

Response to the ESMA PTRR consultation

Executive Summary

Despite the efforts of the financial industry to clear portfolios of suitable transactions, firms still have sizeable bilateral portfolios. These portfolios mostly consist of transactions for which clearing is unavailable or where there is no widespread use of clearing in those markets. These portfolios can pose risks and liquidity requirements that firms want to reduce.

To reduce risk in uncleared portfolios, we propose that transactions that are the result of Post Trade Risk Reduction (PTRR) services should – to the extent they are in derivatives classes that are otherwise subject to the clearing obligation (CO)- be allowed to remain uncleared.

To achieve this risk reduction in a controlled manner, we propose an exemption from the CO for such technical risk reducing administrative transactions under the following strict conditions:

- Independence of in-house traders to avoid gaming: PTRR exercises should be performed by providers independent of the market participants.
- Risk reduction exercises need to demonstrate that the risk in each affected bilateral portfolio has been reduced.
- For each bilateral administrative transaction resulting from risk reduction exercises, an equal and opposite transaction must be booked facing a CCP.

These conditions would remove any potential risk that these exercises can be used to avoid the CO and to book price forming trades into bilateral portfolios.

We also note that the derivatives market is global and that PTRR exercises will affect global portfolios. We therefore urge other policymakers to follow suit in exempting from the CO technical risk reducing transactions resulting from PTRR exercises.

Introductory remarks

The CO has played an integral role in the development of OTC derivative markets in recent years. Initial objections have, over time, been largely mitigated as services have matured and more sophisticated post-trade risk management tools have emerged.

In terms of day-to-day trading activity, the industry does not believe it is necessary or appropriate to remove the CO or otherwise add trader discretion to it. To add some colour:

- From an industry perspective, the growth of the OTC derivative market and its ability to serve the needs of clients has been greatly enabled by clearing. Without clearing, limitations on scarce resources (e.g. capital, funding, leverage, balance sheet) across the industry would severely limit market efficiency. Furthermore, and crucially, the vast enhancements in the efficiency of trade compression since the initial implementation of the CO have resulted in a

situation whereby around 75% of trade volume within the year is compressed and, when trade maturities are included, year-end notional amounts outstanding at CCPs are broadly similar¹ to those at the beginning of the year.

- Clearing has increased steadily, as shown by graph A8 in the latest BIS “Statistical release: OTC derivatives statistics at end-December 2019”². Compression has increased at a similar rate, enabling the increases in cleared transactions.

In short, for those products where it is available, clearing – together with compression and other post trade risk reduction (PTRR) services - has become a very efficient solution while, as set out by the G20, greatly reducing the overall risk in the system.

Bilateral Portfolios

The trades that remain in bilateral portfolios between firms are often complex and customised. These portfolios mostly consist of transactions for which clearing is unavailable or where there is no widespread use of clearing in those markets. Unfortunately, simply expanding the scope of CCP service offerings to encompass such trades would represent a systemic risk that was recognised, and ruled out, by policymakers and regulators when designing regulation like EMIR.

However, while the first order counterparty risks are mitigated by margining of these portfolios, these portfolios can pose a growing, emergent risk to firms and the wider market:

- Default competition risk: If a market participant defaults, both CCPs and non-defaulting market participants, may compete for hedges to close out the defaulter’s risk. The larger the bilateral portfolios, the greater this competition can become.
- Liquidity risk: Bilateral positions can have different directionalities, and tend to be offsetting to a large degree. Large market moves trigger large margin payments and a firm cannot rely on receiving all incoming margin receipts on time so has to fund the gross outflowing margin.

In addition, there are general liquidity issues caused by inefficient margining: In the bilateral portfolios. Margin (both IM and VM) has to be paid/posted to/by each counterparty. As a result, the requirement for high quality liquid assets (HQLA) is large and, in times of stress, might cause problems for some market participants with lesser access to liquidity.

To reduce these risks in uncleared portfolios, we propose that transactions that are the result of PTRR services should – to the extent they are in derivatives classes that are otherwise subject to the clearing obligation - be allowed to remain uncleared. As an example, in foreign exchange G10 NDFs are already used to manage these risks.

¹ within approximately 10% rounding tolerance

² See https://www.bis.org/publ/otc_hy2005.pdf. For more granular detail, in January LCH published a press release announcing, once again, record volumes cleared in 2019. Specifically, to quote: “In 2019, SwapClear, LCH’s interest rate derivatives clearing service, registered over \$1,229 trillion in notional, an increase of 14% from 2018’s volumes. Compression volumes also continued to grow, with more than \$920 trillion compressed over the course of the year, up 19% from 2018.”

To achieve this risk reduction in a strictly controlled manner, we propose an exemption from the CO for such technical risk reducing transactions under the following strict conditions (see also further under Question 9 below):

- Independence of in-house traders to avoid gaming: PTRR exercises should be performed by providers independent of the market participants.
- Risk reduction exercises need to demonstrate that the risk in each affected bilateral portfolio has been reduced.
- For each bilateral technical risk reducing transaction resulting from risk reduction exercises that is exempt from the CO, equal and opposite technical risk reducing transactions must be booked facing a CCP (on a net basis).

We believe, therefore, that in these strictly controlled circumstances, this proposal presents a viable and controlled mechanism to bring increased efficiency to the market and to mitigate the risks described above (that are developing as a result of the success of clearing). This approach uses existing, well understood and liquid products to manage risks.

Benefit for collateral markets

In addition to the clear risk reduction benefits for the derivatives market, there is a not to be underestimated additional benefit. Many of the regulatory changes since 2008 depend on collateral availability. Despite the huge increase in government and other types of bonds, availability of such high quality collateral is restrained for a number of reasons. This can be observed in particular at quarter-ends but also in stressed market conditions like the recent COVID-19 crisis. The ICMA ERCC continues to encourage industry wide discussions to optimise the use of collateral, avoiding a potential gridlock that would jeopardise the important reforms so far achieved. Availability of collateral has to be sufficient, transmitted without any delay to achieve same day settlement for both bilateral and centralised clearing purposes in the right currency, the right amount and the correct location. Shortening settlement cycles as well as increasing electronification of the financing markets through further industry innovation will play an important role in the predictability of IM and VM for derivative market users. The central bank community is making huge efforts to accommodate today's financing needs through expanding the scope of eligible of collateral. This is a topic not directly addressed in this consultation but clearly of huge importance. PTRR services are one important step in achieving the goal of the G20 regulatory agenda.

Question 1: Would you agree with the description of the benefits (i.e. reduced risks) derived from PTRR services? Are there any missing? Could PTRR services instead increase any of those risks? Are there any other risks you see involved in using PTRR services?

The description of the benefits derived from portfolio compression is broadly accurate in that it does help reduce risks such as operational and ultimately systemic risks, by reducing the number of transactions and/or notional exposure between counterparties. Bilateral compression of uncleared transactions or compression of cleared transactions, by its very risk-neutral nature, does not materially impact counterparty risks, whereas multilateral compression of bilateral uncleared transactions tends to also reduce counterparty risk.

The description of other PTRR services, such as rebalancing, is accurate and, unlike bilateral compression, does have an impact on counterparty risk.

For more descriptions on compression please refer to our 2018 whitepaper “EMIR REFIT: Incentivizing Post-trade Risk Reduction”.³

PTRR services have evolved to reduce second order risks, such as operational, counterparty, and systemic risk. Both cleared and non-cleared portfolios are optimized to minimise the build-up of notional amounts, trade count and counterparty risk, which both market participants and regulators recognize as helping to reduce systemic risk.

We believe that portfolio compression and PTRR services can play an important role in the migration from legacy reference rates and benchmarks (IBORs) to risk free rates (RFR). The use of such services should not be disincentivised by subjecting resulting transactions to the clearing or margin requirements.

The transition to new reference rates, both for the replacement of legacy benchmark rates in trade terms (such as IBORs) as well as reformed risk-free rates used by CCPs (SOFR discounting/PAI) is already being facilitated by PTRR services as part of their optimisation suite. Balancing risk between the uncleared derivatives market and centrally cleared portfolios, as well as venues for exchange-traded derivatives (futures & options) has emerged as an important service over and above notional compression services and is commonly summarised as “risk rebalancing”.

Other objectives of PTRR services include reduction in funding impacts, exposures under stress test scenarios, increasing legal and operational robustness by migrating trades and risks to standardised trade platforms and mitigating settlement and funding risks to payment/settlement netting processes.

³ <https://www.isda.org/a/TDmEE/EMIR-REFIT-Incentivizing-Post-Trade-Risk-Reduction-Whitepaper.pdf>

Question 2: Would you agree with this description of portfolio compression? Please explain the different compression services that are offered and how they may differ from the description above. Are there today viable alternatives to using PTRR services to achieve a similar outcome?

We agree with the description in the consultation paper of portfolio compression as it applies to bilateral compression. However, compression is much more efficient on a multilateral basis, as trades across multiple dealers involved in a compression cycle can be offset, reducing the open risk in bilateral relationships. As with bilateral compression, there is no change to overall market risk exposures. Please refer to our whitepaper “EMIR REFIT: Incentivizing Post-trade Risk Reduction” for an illustration of multilateral compression.

We believe that the description of compression in a CCP in paragraph 14 of the consultation paper is not correct: “CCPs may perform compression as, by interposing themselves between two counterparties, the CCP ends up with several transactions with different counterparties and may conduct netting or termination of exposures where only the net exposure would remain as the exposure towards the CCP within the given parameters”. It looks like these sentences describe multilateral netting, which will reduce the risk of cleared transactions regardless of the use of compression. CCPs do use compression, however.

Question 3: Without changing the market risk of the portfolios, how different can the transactions included in the portfolio compression exercise be? Would the market risk be changed at all by the applied tolerances and if yes, how can the portfolio remain market neutral? What tolerance levels are often applied and could/should restrictions be placed on tolerances?

Without the application of basic risk tolerances as part of compression or risk rebalancing cycles, such exercises would either result in strongly impaired results or in uncontrolled risk exposures post-exercise. Risk tolerances therefore form an essential part of these processes. They are typically applied to a variety of market risks such as outright/first-order risks to the underlying risk factor, curve and discounting sensitivities, but equally to counterparty credit risk measures. Without such tolerances, the risk profile of an existing portfolio of derivative transactions would not be maintained, nor could counterparty credit risk exposures be kept within a stable boundary or moved to offsetting counterparty exposures. Some risk tolerances are driven by the need to accommodate different trade and collateralisation terms, both between uncleared counterparties and CCPs. With risk tolerances constantly evolving, counterparties are motivated to put in place and document a framework for such tolerances as part of derivative optimisation exercises. A prescriptive framework would not be able to accommodate counterparty-specific risk considerations, as counterparties may want to accommodate idiosyncratic risk profiles specific to their institution. An example of firm specific risk considerations are existing counterparty and market risks over and above the specific compression portfolio: the counterparty credit risk sensitivity to exchange-rate movements, which will only be partly driven by a subset of trades included (e.g. in a cross-currency compression cycle).

This flexibility in terms of tolerances should be maintained.

Question 4: Should there be a clearing exemption for PTRR trades that are a direct result from a portfolio compression? If not, why? Is there a difference between bilateral and multilateral portfolio compression for the sake of an exemption?

Generally, bilateral and multilateral compressions are broadly similar in approach however multilateral compressions offer much greater opportunities for efficiency. In addition, bilateral compressions can be run directly between two firms without the involvement of a service provider. However, our proposal is that a clearing exemption for any new technical risk reducing transactions that might result should only be available where there is the involvement of an independent service provider, subject to appropriate supervision.

While historically trade compression has operated on the basis of fully or partially terminating existing trades, recent developments have focussed on terminating a greater number of trades and recreating the risk on standardised new transactions, commonly called “risk replacement trades”. This allows the transition of a greater number of existing trades to new standardised terms. As an example, a PTRR/compression service is already applied today to existing Libor transactions and replacing them with new risk free rates-based trades, aiding the transition from legacy benchmark risks and cash flows. It is therefore important to exclude such risk replacement trades from any CO, as the CO may create a disincentive to the use of such trade compression approach. Only allowing the termination of existing trades would create a disincentive to the migration to risk free rates. Counterparties should document why such risk replacement trades have been chosen as part of a compression exercise.

Question 5: Would you agree with this description of PTRR Services? What other forms of PTRR services exist? What do they do? How do they work? Are there any other viable alternatives to PTRR services, if yes, why are they not sufficient?

The example of multilateral risk mitigation using offsetting transactions provided is presented as being “simplified” and we accept this. We would note that the dividing line between multilateral compression and PTRR services is not particularly clear.

However, while the use of such PTRR service is illustrated in a broadly accurate manner, the reality of the process is more complex. In addition, the nature of the products used (i.e. short dated swaptions) means that there is no ongoing build-up of bilateral transactions. It does, nevertheless, require regular runs of the service (at roughly the frequency of the swaption’s expiration dates) to ensure the portfolio remains rebalanced over time. As such, the contribution of existing PTRR services to the EMIR portfolio compression requirement is relatively immaterial.

Worked Example:

The example table below shows the interest rate sensitivities that a typical firm (“Firm A”) might have to bilateral counterparties, using anonymised, randomised but representative figures:

EUR	Exposure/Sensitivity (Measured in EUR gain/loss for a 1 Basis Point move in the EUR Rates Curve Point)										Sum
	2w	3m	6m	1y	.....	10y	15y	20y	30y		
LegalEntity1	-108	-4,299	2,718	98	.....	63	0	0	0		21,388
LegalEntity2	0	-54	237	-55	.....	0	0	0	0		198
.....											
LegalEntity12	-35	41,979	4,682	57,807	.....	-23,175	484,782	-274,055	505,676		848,667
LegalEntity13	17	4,777	-32,965	49,806	.....	72,792	21,017	47,659	1,211		206,176
LegalEntity14	-986	-169,469	11,092	38,604	.....	348,982	230,065	-57,848	-23,081		112,946
.....											
LegalEntity43	306	-46,536	13,249	-37,293	.....	-17,053	28,342	-6,266	-86,834		415,995
LegalEntity44	-429	4,298	21,482	-56,451	.....	-119,882	-796,869	-421,892	158,647		-1,645,279
LegalEntity45	1,762	9,277	-8,002	-146,689	.....	-163,414	-14,432	-164,264	128,629		-4,784
.....											
LegalEntity46	2,270	12,227	-1,993	63,116	.....	-71,706	-8,739	-76,272	36,654		-49,592
LegalEntity47	2,198	78,428	6,961	-4,880	.....	-862	151	177	-184		53,153
LegalEntity48	0	-1,126	-3,984	1,603	.....	0	0	0	0		-4,704
.....											
LegalEntity58	0	-19,862	6,969	-273	.....	-19	0	0	0		-13,044
Net Total	-7,785	-274,731	147,949	133,816		-170,108	-258,573	-86,287	-270,742	total =	1,806,389
.....											
Total where DV01 >0	13,238	350,037	373,553	864,636		1,834,241	1,167,037	1,046,446	980,748	total =	13,061,852
Total where DV01 <0	-21,023	-624,768	-225,604	-730,820		-2,004,349	-1,425,610	-1,132,732	-1,251,490	total =	-11,255,463
.....											
Sum ABS(DV01)	34,261	974,805	599,157	1,595,456		3,838,589	2,592,647	2,179,178	2,232,238		24,317,314

To explain further, this table shows the sensitivities a Firm A has facing, in this case, 58 different legal entities, to a 1 basis point move in the EUR interest rates (“DV01”):

- For instance, looking at the table above, if the 10y EUR Interest Rate increases by 1 basis point, and no other rate moves in the entire market, then Firm A would make a gain on its portfolio facing LegalEntity14 of EUR 348,982, a loss on its portfolio facing LegalEntity45 of EUR 163,414 etc.
- Likewise, for a single basis point increase in just the 10y EUR interest rate, across the entire 58 bilateral portfolios Firm A would suffer an overall loss of EUR 170,108. Overall, Firm A would make a total gain of EUR 1,834,241 from those portfolios where it has positive sensitivity, and EUR 2,004,349 in losses from those portfolios with negative sensitivity.

If the example is extended to a 1 basis point upward shift in ALL of the rates that make up the entire EUR interest rate curve (while keeping all other market factors constant) this would imply:

- Firm A would make a gain on its portfolio facing LegalEntity14 of EUR 112,946, a loss on its portfolio facing LegalEntity45 of EUR 4,784 etc.
- Likewise, for this single basis point increase across the entire EUR interest rate curve, across the entire 58 bilateral portfolios Firm A would make a total gain of EUR 1,806,389. Overall, Firm A would make a total gain of EUR 13,061,852 from those portfolios where it has positive sensitivity, and EUR 11,255,463 in losses from those portfolios with negative sensitivity.
- As can be further seen from the table, the net sum of the sensitivities that Firm A has to a 1 basis point rise in EUR interest rates is EUR 1,806,389, however the gross sum of these sensitivities is EUR 24,317,314.

Unfortunately, these exposures cannot simply be cleared. The transactions in these portfolios also give rise to sensitivities to other market risks parameters (curvature, volatility, FX rates etc.) as well as interest rates. As a result, this table just shows one particular slice of the overall exposures on

these portfolios. The transactions themselves are unable to be cleared as they do not fit into the set of standardised products that CCPs can offer for clearing.

Alternatives to PTRR

While the industry actively supports the clearing of suitable products, we do not believe it is appropriate to extend the scope of mandatory clearing to encompass all products that might be found in the bilateral portfolios between firms. As such, clearing does not offer a full solution to these problems – although for suitable products, the industry supports the ongoing growth of clearing offerings. Ultimately, the multilateral netting and risk management benefits of clearing offer an efficient answer for such suitable products.

Existing PTRR services therefore rely on products that fall outside the CO which, by their nature, are often more complex. This naturally limits the usability of these offers to those firms with the sophistication and/or mandate to manage portfolios of such products.

Question 6: Without changing the market risk of the portfolios, how different can the transactions included in the PTRR exercise be? What tolerance levels are often applied and what restrictions could/should restrictions be placed on tolerances (if applies)?

In our proposal, transactions included in the PTRR exercise can be very different from the actual portfolio. Uncleared portfolios likely contain transactions that are neither standardised nor liquid. The PTRR service could use vanilla, clearable transactions that neutralize the delta risk in the uncleared portfolio and book equal and opposite transactions (on a net basis) into a CCP. In this proposal, no tolerances are required as long as the following three conditions are satisfied:

1. The exercise is performed by an independent PTRR service provider.
2. Risk in the uncleared portfolios reduced.
3. Equal and opposite transactions to technical risk reducing transactions that utilise a clearing exemption are booked in the CCP (on a net basis).

Existing PTRR services utilize tolerances to make sure increases of market risk can be kept under control. There are occasions when small increases in counterparty risk might be realised against a few counterparties in order to facilitate greater counterparty risk reduction vs others and overall. These would be within pre-agreed tolerances. Allowing counterparty risk to increase a little bit in some portfolios increases the potential for overall risk reduction significantly.

These tolerances are small compared to added transactions and are symmetrical. No participating firm knows ex-ante in which direction the tolerance will be applied and therefore cannot use these tolerances (even if they were larger) to add price forming risk to the portfolio.

Please see also the response to question 3. Many points made there apply also to PTRR.

Question 7: Is the requirement under EMIR of portfolio compression sufficient to mitigate the risk of build-up of transactions and how is the market managing this risk today?

The EMIR portfolio compression requirement is working effectively today. Firms are sensitive to large build-ups of bilateral portfolios for a number of reasons, not least capital and other use of scarce resources. As such, major dealers regularly participate in compression runs to manage risks.

Question 8: Based on all of the above, how would you define (algorithm based, second order risk, market neutral) PTRR services that cover all of the relevant aspects?

We refer to bilateral responses from PTRR service providers.

Question 9: Should there be an exemption from the clearing obligation for PTRR trades (other than portfolio compression) that are a direct result from a PTRR exercise? If not, why?

We believe that such an exemption is justified in strictly limited circumstances.

To achieve this we believe that three separate controls are necessary to establish the right risk framework. Note that these controls are only relevant for PTRR exercises that avail themselves of an exemption from the clearing obligation. We do not propose to apply these controls to services that are possible now and do not require an exemption from the clearing obligation.

- **Control 1 of 3: Independent of Trading Firms**

The end-to-end process must be non-discretionary. In other words, at no point should a trader or other employee at any firm subject to the CO be making decisions about whether a trade should be cleared or not.

Rather, the industry believes this should be a technical risk management process being run independently of the market participants by a regulated firm. There are existing firms that run trade compression services that operate on an all-or-nothing basis whereby trading firms submit their positions on a post trade basis, and these third party companies calculate the appropriate adjustments needed to best manage the risk in the portfolios submitted. Firms participating in compression runs must either accept or reject in full the result of the exercise, with the PTRR run only void if all participating firms do not accept it.

By making these processes run by such firms supervised in an appropriate manner, the algorithms that are used, and their outputs, would be under the purview of regulators and, thus, both independent of market participants and subject to an appropriate level of oversight.

- **Control 2 of 3: Risk Reducing on a Portfolio by Portfolio basis**

Where any two parties to such a process agree to book a transaction into a bilateral portfolio, they must be able to demonstrate by some measure that the risk in that portfolio is reduced. The appropriate measure would be developed as part of Level 2 rule-making but, as an initial suggestion, it would be appropriate for participating firms to agree a suitable measure, in alignment with their own risk appetites with their prudential regulator.

This would ensure that the definition of “reduction” for a given firm aligns with its business as usual risk management framework.

In this way, participating firms would be restricted in such a way as to only ever allow risk reduction on a bilateral basis. Since both of the illustrated emerging risks benefit when bilateral risks are reduced, we believe this is a necessary and useful control.

- **Control 3 of 3: For Each and Every Technical Risk Reducing Transactions Booked in a Bilateral Portfolio that benefits from this exemption, an Equal and Opposite Risk Must be Booked Facing a CCP**

Mechanically this control would operate in the following way. Where firms A and B are proposed to enter in a technical risk reducing transaction (an output trade from the PTRR exercise) - for instance an interest rate swap (IRS) that is exempt from clearing (by virtue of a CO exemption facilitated by the outcome of this consultation), they would accept this swap and book it in their bilateral portfolio. In addition, they would book a second, equal and opposite technical risk reducing IRS, which they would give-up to a CCP.

As a technical matter, to avoid unnecessary booking (and subsequent compression) of large numbers of offsetting technical risk reducing transactions, PTRR service providers should be permitted to pre-compress CCP-facing technical risk reducing transactions such that the CCP facing risk is booked efficiently, while keeping records of the corresponding bilateral and cleared IRS to demonstrate compliance with control 3 to supervisors.

This third control has four desirable effects:

1. By definition, the sum total of the exposures of all the technical risk-reducing transactions booked must be zero and, thus, the overall exercise should be demonstrably non-price-forming. We believe this is a key aspect of post-trade portfolio management services, both from a regulatory perspective and, importantly, from a market perspective. In developing these services, it is key for trading desks and their customers to be assured that they will not move the market.
2. From an auditability perspective, it would be easy for supervisors to check that, indeed, for each and every bilateral IRS there was an equivalent cleared IRS, and that the risk booked versus the CCP equals (and offsets) the risk booked into bilateral portfolios under this limited exemption.
3. In line with the G20 commitment and general regulatory goals, this approach demonstrably rebalances risk between bilateral and cleared portfolios. Control 2

ensures that the bilateral risk must be reduced (in each and every portfolio) and, while it is possible that the overall risk in the CCP might be reduced or increased – it depends on the overall positions of the parties in question – what is certain is that the overall proportion of risk warehoused at the CCP (rather than bilaterally) will be increased, in line with policy goals.

4. By focussing only on transactions that would be exempt from the CO, existing PTRR services can continue unchanged.

By applying these three controls cumulatively, we can be assured that risks can be managed, but controls are suitable and sufficient to prevent a weakening of the CO in existing regulation. Furthermore, as and when the scope of the CO expands, this future-proofed approach automatically expands with it. It would also automatically cover other asset classes, such as FX and Equities as and when the CO is extended in scope to cover those products.

Note, this proposal is not intended to limit the scope of products available to PTRR service providers as there are good reasons why more complex products might be used by such service providers – particularly where a firm has offsetting complex bilateral risks. The proposal applies where a PTRR service provider, as part of its offering, proposes the booking of a technical risk reducing transaction - that would normally be subject to the CO - into a bilateral portfolio.

Question 10: Is there a PTRR service today including offsetting transactions with a CCP?

Yes, companies such as Quantile, Capitalab and Tri-Optima offer such services to their clients. While the transactions span different product types (e.g. swaptions and IRS), these services use these products to offset risks in bilateral portfolios with risks in cleared portfolios.

Bilateral responses by PTRR service providers will provide more details about how their services work.

Question 11: Assuming there would be an exemption to the clearing obligation:

(i) Could PTRR services conduct offsetting opposite trades in the counterparty's cleared portfolio and if yes, should it be mandatory to enter into such offsetting transactions?

(ii) Would the PTRR transaction in the non-cleared portfolio then remain between the counterparties or be terminated (netted)?

Regarding point (i) please refer to our answer to Q9:

Where firms A and B are proposed a technical risk reducing transaction (an output trade from the PTRR exercise) - for instance an interest rate swap (IRS) that is exempt from clearing (by virtue of a CO exemption facilitated by the outcome of this consultation), they would accept this swap and book it in their bilateral portfolio. In addition, they would book a second, equal and opposite IRS which they would give-up to a CCP.

As a technical matter, to avoid unnecessary booking (and subsequent compression) of large numbers of offsetting swaps, PTRR service providers should be permitted to pre-compress the CCP facing technical risk reducing transactions such that the CCP facing risk is booked efficiently, while keeping records of the corresponding bilateral and cleared IRS to demonstrate compliance with control 3 to supervisors.

This third control has four desirable effects:

- 1) By definition, the sum total of the exposures of all the technical risk-reducing transactions booked must be zero and, thus, the overall exercise should be demonstrably non-price-forming. We believe this is a key aspect of post-trade portfolio management services, both from a regulatory perspective and, importantly, from a market perspective. In developing these services, it is key for trading desks and their customers to be assured that they will not move the market.
- 2) From an auditability perspective, it would be easy for supervisors to check that for each and every technical risk reducing transaction (for instance a bilateral IRS) there was an equivalent cleared IRS, and that the risk booked versus the CCP equals (and offsets) the risk booked into bi-lateral portfolios under this limited exemption.
- 3) In line with the G20 commitment and general regulatory goals, this approach demonstrably rebalances risk between bilateral and cleared portfolios. Control 2 ensures that the bilateral risk must be reduced (in each and every portfolio) and, while it is possible that the overall risk in the CCP might be reduced or increased – it depends on the overall positions of the parties in question – what is certain is that the overall proportion of risk warehoused at the CCP (rather than bilaterally) will be increased, in line with policy goals.
- 4) By focussing only on transactions that would be exempt from the CO, existing PTRR services can continue unchanged.

In regard to point (ii) –PTRR technical risk reducing transactions would remain. The risk of the PTRR technical risk reducing transactions often offsets part, but not all, of the risk of a given existing bilateral transaction. Given that the PTRR transaction is not necessarily an exact offset of the existing transaction, it is not certain that the existing transaction and the technical risk reducing transactions will reduce to zero.

(iii) Question 12: Please provide data (number of trades and notional compressed, amount of initial margin reduction, number of counterparties regularly using PTRR services, other metrics) per type of PTRR service, with as much granularity as possible (per entity, per asset class/currency, per run, over the years and over the past year, etc.) and the related explanations on how PTRR services are used.

Compression data is provided by compression services via Approved Public Arrangements (APAs), clearly identifiable as compression transactions and available to regulators.

Data on PTRR services like risk rebalancing will be closely linked to the service offering and processes used by each provider. Please refer to bilateral responses of PTRR service providers.

We note the importance of reporting mechanisms for PTRR technical risk reducing transactions so that supervisors can identify these transactions and verify risk neutrality if required. Please see also our response to question 30.

Question 13: Please also, where possible, provide data whether those numbers would be expected to change if there was an exemption to the clearing obligation.

We believe that an exemption to the CO would open up participation in PTRR services (such as portfolio rebalancing) to a wider range of participants due to the reduced need for products such as swaptions to be deployed. In turn, this reduction would reduce the emergent systemic risks (e.g. default competition risk, and liquidity risk) across a wider spectrum of the market.

Question 14: Do you think an exemption from the clearing obligation for transactions resulting from PTRR services would increase the use of PTRR services? Please explain.

Yes, we believe that an exemption from the CO for transactions resulting from PTRR services would increase the use of such service:

- Smaller, less sophisticated firms might not be able to trade, price and risk manage swaptions etc., but would be comfortable with vanilla products.
- The use of swaptions for PTRR purposes could be seen as avoiding the CO.
- The use of more vanilla products will make the compression more straightforward and therefore easier to manage for firms.
- The use of swaptions might mean additional operational requirements to service these products.

Question 15: Do you think an exemption from the clearing obligation is not needed for legacy portfolios and PTRR services generally? To what extent can the use of plain vanilla transactions in PTRR services be replaced with the use of non-plain vanilla transactions, or should this be avoided? Please explain.

See our response to question 14 - we believe that replacing vanilla transactions by complex products can increase operational risks and make PTRR services too complex for smaller firms.

Question 16: Would an exemption to the clearing obligation contradict the G20 commitments? Please explain.

No, we do not believe such an exemption would contradict the G20 commitments. As we propose, the clearing exemption would be strictly limited and would only be used to reduce risk in the

bilateral portfolios such that a greater proportion of the total risk in the market faces CCPs. This is due to the benefits of multilateral netting offered by CCPs, rather than the effective grossing up of offsetting positions that can occur in a bilateral portfolio. In fact, although counterintuitive, the exemption of technical risk management transactions from the clearing obligation will only serve to strengthen adherence to the goals of the G20 commitments. Please also refer to the Clarus blog post⁴ that estimates that two-thirds of the gross global OTC interest rate derivatives counterparty risk is uncleared and about half is uncleared IR delta.

To achieve this, as stated, we strongly support safeguards that ensure that such administrative transactions are not price forming and cannot change market risk.

Question 17: How could an exemption to the clearing obligation for PTRR trades lead to a circumvention of the clearing obligation? Please explain.

We believe that the likelihood of firms either wanting to circumvent the clearing obligation or using PTRR exercises with an elusive intent is extremely low. Based on the existing benefits of clearing, we find it very difficult to imagine a “real” scenario where what mentioned above could actually materialize.

That said, we believe that the strict control framework we propose will prevent circumvention of the CO by ensuring that all technical risk reducing transactions are risk neutral, non-price forming administrative transactions. Under this framework, each and every market price-forming transaction that is executed and cleared under today’s rules would still be executed and cleared under the same rules even if such an exemption exists – there is no change whatsoever to trading market practice, systems, or other controls. This additional step of PTRR exercises would be run independently of market activity and would enable more efficient credit and liquidity risk management, thus reducing systemic risk, without impacting markets, as long as the three conditions we propose are satisfied:

1. The exercise is performed by an independent PTRR service provider.
2. Risk in the uncleared portfolios is reduced.
3. Equal and opposite transactions to those technical risk reducing transactions that are exempted from the CO are booked in the CCP (on a net basis).

Question 18: Would you consider introducing an exemption to the clearing obligation as an incentive not to clear transactions that technically are covered by the clearing obligation. If yes, why?

We believe the framework we propose prevents this outcome because:

- It is an additional post-trade risk management step that is market risk neutral
- All such technical risk-reducing transactions must reduce the bilateral risk in the portfolio into which it is booked.

⁴ <https://www.clarusft.com/counterparty-risk-some-way-to-go-for-derivatives/>

Dealers clear transactions that can be cleared because of existing incentives, which are more driven by the benefits of clearing like multilateral netting, operational efficiency and reduced risk than by the cost of un-cleared portfolios.

Question 19: Are there risks with reducing collateral? Even if complying with regulatory requirements, could this lead to such capital being used to increase risks, possibly systemic risks?

We do not believe that this is happening and believe that this question is based on a false assumption. It is important to note that, for the same risk model, an increase in collateral is indicative of an increase in risk. Thus, as collateral increases across bilateral portfolios, it is not safe to conclude that, in some way, the system is “better protected”. The safer conclusion to reach is that risk is increasing. It is true that, under these proposals, collateral for the bilateral portfolios would reduce, but that is because the counterparty risk in these portfolios is smaller, representing a better systemic risk profile.

The assumption underlying the question seems to be that dealers would use freed up collateral to support an increase in other more risky investments. Collateral funding is only one constraint for banks. Rules like the Volcker rule, limits of risk weighted assets (RWA), the leverage ratio and market risk capital requirements, would restrict build-up of risk. Freed up collateral could however be used to better service clients or reduce pressure on funding markets.

In addition, the reduction of the requirement for collateral should also be seen as a position with respect to the reduction of collateral risks. Bank regulation has addressed a variety of risks arising from the use of collateral, such as FX collateral haircuts, securities haircuts, legal enforceability right of collateral vs derivative net present value, collateral substitution risk, margin segregation and bankruptcy remoteness etc. Minimising a collateral balance will in turn minimise collateral risks and lead to a more stable market environment. The focus should therefore be on the reduction of the need for collateral, rather than concentrating on ever increasing collateral balances for increased risk exposures.

Question 20: Are there other jurisdictions where PTRR trades have been exempted from the clearing obligation? Please explain the features of any such exemption. Do you use any of those exemptions, and for what type of trades?

We are not aware of other jurisdictions than the ones in the consultation paper.

Question 21: Should conditions, similar to the ones as outlined above, apply to a possible exemption under EMIR for PTRR transactions? Should other conditions apply? Would the answer depend on the type of PTRR service? Please explain.

In our proposal, we have put forward three conditions:

- Independence of in-house traders to avoid gaming: PTRR exercises would be performed by providers independent of the market participants.
- Risk reduction exercises need to demonstrate that the risk in each affected bilateral portfolio has been reduced.
- For each bilateral administrative transaction resulting from risk reduction exercises, an equal and opposite transactions must be booked facing a CCP.

We believe these conditions are sufficient to ensure an exemption from the CO cannot be gamed.

Please find below comments to the conditions listed in the consultation:

Condition 1: Only uncleared transactions should be included in the portfolio for compression:

We propose to explicitly link equal and opposite cleared technical risk reducing transactions (on a netted basis) to the process to ensure that the exercise does not lead to price forming transactions. We agree with the condition if it is meant as the universe of transactions whose risk is to be reduced.

Condition2: Only multilateral compression can be exempted, i.e. more participants than 2 excluding the service provider:

While PTRR will be enacted mostly with more participants, the process put forward by ISDA will also work for only two participants. Even with only two participants there is no possibility of avoiding the CO. As all there needs to be an equal and opposite cleared transactions for each technical risk reducing transaction, even a bilateral exercise would theoretically be multilateral as it includes a CCP.

Condition 3: The compression exercise should result in reduced notional and/or risk:

We agree and have made this one of the explicit conditions for a PTRR exercise.

Condition 4: The compression exercise should involve the same counterparties as the original transactions being compressed:

We agree with this condition. Even in multilateral compression, PTRR exercises would include only counterparties involved in the exercise.

Condition 5: The PTRR service provider should be acting independently and PTRR transactions shall be generated in accordance with a multilateral portfolio compression service provider's established rules and parameters for multilateral portfolio compression exercises:

We agree and have made this an explicit condition in our proposal to ensure the exercise cannot be gamed.

Question 22: Is there a difference between bilateral and multilateral portfolio compression justifying an exemption to the clearing obligation only to apply for multilateral portfolio compression?

See our response to Question 21 regarding your condition 2: we do not believe that there should be a difference.

Question 23: Should only uncleared transactions be included in portfolio compression in order to qualify for the clearing exemption? How would a possible limitation to uncleared transactions limit the effectiveness?

See condition 1 in the proposed list (question 21): We believe that it is reasonable to only consider uncleared transactions in the portfolio for which risk is to be reduced.

With a PTRR including cleared and non-cleared transactions in the portfolio compression, depending on the optimization criteria and algorithms, there could be outcomes where risk is moved from the CCP to the uncleared portfolio.

We do not believe a limitation on uncleared portfolios would limit effectiveness.

Question 24: To benefit from an exemption to the clearing obligation, should PTRR trades be strict risk neutral or should there be tolerances for small changes in the risk of portfolios? How would you define what is an acceptably small change in risk?

In the proposal we put forward, no tolerances are required. Existing compression and PTRR services utilize limited tolerances to gain flexibility. For instance, converting IBOR based transactions/portfolios into portfolios with a higher ratio of RFR based transactions would be near impossible without utilizing tolerances.

We note however that such tolerances are small compared to the risk that would be added by only one price forming trade and are symmetrical – the overall portfolio of technical risk reducing transactions is always risk flat.

Question 25: To benefit from an exemption to the clearing obligation, to what extent should parties to a PTRR exercise be able to be changed, i.e. not limited to the original counterparties? Would the answer depend on the type of PTRR service? Please explain.

Even in multilateral compression, PTRR exercises would include only counterparties involved in the exercise. We therefore agree with such a condition associated with an exemption from the CO.

Question 26: Should there be a requirement for PTRR services to reduce risk for a clearing exemption to apply? Should it apply to all PTRR services? If not, please explain why. How would a successful PTRR exercise be measured?

See our response to Question 25. We believe that reduction of risk in the bilateral portfolio should be a condition.

We propose that the PTRR service provider produces a list of technical risk reducing transactions and demonstrates that the overall risk in the portfolios that have been presented for the PTRR exercise have reduced.

As the PTRR service provider has no knowledge of the full portfolios of their clients and local clearing obligations, it will be in the interest of the banks involved to show that the risk of their bilateral portfolios has been reduced and that for all technical risk reducing transactions that are exempt from the clearing mandate, equal and opposite transactions have been booked on a net basis at a CCP.

In terms of risk reduction measurements, the appropriate measure would be developed as part of Level 2 rule making but, as an initial suggestion, it would be quite appropriate for participating firms to agree a suitable measure with their prudential regulator, in alignment with their own risk appetites. This would ensure that the definition of “risk reduction” for a given firm aligns with its business as usual risk management framework.

Question 27: Could PTRR services increase exposure or risk on a participant basis? Would the answer depend on the type of PTRR service provided? How should the PTRR service provider limit any possible increase in notional amount or risk? Please explain.

As PTRR services add transactions to portfolios, gross notional of such portfolios might increase. This is in our opinion perfectly acceptable, as long as counterparty risk is reduced.

In our proposal, reduction of risk of each bilateral portfolio included is a condition. We therefore don't think that risk in the uncleared portfolio on a participant basis will increase.

As our proposal includes equal and opposite cleared transactions, the risk in the cleared portfolio can increase, but never to a larger extent as the risk in the uncleared portfolio is reduced. We consider this replacement of uncleared counterparty risk by cleared counterparty risk an overall improvement. In many cases the cleared technical risk reducing transactions will at least partially net with other cleared exposures.

Question 28: How could a limitation like “no participant worse off” be defined?

Please see the detailed description of our proposal (see response to question 9): We postulate that risk in the uncleared portfolio of every participant needs to be reduced. We understand this as “no participant worse off”.

Question 29: How should it be ensured that PTRR service providers are independent in their assessment? Should the conditions imposed on the providers of PTRR services include requirements on governance of the algorithms to ensure the definition and the setting of parameters takes place with minimum influence from market participants? Should algorithms run with minimum manual intervention? Any other conditions or structural requirements that should apply?

We agree that the algorithms of PTRR service providers should not be changed based on influence by participants.

We believe that a crucial control is for the PTRR service provide to keep records of the transactions inserted into the bilateral portfolios, the risk of these portfolios before and after the exercise and the transactions cleared at the CCP. After each PTRR exercise it would be straightforward to review that - for each administrative transaction inserted into the bilateral portfolios - an equal and opposite transaction has been booked into a CCP (on a netted basis) and that the risk in each affected bilateral portfolio has been reduced.

Question 30: Do you consider that a PTRR service provider should be specifically licenced or authorised? Would this depend on the remits of the services provided? Would it be sufficient to provide requirements on the service provided, i.e. on transaction level rather than entity level? What do you see as the benefits of regulating PTRR services? Would this create any impediment or barriers?

Regulation

Existing PTRR service providers are already regulated in the jurisdictions where they operate. There are not many such providers and regulation should be commensurate with the size of the market.

PTRR service providers operating in the EU should be regulated as MIFID investment firms or under an equivalent framework if they are from a third country. The MIFID regulatory framework already contains appropriate requirements regarding governance, independence, product development and conflicts of interest. It is important to consider that PTRR services are fundamentally a technology applied to investment activities and services, rather than an investment activity or service itself, and therefore the existing MIFID regulatory framework is appropriate for addressing the operation of these services in the EU.

Compression and PTRR exercises are global, with bank participation driven by the large banking blocks of North America (US and Canada), UK, EU and Japan. PTRR exercises require a suitable large pool/network to optimise between participants. If this pool is reduced, PTRR exercises become less efficient and less risk is reduced. We would therefore like to highlight that there should be no location requirement for PTRR service providers, as any location requirement would automatically reduce the pool of eligible transactions. If there are overlapping location requirements, PTRR exercises might not be possible at all. Having access to an equivalence framework is therefore crucial. It is also important that any supervision does cover the whole PTRR service to avoid the possibility that for instance the introduction of technical risk reducing transactions is covered by different regulation or supervision as that covering the PTRR service itself.

We believe that there is no justification to consider any location policy as these PTRR services are risk neutral.

As with every new and developing market, it is also critical that prospective regulation is prudent and measured. The regulatory framework applying to PTRR services should allow enough room for innovation and new technologies to develop, whilst ensuring financial market integrity and safety. At this stage PTRR services remain in a state of development and prospective regulation should encourage prudent innovation. Policy makers and regulators should work in a coordinated manner across jurisdictions where possible in order to facilitate global regulatory cohesion and to promote a common best practice approach to understanding the uses and challenges and regulatory treatments for these services, in particular for the global adoption of an appropriate clearing exemption for these services.

Given that the PTRR services apply to the global derivatives market, there should not be an EU regulatory silo. Likewise, we will urge other rule-makers to follow suit and exempt transactions resulting from PTRR exercises from the CO (under the conditions we put forward).

Reporting

The most important consideration herein, in our view, is the easy review of the outcome of PTRR exercises. For this, a reporting mechanism needs to be defined so that supervisors can review the introduced technical risk reducing transactions and verify that these transactions have not added any market risk and that for each technical risk reducing transaction that would have been exempted from the clearing mandate, an equal and opposite transaction has been cleared.

Question 31: What would be the cost-benefit of exempting PTRR transactions (replacement and risk mitigation services through offsetting trades such as rebalancing) from the clearing obligation?

We appreciate that it will be very difficult to obtain quantitative data, but we would like to put forward some factors that affect the cost benefit analysis:

Cost

We believe most costs we have identified will not be significant compared to benefits, with the potential exception of capital requirements for firms constrained by notional driven measures.

- Constraints driven by notional, for instance capital requirements, the leverage ratio, the GSIB surcharge and US stress tests might increase if the PTRR exercise adds many new trades to the uncleared portfolios. While this cost can be mitigated by careful design of the PTRR algorithms, these constraints might affect the extent to which firms will utilize PTRR services.
- Other “second order “ cost:
 - There will be transaction cost to each PTRR service run – banks would likely not participate in a PTRR exercise where the benefits (saving in margin, capital requirements, gross notional and operational complexity) will not outweigh the cost.
 - Additional operational complexity (linked to the transaction cost point above).

- Exemption from the CO: This might be seen as a “regulatory cost”. However, the exemption from the clearing obligation will support overall risk reduction.

Benefits

We believe these benefits materially outweigh the costs above:

- Overall risk reduction (counterparty risk, collateral risk, systemic risk).
- Reduction of default competition risk.
- Reduction of liquidity risk driven by margin payments (see below).
- Reduced margin requirements, leading to reduced liquidity risk (see below).
- Reduced margin requirements are also a proxy measure for reduced counterparty risk in the uncleared portfolios.
- The overall proportion of risk warehoused at the CCP (rather than bilaterally) will be increased as we require the bilateral risk to be reduced by a PTRR exercises using technical risk reduction transactions that otherwise would be under a CO and postulate that for each technical risk reducing transactions there has to be an equal and opposite cleared transaction (at least on a net basis), which will also increase clearing volumes.

Impact estimate on margin requirements for uncleared transactions

Should PTRR services manage to reduce the majority of the interest rate delta (we assume 90%), SIMM margin would reduce by 15.3%⁵. With margin being a proxy of risk, we could also assume about 15% of total risk has been reduced. Based on total margin of USD 82.1bn from the 2019 SIMM backtesting, this would result in a reduction of margin requirements of USD 12.6bn.

Our proposal requires equal and opposite transactions to be cleared. In an unlikely worst case scenario where all the bilateral portfolios have the same direction, margin at the CCP would increase by a similar amount to the reduction in SIMM margin⁶. In reality however, due to multilateral netting, CCP margin would be considerably lower. Please see the example in question 5 which shows that for a sample firm, the net Euro DV01 of cleared portfolios is about 5% of the grossed up absolute DV01 across portfolios.

Depending on jurisdiction and idiosyncratic situation, the constraints listed above might pose additional costs for banks.

⁵ The reduction is not linear with the delta mentioned above since within each product class the product class margin is calculated using the risk class correlations, in this case the correlation to FX delta.

⁶ This would be smaller as certain regulations mandate SIMM margin to be more conservative than comparable CCP margin.

Liquidity:

A medium sized member reports that under normal market conditions, gross payments and receipts would be between three or four times the net VM for bilateral portfolios⁷. During the recent stressed period from mid-March, net VM did change only modestly (typically two to three times). However, gross VM paid and received increased from the order of three or four times to the order of ten to twelve times. This points to significantly increased liquidity requirements exactly when funding markets might be less liquid. Extrapolated across all participants in the bilateral OTC markets this increase can be material during periods of stress⁸.

In fact, on 2nd June 2020 Acadiasoft, a market utility company that handles calculation and communication of margin payments on behalf of a significant proportion of the major market participants, published a paper “Smooth Sailing Through the Perfect Storm”⁹-that sets out the significant increases in Variation Margin on bilateral trading that arose during the Covid-19 crisis in March 2020.



Illustration 5: Sourced by AcadiaSoft Analytics

This analysis is in line with the experience of the medium sized member already referenced, and shows these flows increased to around 350% of their typical levels in prior months. Broadly, during March 2020, around USD 260bn of liquidity was being utilised each and every day in settlement of these obligations. Large offsetting bilateral credit risks will have contributed materially to these amounts.

⁷ Please note that the ratio between net and gross VM payments is not in line with the worked example in question 5, where the ratio between net and gross dv01 is around 13. The difference is that the worked example looks at EUR dv01 only and the VM payments in the example above are across all books and products. Also, dv01 on the long and short side in the worked example would not move in a linear fashion in stressed markets.

⁸ Please note that banks will not pay out all payments before receiving receipts – there will be some amount of netting over the day.

⁹ <https://acadiasoft.com/smooth-sailing-through-the-perfect-storm/>

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 74 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](#).

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