Europe's Central Clearing Mandate on the Horizon

By Emma Davey

The approach to mandatory clearing of over-the-counter derivatives in Europe has not mirrored the swifter, more structured approach seen in the U.S., where the Dodd-Frank Act resulted in the start of mandatory clearing from early 2013.

At the present pace, the earliest that mandatory clearing could begin in Europe will be the end of this year—and the latest it could begin is next summer. However, these deadlines are dependent on a number of factors arising from the European Market Infrastructure Regulation, under which clearing and the authorization of clearinghouses are regulated.

EMIR, which came into force in March 2013, requires mandatory clearing for certain classes of OTC derivatives, as determined by the European Securities Markets Authority, that are entered into by EU authorized counterparties, relevant non-financial counterparties and certain non-EU entities.

Several important details remain to be determined. First, there is the question of determining which products will be subject to the clearing mandate. As specified by EMIR, this follows a bottom-up and top-down approach.

The former looks to the products currently accepted for clearing by an authorized CCP and is set in motion as soon as a CCP is authorized. The latter looks to the European Securities and Markets Authority to determine that a class of derivatives should be cleared even if that class is not accepted for clearing at an authorized CCP.

Secondly, there is the question of when these products should be cleared. Again, this part of the process is set in motion as soon as a CCP is authorized.

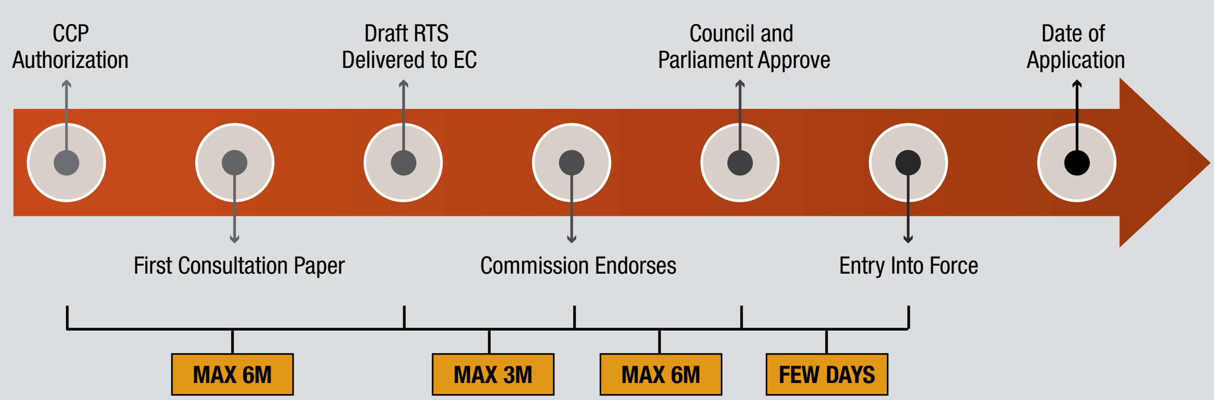
Lengthy Process

CCPs were required to apply for authorization by September last year, and it was expected that each would be approved within six months of their application being deemed complete. As of mid-May, only four CCPs had been authorized:

- Nasdaq OMX Clearing;
- European Central Counterparty (Euro CCP);
- Poland's KDPW CCP; and
- Eurex Clearing.

When Will the Clearing Obligation Apply?

Counterparties to comply following a phase-in to be defined.



Source: ESMA

Frontloading Period		
Period A (8-15 months)	**Period B** (few months up to several years)	
D1	**D2**	**D3**
March 18, 2014 First CCP authorization and notification to ESMA	Nov 14/June 15 Entry into force of the RTS on the clearing obligation (if the conditions for the clearing obligation on those classes are met)	Date of application Frontloaded contracts to be cleared New contracts to be cleared from that date

Following authorization of a CCP by a national competent authority, ESMA must then submit a draft regulatory standard corresponding to that CCP and the classes of OTC derivatives covered by the CCP to the European Commission for endorsement. That process is then followed by a period of consultation for up to six months. The consultation process includes a public consultation and consultation with the European Systemic Risk Board.

Once the Commission receives the draft RTS, it must forward it to the European Parliament and Council and conduct open public consultations on the draft. The Commission has up to three months, from receipt, to endorse it. If the RTS is not endorsed, or is endorsed by the Commission with amendments, the Commission must send the draft back to ESMA, which in turn then has up to six weeks to amend and resubmit it. The Commission must then endorse the RTS.

Only then will mandatory clearing of those classes of OTC derivatives come into effect, 20 days after the final RTS is published in the official journal as a Commission Delegated Regulation.

On the basis of this time line, the earliest that the first OTC derivatives can be mandated for clearing, those listed by Nasdaq OMX Clearing, would be Dec. 18, 2014. The latest would be the summer of 2015.

Uncertainties with Frontloading Requirement

A further complication for CCPs is the application of the frontloading requirement. This is the obligation to clear OTC derivatives contracts entered into after a CCP has been authorized under EMIR and before the date of application of the clearing obligation. Given the 'flexible' timeline between these two points, it is possible that contracts concluded on a bilateral basis following the authorization of a CCP might become subject to the clearing obligation before they have reached expiration. The risk is that certain contracts may not meet the criteria for mandatory clearing even though they are currently cleared by a CCP.

By its own admission, ESMA has identified that this requirement 'may introduce significant uncertainties in the market with the consequences mainly borne by derivatives end-users.'

In a letter to European Commissioner Michel Barnier in May, ESMA chairman Steven Maijoor said that the overall effect of this position "could well be a reduction in the incentive to hedge risks during a certain period (to avoid the consequences of the frontloading effect), which would in turn increase the un-hedged risks and would impact negatively on financial stability."

ESMA adds that "the frontloading requirement poses a significant challenge from a legal, operational and financial point of view, mainly because of the uncertainty that it creates. Indeed, a transaction that is centrally cleared is subject to a different collateral regime than a transaction that is not, and this has a substantial impact on pricing. This pricing uncertainty may have a number of effects such as a widening of bid-offer spreads, difficulties or dis-incentives for counterparties to appropriately manage their risks, which may eventually increase risks and reduce market stability."

In order to mitigate this potential negative impact, ESMA is proposing to amend the clearing obligation so that frontloading may only apply to contracts entered into during the period between the entry into force of the RTS and the date of application of the clearing obligation, the phase-in period (Period B) for each category of counterparty. (see box)

There remains some concern that this step has not gone far enough and ESMA still needs to determine the remaining maturity threshold for contracts which may exclude some contracts entered into in Period B.

The market is awaiting a response to ESMA's request to amend the frontloading period. It is also awaiting authorization of further CCPs which will add to the list of OTC classes that may be subject to mandatory clearing and will bring in new timelines for implementation.

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Emma Davey is director of membership and corporate affairs at FIA Europe.