

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

The International Swaps and Derivatives Association ("**ISDA**") welcomes the opportunity to respond to the consultation paper on a proposal to amend the phase-in period of the clearing obligation for financial counterparties with a limited volume of OTC derivative trading activity.

We strongly support the overarching goal of reducing systemic risk in the OTC derivatives market and the central clearing of certain classes of OTC derivatives in central counterparties ("**CCPs**") that have been authorised or recognised in accordance with the requirements of Regulation (EU) No 648/2012 ("**EMIR**"). However, we recognise that access to central clearing remains an issue for certain EMIR-obligated market participants, in particular those with limited derivative trading activity.

We therefore understand the rationale and drivers behind the proposal in the draft RTS included in Annex 5 to extend the phase-in period applicable to Category 3 counterparties. In view of ESMA's market analysis outlined in the consultation paper, we believe that by adding two years to the current compliance deadlines of the small and less systemically important financial counterparties in all three existing clearing obligation RTS¹, will not compromise the overall objective of the clearing obligation to reduce systemic risk². Such a measure will allow for extra time for (i) the EU transposition of the Basel Committee on Banking Supervision ("**BCBS**") Leverage Ratio as a part of the next iteration of the Capital Requirements Regulation ("**CRR**"), and (ii) the market to explore the development, in conjunction with regulators, of safe and efficient indirect client clearing solutions.

However, it is crucial that the European transposition of the BCBS Leverage Ratio include amendments, which will help facilitate the ability of clearing members to offer client clearing services. As it currently stands, the design of the leverage ratio does not appropriately recognise the risk reducing effect of collateral. This means that in certain cases banks need to hold extra capital against the collateral received from counterparties which can ultimately make the cost of transacting in derivatives (both cleared and non-cleared) more expensive. In practice, this will act as a severe constraint on the ability of end-users to gain access to central clearing and may force some to abandon the use of derivatives. As explained in our response to question 2, we believe it is crucial that clearing members are allowed to offset initial margin received from clients against the potential future exposure of the clearing member to client leg of a clearing transaction. Moreover, because such a delay to the phase-in for Category 3 counterparties will further postpone clearing activity and stay the recovery of costs against investments in clearing businesses by clearing members, it is essential that these issues are addressed within the two-year period to allow such businesses to recoup costs and avoid further implementation costs³.

¹ G4 Rates Clearing Obligation RTS – Commission Delegated Regulation (EU) 2015/2205; CDS Clearing Obligation RTS – Commission Delegated Regulation (EU) 2016/592; and EEA Rates Clearing Obligation RTS – Commission Delegated Regulation (EU) 2016/1178.

² We would also highlight that the proposed extension will likely impact the MiFID trading obligation to the extent that the same trades are excluded from the trading obligation at least until the end of the two-year period.

³ In addition to recovery costs against investments in clearing business, a deferral of the clearing obligation will create further implementation costs on dealers, such as additional client outreach costs and amendments to recently launched technical infrastructure.

If such changes are forthcoming, we believe they will help facilitate clearing access for counterparties with a limited volume of activity. However, it must be noted that while the removal of such impediments and the development of alternative clearing access mechanisms will help mitigate clearing access issues, we believe that even with such changes there may be some counterparties who may still face difficulties to access clearing services. The scope of counterparties covered by EMIR is extremely broad, and as the European Securities and Markets Authority ("ESMA") notes, unlike in other jurisdictions where limited exemptions for smaller counterparties exist⁴, there is no specific clearing exemption for financial counterparties with limited activity in the EU. If it is the case that some financial counterparties with limited activity are unable to obtain clearing access, national competent authorities and ESMA may need explore possible ways to address the clearing access issue with the European Commission ("EC") in the context of the EMIR Review – for example, by introducing a potential de minimis exemption for financial counterparties⁵.

This response is intended to continue the constructive ongoing dialogue between ESMA and derivatives market participants, we hope that our comments in this response and follow-up discussions will assist ESMA with the preparation of the form of RTS which will be submitted to the EC.

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?

Please indicate the likely category of counterparties if the determination has not been done yet. For respondents that are in none of the four categories, please indicate the nature of the activity performed in relation to the clearing obligation (e.g. CCP). For associations, please indicate the category of counterparties that you mainly represent.

ISDA represents counterparties in all four clearing categories.

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.

Leverage Ratio

The provision of clearing services is typically a low return-on-equity business that is under pressure as banks' balance sheets are affected by regulatory and structural changes. The increased capital costs to clearing members – due to the treatment of client margin for the purposes of calculating the leverage ratio, in particular – put pressure on clearing businesses that are already under strain. It is important that the time

⁴ For example in the US and Switzerland.

⁵ It must be noted that some Category 2 counterparties may also have limited activity derivatives volumes, and may have been classed as Category 2 counterparties by dint of being part of a larger group of counterparties. These financial counterparties may still face difficulties in establishing clearing arrangements even if they belong to a group (for instance, there may not be within the group an entity with the capability to offer clearing services)

afforded by any delays to existing clearing mandates is used to address and fix these sources of cost pressure, particularly the calculation methodology for the leverage ratio.

In particular, the industry believes that, in the context of a bank exposure created by a cleared derivative transaction, the leverage ratio framework should recognise the exposure-reducing effect of initial margin, particularly as it is not used to increase the bank's leverage. Treating initial margin for client clearing as additional leverage ratio exposure, as under the current leverage framework, unnecessarily and significantly overstates leverage ratio exposure, acting against client clearing businesses, and contradicting the G20 mandate by creating an economic disincentive for clearing brokers to offer clearing services. Preliminary results from our industry LR Quantitative Impact Study (QIS), based on aggregated results from 21 international banks, show that ignoring the exposure-reducing effect of IM for client clearing results in a 79 % increase in client cleared transactions leverage ratio exposure compared to recognizing the exposure-reducing effect of initial margin.

It is important that these issues are addressed irrespective of any delay to particular clearing obligations. This is not least because such a delay will result in further postponement of commercial clearing activity that is necessary for clearing members to recover costs against investments in their clearing businesses, where revenues are necessary to justify continued balance sheet allocation, and could even result in certain clearing members reviewing their decision to offer clearing services.

Please see ISDA's response to the BCBS's consultation on revisions to the Basel III Leverage Ratio Framework for further analysis.⁶

Indirect Clearing

ESMA delivered its draft final amendments to the EMIR indirect clearing RTS to the European Commission (EC) on May 26 (which needs to be endorsed by the EC, and approved by the European Parliament and Council). While the RTS acknowledges some of the concerns that ISDA raised in the consultation process, and takes steps to mitigate certain concerns, the industry will likely need further regulatory guidance and engagement on a number of implementation issues. As a result, firms have yet to work out their implementation strategy with regards to developing indirect clearing offerings for OTC derivatives taking into consideration the complex operational and legal arrangements involved, in particular in a cross-border context.

Other

- KYC – there are certain circumstances, some of which are outside of a clearing member's control, where it may not be able to take on an entity as a client for KYC reasons following due diligence including anti-money laundering and sanctions checks.

It is crucial to note, however, that while removing some of the impediments to offering clearing services will go a way to helping facilitating clearing access for derivatives users with limited trading activity, it is by no means certain that all users will be able to obtain access.

⁶ <http://www2.isda.org/attachment/ODUwMQ==/FINAL%20Joint%20trade%20response%20BCBS%20LR2016.pdf>

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.

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.

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?

While we agree with the proposal to keep the definitions of the categories of counterparties as currently defined – which we believe is the most simple and cost effective approach – we believe that category 4 counterparties should also benefit from an extended phase-in period. In particular, category 4 counterparties may experience the same obstacles to obtaining clearing access as financial counterparties, and thus should be afforded consistent treatment with those counterparties in Category 3. While we understand the rationale for a staggered phase-in schedule so as to mitigate potential disruption, we believe that the risk of such disruption by aligning the phase-in period for Category 4 counterparties with the proposed phase-in for Category 3 counterparties is minor given that the number of potential Category 4 counterparties⁷ is relatively small compared to the pool of Category 3 counterparties. Moreover, given the significant lead time that would have been in place by the implementation dates, the necessity for a staggered implementation will have lessened significantly.

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?

We understand the drivers behind the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines, but as noted above, we believe such proposal should be amended to extend the phase-in period for category 4 counterparties by an extra six months.

We believe that by adding two years to the current compliance deadlines of Category 3 counterparties in all three existing clearing obligation RTS, will not compromise the overall objective of the clearing obligation to reduce systemic risk. By extending the phase-in, we believe that such a measure will allow for extra time for (i) the EU transposition of the BCBS Leverage Ratio as a part of the next iteration of the CRR, and (ii) the market to explore the development, in conjunction with regulators, of safe and efficient indirect client clearing solutions.

⁷ According to ESMA's EMIR Review Report No 1, the number of NFC+s is fairly limited, with 43 groups representing 424 counterparties.

However, it is crucial that the European transposition of the BCBS Leverage Ratio include amendments, which will help facilitate the ability of clearing members to offer client clearing services (see answer to Question 2).

If such changes are forthcoming, we believe they will help facilitate clearing access for counterparties with a limited volume of activity. However, it must be noted that while the removal of such impediments and the development of alternative clearing access mechanisms will help mitigate clearing access issues, we believe that even with such changes there may be some counterparties who may still face difficulties to access clearing services. If it is the case that some financial counterparties with limited activity are unable to obtain clearing access, national competent authorities and ESMA may need to explore ways to address this issue with the EC in the context of the EMIR Review – for example, introducing a potential de minimis exemption for financial counterparties.

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

Yes, we agree with the approach to amend all three delegated regulations