Responses on European Securities and Markets Authority ("ESMA") discussion paper

Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories ("EMIR")

March 2012
Q1: In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

Q2: In your views, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

RESPONSE: This is an important priority but equally it is critical to ensure for pension funds that benefit for the transitional arrangements under EMIR are not captured by Dodd Frank under which specific provisions for pension funds do not exist.

Q3: In your views, what should be the characteristics of these indirect contractual arrangements?

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

Q5: For a reasonable assessment by ESMA on the basis of the information provided in the notification, what period of time should historical data cover?

Q6: What are your views on the review process following a negative assessment?

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, availability of pricing information?

RESPONSE: The considerations set out by ESMA seem reasonable and we would support those. We would however suggest that ESMA also considers two further points. Firstly, how a clearing obligation may impact future liquidity of the contracts. Clearing may not necessarily increase liquidity in the market, and there maybe circumstances when liquidity could in fact decrease following a mandatory clearing obligation.

One example of this could be a situation where two classes of derivatives may often be traded together and may provide some natural offsetting behaviours, however only one of those classes of derivatives maybe liquid enough to be able to clear and therefore a clearing obligation is mandated by ESMA for that class of derivatives only. This may lead to a situation where the positions shall need to be bifurcated with some of the positions being cleared and others being risk managed on a bilateral basis. This not only increases counterparty risk (because the natural offsets the positions provided no longer reduce counterparty risk as the positions are bifurcated), but may lead to a situation where the liquidity in the class of derivatives (even those that are cleared) reduces. In these situations ESMA may want to 1) weigh up the potential downside of a mandatory clearing obligation as part of its criteria for determining the mandatory clearing obligation; and 2) determine if phasing in of the clearing obligation can be introduced by category of counterparties in order to limit these consequential risks.

Secondly, the benefit of clearing must be traded off against any potential risks of applying a mandatory clearing obligation. In particular ESMA should assess how a mandatory clearing obligation could increase other risks to market participants or have other unintended consequences. These could for instance include, but not be limited to, an increase in repurchase and other financing transactions (thereby increasing counterparty credit risk) in the market as a result of market participants needing to transform physical collateral into cash in order to meet cash variation margin obligations for clearing. ESMA should ensure that the benefits of applying mandatory clearing obligation for a particular class of derivatives outweigh the risks of any unintended consequences.

Finally, EMSA should consider requiring a formal process to be put in place where a mandatory clearing obligation on a particular class of derivatives could be revoked upon a change in the market which could cause the clearing obligation criteria set out by ESMA to no longer be satisfied for such class of derivative contracts.
Q8: What are your views, regarding the details to be included in ESMA Register of classes of derivatives subject to the clearing obligation (Article 4b)?

Q9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

RESPONSE: Whilst we consider the wording set out here to be reasonable to define such contracts, we would like to highlight a potential inconsistency within EMIR which could have some unintended causes.

Whilst EMIR currently captures pension funds as a financial counterparty which shall be captured by the clearing obligation (once the temporary exemption expires), non-financials are provided an exemption for commercial hedges and for non-hedges that fall within the clearing threshold. This could provide an economic incentive for non-financials to keep pension liabilities on their balance sheets given that the use of OTC derivatives for the purpose of hedging shall be permitted without the requirement to clear. This could disadvantage non-financials that prudently manage these liabilities by transferring the pension fund liabilities into a separate stand-alone entity (such as a pension fund), because these entities would not be able to take advantage of the non-financial exemption, even when used for hedging purposes.

We believe the difference in treatment of the use of OTC derivatives used to manage pension liabilities as described above unfairly favours those non-financials that adopt a less prudent approach to risk management of pension liabilities.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

RESPONSE: Yes, if the definition of commercial hedging and treasury financing is sufficiently encompassing then the required threshold should be set at a relatively low level.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

Q14: In your views, is the definition of market conditions preventing marking-to-market complete? How should European accounting rules be used for this purpose?

RESPONSE: Whilst we largely support ESMA setting out guidance and rules on when mark-to-model or mark-to-market should be applied, ESMA must be mindful of not being overly prescriptive, if at all, on how mark-to-market or mark-to-model shall be calculated. Market participants must be provided with sufficient flexibility to be able to develop best practises and methodologies for pricing and valuing positions based on market best practise.

Furthermore, ESMA should not be too narrow in the definitions of mark-to-market and mark-to-model. There are many classes of derivatives that fall in between what maybe strictly described as mark-to-market and mark-to-model. For instance many classes of derivatives contracts often have key pricing parameters that are widely quoted in the market (such as implied volatility in the pricing of options contracts for example) but the actual pricing shall require feeding these quoted parameters.
into a model. Any rules regarding mark-to-market or mark-to-model should not prohibit market participants from being able to value the contracts in a manner that best captures fair value of the contracts based on industry best practice.

Q15: Do you think additional criteria for marking-to-model should be added?

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

RESPONSE: Any procedures set out by ESMA here should not prejudice industry best practices that are being developed for handling disputes, including the ISDA dispute resolution procedure.

ESMA should make clear what constitutes a dispute. There are situations when two counterparties may not have the same collateral valuation but neither of the counterparties raises it as a dispute and the counterparties effectively are comfortable with retaining the risk associated with the valuation difference.

Note that whilst we would not have any issues disclosing any disputes to the national competent authority, we would ask that the competent authorities treat this information to be sensitive and in a confidential manner. Collateral disputes could have important pricing information associated with it and may not be in the best interest of the end investor to disclose this to the counterparty in question or other counterparties.

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

RESPONSE: We support a threshold set at a level of EUR 15m. We suggest that the reporting requirements be limited to dealers (where dealers are party to a transaction), any disputes shall be visible to both sides of the trades.

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

Q22: In your views what details of the intragroup transactions should be included in the information to be publicly disclosed by counterparty of exempted intragroup transactions?

RESPONSE: We believe only a limited amount of generic information should be made public regarding intragroup trades. Publically disclosing detailed information can reveal highly confidential and sensitive information about a group’s risk positions and shall discourage firms from engaging in prudent risk management where risk is aggregated across the group and managed centrally within one entity.

Q23: What are your views on the notion of liquidity fragmentation?
Q24: What are your views on the possible requirements that CCP governance arrangements should specify? In particular, what is your view on the need to clearly name a chief risk officer, a chief technology officer and a chief compliance officer?

Q25: Are potential conflicts of interests inherent to the organisation of CCPs appropriately addressed?

RESPONSE: We agree that regulators have an important role to play in ensuring that conflicts of interests are managed appropriately in the organisation of CCPs. We agree with the overall approach set out in the paper and regulators should stay engaged as the CCP market develops to ensure that this happens in a manner which represents all market participants and does not introduce any unwarranted risks. As part of this it is important that there should be representations from buy side clients on the governing bodies and risk committees relating to CCPs. This shall be important to tackle any commercial conflicts that may otherwise arise.

Q26: Do the reporting lines – as required – appropriately complement the organisation of the CCP so as to promote its sound and prudent management?

Q27: Do the criteria to be applied in the CCP remuneration policy promote sound and prudent risk management? Which additional criteria should be applied, in particular for risk managers, senior management and board members?

Q28: What are your views on the possible organisational requirements described above? What are the potential costs involved for implementing such requirements?

Q29: Should a principle of full disclosure to the public of all information necessary to be able to understand whether and how the CCP meets its legal obligations be included in the RTS? If yes, which should be the exceptions of such disclosure requirements? Has the information CCP should disclose to clearing members been appropriately identified? Should clients, when known by the CCP, receive the same level of information?

RESPONSE: We believe that clients should receive the same level of information so that clients can fully understand the risks and costs associated with using clearing services.

Q30: What are your views on the possible records CCPs might be required to maintain?

Q31: What are your view on the modality for maintaining and making available the above records? How does the modality of maintaining and making available the records impact the costs of record keeping?

Q32: What are your views on the possible requirements for the business continuity and disaster recovery plan and in particular on the requirements for the secondary site? Would it be appropriate to mandate the establishment of a third processing site, at least when the conditions described above apply? What are the potential costs and time necessary for the establishment of a third processing site and for immediate access to a secondary business site?

Q33: Is the 2 hours maximum recovery time for critical functions a proportionate requirement? What are the potential costs associated with that requirement?

Q34: Are the criteria outlined above appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP’s margin models? Should a criteria based approach be complemented by an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?
RESPONSE: We believe that it is important to get the right split between default fund and initial margin contributions. Default fund plays an important role in ensuring that clearing members have an appropriate alignment of interest and as such it would be important to ensure that the confidence interval is not set too high such that the default funds are disproportionately small.

Q35: Taking into account both the avoidance of procyclicality effects and the need to ensure a balance distribution of the financial resources at the CCP disposal, what is in your view the preferred option for the calculation of the lookback period.

RESPONSE: We believe that (c) is more appropriate. It is important to ensure that any look back period contains period of stressed market conditions. A clearing member default is likely to occur in stressed market conditions and therefore it would be prudent to ensure such market conditions form the premises for any analysis for CCP margin requirements. Not including stressed market conditions in the look back period can result in either 1) the CCPs from being inadequately collateralised or 2) for the margin requirements to increase as market conditions worsen which can add further stress to an already worsening market.

Q36: Is in your view the approach described above for the calculation of the liquidation period the appropriate one? Should a table with the exact number of days be included in the technical standards? Should other criteria for determining the liquidation period be considered?

RESPONSE: We believe that consideration for liquidation period should take into consideration the liquidity, size and depth of the market relating to the particular class of derivatives. Based on this there should be a simple table setting out the liquidation period per class of derivatives. Liquidation period shall be calibrated by examining historic liquidity during stressed periods.

Q37: Is procyclicality duly taken into account in the definition of the margin requirements?

RESPONSE: We support the approach of duly taking into account cyclicality of market conditions and including stressed scenarios. We think this should include scenario stress testing incorporating antithetic scenarios (where simulated symmetrical market moves are analysed).

Q38: What is your view of the elements to be included in the framework for the definition of extreme but plausible market conditions?

Q39: Do you believe that the elements outlined above would rightly outline the framework for managing CCPs' liquidity risk?

Q40: Do you consider that the liquid financial resources have been rightly identified? Should ESMA consider other type of assets, such as time deposits or money market funds? If so, please provide evidences of their liquidity and minimum market and credit risk.

Q41: Should the CCP maintain a minimum amount of liquid assets in cash? If so, how this minimum should be calculated?

Q42: What is your preferred option for the determination of the quantum of dedicated own resources of CCPs in the default waterfall? What is the appropriate percentage for the chosen option? Should in option a, the margins or the default fund have a different weight, if so how? Should different criteria or a combination of the above criteria be considered?

RESPONSE: We believe there should be a material minimal amount of dedicated own resources contributed by the CCPs to ensure alignment of interest and appropriate incentives to adopt a stringent risk management practice. However the vast majority of the protection a CCP provides
should be covered by default fund and margin requirements; the CCP’s own resources should only be a small component to this.

**Q43:** What should be the appropriate frequency of calculation and adaptation of the skin in the game?

**Q44:** Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

**RESPONSE:** We would support cash and a narrow list of high quality sovereign bonds that meet the EMIR requirements of highly liquid collateral with minimal credit and market risk. We would not generally consider bank guarantees and gold to meet the EMIR requirements of highly liquid collateral with minimal credit and market risk.

**Q45:** In respect of the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member seeking to lodge those financial instruments, is it appropriate to accept covered bonds as collateral issued by the clearing member?

**RESPONSE:** We are concerned that covered bonds do not meet the EMIR requirements of highly liquid collateral with minimal market risk.

**Q46:** Do you consider that the proposed criteria regarding the currency of cash, financial instruments or bank guarantees accepted by a CCP have been rightly identified in the context of defining highly liquid collateral? Should ESMA consider other elements in defining the currency of collateral instruments that should be permitted should be the same as the currency of exposures it relates to in order to avoid creating unwanted default contingent currency risk.

**RESPONSE:** We believe that currency of collateral instruments that should be permitted should be the same as the currency of exposures it relates to in order to avoid creating unwanted default contingent currency risk.

**Q47:** Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements?

**RESPONSE:** We support the approach that ESMA has suggested regarding haircuts focusing on types of asset, level of credit risk, maturity and liquidity.

**Q48:** Do you believe that the elements outlined above would rightly outline the framework for assessing the adequacy of its haircuts? Should ESMA consider other elements?

**RESPONSE:** We support the approach suggested by ESMA here.

**Q49:** Do you consider that the elements outlined above would rightly outline the framework for determining concentration limits? Should ESMA consider other elements?

**Q50:** Should a CCP require that a minimum percentage of collateral received from a clearing member is provided in the form of cash? If yes, what factors should ESMA take into account in defining that minimum percentage? What would be the potential costs of that requirement?

**RESPONSE:** No we believe that combined with the use of haircuts, an appropriate level of credit protection can be provided by high quality sovereign bonds that meet the EMIR requirements of highly liquid collateral with minimal credit and market risk.
Q51: Do you consider that financial instruments and cash equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?

RESPONSE: Risks relating to long duration instruments can be dealt with appropriate haircuts. We do not think there should be a maximum duration of debt instruments as long as the instruments meet the EMIR requirements of highly liquid collateral with minimal credit and market risk.

Q52: Do you think there should be limits on the amount of cash placed on an unsecured basis?

RESPONSE: Yes there should be a limit for cash placed on an unsecured basis.

Q53: Do you consider that CCP should be allowed to invest in derivatives for hedging purposes? If so, under which conditions and limitations.

RESPONSE: If there is a genuine business need to use derivatives for hedging purposes, we believe a CCP should be able to use derivatives. CCPs must however adopt appropriate risk management standards, at least as stringent as those applied to the rest of the market due to their systemic importance. Such business needs should be discussed with, and disclosed to, the regulator.

Q54: Do you consider that the proposed criteria regarding the currency of financial instruments in which a CCP invests has been rightly identified in the context of defining highly liquid financial instruments with minimal market and credit risk? Should ESMA consider other elements in defining the currency of highly liquid financial instruments with minimal market and credit risk? Please justify your answer.

RESPONSE: Any investment of margins posted by clearing members (or its clients) should be invested or deposited in arrangements that do not create any additional currency risk.

Q55: Do you consider that the elements outlined above would rightly outline the framework for determining the highly secured arrangements in respect of which financial instruments lodged by clearing members should be deposited? Should ESMA consider other elements? Please justify your answer.

RESPONSE: We broadly support ESMA’s thoughts here.

Q56: Do you consider that the elements outlined above would rightly outline the appropriate framework for determining concentration limits? Should ESMA consider other elements? Please justify your answer.

RESPONSE: We broadly support ESMA’s thoughts here.

Q57: What are your views on the definitions of back and stress testing?

RESPONSE: Any stress testing should include stressed market scenarios as well as specific scenario testing incorporating antithetic scenarios (where simulated symmetrical market moves are analysed).

Q58: What are your views on the possible requirements for a CCP’s validation process?

RESPONSE: We broadly support ESMA’s thoughts here.
Q59: What are your views on the possible back testing requirements?

RESPONSE: We broadly support ESMA’s thoughts here.

Q60: Would it be appropriate to mandate the disclosure of back testing results and analysis to clients if they request to see such information?

RESPONSE: Yes disclosure of such information, upon request by clients is important information for clients when selecting a clearing house.

Q61: Should the time horizons for back tests specified under 144(e) be more granular? If so, what should the minimum time horizon be? Should this be different for different classes of financial instruments?

Q62: What are your views on the possible stress testing requirements?

RESPONSE: We broadly support ESMA’s thoughts here.

Q63: Would it be appropriate to mandate the disclosure of stress testing results and analysis to clients if they request to see such information?

RESPONSE: Yes disclosure of such information, upon request by clients is important information for clients when selecting a clearing house.

Q64: What are your views on the possible requirements for reverse stress tests? And what impact do you think such requirements would have on industry?

RESPONSE: We fully support ESMA’s suggestion here - this is very useful information when analysing the robustness of the CCP model.

Q65: Should there be any other parties involved in the definition and review of tests? Please justify your answer and explain the extent to which suggested parties should be involved?

Q66: Should the testing of default procedures involve a simulation process?

RESPONSE: Yes, we believe this will be a valuable exercise.

Q67: Are the frequencies specified above appropriate? If no, please justify your answer.

Q68: In your view what key information regarding CCP risk management models and assumptions adopted to perform stress tests should be publicly disclosed?

Q69: What is your view on the need to ensure consistency between different transaction reporting mechanisms and the best ways to address it, having in mind any specific items to be reported where particular challenges could be anticipated?

Q70: Are the possible fields included in the attached table, under Parties to the Contract, sufficient to accurately identify counterparties for the purposes listed above? What other fields or formats could be considered?
RESPONSE: We believe table 1 broadly captures enough information to identify all parties related to either a bilateral or CCP trade. We are unsure if ESMAs intention is to ‘link’ the information between table 1 and 2, it is unclear how this would currently be achieved.

Q71: How should beneficiaries be identified for the purpose of reporting to a TR, notably in the case of long chains of beneficiaries?

Q72: What are the main challenges and possible solutions associated to counterparty codes? Do you consider that a better identifier than a client code could be used for the purpose of identifying individuals?

Q73: What taxonomy and codes should be used for identifying derivatives products when reporting to TRs, particularly as regards commodities or other assets for which ISIN cannot be used? In which circumstances should baskets be flagged as such, or should their composition be identified as well and how? Is there any particular aspect to be considered as regards a possible UPI?

Q74: How complex would be for counterparties to agree on a trade ID to be communicated to the TR for bilaterally executed transactions? If such a procedure is unfeasible, what would the best solution be to generate the trade ID?

RESPONSE: The work on the Universal Swap ID’s may aid in resolving this point, however the final details are still to be published by ISDA.

For trades which are confirmed via market matching systems, such as MaritWire and Ice Link, the platforms typically create unique trade ID between Counterparties. For manually confirmed trades the challenge is more significant and would require a cross party working group to scope and define an appropriate industry solution.

Q75: Would information about fees incorporated into pricing of trades be feasible to extract, in your view?

RESPONSE: We would expect to receive full information of transaction fees from our dealers and we would support an obligation on the dealer to report this to the regulator. However we would not be supportive of making this information available to the public or to other market participants.

Q76: What is your view of the granularity level of the information to be requested under these fields and in particular the format as suggested in the attached table?

RESPONSE: We broadly support ESMA’s thoughts here.

Q77: Are the elements in the attached table appropriate in number and scope for each of these classes? Would there be any additional class-specific elements that should be considered, particularly as regards credit, equity and commodity derivatives? As regards format, comments are welcome on the possible codes listed in the table.

RESPONSE: Further work is required on the industry standards for UPI, USI, etc. However, we broadly support ESMA’s thoughts here.

Q78: Given that daily mark-to-market valuations are required to be calculated by counterparties under [Article 6/8] of EMIR, how complex would it be to report data on exposures and how could this be made possible, particularly in the case of bilateral trades, and in which implementation timeline? Would the same arguments also apply to the reporting of collateral?

RESPONSE: Reporting of exposure data, to regulatory bodies, would be relatively straightforward. However we would not be supportive of making this information available to public or to other
market participants. We are open to discussion on the best way to technically implement any reporting requirements to trade repositories. Broadly, collateral information can also be distributed relatively conveniently, but it should be noted that collateral balances are calculated per account rather than per trade.

Q79: Do you agree with this proposed approach? What are in your view the main challenges in third party reporting and the best ways to address them?

RESPONSE: We broadly support ESMA’s thoughts here.

Q80: Do you envisage any issues in providing the information/documentation as outlined above? In particular:

a) what would the appropriate timeline over which ESMA should be requesting business plans (e.g. 1, 3, 5 years?)

b) what would the appropriate and prudent length of time for which a TR must have sufficient financial resources enabling it to cover its operating costs (e.g. 6 months / 1 year)?

Q81: What is your view on these concerns and the ways proposed to address them? Would there be any other concerns to be addressed under the application for registration and tools that could be used?

Q82: What level of aggregation should be considered for data being disclosed to the public?

RESPONSE: We believe any disclosure should be broad and at an aggregate level (as already specified in level 1). Information should not be broken down by either trade or counterparty, but be aggregated on a market level only. Any detailed public disclosure of information forms sensitive market information and may adversely impact the liquidity of the market.

Q83: What should the frequency of public disclosure be (weekly? monthly?); and should it vary depending on the class of derivatives or liquidity impact concerns; if yes, how?