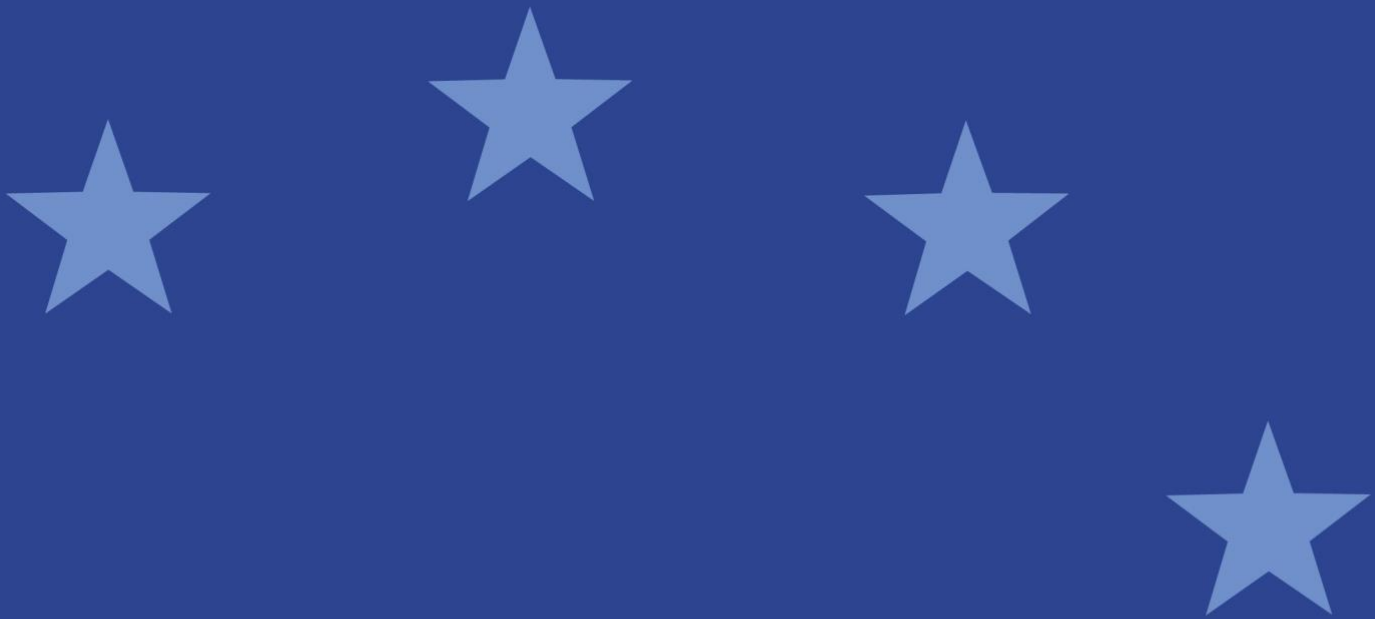




European Securities and
Markets Authority

Response Form to the Consultation Paper

Draft Guidelines for the methodology to value each contract prior to termination (Article 29(7) of the CCPRRR)



Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex III. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **24 January 2022**.

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input - Consultations’.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Please do not remove tags of the type <ESMA_QUESTION_VALPT_1>. Your response to each question has to be framed by the two tags corresponding to the question.
3. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
4. When you have drafted your response, name your response form according to the following convention: ESMA_VALPT_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_VALPT_ABCD_RESPONSEFORM.
5. Upload the form containing your responses, in Word format, to ESMA’s website (www.esma.europa.eu under the heading “Your input – Open consultations” → “Consultation on the Methodology to value each contract prior to termination”).

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you

do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper?

All interested stakeholders are invited to respond to this consultation. In particular, this paper may be specifically of interest for EU central counterparties, clearing members and clients of clearing members.

General information about respondent

Name of the company / organisation	Futures Industry Association and International Swaps and Derivatives Association
Activity	Banking sector
Are you representing an association?	<input checked="" type="checkbox"/>
Country/Region	International

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_VALPT_00>

The Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA), together the Associations, represent the largest number of global and national participants in clearing, banking and financial markets. The Associations appreciate this opportunity to comment on this consultation.

We applaud ESMA for its enormous efforts and impressive work it has delivered on the consultations on CCP resolution, providing a thorough and comprehensive analysis for each of them.

We appreciate the challenging task that ESMA faced when developing these guidelines, as valuation is extremely challenging in a situation when an auction has failed and the resolution authority needs to resort to partial or full tear-up. We make technical comments and identify issues with each of the proposed methods.

This consultation response covers the positions of our members that are clearing members and their clients. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views expressed herein.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

<ESMA_COMMENT_VALPT_00>

Questions

Q1 : Do you agree with the proposed analysis and the corresponding limitations on the use of market standard approaches? If not, please explain why? Have you identified other points not mentioned above.

<ESMA_QUESTION_VALPT_01>

We agree in principle with the proposed analysis and corresponding limitations.

Valuations of contracts before termination must be applied in a very particular situation, and there is therefore little scope to use results of valuations in other contexts or approaches from bank resolution. For instance, the valuation according to Article 24 of CCPRRR might be similar, but not necessarily at contract level and might have been done several hours or days before the actual contract termination. The market price of the transactions to be terminated will have changed by the time the valuation will be needed.

We agree that master agreements are of limited value here, as these agreements look at whole portfolios and might include manual steps that could be difficult to replicate if a larger number of transactions is to be terminated.

That the valuation has to be based on a fair market price is welcome, but the issue in termination (or tear-up) is likely that there is no clear market price. Otherwise, clearing participants would have been able to bid on the auction.

<ESMA_QUESTION_VALPT_01>

Q2 : Do you agree with the proposed analysis on the scope of the methodology and the concept of “contracts”? If not, please explain why and provide your analysis.

<ESMA_QUESTION_VALPT_02>

We agree that the termination will have to affect both sides of each contract, and that – due to compression or trading activity - the other side of the defaulter’s transaction is often not the original contract anymore.

We also agree that this valuation should not cover collateral, but that the CCP should recalculate margin requirement after terminations.

<ESMA_QUESTION_VALPT_02>

Q3 : Do you agree with the interpretation of what could be the resolution authority methodology i.e. the re-use of the valuation methodology of the CCP unless the resolution authority deems it necessary to use another appropriate price

discovery method? If not, please explain why and provide your interpretation of methodology and sequencing.

<ESMA_QUESTION_VALPT_03>

Valuation before termination will be challenging. Termination is usually a fall-back when the auction doesn't work or the CCP cannot close the defaulter's portfolio in another way. One likely reason for a failing auction is that there are no auction participants that are sufficiently confident in their ability to price the auction portfolio to actually bid in the auction. In such a situation, it might be possible that the CCP methodology will also not result in fair market prices.

However, the RA should review the CCP methodology to value contracts as part of the resolvability assessment.

We agree with the proposal that the RA should have regard to the CCP methodology and the choice to use this methodology to value transactions to be terminated but should have a fall-back to provide fair market prices in case the CCP methodology does not provide such fair prices.

Another reason (other than no market price available) for the auction to fail could be that the auction portfolio is too big, and the bid price would need to be too far from the mid for anyone to take it on, either because of the size of market risk or the cost of capital. While this situation could be managed by better design of the auction portfolio (for instance by breaking it down into smaller portfolios), if termination would be necessary, in such a case the underlying products would still be traded. Nevertheless, the prices that could be taken from the exchange or another avenue would not be representative for the termination of a big portfolio, as the valuation based on trades in small quantities would not be a representation of the fair value of the larger contracts in the auction portfolio.

It also needs to be examined whether termination prices should be bid, mid or ask: At banks, contracts must be valued at the price contracts could be liquidated at. If a contract is long, it would be the bid price. If the contracts to be terminated are valued at bid, the firms whose contracts are terminated would have an immediate loss (the difference between their marked price and the mid price).

As to CCP valuation rules, we believe that the "*end-of-day closing or settlement price of the terminated contract for the purpose of daily valuation of positions or daily settlement of profit and loss resulting from the contracts*" (paragraph 46 a) i.). As described above, one reason for terminations becoming necessary is that prices are extremely illiquid. In this case, previous day valuations or settlement prices are likely not representative of market conditions.

For similar reasons, the mid of bid-ask from other venues is also likely not reflective, as there might not be quotes or the bid-ask spread is too wide. See also above as to the general question whether the mid-price is the correct price to use.

<ESMA_QUESTION_VALPT_03>

Q4 : Do you agree with the proposed analysis with regards to the valuation methodology? If not, please explain why and provide your analysis.

<ESMA_QUESTION_VALPT_04>

We believe that the mechanics for valuing contracts that should be terminated based on the CCP default management procedures will likely not be applicable, because termination of contracts will be only necessary when the default management procedure have failed to close out the defaulter's portfolio, as the consultation alludes to.

As to the use of CCP valuation, we disagree with using an end-of-day closing or settlement price (paragraph 46 (a) i.) unless the termination is executed at the same time of the end-of-day or closing valuation. Otherwise, termination would very likely allocate losses to clearing participants subject to termination, as the market price will likely have moved considerably between a closing prices and termination next day, especially in a stressed market situation.

In line with the above, we agree with the principle that "*the termination price should reflect the market conditions prevailing on a day and time that is as close as possible to the day and time of the termination of the contracts*" and propose that "as close as possible" should be a very short time (minutes, not hours).

We would like to highlight that it will be very challenging to find the fair market price in a situation where terminations are necessary. Ultimately, the fair market value is what someone would be willing to pay for the portfolio/contract.

- a) Settlement prices of other CCPs are not necessarily representative if the reason for the termination is a very large portfolio where the fair value would have to include the cost of liquidating a concentrated portfolio (see also our response to question 3). Also, even though another CCP did not suffer a default, their settlement prices could also be set based on very illiquid trading.
- b) Using prices from other trading venues could potentially have the same issues as using settlement prices of other CCPs: trading could be too thin to produce fair prices that could be applied to large terminations.
- c) Likewise, prices obtained from market makers would not necessarily be based on real transactions. While market makers will have an understanding of concentration effects, it will be difficult to locate a market maker for the products in question which will not be affected by the terminations and the ability to provide independent prices.
- d) Theoretical prices could be helpful if the calculation straightforward (interest rate swaps prices determined from interest rate curves based on futures prices), but could be questionable if these models rely on inputs that have to be estimated (e.g. valuing swaptions where some kind of volatility estimate is required).

We also note that valuations depend on the market conditions in each particular case. A tool that might work in one market situation might not be usable in another.

Acknowledging the difficulties in finding fair market prices, we agree with the methods ESMA proposes the RA to use, including the order in which these methods are proposed. We welcome that every possible methodology has a caveat that the outcome should represent a fair market price.

<ESMA_QUESTION_VALPT_04>

Q5 : Do you agree with the Option 2, if not please explain. Have you identified other benefits and costs not mentioned above associated to the proposed approach (Option 2)?

<ESMA_QUESTION_VALPT_05>

We agree with Option 2.

<ESMA_QUESTION_VALPT_05>

Q6 : If you advocated for a different approach, how would it impact the cost and benefit assessment? Please provide details.

<ESMA_QUESTION_VALPT_06>

We do not advocate for a different approach.

<ESMA_QUESTION_VALPT_06>