Response Form to the Consultation Paper

Report on highly liquid financial instruments with regards to the investment policy of central counterparties (EMIR Article 85(3a(e)))

19 November 2021 | ESMA 91-372-1593

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_CCP investment policy_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_CCPinvestmentpolicy_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_CCPinvestmentpolicy_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 financial instruments eligible for investments by CCPs, including EU Money Market Funds").

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	International Swaps and Derivatives Association
Activity	Banking sector
Are you representing an association?	☒
Country/Region	International

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_CCP investment policy_00>

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

We welcome the report on highly liquid financial instruments with regards to the investment policy of central counterparties (the Report) and the analysis performed by ESMA.

The report shows that other jurisdictions allow CCPs a wider list of investments, or are more principle based than EU regulation. While we believe that risk is the paramount consideration in relation to CCP investment policies, we believe that regulation does not need to be overly prescriptive and could be more principle based. We agree that any benefits of a wider range of CCP investments need to be commensurate with the risk of these investments but propose to leave the CCP and its governance forums including supervisors more leeway to determine where the best trade-off between risk and benefits lies for its particular circumstances.

We agree with ESMA's proposals to extend the list of allowed investments, especially explicitly including bonds issued by the European Union.

Discussions about money market funds (MMF) are ongoing. We however note that the most conservative MMFs, public debt constant net asset value (PDCNAV) funds, experienced high inflows and represented a safe haven in times of market turmoil. We believe there should be no reason to delay including a specific sub-set of MMFs which are of the same credit quality and as highly liquid as other instruments eligible for CCP investments, in particular PDCNAV MMFs, as eligible instruments for investment by EU CCPs.

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_ CCP investment policy_00>

Questions

Q1 : Does the above section describe accurately the requirements on CCP investments outside the EU? Are there other jurisdictions that ESMA should consider to inform its analysis?

<ESMA_QUESTION_CCP investment policy_01>

We welcome that ESMA has collected requirements on CCP investment in global guidelines and other jurisdictions. agree that the section above question 1 overall describes accurately the requirements on CCP investments outside the EU. We don't think that adding other jurisdiction to this analysis will create much additional value. The summary shows that many jurisdictions, all deemed equivalent to the EU, already allow the use of MMF for investment of cash margin at CCPs.

<ESMA_QUESTION_ CCP investment policy_01>

Q2 : Does the above section provide an accurate description of CCP practices regarding their investment and collateral policies?

<ESMA_QUESTION_ CCP investment policy _02>

We agree with the description of CCP practices regarding their investment and collateral policies, but would like to make a few points:

Paragraph 35 states that "*an EU CCP can either deposit the cash received from clearing members in a central bank or in another financial institution, or reinvest it in highly liquid debt instruments.*" Our understanding is that the majority of CCPs (outside certain CCPs in Asia) will not deposit cash in accounts at other financial institutions, which would be a large credit risk, but in reverse repos. While these two forms of investment might technically fall under the same heading, the credit risk of bank deposits and reverse repos is considerably different. This also affects the chart below paragraph 36. It would be helpful if this chart made a difference between reverse repos and unsecured cash deposits at commercial banks.

In this context it would also be helpful to analyse the depth of the repo market in jurisdictions where CCPs use material levels of cash deposits at commercial banks, citing no available better choices for investment of member cash.

The same figure shows that a lot of CCPs have access to central bank accounts to deposit cash IM, which is the safest way to invest cash margin and is also the best option in terms of liquidity management. Central bank accounts to deposit cash are however usually only available in the home currency of the CCP.

The dashboard shows that in particular US CCPs invest a very large part of cash margin in central bank accounts. This is for safety and liquidity, but we believe also because investment returns offered by the Federal Reserve are currently more favourable than the returns money market fund currently offer.

<ESMA_QUESTION_ CCP investment policy_02>

Q3 : Does the above section accurately describe the trade-offs faced by CCPs when developing their investments strategies? What other factors or trade-offs can influence CCP investment strategies?

<ESMA_QUESTION_ CCP investment policy_03>

We agree with the description of the trade-offs faced by CCPs when developing their investments strategies, especially the statement that the most secure form to hold cash remains in central bank accounts. We encourage central banks and regulators across the globe to offer as much access to central bank deposits in as many currencies as possible for CCPs.

CCPs require a broad range of investment opportunities though, for instance in cases where

- central bank deposits are not available, either because this is not an option in the CCP's jurisdiction, or the central bank only accepts deposits in the home currency
- cash needs to be invested overnight after the central bank's investment window has closed.
- The CCP, potentially directed by its members, seeks better investment returns within strict risk controls.

We agree that there are trade-offs for CCPs for investments where central bank deposits are not an option. Money Market Funds would be helpful to give a CCP more flexibility, as long as CCPs use only the most conservative types of MMF (see the responses to questions further below for more details).

<ESMA_QUESTION_CCP investment policy_03>

Q4 : Do you agree with ESMA's premise that changes to the list of financial instruments for CCP investments should be in line with the PFMI?

<ESMA_QUESTION_ CCP investment policy_04>

We absolutely support that all changes to CCP investments, as with other facets of risk management frameworks, must be in line with the PFMI.

We agree with the statement in paragraph 69 that diversification of investments can reduce risks and note that for instance the use of MMF could also provide operational benefits, especially for smaller CCPs that cannot afford a treasury trading desk, or for investment in currencies which are not the home currency of the CCP, or which are in a different time zone.

<ESMA_QUESTION_ CCP investment policy_04>

Q5 : Do you agree with ESMA's policy approach that benefits should outweigh risks to support a policy change?

<ESMA_QUESTION_ CCP investment policy_05>

We fully agree that the policy approach should only be changed if the benefits outweigh risks. Given the nuances of CCP risk management frameworks, we believe the policy should allow CCPs to adapt their risk management framework in a way that benefits outweigh risks in their particular case. It is difficult for regulation to prescribe where this balance between risk and benefits lies for each CCP, particularly given how much can and does change in the market and in other regulation in the time before a regulatory issue is commonly revisited.

We believe that ESMA shouldn't refrain from enacting policy changes because there might be specific cases where benefits don't outweigh risks.

CCPs themselves apply stringent risk controls. CCPs' central function is risk management and CCPs have carefully constructed risk controls and governance. A CCP's members also have an interest in extremely conservative risk management frameworks. Their participation in for instance the risk committee of a CCP will give them as a group a lever to ensure investment policies that won't take undue risks. CCPs are heavily regulated and supervised, often by multiple regulators, helping to ensure day-to-day governance and also allowing finer control of CCP investment as regulation evolves (such as the introduction of the MMF regulation) and the market conditions like the interest rate levels changes. Neither of these governance structures will accept changes that would introduce risks that outweigh benefits.

<ESMA_QUESTION_ CCP investment policy_05>

Q6 : Do you agree with ESMA's approach to focus on the list of conditions to define highly liquid instruments bearing minimal credit and market risk? Do you believe it would be appropriate to align EMIR with other definitions of highly liquid instruments in the EU financial legislation, such as CRR?

<ESMA_QUESTION_ CCP investment policy_06>

We agree with ESMA's approach to focus on the list of conditions to define highly liquid instruments bearing minimal credit and market risk.

It will at least be appropriate to analyse whether EMIR could be aligned with other definitions of highly liquid instruments in the EU financial legislation, such as CRR, as long as the context of these definitions is the same. Such analysis should take into account the differences between purpose of the CRR and purpose of the CCP investment policy controls and the differences in how investment banks and CCP apply their respective risk controls.

<ESMA_QUESTION_ CCP investment policy_06>

Q7 : With regards to condition (a) on public entities outlined in Annex II:

i. Should the list of international organisations be expanded beyond the EFSF and the ESM to explicitly include the EU?
ii. Should it include other international organisations (IMF? BIS? Others?)?
iii. Do you agree with ESMA's legal analysis that it is not necessary to explicitly include regional governments and local authorities as these should be covered by the generic term of government under condition (a)(i)? Should ESMA consider adding conditions similar to those outlined in Article 115 of the CRR?
iv. Should ESMA consider limiting the list of governments and central banks in particular to those from third-countries deemed to have equivalent regulatory and supervisory arrangements?
v. Do you agree that the list of multilateral development bank listed under Article 177(2) of CRR is suitable?

<ESMA_QUESTION_ CCP investment policy_07>

We agree with the suggestion to expand the list of eligible public entity investments, as suggested, provided that they meet the conditions applicable to highly liquid financial instruments as set out in Annex II.

We also agree with the list of international organisations be expanded beyond the EFSF and the ESM to explicitly include the EU, IMF, BIS and similar entities.

To sub-question iv, we don't believe that equivalent regulatory and supervisory arrangements are relevant for government bonds: all that should count is the credit quality and market risk of these government bonds.

<ESMA_QUESTION_ CCP investment policy_07>

Q8 : Should ESMA consider expanding condition (a) to certain debt instruments issued or backed by private entities? If so, to which type of corporate debt securities (Commercial Paper, Certificates of Deposits, covered bonds, etc.)? Under what conditions? How would the benefits outweigh the added risks?

<ESMA_QUESTION_ CCP investment policy_08>

We do not object to the inclusion of corporate debt securities in the list of eligible investments, subject to strict criteria to ensure they are as highly liquid, and of as high credit quality as other eligible collateral (as assessed by the CCP's credit risk management framework); and that CCPs can demonstrate that they can immediately convert securities to cash.

- They should be subject to appropriate concentration limits and other risk mitigants to reflect credit and market risk and to reduce the risk of losses to the CCP.
- There should be transparency around CCP's risk management of its investment, to ensure that clearing members and participants are aware of the risk posed.

As the CCP makes the choices on its investments, it should be clear that the CCP is responsible for any investment-related losses.

Any such debt instruments should be required to meet the conditions applicable to highly liquid financial instruments as set out in Annex II.

<ESMA_QUESTION_ CCP investment policy_08>

Q9 : With regards to condition (b) on CCP internal assessments in Annex II:

i. What are, to your knowledge, the best practices used by CCPs to identify low credit and market risk?

ii. What are the safeguards put in place to avoid overreliance on external opinions, notably CRAs?

iii. In order to avoid supervisory divergence, do you deem necessary that ESMA issue further guidance on how NCAs should assess these provisions?

<ESMA_QUESTION_ CCP investment policy_09>

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<ESMA_QUESTION_ CCP investment policy_09>

Q10 : With regards to condition (c) on the average time to maturity, do you believe that this time period is appropriate? Should its calculation be further specified in the RTS?.

<ESMA_QUESTION_ CCP investment policy_10>

We do not believe that the RTS needs to be more prescriptive in this respect.

<ESMA_QUESTION_ CCP investment policy_10>

Q11 : With regards to conditions (d), (e), (f) and (g) under Annex II, should these be amended?

<ESMA_QUESTION_ CCP investment policy_11>

We propose that condition (e) ("*freely transferable and without any regulatory constraint or third-party claims that impair liquidation*") should be looked at in a more pragmatic way:

While it is important that there are no third-party claims that impair liquidation, the fact that MMF could theoretically have gates and fees should not be seen as a reason these instruments are not freely transferrable.

Firstly, we note that no MMF in the EU activated any fees/gates in the 2020 liquidity crisis.

Secondly, a situation in which a PDCNAV manager would have to enact gates and fees would be a situation where a CCP would not be able to liquidate its liquid resources either, given that PDCNAV MMF's investment criteria are even more conservative as CCP investment criteria. Admittedly the decision whether invoke gates or other measures would in this case not be made by the CCP, whereas in the case for direct investments the CCP can make liquidation decisions itself.

Generally, gates could incentivise procyclical behaviour (market participants liquidating their investment in advance of the potential use of gates, therefore making the use of gates more likely) and should be abolished, at least for certain types of MMF. Paragraph 132 of the consultation states that under SEC regulation ("Rule 2a-7") for instance, the use of gates or liquidity fees is not mandatory for "Government MMFs". A similar rule should be enacted in the EU.

We also note that in March 2020, even US Treasuries did not have "*an. active outright sale or repurchase agreement market*".

<ESMA_QUESTION_ CCP investment policy_11>

Q12 : Do you agree with this conclusion? To what extent are MMFs currently used as collateral or CCP investments beyond the EU?

<ESMA_QUESTION_ CCP investment policy_12>

The moderate to low use of MMFs by non-EU CCPs should not mean that their use by EU CCPs should continue to be barred. ESMA's research shows that many jurisdictions do allow investment in MMFs by CCPs and they are used (see sections 3.3 and 5.2.3 of the report). Adding MMFs to the range of permitted investments for EU CCPs would bring benefits of diversification and flexibility, allowing optionality to mitigate risk as market and regulatory circumstances change.

The consultation notes the liquidity stress experienced by MMFs during the Covid crisis. We note that liquidity stress was market wide and yet the most conservative MMFs, public debt constant net asset value (PDCNAV) funds experienced high inflows and therefore represented a safe haven in times of market turmoil. This in itself is unsurprising. The EU's introduction of the MMF Regulation has brought standardisation and increased security to MMFs, while at the same time providing helpful labelling to distinguish the different types of funds. The Covid crisis has acted as a real-world test of PDCNAV MMFs, so we believe there should be no reason to delay including PDCNAV MMFs as eligible instruments for investment by EU CCPs.

We note that certain other types of MMFs, such as private debt funds, experienced stress and outflows. Consultations on the causes of the liquidity stress, including from the FSB, ESMA and the PWG in the US all indicate that gates and suspensions can have a pro-cyclical effect[1]. While no EU MMF used gates or suspensions, investors' concern of gates being applied may have driven withdrawals. We expect to see regulatory movement to remove this pro-cyclical effect, to increase the stability of such funds in the next crisis.

In general, we agree with ESMA's conclusion to consider allowing CCPs to invest in a specific sub-set of MMFs which are of the same credit quality and as highly liquid as other instruments eligible for CCP investments, subject to certain conditions:

- Cash needs to be immediately returnable.
- MMF investments should be restricted only government debt funds.
- There should be concentration limits, with max concentration size linked to issuance and issuer.
- Regular due diligence on the funds performed by the CCP.

As the CCP makes the choices on its investments, it should be clear that the CCP is responsible for any investment-related losses.

<ESMA_QUESTION_ CCP investment policy _12>

[1] Please also see the SEC's proposed rule on Money Market Reform (pages 31 - 26)

Q13 : Do you agree with the premise that the assets held by eligible MMFs for CCP investment should at least meet the same criteria as for other financial instruments?

<ESMA_QUESTION_ CCP investment policy_13>

We agree with the premise that the assets held by eligible MMFs for CCP investment should at least meet the same criteria as for other financial instruments.

<ESMA_QUESTION_ CCP investment policy _13>

Q14 : In your view, how could ESMA bridge the need for macroprudential tools for MMFs and the need for high quality and highly liquid collateral for CCPs?

<ESMA_QUESTION_ CCP investment policy_14>

Please refer to our response to question 11 and 12: The fact that MMF could theoretically have gates and fees should not be seen as a reason these instruments are not freely transferrable. During the 2020 crisis, PDCNAV MMFs had huge inflows.

A situation in which a PDCNAV manager would have to enact gates and fees would be a market so stressed that a CCP would not be able to liquidate its liquid resources either, given that PDCNAV MMF's investment criteria are even more conservative as CCP investment criteria, even though in such a situation the CCP has less control as it would have if it managed the investments itself.

<ESMA_QUESTION_ CCP investment policy_14>

Q15 : Do you agree with ESMA that it is not appropriate at this stage to decide on the potential eligibility of MMFs for CCP investments before policy discussions on MMFs at the international and EU levels are finalized?

<ESMA_QUESTION_ CCP investment policy_15>

We note that the policy discussions on MMFs at the international and EU levels will develop over a very long timeframe.

In the meantime, we propose to consider allowing CCPs to invest in a specific sub-set of MMFs (the most conservative class of MMF, PDCNAV, or MMF that invest in assets at least as conservative as the CCP is allowed to invest in), which are of the same credit quality and as highly liquid as other instruments eligible for CCP investments, subject to certain conditions (see question 12).

This would allow CCPs to benefit from diversification in investment tools and potential operational improvements / ease of use. Whether other MMF types are suitable for CCP investments should then be considered after MMFR has been reviewed.

<ESMA_QUESTION_ CCP investment policy_15>

Q16 : What would be the costs and benefits of extending the list of financial instruments considered highly liquid with minimal market and credit risk, in the context of EU CCPs' investment policies?

<ESMA_QUESTION_ CCP investment policy_16>
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Q17 : What would be the costs and benefits of extending the list of financial instruments to money market funds authorised in accordance with MMFR?

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