EFAMA response to the ESMA consultation paper on the clearing obligation for financial counterparties with a limited volume of activity

The European Fund and Asset Management Association[1], EFAMA, welcomes the opportunity to comment on the ESMA consultation paper on the clearing obligation for financial counterparties with a limited volume of activity.

1. General Comments

As a principle, EFAMA supports every effort made to enhance financial market regulation which reinforces the stability of the financial system, of which EMIR is an important part.

Prior to replying to the consultation, we wish to make the following general remarks.

Firstly, we fully support the points raised by ESMA that recognizes that several types of counterparties active in the OTC derivatives markets are facing numerous issues in relation to the access to central clearing due to:

- The difficulty to become a clearing member ("CM") due to the related cost (e.g. minimum capital requirements), risk (e.g. mutualisation of default fund resources) and other legal issues;
- The limited interest of the clearing members to provide client clearing services outside from their biggest and most active clients;
- The lack of conclusion of indirect clearing arrangements for OTC derivatives instruments compared to the exchange traded derivatives market;
- The costs associated with the on-boarding of clients and the on-going management of the client cleared positions (including risk and compliance monitoring, trade management, collateral management, client reporting, client service), versus the revenues of the clearing member.

Secondly, we are supportive of the idea to delay the implementation of the clearing obligation for all instruments and for all counterparties in category 3. In addition, EFAMA considers that this delay should be extended to category 4 participants.

[1] **EFAMA** is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 61 corporate members EUR 21 trillion in assets under management of which EUR 12.6 trillion managed by 56,000 investment funds at end 2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 25,900 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org

Nevertheless, we consider that this extended deadline does not resolve the issue of eligible collateral scarcity nor the need to review the rules on the usage of repos as a tool to provide eligible collateral.

Therefore, we reiterate the need to review and significantly amend the ESMA Guidelines on ETF[2]. These guidelines are creating excessive pressure on the capability of many funds to deliver collateral or assets eligible for CCPs and CMs.

We want to insist on the fact that the difficulties described by ESMA do not only apply to smaller firms but to the vast majority of regulated funds whose protections have not been sufficiently assured in the EMIR's text

Thirdly, even if we see the benefits of EMIR in terms of control of the systemic risk through the mandatory use of clearing for some classes of OTC derivatives, we deem it crucial for funds and asset managers to be subject to a fair and appropriate treatment. As a result, it is important that a robust solution is found for the margining issues. Otherwise, the application to funds and asset managers of the EMIR rules will affect long term investments and increase the costs for end-investors. This would be driven by the higher costs of using derivatives, immobilisation of assets and loss of return on cash collateral.

Lastly, the figures[3] used to build the proposed legislative change should differentiate between:

- buy-side volumes of transactions against sell-side volumes of transactions; as well as
- low-leveraged regulated funds versus highly leverage structures (which create higher risk irrespective of the amount of assets that they manage).

2. Detailed reply

Question 1: To which category of counterparties does your organisation belong: (1) in the context of the 1st Commission Delegated Regulation on the clearing obligation, and (2) in the context of the 2nd Commission Delegated Regulation on the clearing obligation?

The vast majority of EFAMA's members operate regulated funds which are in category 3 and to a lesser extend the few remaining other funds are in category 2.

We would consequently be supportive of an extension of deadline for all category 3's market participants to facilitate referencing and ensure consistency.

[2] ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2014/937, respectively former ESMA/2012/832)
[3] See Section 3.2 and Section 3.3 of the Consultation Paper

Question 2: If you offer clearing services, please provide evidence on the constraints that would prevent you from offering clearing services to a wider range of clients.

This is not applicable to regulated funds or asset managers of regulated funds as they do not offer clearing services.

Currently we have no indication that our members will offer clearing services.

Question 3: Have you already established clearing arrangements (1) for interest rate swaps? (2) for credit default swaps? If not, please explain why (including the difficulties that you may be facing in establishing such arrangements) and provide an estimation of the time needed to finalise the arrangements.

There are two different positions in EFAMA’s membership:

Some EFAMA members have set clearing arrangements voluntarily for their funds, across instruments.

Their choice was initially dictated by the most favorable economic treatment offered by the banking counterparts when the buy-side firms accepted to clear in advance of the regulatory deadline.

Other members have taken other criteria into account as described below, leading them to postpone or preventing them from finalising the execution of clearing arrangements.

The first level of barriers expressed are:
- The lack of legal certainty in the treatment of underlying clients’ assets;
- The fact that CCPs collateral requirement are different from the ones of CMs. In particular that the CMs having more stringent criteria;
- The lack of preparedness of the CMs to implement Individually Segregated Accounts; and
- The priority given to other projects such as increased reporting requirements in several files.

Taking into account those barriers, we note a new development with a few CCPs offering hybrid models where funds can access some aspects of being a direct member.
However these models still require the need for a full clearing member to support it and could expose funds or asset managers to a risk of capital loss.

The second level of barriers expressed by our members are related to collateral issues:
- At CCPs, only cash is accepted as variation margin. However, several funds are facing severe difficulties in delivering cash as collateral:
    - Some funds are fully invested. Consequently, they have no cash to deliver as collateral.
    - Some type of funds (UCITS globally speaking and AIF in some countries) are not allowed anymore to use repos to transform securities assets that they have in portfolios into cash.
- At clearing members’ level, we also noted in several occasions that

- o some clearing members ("CM") impose more stringent collateral eligibility criteria, that negatively impacts end-investors and intensifies the liquidity squeeze for UCITS triggered by ESMAs Guidelines on ETFs and other UCITS issues (cf. Point 42 and 43j of ESMA/2014/937);
- o Many clearing members refuse to be a pass through of the CCP and in particular on the collateral terms; and
- o Most of the clearing members refuse to negotiate prior notices when they modify the collateral terms agreed with clients.

Therefore, we urge here again ESMA to review its position on this latest part of legislation and to:
- Remove the burdens on UCITS and some AIFs[4] put in place by ESMA's Guidelines on ETFs [5]and other UCITS issues (cf. para. 42 in combination with para. 43 j) of ESMA/2014/937, respectively former ESMA/2012/832), especially those related to concentration limits and restrictions to use repos with the aim to produce eligible collateral with asset in their portfolios;
- Impose to CMs to be a pass-through of the CCP's requirements or at least to encourage CMs; or/and
- Impose to CCPs and CMs the acceptance of a broad range of non-cash assets as variation margin.

Question 4: Please provide information and data you may have that could complement this analysis on the level of experience and preparedness of financial counterparties with CCP clearing.

We do not have information available at EFAMA level as the points raised are directly related to the business that each one of our members has.

On a more global perspective, as already stated previously[6], even if we believe that the mandatory central clearing of standardised and sufficiently liquid OTC derivative contracts does not adequately protect end-investors, we do accept its benefits for the objective of systemic risk control.

However, two concerns related to preparedness of central clearing are remaining according to us:

(1) <u>The need for two CCPs to enforce clearing obligation.</u>

We have been insisting on the need to have two different viable CCPs offering clearing services for instruments which are subject to the clearing obligation.

Without this condition, indirectly, we deem it impossible to ensure portability in case of default. This would have for direct consequence to concentrate risks on a single CCP for one class of assets, possibly creating a systemic disaster on that asset class.

[4] Regulators e.g. in Germany have extended those guidelines to AIFs.

[6] See for example EFAMA's reply [ESMA's Consultation Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR)].

(2) The need for trading suspension mechanisms.

We also remain concerned that there is currently no mechanism available to suspend the clearing obligation in emergency situations when clearing is no longer appropriate.

This concern would be increased even more should the European Commission maintain a mandatory clearing obligation of derivatives instruments that would not be centrally clearable in at least two different CCPs.

In contrast, if the clearing obligation were terminated, firms would be afforded the option to de-clear the product and maintain their positions on an uncleared basis and they might more easily find market participants who are willing to transact bilaterally.

Consequently, a brief suspension of the clearing obligation may help end users to execute certain transactions bilaterally, which they are unable to execute via the CCP.

This is likely to reduce systemic risk by firebreaks in allowing bilateral hedging and give every market user some flexibility which may be essential at that time.

Specifically, we believe it is critical that ESMA has the tools to dis-apply the clearing obligation in the event that:

- a CCP notifies ESMA that the liquidity of a class (or contracts within a class) has deteriorated to an extent that it may become difficult for the CCP to risk manage such derivative class; and/or
- the liquidity of the class (or contracts within a class) becomes materially less than that on the basis of which ESMA originally determined to make the relevant class subject to mandatory clearing; and/or
- a CCP stops clearing that class of assets, thereby leaving only one CCP as a viable clearer.

Therefore, we would recommend that EMIR be amended to include a mechanism to enable the short-notice suspension or termination of the clearing obligation in emergency situations.

With respect to the proposed draft technical standard, EFAMA is concerned about the consequences of the proposed postponement. It should be clarified that those transactions for which category 3 entities will benefit from a delay to comply with the central clearing obligation will be exempted from bilateral collateralisation that might become mandatory under EMIR in the meantime.

Question 5: Do you agree with the proposal to keep the definitions of the categories of counterparties as they currently are and to postpone the date of application of the clearing obligation for Category 3? If not, which alternative would achieve a better outcome?

We agree with the proposed approach and would extend it to category 4.

Question 6: Do you agree with the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines?

Yes, we agree with the proposed phase-in period for category 3, and suggests adding two further years to the current deadlines.

We also recommend ESMA to take an identical approach for category 4.

However, we consider that, as rightly pointed in the CP, the delay should be calibrated with reference to the application of the expected amendment to the banking regulation applying to Clearing Members. Therefore, we suggest to apply a delay of two further years or 1 year after the application date of the new banking regulation.

Please see also our replies to questions 3 and 5.

Question 7: Do you agree with the proposal to modify the three Commission Delegated Regulations on the clearing obligation at the same time?

We consider it highly preferable to have a homogeneous approach across all texts.

This would guarantee legal certainty.

We would also recommend to foresee a possible extension to upcoming delegated acts that would been approved before the publication of the final text in the Official Journal.

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