6 August 2015

2015 EMIR Review

Simon Puleston Jones

EMIR Review - overview

21 May 2015: The European Commission launched a review of EMIR, publishing a questionnaire.

Covers 4 main areas:

- Scope of the EMIR requirements
- Clearing
- Reporting
- CCPs

29 May 2015: The European Commission held a public hearing in Brussels – I spoke as a panellist on various topics relating to clearing.

13 August 2015: Deadline for responses.

FIA EUROPE

Scope of the EMIR requirements

Your proposed feedback regarding scope relates to 5 main areas:

- Equivalence with respect to cross-border activity in the OTC derivatives markets
- Counterparty categorisation
- Counterparties in scope
- The definition of "OTC derivative"
- Portfolio hedging

Equivalence

- Article 13 EMIR: **conflicts with third country laws**
  - Important for intra-group exemption.
  - Impact delayed for 3 years pursuant to the latest RTS for clearing of G4 IRS.
  - No equivalent exemption mechanism in draft RTS for margining of uncleared trades - IM and VM requirements would therefore apply if group-wide gross notional is above EUR3 trillion threshold and both parties are FC/NFC+ (or third country equivalent thereof).

- Article 25 EMIR: **recognition of third-country CCPs**
  - Numerous important assessments still outstanding.
  - Link to CRR deadline of 15 Dec 2015 and reg cap impact of a CCP not being a "QCCP".
  - Various issues relating to timing and frontloading.

- Article 19(6) MiFID I and its relevance to Article 2(7) of EMIR: **definition of "OTC derivative"**
  - ETD on a third country markets currently treated as an OTC derivative under Article 2(7) of EMIR.
  - Such cleared trades therefore count towards the clearing EMIR threshold.
  - We approve of the proposed SFTR changes to the definition of "OTC derivative" in EMIR.

Counterparty categorisation

Firms are finding it challenging to categorise non-EU counterparties:

- Funds with third country AIFMs a particular problem.
- Under Article 4 of EMIR, trades between an EU bank and a non-EU entity may be caught if the non-EU entity would be subject to the clearing obligation if it were established in the EU. It is unclear whether a foreign fund would be equivalent to an FC and so subject to the clearing obligation, or similar to an NFC and therefore exempt.
- [You propose that it be clarified that third country AIFs are FC equivalents – [*TBC*]. This would create a level playing field vis a vis EU AIFs and also with the US (where funds are financial entities).]

FIA EUROPE

Counterparties in scope

Should all FCs be treated the same, both large and small?

Should all NFCs be subject to all obligations under EMIR?

Disproportionate impact on NFC- in particular: are they sufficiently systemically important to justify the cost?

What about Non-EU NFC-? It is incongruous for the EU to extraterritorially apply its margin rules to entities that do not fall under equivalent margin rules in their home jurisdiction.

These concerns regarding Non-EU NFC- are proposed to be addressed in the latest proposed RTS from the ESAs, such that Non-EU NFC- should be excluded from the risk mitigation technique requirements of Article 11.

Definition of "OTC derivative"

- SFTR proposes to amend the definition of "OTC derivative" in EMIR. You agree with the proposed amendments, which would remove the cross reference to Article 19(6) MiFID I, which doesn't work in any event as that article only refers to securities exchanges, not derivatives exchanges.

- Art 2(7) should also be amended so that trades executed on a Regulated Market, an MTF or OTF, or equivalent third country venues (as determined under MiFIR) should be excluded from the definition of "OTC derivative".

- If that change is adopted, EC needs to make a corresponding change to the definition of "exchange traded derivative" under MiFID II.

Portfolio Hedging

- Many NFCs focus all their trading activity across the group into a single entity: such firms can't split out what represents hedging and what represents speculation, without a major restructuring.

- Effect of ESMA Q&A Question OTC 10(c)(3) is that if the firm has a single speculative trade in the group's portfolio, it is not possible to rely on the hedging exemption:

  - this gives an inaccurate impression of the market; and
  - several firms who mostly engage in hedging will not be able to rely on the "ancillary activities" exemption under MiFID II because of the way they are required to report the extent of their speculative trading under EMIR - this not only brings such firms within scope for MiFID II/R and requires them to seek authorisation as an investment firm, but will also in time bring them into scope for the regulatory capital regime under CRDIV.

- You recommend following Canada's approach of adopting a "*<u>reasonable commercial basis</u>*" test for use of the hedging exemption.

FIA EUROPE

Clearing

Your proposed feedback on the topic of "clearing" relates to the following areas:

- Indirect clearing
- Frontloading
- Suitability of OTC derivative contracts for clearing
- The suspension of the clearing obligation
- Trading and liquidation bans
- The clearing threshold for NFCs
- Portfolio compression
- Client choice of account segregation at the CCP
- The impact of regulatory capital and leverage ratio on access to clearing

FIA EUROPE

Indirect clearing

- It must remain voluntary for clearing members to offer an indirect clearing service.

- Lack of certainty on jurisdictional scope for each party in the chain of contracts from CCP to end-user: this is important, because such jurisdiction drives insolvency analysis.

- The "leapfrog" payment and the potential conflict with insolvency laws of Member States and of third countries: You note the industry disagreed with the ESMA/EC analysis but ask the EC to amend the level 1 text to take this issue beyond doubt. If direct client is located in a third country whose insolvency laws conflict with EMIR, the clearing member should not be required to make the leapfrog payment.

- The impact of the Capital Requirements Regulation: CRR should be amended to reflect the exposure reducing effect of segregated margin.

- Is post-default porting of indirect clients' positions viable? Note that such a mechanic was not included in MiFIR's indirect clearing provisions relating to ETD.

- Adopt the MiFIR account segregation options for indirect clearing (GOSA/NOSA).

Frontloading

- Market participants are unable to accurately price trades that will be cleared at a future date.

- You propose that the concept of frontloading for OTC derivatives be removed from EMIR for future asset classes and products.

FIA EUROPE

Suitability of OTC derivatives for clearing

- Detrimental impacts of clearing unsuitable products.
- Clearing members do not have absolute control over what products a CCP chooses to clear: the CCP's risk committee is merely an advisory body.
- A clearing mandate for certain classes of OTC derivatives should only be imposed if:
  - the class is sufficiently liquid and standardised;
  - CCPs have a proven track record of clearing and risk-managing the product; and
  - there is sufficient price reliability/availability in the given class.

Suspension of the clearing obligation

- The trading obligation under MiFIR can be suspended or revoked by regulators.
- ESRB have suggested that the same should be permissible with respect to the clearing obligation under EMIR. As there might be an as yet unforeseen situation where it was necessary for the mandatory clearing obligation to be either suspended or terminated, you agree.
- In such event, clearing members should not be required to “de-clear” the affected trades – rather, they should no longer be required to mandatorily clear new trades.
- EC should give thought to what the impact would be of such trades being executed bilaterally and uncleared.

Trading and liquidation bans

- If all authorised/recognised CCPs have their authorisation terminated/revoked/suspended: What are the processes and the timescales? What are the impacts for contracts that are being cleared by the CCP (both ETD and OTC)? What happens to those markets/Exchanges that use the services of that CCP? What happens to new OTC trades – are they still subject to the clearing obligation? If so, how?

- If the clearing obligation for particular contract/asset class suspended: Who has the power/authority to suspend the clearing obligation? Is that across all CCPs or just in relation to a specific CCP? What is the status of contracts that are already in clearing? Do they continue to be voluntarily cleared? What happens to new contracts? Can they continue to be cleared in the same CCP voluntarily even though the Clearing Obligation has been suspended?

- If a CCP determines not to continue clearing a contract: Would this fall under a CCP's existing processes for de-listing contracts where the CCP normally provides continuity for clearing the contracts until all open interest expires or is closed out – continuing to accept new trades that are risk reducing? Should the CCP to facilitate the transfer of open trades/positions to the other CCP? If so, how? Clearing Members/clients would be forced to use the other CCP.

The clearing threshold for NFCs

The main objections to the current approach are as follows:

- The calculation is based on <u>simple notional</u> rather than a measure of exposure;
- The calculation <u>includes intra-group trades:</u>
  - by their nature, these trades do not create risk to the financial system at large; and
  - leads to double-counting, thus overstating the notional being measured against the clearing threshold; and
- The clearing threshold calculation captures both non-financial counterparties and financial counterparties (that conduct only a small amount of business) that are not systemically important.

You recommend that the European Commission adopt an approach similar to the Major Swap Participant calculation utilized by the CFTC, which excludes intra-group trades and take into account collateralization and other factors to determine whether a non-financial counterparty is systemically important and thus would be subject to the US clearing requirement.

FIA EUROPE

Portfolio Compression

You recommend that if you:

- compress two or more trades (none of which were subject to the EMIR clearing obligation as at the trade date);
- via a certified third party vendor; and
- the output thereof is a new trade that *would* be subject to the EMIR mandatory clearing obligation,

then such new trade should be exempt from the mandatory clearing obligation.

FIA EUROPE

Client choice of account segregation at the CCP

Article 39(5) of EMIR states that the client of the clearing member must confirm its choice of account segregation at the CCP (i.e. ISA or OSA) in writing.

Unfortunately, that Article does not specify:

- by when the client must provide such written confirmation; nor
- what should happen if it does not do so.

Members views are split on the first question: one firm has suggested 30 days after the request for confirmation is provided to the client, another suggested 6 months.

If no confirmation is received, you recommend that the client should be deemed to have opted for the existing account structure through which their trades are cleared at that time (likely to be the client omnibus account).

Impact of regulatory capital and leverage ratio

- EMIR requires a sufficient number of clearing members.

- Primary cost of business for clearing members is regulatory capital under CRR.

- The leverage ratio under CRR results in a finite balance sheet capacity for clearing members to clear derivatives.

- You encourage the European Commission to work closely with prudential regulators, in particular the Leverage Working Group of the Basel Committee, to highlight the detrimental impact that the leverage ratio as currently calculated is having on access to direct and indirect clearing, with the goal of amending the leverage ratio to recognize the exposure-reducing effect of segregated margin.

Reporting

Your proposed feedback regarding the options available for EMIR reporting splits into three:

1. Your starting position for ***ETD*** reporting: ETD contracts should be completely excluded from the EMIR reporting obligation.

2. Your fallback position for ***ETD*** reporting: single sided position reporting should be adopted under EMIR.

3. Your position for the reporting of all ***other derivatives***: single sided transaction reporting should adopted, in place of today's dual-side transaction reporting regime.

CCPs

Your proposed feedback regarding CCPs relates to 5 main areas:

- The 95% reinvestment rule
- CCP access to central bank liquidity facilities
- CCP colleges and supervision
- CCP margining
- CCP risk management

95% reinvestment rule

- Article 44: not less than 95% of all cash balances maintained by a CCP overnight shall be reinvested in repos.
- Is 95% a justifiable figure or should it be lowered?
- Circularity of credit risk - repo counterparties and settlement agents are typically the larger clearing members too.
- Distinguish between the access by European CCPs to central bank funding liquidity and deposit facilities: CCPs should at least have access to central bank deposit facilities.
- LCH.Clearnet have to reinvest c.£150bn a night – is there enough capacity in the repo market for all CCPs to reinvest? Smaller CCPs struggle to meet the reinvestment requirement.
- To the extent that there is insufficient liquidity in the commercial repo markets to enable a CCP to meet its EMIR obligations and to prudently manage its credit and liquidity risks, central banks should fill that gap.

CCP access to central bank liquidity facilities

- No changes to EMIR are required to facilitate such access.

- CCPs should not have to be credit institutions in order to access central bank liquidity facilities, but should nonetheless be subject to CCP Recovery and Resolution requirements.

- Not only in stressed or crisis situations, but at all times:
  - all CCPs (not just those that are regulated as credit institutions) should be able to hold at least some of their cash deposits at one or more central banks; and
  - subject to this being consistent with the liquidity provisions made available to other credit institutions (acceptable collateral being lodged, etc.), such central banks should offer CCPs access to their liquidity facilities, as such an outcome is preferable to a CCP default.

- CCPs should provide transparency as to which liquidity facilities they have access, at what times access is permitted and on what (high level) terms.

- To address time-zone issues, it would be helpful if at least some of a CCP's USD cash balances could be held by CCPs on deposit overnight at European central banks.

CCP colleges and supervision

- Authorisation issues:
  - Greater focus on the extension to a CCP's authorisation, together with further transparency as to what constitutes an extension to such authorisation.
  - EMSA's website be updated regularly with timetables of authorisations, advising of an effective date in advance of an application being deemed completed and/or anticipated date of authorisation.
  - Greater clarity should be provided as to the precise circumstances that require the Article 17 procedure to be followed. In addition, ESMA should seek to provide a standardised list of information required for the college process, depending on whether the process falls under Articles 15, 17 or 49.
- ESMA should ensure consistency of standards across the NCAs and colleges by providing guidelines and standards to those NCAs and colleges, whilst allowing NCAs to remain responsible for review, technical validation and presentation of specific matters to colleges.
- The College should adhere to the timings set out in EMIR. Meetings should be held promptly and all agenda items discussed.

CCP margining

- FIA Global proposes to publish a paper on CCP margin later this year.
- "Which is better: 1 day gross under Dodd-Frank or 2 day net under EMIR?" - it is not that simple…
- The transparency available to affected participants varies, with differing implementation styles.
- The possibility of a "race to the bottom".
- Confidence interval should be a function of liquidity of product rather than classification of products into OTC vs. non OTC.

CCP risk management

Some proposals from the FIA Global paper on CCP Risk form a part of our response.

FIA EUROPE

National Competent Authority feedback to-date

FIA Europe has raised these issues with the UK, French, Dutch and German regulators in recent weeks, during the course of the consultation period.

FIA EUROPE

NCA feedback - scope

Equivalence: These issues are on the EC's radar. Article 13 equivalence may not be granted for all applicable third countries before the clearing obligation goes live. One NCA felt that too much focus is put on the legal text of the third country provisions and not enough on effective execution and supervision of those requirements.

Counterparties in scope: One NCA considers that EMIR should distinguish between systemically important counterparties and non-systemically important counterparties, rather than between FCs and NFC +/-. EMIR has a disproportionate impact on small Financial Counterparties and regional pension funds. Another NCA struggles to understand EMIR's treatment of NFC-: a balance needs to be reached between the regulatory burden imposed on firms and having a transparent market.

Definition of OTC derivative: Support for the carve out of trades executed on RMs, MTFs, OTFs or third country equivalent venues.

FIA EUROPE

NCA feedback - clearing

Indirect clearing: The issues have been discussed a great deal within ESMA: the lack of offering of indirect clearing is a concern. ESMA and some NCAs see no insolvency law conflict with EMIR, but one NCA expressed strong support for your position. Acknowledgement that EMIR cannot override third country insolvency regimes.

Frontloading: Significant support from continental NCAs for frontloading to be reviewed.

Suspension of clearing mandate: NCAs expressed support for your position.

Account segregation: Several NCAs see the case for providing the requested clarification regarding the client's choice of account segregation.

Regulatory Capital/leverage ratio: These issues are on the radar of the NCAs and are a valid point to raise in the FIA Europe response.

FIA Global paper on margin: Regulators encouraged us to ensure this paper discusses the impact of regulatory capital and leverage ratio requirements on direct clients, as well as on clearing members.

NCA feedback - reporting

Reporting down the chain: What are members' expectations for how regulators would have visibility on the trades executed further down the chain, if EMIR exempts ETD reporting on the basis that the data is already available from the trading venue or CCP?

Dual-sided: Regulators like the quality assurance that is (in theory) provided by dual-sided reporting. Whilst there was strong support for single sided reporting at the public hearing, it is now less clear that everyone wants single sided reporting. Potential scope for reconciliation to occur after trade report has been submitted to the trade repository.

Exemption: Some NCAs do not yet have a position on whether ETD should be excluded from EMIR reporting. Some have only focussed on OTC derivative reporting to-date. One NCA prefers transaction reporting to position reporting, as it enables them to see the intra-day activity.

Reconciliation: Some NCAs support the idea of reconciliation post-submission to the TR.

UTIs: NCAs aware that inter-TR reconciliation failure rates are typically driven by non-economic terms.

Purpose: Some regulators use EMIR reporting data for market abuse monitoring.

NCA feedback - CCPs

Access to central bank liquidity by CCPs: This is "a big thing" that "adds further risks". Any arguments we put forward should be based on international standards, e.g. PFMIs.

When CCPs should have access: Two of the continental agree that CCPs need to have access to central bank liquidity not only in stressed situations but also for CCPs' day-to-day business. The discussion is very political – their central bank cannot provide such liquidity access without the European Central Bank's approval.

CCPs as credit institutions: Some NCAs are not yet decided on whether CCPs should be required to be credit institutions in order to have access to central bank liquidity. Whilst France requires all CCPs to be authorised as credit institutions, not all banking rules apply to them. In Germany, CCPs are required to be credit institutions as regulators do not feel EMIR goes far enough on its own – e.g. the German Banking Act enables regulators to fire the CCP's board in the event of significant failures.

RRP: No appetite in Brussels to incorporate CCP recovery and resolution provisions into EMIR.

Risk Committees: Industry must clarify the specific changes to EMIR that it is asking for with respect to CCP risk committees.

Questions