prepared by the European Commission in accordance with Article 85(1) of EMIR[4] and, in particular, that the Commission is planning to include an emergency mechanism for swiftly suspending the clearing obligation and to increase the transparency and predictability of margin requirements in the revision of this legislation.

The ESRB shares the Commission's assessment that no fundamental change to the EMIR core requirements is needed at this time, while seeing an opportunity to improve some aspects of the Regulation. The second annual report of the Financial Stability Board (FSB) to G20 leaders on financial regulatory reforms underscored that continued focus is necessary to make derivatives markets safer.[5] In this context, the ESRB considers the EMIR review an opportunity to improve on certain aspects of the Regulation, while simplifying some of its requirements, increasing their efficiency and reducing disproportionate costs and burdens. In general, while ensuring high standards for central and bilateral clearing, the approach taken by the EMIR review should be in line with internationally agreed standards and guidance.

The ESRB reiterates that enhancing procyclicality-limiting tools in EMIR would reduce risks to financial stability and could simplify EMIR requirements and increase their efficiency. As

---

[1] Some of the G20 commitments were put into practice via other regulations, e.g. an obligation to trade all standardised OTC derivatives contracts on exchanges or electronic trading platforms, where appropriate, was reflected in Article 28 of the Markets in Financial Instruments Regulation (MiFIR).

[2] CPSS-IOSCO (2012), "**Principles for financial market infrastructures**".

[3] ESRB (2015a), "**Report on the efficiency of margining requirements to limit pro-cyclicality and the need to define additional intervention capacity in this area**"; and ESRB (2015b), "**Report on issues to be considered in the EMIR revision other than the efficiency of margining requirements**".

[4] European Commission (2016), "**Report from the Commission to the European Parliament and the Council under Article 85(1) of 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**".

[5] FSB (2016), "**FSB reports to G20 Leaders on financial regulatory reforms**".

a means of giving more guidance to market participants and CCPs and, hence, to further increase transparency of the risk management practices of CCPs, the ESRB sees the need to include a definition of procyclicality in the EMIR Level 1 text and to have more granular requirements for the operationalisation of the EMIR tools designed to limit the procyclicality of margin and haircut requirements. The ESRB would also welcome the mandatory adoption by CCPs of a holistic approach to procyclicality, which should take into account the combined effect of margin, haircut and add-on requirements. At the same time, it highlights the possibility that procyclicality could be transmitted through (or even generated within) the relationship between clearing members and their clients.

The ESRB also sees an opportunity to address other aspects of EMIR. It welcomes the European Commission's commitment to assessing how to streamline and improve the framework on trade reporting data. In order to increase transparency and clarity for market participants, the ESRB believes that it should be further clarified that, when the need to impose a clearing obligation on certain OTC derivatives classes is assessed, the evaluation by the European Securities and Markets Authority (ESMA) of systemic risks stemming from OTC derivatives should be performed at both the EU and national levels. The ESRB reaffirms its proposal for a legal obligation for all CCPs to publish quantitative and qualitative information consistent with the CPMI-IOSCO public disclosure framework[6].

While recognising the challenges faced by some counterparties in meeting the clearing obligation, the ESRB advises caution regarding exemptions from central clearing. It agrees with the European Commission's assessment that disproportionate costs and burdens need to be reduced. However, it supports a broad application of the clearing obligation, including for pension scheme arrangements and large non-financial counterparties (NFCs) that are active in the derivatives market.

The ESRB sees a need for a comprehensive review of EMIR in the future, including with a view to addressing the potential use of margins and haircuts to meet macroprudential objectives. Such a review may also be needed to introduce potential changes to EMIR following the European Commission's consultation on the operations of the European Supervisory Authorities[7]. It should follow a holistic approach, taking into account the experience gained from implementing the forthcoming legislation on the recovery and resolution of CCPs. It should also address the potential use of margins and haircuts to meet macroprudential objectives, as the quantitative and conceptual analysis needed to develop these tools will have progressed.[8] Finally, it should reflect on other potential changes which – reflecting the targeted scope of the current review – are not being considered now.

The ESRB reaffirms previous proposals, such as revising the determination mechanism of dedicated resources ("skin in the game") and interoperability arrangements. However, it acknowledges that these proposals do not fall under the targeted scope of the European Commission on this occasion. The ESRB will evaluate whether these proposals can be better

---

[6] CPMI-IOSCO (2015), "**Public quantitative disclosure standards for central counterparties**".

[7] Available at: **https://ec.europa.eu/info/finance-consultations-2017-esas-operations_en**

[8] See ESRB (2015a); ESRB (2016) "**Macroprudential policy beyond banking: an ESRB strategy paper**"; and ESRB (2017), "**The macroprudential use of margins and haircuts**". As pointed out in ESRB (2017), further empirical and conceptual work is needed. Specifically, the objectives of the tools in terms of building resilience or "leaning against the wind" have not been established yet. The transmission between margin and haircut levels and the financial cycle, as well as the calibration of potential tools, are not well understood. Indicators pointing to the build-up of excessive leverage at the desired level of aggregation and thresholds that might signal a need for activation have not been identified. In addition, there is little knowledge about the impact of any of the tools considered, their effectiveness and potential undesirable side effects.

considered when discussing other legislative proposals, for example in the context of the above-mentioned recovery and resolution of CCPs.

The ESRB would like to highlight some issues which it deems important but for which it is not delivering proposals, considering the targeted approach of the European Commission[9]. First, the framework under which third-country CCPs are recognised to provide clearing services in the EU could be reinforced, given their growing presence in the EU. In this context, the ESRB supports ESMA's proposals to improve the framework, while taking the view that the consultation with European and national authorities should continue[10]. Second, the ESRB is mindful that, at the international level, increasing attention is being given to the interconnectedness and concentration of clearing of certain financial instruments across CCPs. In this context, further analysis could be conducted with regard to CCPs offering their services in the EU, and at a later stage it could be considered whether, consistent with the international framework, further requirements might be warranted. A third point that could be considered for future analysis relates to the financial stability implications of the potential interactions, for example in terms of incentives, between the risk models used by CCPs to determine margin requirements and default fund contributions, and those used by intermediaries for risk mitigation in non-centrally cleared transactions. This issue may also have implications for the EMIR Level 1 text. As a last point, future analysis could explore whether to include further microprudential tools to limit the procyclical effects of margin and haircut-setting in the Regulatory Technical Standards (RTS) No 153/2013.

---

[9] The European Commission is reviewing the EMIR within the 2016 Regulatory Fitness and Performance programme (REFIT).

[10] ESMA (2017), "**ESMA letter on EMIR review and sanctioning powers to the European Commission**".

Section 1
Introduction

Financial stability is a precondition for jobs and growth that can be threatened by a number of conditions. This includes highly leveraged and interconnected institutions from the bank and non-bank sector and failures in the functioning of financial markets. Unregulated, opaque over-the-counter (OTC) derivatives markets in which risks are not properly priced and/or mitigated were one of the fault lines that caused the global financial crisis.

The European Market Infrastructure Regulation (EMIR) is a milestone for making Europe's derivatives markets and the provision of central clearing services safer. It entered into force in 2012 and is designed to put into practice in the EU several of the commitments made by the G20 leaders to reform derivatives markets.[11] It promotes transparency in derivatives markets and aims to reduce systemic risk. EMIR mandates the central clearing of standardised and liquid OTC derivatives contracts and sets out prudential and operational requirements for derivatives transactions. Counterparties and CCPs are required to report all details regarding their derivatives contracts to trade repositories. EMIR also requires CCPs and trade repositories to fulfil prudential minimum requirements; in doing so it follows the Principles for Financial Market Infrastructures (PFMIs) issued in 2012 by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO)[12].

The ESRB issued two reports in 2015[13] containing proposals that it believes would further enhance the safety of derivatives clearing in the EU. In this context, the ESRB welcomes the report prepared by the European Commission in accordance with Article 85(1) of EMIR[14] and, in particular, that the Commission is planning to include an emergency mechanism for swiftly suspending the clearing obligation and to increase the transparency and predictability of margin requirements in the revision of this legislation.

The ESRB shares the Commission's assessment that no fundamental change to the EMIR core requirements is needed at this time, while seeing an opportunity to improve on some aspects of the Regulation. The second annual report of the Financial Stability Board (FSB) to G20 leaders on financial regulatory reforms underscored that continued focus is necessary to make derivatives markets safer.[15] In this context, the EMIR review is an opportunity to improve on certain aspects of the Regulation. Such improvements can be consistent with increasing the efficiency of the requirements, simplifying them and reducing disproportionate costs and burdens.

This report sets out proposals to further enhance the effectiveness and transparency of the current EMIR framework. It is structured as follows: Section 2 presents proposals concerning the clearing obligation and trade reporting; Section 3 contains proposals regarding how to enhance the

---

[11] Some of the G20 commitments were put into practice via other regulations, e.g. an obligation to trade all standardised OTC derivatives contracts on exchanges or electronic trading platforms, where appropriate, was reflected in Article 28 of the Markets in Financial Instruments Regulation (MiFIR).

[12] CPSS-IOSCO (2012), "**Principles for financial market infrastructures**".

[13] ESRB (2015a), "**Report on the efficiency of margining requirements to limit pro-cyclicality and the need to define additional intervention capacity in this area**"; and ESRB (2015b), "**Report on issues to be considered in the EMIR revision other than the efficiency of margining requirements**".

[14] European Commission (2016), "**Report from the Commission to the European Parliament and the Council under Article 85(1) of 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**".

[15] FSB (2016), "**FSB reports to G20 Leaders on financial regulatory reforms**".

existing procyclicality-limiting tools in EMIR; and Section 4 sets out further proposals for improving EMIR.

Section 2
Clearing obligation and trade reporting

2.1 Introducing a mechanism to suspend the clearing obligation

The ESRB welcomes the fact that the European Commission will endorse the suggestion from ESMA and the ESRB to establish a mechanism for swiftly suspending the clearing obligation.[16] As pointed out in a previous ESRB report[17], there may be situations in which a prompt suspension of the clearing obligation could be beneficial from a financial stability perspective. This could include times of market stress and cases in which parts of the market are cut off from central clearing. Currently, the suspension of the mandatory clearing obligation would take several months due to extensive consultations required in the legal provisions, which is too time-consuming in the case of adverse market scenarios. The ESRB welcomes the fact that the Commission recognises these risks and will propose a mechanism for rapidly suspending the obligation.

There are several reasons why the conditions of efficient central clearing may become impaired. In 2015, the ESRB proposed[18] that EMIR set out the conditions upon which the obligation for central clearing can be suspended to avoid negative effects on financial stability. With regard to the dysfunction or failure of a CCP, the ESRB recognises that the European Commission included in its legislative proposal on the recovery and resolution of CCPs an amendment to the EMIR Level 1 text providing for the suspension of the central clearing obligation in the context of CCPs in resolution. With regard to further reasons beyond the resolution of a CCP, the ESRB welcomes the fact that the Commission is considering the possibility of broadening the scope of suspending a clearing obligation for other purposes. This would be a useful additional tool to mitigate systemic risk and react quickly to severe changes in market conditions (e.g. sharp changes in volumes cleared or in liquidity, or in the event that parts of the market are cut off from central clearing). Another possible avenue to explore is whether to give authorities the mandate to abstain from imposing sanctions for breaches of the clearing obligation if the market situation impairs central clearing.

In the ESRB's view, EMIR should include a provision on a swift but clearly framed process to suspend the clearing obligation. This process should include a short consultation between European authorities, in particular between ESMA and the European Commission. However, as the suspension of the central clearing obligation for some classes of OTC derivatives could shift market pressure from CCPs back to market participants in bilateral transactions, its overall effect on financial stability cannot be unambiguously anticipated for any circumstance. Therefore, the proposed mechanism should only be used in crisis periods, for example in times of impaired liquidity, and its potential side effects might need to be considered on a case-by-case basis. In every case it should be spelled out that the suspension of the clearing obligation focuses only on new transactions. In addition, the ESRB would like to emphasise that the suspension of the clearing obligation does not mean a prohibition of central clearing. Hence, market participants could still centrally clear their transactions on a voluntary basis during the duration of the suspension.

---

[16] European Commission (2016).

[17] ESRB (2015b).

[18] Ibid.

2.2 Scope of the clearing obligation

In line with the spirit of the objectives set by the G20 in 2009, the ESRB supports a broad application of the central clearing obligation. Central clearing reduces counterparty credit risk and provides greater transparency in derivatives markets by simplifying the complex network of exposures via multilateral netting. Therefore, central clearing provides considerable financial stability benefits.[19]

The ESRB recognises the challenges faced by some categories of counterparties in meeting the clearing obligation. This includes certain pension scheme arrangements (hereinafter "pension funds"), small financial counterparties and non-financial counterparties (NFCs). In order to allow for a broad application of the clearing obligation, the ESRB does not support a permanent exemption of pension funds[20], which could trigger similar requests by other derivatives users. Instead, it takes note of the temporary exemption that has been granted to pension funds until 16 August 2018[21] and encourages market participants to use this time to explore, together with CCPs, alternative solutions to the issues pension funds are facing with providing variation margins in cash. The ESRB supports a broad application of the clearing obligation for small financial counterparties and NFCs actively using the derivatives markets. According to its report on the EMIR review, the European Commission is considering whether any or some NFCs, based on volume and type of activity, should be captured by clearing requirements. The ESRB understands that the Level 1 text could thus be amended by including some exemptions to the clearing obligation for small financial counterparties and adjusting the method of identifying NFCs subject to the clearing obligation. The ESRB, in principle, supports a simplification of the provisions, but considers it important that active derivatives market participants fall under the clearing obligation. In this respect, since derivatives contracts entered into by small financial counterparties and NFCs established in smaller European countries tend to be for a smaller notional amount, the ESRB believes that these thresholds should be set at a level that captures the most active market participants in all EU Member States. In addition, and as outlined in previous publications[22], the ESRB encourages the industry to work more closely with small financial counterparties and NFCs to find solutions that would facilitate their access to central clearing, for example by further developing client clearing.

2.3 Trade reporting

The trade reporting regime established under EMIR is a key step forward in enhancing authorities' ability to monitor systemic risk in the financial system. The data collected through trade repositories (TRs) since February 2014 is crucial to the work of the ESRB and its member institutions. The recent crisis showed that derivatives exposures can be contagious and impair the functioning of the financial system – monitoring systemic risks stemming from derivatives markets is therefore a core task of the ESRB and its member institutions. Authorities have started to analyse this data and have published their initial findings.[23]

---

[19] This general assessment does not contradict a suspension of the clearing obligation under certain circumstances, as laid down in section 2.1.

[20] This provision holds for those pension funds falling under the definition of Article 2(10) of EMIR.

[21] See: **http://europa.eu/rapid/midday-express-20-12-2016.htm?locale=en**.

[22] See, for example, ESRB (2016), "**ESRB response to the ESMA Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity**".

[23] See, for example, Abad, J et al. (2016), "**Shedding light on dark markets: First insights from the new EU-wide OTC derivatives data set**", *Occasional Paper Series*, No 11, ESRB, Frankfurt am Main, September; and Cielinska, O. et al. (2017), "**Gauging market dynamics using trade repository data: the case of the Swiss franc de-pegging**", *Financial Stability Paper*, No 41, Bank of England, London, January.

Despite the clear financial stability benefits that would arise from high-quality derivatives data, authorities are facing considerable obstacles in generating usable data. The EMIR data are of mixed quality and their use requires a substantial amount of data "cleaning" work. High-quality data can only be ensured if a fully-fledged and functional data quality framework is put in place along the whole chain of data collection. For now, the data provided by the TRs authorised under EMIR are not harmonised and, in some cases, not suited to macroprudential analysis. The revision of standards on the aggregation and comparison of TR data (under Article 81 of EMIR) recently endorsed by the European Commission provides clear improvements, but other data-related issues remain. For this reason, it is imperative to ensure that EU data are aligned on an ongoing basis with the international guidance to be released by CPMI-IOSCO, which seeks to standardise global reporting standards (see section 4.2 of this report).

A significant increase in the maximum thresholds for fines which can be imposed on TRs by ESMA under EMIR would improve incentives for the provision of high-quality data. For instance, it would be appropriate to link the minimum and maximum amounts of fines with the size of TRs (e.g. as measured by annual TR turnovers), rather than relying only on fixed thresholds. In this respect, the ESRB supports the proposals put forward by ESMA to increase the fines imposed on TRs[24]. The actual amounts of fines should be proportionate to the frequency and gravity of the TR's infringements.

The ESRB recognises that certain categories of counterparties are facing challenges in meeting their reporting obligations, and supports the simplification of the requirements. However, the overall quality and purpose of the data have to be preserved. In general, alignment with the approach in the Securities Financing Transactions Regulation (SFTR) could be followed, whereby financial counterparties are obliged to report on behalf of their smaller non-financial counterparties without breaching the logic of double-sided reporting. In the SFTR, the financial counterparty is obliged to report both sides of the trade and the non-financial counterparty retains responsibility for the accuracy and completeness of its "leg" of the reported operation, while receiving any information on the trade and thus being able to perform any check. With the same logic and safeguards, single-sided reporting could be introduced for centrally cleared transactions, to be performed by the CCP on behalf of both beneficiaries if it has all the relevant information. Simplifying the scope of the reporting obligation, as proposed, would lower costs for market participants, create further incentives to move to centralised clearing and provide safeguards to avoid a loss of information or the reported data being of lower quality[25].

On the other hand, the ESRB would not support exemptions to the reporting of exchange-traded derivatives (ETDs). Information on ETDs is indispensable for the complete monitoring of the derivatives markets. As more and more derivatives are traded on exchanges (in line with the commitment made by the G20 leaders at the Pittsburgh summit), it is important to continue to include these transactions. While data on ETDs is already collected by competent authorities via reporting requirements under the Markets in Financial Instruments Directive (MiFID) and the Markets in Financial Instruments Regulation (MiFIR), this reporting fulfils a different purpose, namely monitoring market integrity, and is not fit for monitoring systemic risk. It is therefore essential for ETD data to continue to be reported to TRs under EMIR. Exempting ETD data would lead to a fragmented view and could result in inaccurate estimations of systemic risk.

---

[24] ESMA (2017), "**ESMA letter on EMIR review and sanctioning powers to the European Commission**".

[25] Two ESRB member institutions raised some concerns on this issue. In particular, as it would no longer be possible to match and reconcile data, reporting by the CCP on behalf of both beneficiaries was seen as potentially lowering the quality of data. Two-tiered reporting, where some transactions would be reported by both counterparties and others only by the CCP was also seen as raising complexity.

The ESRB believes that trade reporting needs to take account of the impact of trade compression, given its importance in terms of counterparty risk mitigation. Trade compression is a post-trade technique by which participants may reduce their gross notional position and counterparty risk, without affecting their net position. Despite the benefits in terms of systemic risk via the reduction of gross positions, a full understanding of the systemic risk implications of compression, for example with regard to risk concentration and collateral levels, is lacking. Even though Article 9 of EMIR states that "counterparties and CCPs shall ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract they have concluded are reported to a trade repository (...)", a full understanding of the functioning and market impact of compression is not possible as the reporting scheme only reveals whether a trade is compressed or not. Therefore, a more complete reporting scheme on compression (preferably with a full compression history) should be included within the EMIR reporting scheme. The ESRB is mindful that these revisions would not require adjustments of the Level 1 text and that ESMA could revisit the respective regulatory standards. Nevertheless, it would like to submit this proposal considering the intention of the European Commission to assess "as part of this review […] the relevant technical standards linked to EMIR" [26].

[26] European Commission (2016), p. 11.

Section 3
Enhancing procyclicality-limiting tools within EMIR

The ESRB shares the willingness of the European Commission to enhance the transparency of margin requirements. In this vein, the ESRB interprets this objective in a broad way to include not only margining but also collateral requirements, not only central clearing but also bilateral clearing arrangements, and not only the mere transparency of rules and practices but also the clarity and comprehensiveness of the regulatory framework. However, the ESRB would like to emphasise that its proposals take account of the targeted approach of the European Commission with regard to the EMIR review. While further empirical and conceptual analysis is needed, a future comprehensive review of EMIR would allow the potential use of margins and haircuts for meeting macroprudential objectives to be addressed[27].

3.1 Including a definition of procyclicality in the EMIR Level 1 text

The ESRB report of July 2015[28] proposes, inter alia, including a definition of procyclicality in Article 2 of EMIR. Although this possibility is not mentioned in the European Commission discussion paper on the EMIR review, the ESRB wishes to reiterate this proposal. In its view, a legally established definition of procyclicality would provide stakeholders and supervisors with a commonly shared description and understanding of such a multifaceted phenomenon. This would benefit the overall transparency and predictability of margin requirements. It could also help to close a gap in supervisory convergence on procyclicality that has been identified by ESMA: "no NCAs reported having a supervisory process to receive, on a frequent and regular basis a procyclicality analysis from the CCP to check for the efficiency of the implemented measures on the basis of pre-defined metrics"[29].

The ESRB underlines that such a legal definition of procyclicality should encompass both centrally and bilaterally cleared transactions, in order to avoid fragmentation. In this respect, it notes that the EMIR Level 1 text refers to procyclicality with regards to margins and haircuts applied by CCPs, whereas international principles defined for bilaterally cleared transaction consider procyclicality for both centrally cleared and non-centrally cleared trades.

The ESRB is aware that there is not yet a commonly agreed definition of procyclicality. In the report on the macroprudential use of margins and haircuts, the term procyclicality is used "as shorthand for the mutually reinforcing mechanisms that amplify fluctuations in financial markets, which, in turn, may result in negative feedback loops with the real economy. Collateral valuations and margining and haircut practices are part of these mutually reinforcing mechanisms."[30] In a similar sense, the European Banking Authority (EBA) states in a recent report that "cyclicality is defined as pattern of a specific series (capital requirements) over time significantly reflecting the development of real economic activity (business cycle). Pro-cyclicality consequently implies feedback loops between the real economy and the financial system, in a way mutually amplifying business and financial cycle fluctuations."[31] The internationally agreed PFMIs focus on those

---

27 ESRB (2015a); ESRB (2016); and ESRB (2017) "**The macroprudential use of margins and haircuts**".

28 ESRB (2015a).

29 ESMA (2016), "**Peer Review under EMIR Art. 21 – Supervisory activities on CCPs' Margin and Collateral requirements**", p. 27.

30 ESRB (2017).

31 EBA (2016), "**Cyclicality of Capital Requirements**".

aspects that are most relevant from the perspective of CCPs' risk management practices. They describe procyclicality as a condition which materialises when "changes in risk management requirements or practices [occur] that are positively correlated with business or credit cycle fluctuations and that may cause or exacerbate financial instability".[32]

The existence of various definitions of procyclicality shows the need for clarification in the legal text in order to enhance transparency of risk management practices. The ESRB also underlines that a definition of procyclicality in the Level 1 legislation should take a broad view of the risk management requirements and practices governing bilateral and central clearing of financial market transactions (including spot, securities financing or derivatives transactions), and both margins (including initial margins and add-on margins) and haircuts on collateral, in order to increase their transparency and predictability. The ESRB acknowledges that Article 2 of EMIR specifies that the definitions provided for in the article are meant to be valid for "the purpose of the Regulation". It further recognises that such a definition should not limit the room for supervisors' evaluations to deem a specific characteristic or effect of a risk management decision as procyclical, in both bilateral and central clearing.

From a macroprudential perspective, the concept of procyclicality goes beyond risk management practices for bilateral and central clearing. In a broader sense, procyclicality refers to changes in the risk profile of market actors that are interlinked with business, financial or credit cycle fluctuations and thus may affect financial stability. These changes may be the direct or indirect result of shifts in asset market prices, but may also result from automatically triggered or behavioural changes in risk management. The ESRB report on the macroprudential use of margins and haircuts[33] broadly discusses concepts of procyclicality and further sets out systemic risks stemming from procyclicality in collateral requirements.

3.2 Binding guidance on the operationalisation of the three options to limit the procyclicality of margins

Variability in CCP initial margin requirements is a property of both the portfolio being margined and the initial margin model itself. Typically, as markets become stressed, key components of initial margin models (such as the risk factor volatility and correlation) change, and this usually increases margin requirements. Thus margin requirements, being hardwired to market valuations, tend to be procyclical – they increase in times of stress, and thus put a further burden on those posting margin when they are less able to bear it.

To address this issue, EMIR stipulates three tools within Article 28 of the Regulatory Technical Standards (RTS) No. 153/2013. EU CCPs must use at least one of these tools when calculating initial margin requirements. In general, the ESRB is strongly supportive of the procyclicality-limiting provisions contained in the EMIR framework and is mindful that the current state of the relevant theoretical analysis does not permit an unambiguous affirmation of the superiority of one of them in any circumstance. However, and as outlined in the policy proposal put forward in the 2015 report, the ESRB believes that there is scope to clarify some of the technical components of the requirements. Such clarification would contribute to achieving the objective set by the European Commission of facilitating the predictability of margin requirements. In fact, further guidance on the use of the options would make it simpler for clearing members to simulate or replicate a CCP's margin determination process and thus to anticipate margin calls accordingly,

---

[32] CPSS-IOSCO (2012).

[33] ESRB (2017).

including in stressed conditions. The ESRB is mindful that ESMA can revisit these standards and that this revision does not require adjustments to the Level 1 text[34], and takes note of the proposals already put forward[35] by it. Nevertheless, the ESRB deems it appropriate to submit the following considering the willingness of the European Commission to "assess, as part of this review, the relevant technical standards linked to EMIR", as already referred to in this report.

Specific suggestions for clarifying the existing provisions are:

- **Margin buffer approach:** once a CCP has calculated its final initial margin requirement, which must be in compliance with EMIR and any other relevant RTS, it should then add a "margin buffer" equal to at least 25% of the aforementioned calculated requirement. If, at any point in the future, margin requirements are deemed to be "rising significantly", the CCP is allowed to "temporarily exhaust" this buffer in order to avoid making potentially procyclical initial margin calls.
- **Potential implementation issues and suggested amendments:** at present, EMIR does not include a requirement for CCPs to identify ex ante how or when such a buffer should be released. EMIR could therefore be strengthened by including a specific requirement for CCPs to develop a "buffer release and replenishment" methodology which would aid harmonisation in practices across the EU and for supervision of this tool. However, to ensure that the full benefits of these provisions are achieved, CCPs should also be required to design such a framework ex ante, with input from their risk committee, subject to the review of the national competent authority and college. In line with section 3.3 of this report, this could be included in the documented approach to procyclicality shared with the CCP's supervisor and the college. Further, a less detailed explanation of the measures taken to mitigate procyclicality could be provided to members.
- **Inclusion of stressed observations within an initial margin model's look-back period:** this option targets one of the key components underlying a CCP's initial margin model. Here, a CCP must assign at least a 25% weight to stressed observations in the historical look-back period. By ensuring that a period of stress is always included within the calculation of initial margin, it is hoped that initial margin requirements will not fall to excessively low (or rise rapidly to high) levels during benign (or stressful) market periods.
- **Potential implementation issues and suggested amendments:** the requirement to assign at least a 25% weight to stressed observations in the look-back period is complex to interpret and, as a result, could be applied in a number of different ways. For example, there is neither a definition of what constitutes "stressed observations", nor is the application of the weighting methodology clear. To address this issue, greater granularity could be included which would also aid consistent application of this option, including by specifying permissible methodologies for identifying historical stressed periods, and further guidance on the weighting schemes that can be used in the margin calculation.
- **Use of a ten-year look-back period:** here the CCP has to ensure that its margin requirements are not lower than those that would be calculated using volatility estimated over a ten-year historical look-back period; this option introduces a floor on the margin parameters calibrated at the long-term average volatility.

---

[34] ESMA (2017).

[35] ESMA (2015), "**Final report – Draft technical standards on the clearing obligation – Interest rate OTC derivatives in additional currencies**".

- **Potential implementation issues and suggested amendments:** limiting the look-back period to ten years gives rise to the risk that stressed observations like the global financial crisis of 2007-08 are phased out and eventually disappear from the look-back period without new stressed observations being added. Binding rules could specify that, if the number of stressed observations – identified with the same permissible methodologies specified for Option 28.1.b – falls below a pre-specified level that is defined in reference to the confidence interval of the initial margin model, the CCP should review the length or composition of the historical look-back period.

The ESRB believes that the provisions in EMIR on the procyclicality of haircuts need to be clarified as well. It also previously suggested that more granular guidance on the determination of collateral haircuts should be provided, with the aim of preventing procyclicality resulting from haircut changes.[36] It would like to reiterate its view that the wording of the provisions to take account of the procyclicality of haircuts (Article 41 of RTS No. 153/2013) needs to be clarified to enhance the simplicity of the regulation. In its view, the current wording, using qualitative terms and phrases such as “prudent” and “as far as possible”, does not ensure a sufficient limitation of procyclicality. As an example, more guidance could be given on how to take into account look-back periods or how to estimate pre-defined minimum haircuts. The relevant Level 1 provisions could be revisited accordingly.

The proposed amendments aim to provide additional guidance on specific technical components of EMIR RTS procyclicality-limiting requirements. In some cases CCPs have gone beyond the EMIR requirements and implemented additional procyclicality-limiting measures to operate in conjunction with the EMIR RTS requirements. As theory and practice develop in identifying and measuring procyclicality, there is a case to be made that, in the longer term, CCPs should be allowed to innovate with respect to model procyclicality mitigants, implementing approaches that deliver outcomes consistent with the policy objectives in this area, without necessarily applying one of the specific approaches set out in the EMIR RTS, subject to appropriate supervision and oversight (including sharing of information with the CCP college) and transparency to members. A clarification in the Level 1 text could be useful. In addition, future analysis could explore whether to include further microprudential tools to limit procyclical effects of margin and haircut setting in the RTS 153/2013.

3.3 Introducing a holistic approach to procyclicality for CCPs

The ESRB considers it important that EMIR is amended to include a more holistic approach to addressing procyclicality. Procyclicality can arise across the full range of CCP risk policies that are not addressed by the narrow tools on procyclicality in EMIR. CCPs should therefore be required to include within their risk frameworks a clear and explicit articulation of their approach to procyclicality across their risk policies. By doing so, a CCP’s governing bodies would have to “consider and adopt a holistic anti-cyclical stance, which considers all the various components of a CCP’s risk management”[37], and document it through the adoption of a policy on the overall tolerance for procyclicality. This would also include considering the procyclical effects of the setting of haircuts and add-ons that are currently not sufficiently subject to EMIR, and should document the reasons underlying the choice of a CCP among the procyclicality-limiting tools provided for by

[36] ESRB (2015a).

[37] Ibid.

EMIR, with the aim of demonstrating that the approach chosen is preferable from a financial stability perspective in a wide range of scenarios.

The information provided to members, clients and indirect clients should be comprehensive and include safeguards to protect sensitive and confidential information. This enables these users of clearing services to understand the CCP's risk management framework and assess and manage their risk in respect to the CCP. CCPs should also be required to provide information to clearing members about their risk management framework and, as a minimum, the procyclical properties of their models.[38] These measures would contribute to the objective stated in paragraph 4.1.2 of the European Commission report on EMIR review – to facilitate the predictability of margin requirements.

The desirability of a holistic approach to procyclicality is also recognised at the international level. The CPMI-IOSCO consultation of August 2016[39] states that "a CCP should develop and implement an appropriate approach to procyclicality, where practicable and prudent, that is holistic and cuts across all aspects of its margin system, as well as other related aspects of its default management framework. Forward-looking and conservative collateral haircuts are a tool that a CCP should include among its available tools to manage procyclicality".

3.4 Systemic implications of the procyclicality-limiting measures in EMIR for CCPs

The "ecosystem" of central clearing goes beyond the borders of the direct use of a CCP's services. The scope of the users of the clearing services provided by a CCP goes beyond its clearing members, i.e. the range of intermediaries which are eligible and choose to access it directly. The landscape of entities using a CCP's clearing services also includes the clients of clearing members, i.e. the users of such services who access the CCP through one or more clearing members, either by choice or because they are not eligible[40].

EMIR recognises that the effects of a CCP's risk management framework may impact clients of clearing members in addition to clearing members themselves. The breadth of a CCP's ecosystem is mirrored in the composition of risk committees which, pursuant to Article 28 of EMIR[41], must include representatives of clearing members' clients. EMIR further acknowledges that the decisions of a CCP in terms of its risk management framework may have an economic impact which potentially extends to clearing members' clients[42]. From a macroprudential point of view, this transmission of effects to the clients of clearing members is relevant, particularly when it is represented by changes in risk management requirements which can lead to procyclical effects. It is also necessary to consider that:

---

[38] Research by the Bank of England proposes some candidate metrics that could be used for this purpose, see Murphy, D., Vasios, M. and Vause, N. (2014), "**An investigation into the procyclicality of risk-based initial margin models**", *Financial Stability Paper*, No. 29, Bank of England, London, May.

[39] CPMI-IOSCO (2016), "**Consultative report – Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI**".

[40] According to Article 2(15) of EMIR, "client" means an undertaking with a contractual relationship with a clearing member of a CCP which enables that undertaking to clear its transactions with that CCP.

[41] According to Article 28(1) of EMIR, "a CCP shall establish a risk committee, which shall be composed of representatives of its clearing members, independent members of the board and representatives of its clients."

[42] Recital 66 of EMIR states that: "When defining a sound risk-management framework, a CCP should take into account its potential risk and economic impact on the clearing members and their clients."

1. the relationship between clearing members and their clients is governed purely at the bilateral level, outside the scope of the RTS on bilateral margins, and that consequently margin and collateral requirements imposed by clearing members might differ from those determined by the CCP;
2. the categories of clients may be diverse, ranging from prudentially regulated intermediaries such as banks and investment firms to institutional investors such as hedge funds. These relationships might therefore be susceptible to inducing procyclical effects, if safeguards which limit procyclicality are not implemented at the bilateral level.

EMIR's procyclicality-limiting provisions only target the relationship between a CCP and its clearing members. Recital 68 of EMIR clearly states that "margin calls and haircuts on collateral may have procyclical effects". The ESRB fully concurs with this statement. However, the remainder of this Recital[43] and the procyclicality-limiting provisions included in EMIR and delegated legislation only address the relationship between CCPs and clearing members. In the ESRB's view, the transmission of procyclical inputs via the relationship between client and clearing member should be avoided or limited in order to protect financial stability. It notes that EMIR already includes some requirements targeting the provision of services by clearing members to clients. However, these provisions mostly, if not exclusively, concern the level of segregation of assets and positions offered by clearing members to clients.

In the ESRB's view, the provisions to limit the procyclicality of margin and haircut requirements of CCPs could be broadened to include client clearing as well. Against this background, the ESRB encourages the European Commission to consider broadening the procyclicality-limiting provisions in EMIR to also include the "clients" level, while bearing in mind that smoothing potential procyclical effects could entail more conservative, and therefore more costly, margin and collateral requirements[44]. One way to do this would be to reword Recital 68 to include clearing members in the text, and add a provision addressing clearing members aimed at imposing on them the requirement to avoid procyclical margin and collateral requirements when providing clearing services to their clients.

3.5 Addressing procyclicality in bilateral margining

In the ESRB's view, procyclicality effects can also arise from bilateral clearing arrangements. In this sense, the Basel Committee on Banking Supervision (BCBS)-IOSCO report on margin requirements for non-centrally cleared derivatives[45] outlines the need to avoid, for example, abrupt changes in margin requirements. At the same time, the ESRB notes that the relevant provisions in Article 11 of EMIR do not refer to the need to set bilateral margins in a way that specifically limits procyclical effects.

The ESRB believes that bilateral initial margin models should include measures to limit procyclicality. It notes the intention of the European Commission to consider the possibility for "bilateral initial margin models to be endorsed by authorities" in order to promote certainty for market participants and authorities alike. On the industry side, it also notes that proposals have

---

[43] Recital 68 of EMIR states that: "CCPs, competent authorities and ESMA should therefore adopt measures to prevent and control possible procyclical effects in risk-management practices adopted by CCPs, to the extent that a CCP's soundness and financial security is not negatively affected."

[44] ESRB (2017).

[45] BCBS-IOSCO (2013), "**Margin requirements for non-centrally cleared derivatives**".

been put forward for standardised models for determining the bilateral initial margin[46]. Against this background, the ESRB proposes that, when considering the above possibility, a specific reference be made to the procyclicality-limiting capabilities of such initial margin models as a "feature" that competent authorities should verify in their assessment. In this context, the ESRB acknowledges that the RTS on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP include the requirement that the initial margin model includes at least 25% of observations in a stressed period.

[46] **The International Swaps and Derivatives Association's Standard Initial Margin Model** (ISDA SIMM™).

Section 4
Other issues

4.1 Evaluation of systemic risks for mandatory clearing purposes by ESMA

In order to identify the classes of OTC derivatives subject to the clearing obligation, ESMA (in consultation with the ESRB) needs to take into account systemic risk. The overarching aim of the introduction of the clearing obligation in the EU is the reduction of systemic risk. According to Recital 15 of EMIR, this requires a process of identifying classes of OTC derivatives that should be subject to that obligation. Hence, when doing so, ESMA's analysis (following consultation with the ESRB as required by EMIR) needs to be based on an evaluation of systemic risk of these OTC derivatives, which is not further defined in EMIR.

Systemic risk can be measured at the EU level and at the level of individual Member States. According to Recital 27 of Regulation No. 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, "systemic risks include risks of disruption to financial services caused by a 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. *Any type of financial institution and intermediary, market, infrastructure and instrument* has the potential to be systemically significant" (emphasis added). The italicised sections show that systemic risk can arise not only at the aggregated level of the EU as a whole but also on the level of an individual EU Member State.

The ESRB believes that EMIR should mirror this approach and take into account systemic risk both at the European and national levels. It is of the opinion that some risks can be concentrated in individual financial institutions that are systemically important at the domestic or EU levels, even though they may seem small from an aggregated perspective. Furthermore, the financial sector in a given country might be systemically important and interconnected to other European countries, leading to potential cross-border spillovers. The International Monetary Fund currently considers the financial sectors of 13 EU countries to be systemically important based on their size or interconnectedness[47]. Hence, they could have the potential to spread risks to the financial sectors of other countries in the EU or even to the whole European financial market.

The ESRB reaffirms its proposal to include a provision in EMIR which requires ESMA to measure systemic risk at both the EU and national levels in the context of the clearing obligation. In its latest report on identifying OTC interest rate derivatives classes to be included in the clearing obligation[48], ESMA notes that it agrees with the ESRB's opinion that systemic risk of OTC derivatives should be evaluated at both the EU and national levels for the purpose of assessing the need and scope of a clearing obligation. The ESRB welcomes this approach, which is in line with the definition of systemic risk in Regulation No. 1092/2010. A requirement in EMIR could increase clarity and transparency around how the OTC derivatives classes that fall under the clearing obligation have to be identified by ESMA.

[47] These countries are: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Poland, Sweden and the United Kingdom, see **IMF press release** as of 27 September 2010 and **IMF press release** as of 13 January 2014.

[48] ESMA (2015).

4.2 Consistency with internationally agreed regulations or standards

The EU should aim to ensure high standards for risk management that are internationally consistent, and a level playing field for EU CCPs. Consistency and cooperation in the application of international regulatory standards across global markets is essential to maintain financial stability and avoid disruption and the potential for regulatory arbitrage. Diverging from existing international standards may have strong cross-jurisdictional competitive effects, potentially increase the cost of clearing for EU participants, and may impair the equivalence process for third-country CCPs – which in turn could fragment liquidity along regulatory lines between clearing in the EU and the rest of the world. However, notwithstanding international developments, EMIR should always aim to reduce systemic risk in the EU by applying high standards for central clearing and risk management in bilaterally cleared transactions.

The aim of being consistent with international regulation is reflected in EMIR. Recital 90 of EMIR recalls the importance of ensuring international convergence of requirements for CCPs, that EMIR is intended to follow the international recommendations developed by CPSS-IOSCO (now CPMI-IOSCO), namely the PFMIs, and that ESMA should consider these international standards when drawing up the technical standards as well as the guidelines and recommendations foreseen by EMIR.

The ESRB welcomes the fact that the European Commission acknowledges the evolution of international standards in the revision of EMIR. In the report for the revision of EMIR[49], the Commission acknowledges once more that the core requirements of EMIR should deliver on the international commitments for regulatory reform and that the EMIR review process should "carefully consider the international principles in the derivatives markets field in order to ensure an efficient functioning of global markets". The ESRB supports this aim and proposes that the review of EMIR should revise the text of EMIR and provide for updates to the relevant technical standards to reflect work being carried out at the international level, in particular CPMI-IOSCO's work to develop further guidance on trade reporting, issue more granular guidance on CCP resilience and publish quantitative and qualitative requirements consistent with the CPMI-IOSCO disclosure framework.

On trade reporting, CPMI-IOSCO is working to address the remaining inconsistencies in the data fields being reported under the trade reporting requirements. This work is due to be finalised by the end of 2017 and includes the work of the dedicated CPMI-IOSCO groups on the "unique trade identifier" (UTI), "unique product identifier" (UPI) and other key elements that characterise OTC derivatives transactions and should be reflected in the revised text of EMIR and provisions for updates to the relevant technical standards.

All CCPs should be subject to rigorous requirements concerning all aspects of their business and EMIR already applies high standards for all EU CCPs. CPMI-IOSCO is working on further, more granular guidance in addition to the PFMIs with a view to enhancing the resilience of CCPs. The additional guidance will cover, among other things, governance, stress testing and margin (including procyclicality issues), and is expected to be finalised in the first half of 2017. EU authorities, national competent authorities and central banks have been active participants in this work. The EMIR review provides the European Commission and ESMA with an opportunity to implement this guidance within EMIR, thus simultaneously furthering the resilience of CCPs while ensuring continued consistency with the international framework and a level playing field for EU CCPs.

[49] European Commission (2016).

The quantitative and qualitative information on the risk management of CCPs, as currently published by EU CCPs, is inconsistent and incomplete. These data are of crucial importance for authorities, market participants and interested parties. The ESRB and other authorities involved in monitoring systemic risk have started analysing the data released under these public disclosure frameworks. In doing so, they have identified a number of inconsistencies across CCP disclosures. These inconsistencies significantly reduce the usefulness of the data for authorities and the broader public. In addition, certain EU CCPs are only publishing parts of these data or nothing at all.

The ESRB reiterates its proposal to include in EMIR the obligation for CCPs to publish data according to schemes comparable to the CPMI-IOSCO public disclosure framework. In order to address the shortcomings in the data, the ESRB suggests that the timely and accurate publication of data, consistent with CPMI-IOSCO public disclosures on the risk management of CCPs, be mandated under EMIR, by means of appropriate regulatory standards. This would allow CCP supervisors to require remedial action from CCPs if areas of inaccuracy in the reporting are identified, and to request that CCPs that are not reporting start publishing the data; a lack of (or poor) reporting could be disincentivised by appropriate sanctions.

4.3 Previous ESRB proposals on dedicated resources of CCPs and interoperability arrangements

The ESRB reaffirms previous proposals, such as the revision of the determination mechanism of dedicated resources ("skin in the game") and interoperability arrangements. The ESRB set out that EMIR could be further enhanced by aligning the amount of dedicated resources held by a CCP with the level of the CCP's clearing activity, in order to ensure that the incentives are in some way proportionate to the quantitative dimension of the risks it manages. In particular, it should not be possible for a CCP to reduce the amount of skin in the game when it materially increases the volume of transactions it clears.[50] In another report[51], the ESRB noted that the existing regulatory framework provides the national competent authorities with some flexibility in their interpretation of the EMIR Level 1 text and the ESMA guidelines with respect to interoperability arrangements. Considering the possibility of the further expansion of interoperability arrangements, there could be scope for more granular and prescriptive regulation. The ESRB acknowledges that these proposals do not fall under the targeted scope of the European Commission on this occasion, but believes that they should be considered within a more comprehensive review of EMIR. In addition, the ESRB will evaluate whether these proposals can be better considered when discussing other legislative proposals, for example in the context of the recovery and resolution of CCPs. In this respect, in the ESRB's view the wording of Article 16(2) of EMIR relating to the capital of CCPs could be clarified to enhance the simplicity of the regulation. In its current form, the article could be misinterpreted and taken to mean that there is no capital requirement for default-related losses as they are covered only by the waterfall in Articles 41 to 44. Furthermore, with regard to the right incentives for CCPs, it should be clearly spelled out that, if the waterfall resources are exhausted (and no further recovery or resolution measures are taken), in terms of financial resources CCPs' own capital is the last line of defence foreseen in EMIR.

---

[50] ESRB (2015b).

[51] ESRB (2016), "**Report to the European Commission on the systemic risk implications of CCP interoperability arrangements**".

Imprint

© European Systemic Risk Board, 2017

Postal address	60640 Frankfurt am Main, Germany
Telephone	+49 69 1344 0
Website	**www.esrb.europa.eu**

All rights reserved. Reproduction for educational and non-commercial purposes is permitted provided that the source is acknowledged.

ISBN	978-92-95210-06-6 (pdf)
DOI	10.2849/076903 (pdf)
EU catalogue No	DT-04-17-412-EN-N (pdf)