Template for the Responses to the Discussion Paper on the Clearing Obligation under EMIR

How to use this template

This template is made available to stakeholders who wish to answer to ESMA's Discussion Paper on the Clearing Obligation under EMIR, reference ESMA/2013/925.

ESMA wishes to encourage stakeholders to use the template in order to facilitate the analysis of the responses to this consultation. However, ESMA will duly consider all answers irrespective of the format under which they are submitted.

When not commenting on a specific question or section, please kindly delete the corresponding references (i.e. "Question x", "Answer y", "Comments on paragraphs x to y").

The final submission of your answer in word format is preferred.

A. Respondent

Name: Insurance Europe, the European insurance and reinsurance federation

Country: Belgium

Category: please use the table below

Category	Please select
Audit/Legal/Individual	
Banking sector	
Central Counterparty	
Commodity trading	
Government, Regulatory and Enforcement	
Insurance and Pension	x
Investment Services	
Non-financial counterparty subject to EMIR	
Regulated markets/Exchanges/Trading Systems	
Other Financial service providers	

B. Introduction – General comments

We greatly appreciate ESMA's decision to publish a discussion paper on the clearing obligation well ahead of the actual clearing obligation consultations being published. This approach will give the market participants information which will potentially help them be prepared for the actual clearing of OTC derivatives contracts.

- **Uncertainty and tight timelines with respect to the entry into force of the clearing obligation can pose implementation challenges especially for small financial counterparties.**

The implementation of Regulation 648/2012 (EMIR) has been partially suffering from tight deadlines and postponements in many aspects. With the current proposal regarding the clearing obligation we notice potential for additional uncertainty.

According to paragraph 13 of the discussion paper, the entry into force of the clearing obligation would take from 9 to 16 months (from notification point), without consideration of any phase-ins. Such a wide range in terms of implementation timing is likely to put market participants in different positions in terms of preparedness. Participants with significantly more resources will be able to plan their processes much more in advance, whereas smaller participants will have to struggle with limited resources under this uncertainty. This applies especially to very small financial counterparties which have very limited resources (eg in terms of employees) but who generally use vanilla contracts for which it's highly probable that a clearing obligation will exist.

- **To avoid uncertainty and to create a level playing field between large vs. small market participants and clearing vs. non-clearing members, we strongly encourage ESMA to define a workable phase-in schedule that will be clear and appropriate for all market participants.**

In addition to above-mentioned benefits, a phase-in approach would also give market participants more choices on CCPs and thus create a more level playing field for central counterparties as well. Looking at the indicative timeline on page 10, it seems like a proper phase-in for the clearing obligation for first classes of OTC derivatives would be 1 January 2016.

- **We are particularly concerned about the burden created by frontloading obligations, especially in the case of a phase-in approach, where the challenges and costs of frontloading might overweigh the potential benefits of a phase-in implementation.**

We believe that ESMA should aim to minimise the extent to which frontloading obligations will be imposed on market participants. In its objective of reducing systemic risk in the derivatives market, ESMA should rely as much as possible on the global BCBS-IOSCO requirements that will apply to non-centrally cleared derivatives.

- **We consider that liquidity is of great importance when defining eligibility for clearing and we strongly recommend to ESMA to consider liquidity as a key parameter in its approach.**

Liquidity is of great importance when eligibility for clearing a certain type or class of derivatives is considered. The general approach ESMA has taken on the classes of derivatives does not seem to recognize this as a key priority.

- **Introduction of a clearing obligation for a certain derivative class should always be accompanied by a proper cost-benefit analysis. Any proposals to first introduce a clearing obligation for a given class and then withdraw it should be carefully assessed by ESMA.**

Any administrative and operational burden should be avoided to a large extent in this respect. Negotiating the terms and entering into a clearing relationship with a central counterparty or a clearing member is a major time consumer that requires a range of types of resources. In most cases, this also requires changes in the IT systems and a proper analysis of the legal documentation within both parties to the relationship. All efforts should be made to ensure a proper benefit/cost ratio.

- **We believe that the evidence and rationale that ESMA put forward with respect to increased central clearing vs. OTC is incomplete.**

While ESMA has found numbered evidence regarding the fact that market participants have moved towards standard and centrally cleared products, we believe that some of the reasons for that are missing in the paper. We believe that a proper analysis in this respect should also consider whether some risks are now being hedged with centrally cleared products due to, for example, the uncertainty regarding upcoming requirements for OTC contracts.

- **An additional major concern that the European (re)insurance industry has is to ensure consistency between the treatment of swaps under EMIR and Dodd-Frank.**

If requirements for specific contracts differ under EMIR vs. Dodd-Franck (eg Dodd-Franck requires a given derivative to be cleared while EMIR does not - or the reverse case) this would generate a need for additional infrastructure, eg a two-tier system in which counterparties would have to conduct a compliance analysis on each potential trade. Clearing could then become a factor in the decision of whether or not to trade – and this is certainly not the intention of the regulation(s). Such a situation could also have the effect of creating distortions in counterparties' risk management and hedging processes and could lead to arbitrage opportunities in the markets.

Unfortunately, the ESMA discussion paper does not raise this question; however, we are aware that ESMA and the US CFTC have recently agreed a formal "Path Forward" and we are looking forward to seeing more work in this respect.

- **With respect to the covered bonds case, we appreciate the recognition of a need to protect covered bond investors from a "forced" wind-up of all derivatives whenever the issuer has problems. A similar situation should fully apply to insurance companies whose derivative contracts are there to hedge long-term risks for the benefit of policyholders.**

The central clearing environment functions in such a way that almost any default event coming from an insurer (eg the non-payment of a coupon on issued bonds) could potentially trigger a wind-up situation for all existing derivatives in the insurer's portfolio, including those derivatives which are used for pure hedging purposes. In the case of a stressed insurer, such a wind-up would only serve to make things worse for the insurer, which will find itself left with no hedge in place. In a "normal" situation, as long as derivatives are there to hedge existing assets/liabilities, any positive/negative change in the derivative position is fully covered by a symmetric negative/positive change in the assets/liabilities which are being hedged so there is no economic reason for a wind-up situation.

Following a similar argument as for covered bonds, in the rare event that an insurer registers a default event (eg non-payment of a coupon on issued bonds) the CCP should not wind-up all of the insurer's derivatives which are there to match assets and liabilities. Such derivatives could be identified and implicitly protected from wind-up, as in the case of covered bonds.

- **We believe that FX forwards and swaps should be exempt from the clearing obligations, regardless of the maturity.**

We strongly consider that the risks associated with foreign exchange markets are appropriately mitigated by the current global regime of prudent supervision, practice guidelines and capital implications. This includes principal (or settlement) risk reduction through use of CLS, replacement cost risk reduction by appropriate usage of CSAs, and strengthened supervisory guidance that focuses on ensuring sufficient capital is held against potential exposure to all foreign exchange settlement related risks.

- As a detailed linguistic comment, derivatives markets are often described using a substantial number of abbreviations. In this discussion paper, ESMA has introduced yet another abbreviation. Clearing obligation is referred to as CO. As abbreviations make the text sometimes harder to understand, **we recommend that obligations derived from binding regulations are never shortened in ESMA communications.**

C. Comments on the discussion paper and answers to questions

Comments on paragraphs 1 to 6:

1. Procedure for the determination of the classes to be subject to the clearing obligation

Comments on paragraphs 7 to 17:

We welcome ESMA's intention to define an appropriate phase-in implementation schedule by considering the number of CCPs which would be available at a certain point in time for a certain class/type of derivatives. Imposing a clearing obligation to a class of derivatives where only one CCP is available implies practical problems. CCPs only have a certain amount of access lines. In addition, the service offerings of clearing members may be limited. At least in such circumstances more time and resources are needed to successfully start clearing (eg in terms of pricing of services or resources needed for implementation of cross-border legal processes).

2. CCP-cleared classes of OTC derivatives

Comments on paragraphs 18 to 30:

2.1 Credit derivatives

Comments on paragraphs 31 to 39:

Question 1 (Series for Index CDS):

Please indicate your preference between the options presented. Do you believe that the possibility for a new series to exhibit low liquidity is a risk worth being considered when defining the classes of Index CDS? Under Option C, which criteria do you believe are relevant and how should they be calibrated?

Answer 1 (Series for Index CDS):

We would prefer Option A followed by Option B.

The risk of low liquidity for the on-the-run series is very low. Market participants roll positions into the new series and create liquidity in particular once the series starts trading. The drawbacks of Option C are already mentioned and include "the series to fall in and out of the clearing obligation at an inappropriate frequency".

Question 2 (Index CDS):

Do you consider that the main characteristics of Index CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 2 (Index CDS):

Yes, we consider that the characteristics of Index CDS are adequately captured by the proposed structure.

Question 3 (Index CDS):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 3 (Index CDS):

We believe that the on-the-run series with 5-year tenor are the best candidates for the clearing obligation.

Comments on paragraphs 41 to 44:

We agree that most common CDS indices could be considered eligible for clearing, but not, for example, options on them.

Question 4 (Single name CDS):

Please indicate your preference between the options presented. In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

Answer 4 (Single name CDS):

We prefer Option A. For Option B the geographical zones could be defined according to the index CDS market (Europe/North America/Emerging Markets).

Comments on paragraphs 45 to 50:

Question 5 (Single name CDS):

Please indicate your preference between the options presented. Under Option C, which criteria do you believe are relevant and how should they be calibrated?

Answer 5 (Single name CDS):

We prefer option B.

Question 6 (Single name CDS):

Do you consider that the main characteristics of Single Name CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 6 (Single name CDS):

We consider that the proposed structure is adequate.

Question 7 (Single name CDS):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 7 (Single name CDS):

We believe that only sufficiently liquid and standardised CDS single names are appropriate candidates for central clearing. The 5-year tenor seems to be the most appropriate candidate.

2.2 Interest rate derivatives

Comments on paragraphs 52 to 58:

Question 8 (Interest rate derivatives):

Do you consider that the main characteristics of the interest rate derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 8 (Interest rate derivatives):

The following key characteristics might be missing from a trading perspective:

- In Table 8 (Fixed-to-float Class) and Table 9 (Basis swap Class):
    - Tenor of floating rate (eg 3 month or 6 month),
    - Payment frequency (for floating and fixed leg),
    - Reset frequency for floating leg,
    - Day count fraction (eg Act/365, Act/360).

With regard to the distinction of captured products there might be room for interpretation. For example, would IRS with a spread on the floating rate have to be cleared or not?

- In Table 11 (OIS Class):
    - AUD OIS

- In Table 12 (Interest Rate Option Class):
    - From our perspective there might be room for interpretation on whether interest rate swaptions would be captured or not. If it is intended to impose a clearing obligation on these products, it might be advisable to reflect this intention more clearly; we consider that these products are not appropriate candidates for central clearing.

Question 9 (Interest rate derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 9 (Interest rate derivatives):

Interest rate swaps in all major currencies (EUR, GBP, USD, CAD, AUD) and with maturities of up to 10 years are clearable. However, non-linear products such as caps, floors, swaptions are not yet eligible for mandatory clearing. This is mainly due to "high dimensionality" (ie strike, moneyness, option maturity, underlying assets, swap tenor, conventions) which all add to illiquidity, non-uniqueness and complexity in pricing for most products.

2.3. Equity derivatives

Comments on paragraphs 59 to 70:

Question 10 (Equity derivatives):

Please indicate your preference between the options presented. Under Option D, which criteria do you believe are relevant and how should they be calibrated?

Answer 10 (Equity derivatives):

We believe that an appropriate way to categorise single name derivatives is to use membership of a specific index (**Option B**). One possible alternative would be to use as reference one main index per country. The following possibilities would arise:

i) If the equity belongs to the "country reference index", then the country reference index would be used.

ii) If the equity belongs to another index and does not belong to the "country reference index", then the other index would be used.

iii) If the equity belongs to the country reference index and to other indices as well, then the "country reference index" would be used.

iv) If the equity does not belong to any index, then the "country reference index" would be used.

Regarding the open definition of **option D**, the scope of the clearing obligation could be defined based on a notional threshold of €50m per single name equity derivative.

Comments on paragraphs 71 to 73:

Question 11 (Equity derivatives):

Please indicate your preference between the options presented.

In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

Answer 11:

We believe that settlement currency (**Option A**) should be used instead of geographical region (**Option B**), as it would be much easier to only look at the derivative currency to categorise the trade than to look at where the underlying stocks are traded.

Question 12 (Equity derivatives):

Do you consider that the main characteristics of Equity OTC derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 12:

-/-

Question 13 (Equity derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 13 (Equity derivatives):

We consider that only vanilla products with Index or Single names as underlying and maturities up to 6 months are eligible, excluding total return swaps. Bearing in mind the important aim to limit systemic risk this scope would cover a large part of the OTC market.

2.4. Foreign Exchange derivatives

Comments on paragraphs 75 to 78:

Question 14 (FX derivatives):

Do you consider that the main characteristics of the FX derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 14 (FX derivatives):

According to EMIR recital 19 *"in determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts.."*

We consider that FX forwards and swaps are examples of derivatives which should be exempt from the clearing obligation, as the risk is primarily driven by counterparty settlement risk (loss of principal), rather than by counterparty credit risk (ie the change in the mark-to-market value). While settlement risk can be better mitigated through either Continuous Linked Settlements (CLS) or the establishment of prudent settlement limits, rather than through mandatory margin requirements, the risks emerging from mark-to-market exposure can be managed through, for example, the use of variation margin in the OTC environment. These processes are well established, generally available and have proved to work well.

For portfolios that do not have easy access to eligible securities, the need for central clearing would make the use of FX forwards uneconomic. This may result in a general increase in risk, given that the majority of FX forward transactions are executed to reduce currency risk in asset portfolios.

Moreover, international companies with a holding structure would be penalised even more. They hold participations in foreign currencies and put in place hedge strategies. Since they do not hold securities, they would be forced to post cash on an evergreen basis because of the structural nature of these hedges. This specific situation would lead to an extremely severe liquidity stress for holding companies and could dis-incentivise them from managing their economic risk properly.

In addition, Insurance Europe strongly urges ESMA to consider that, in order to avoid regulatory arbitrage and to ensure operational efficiency, margin tools and requirements need to be aligned in a global context (eg with the Dodd-Frank Act). Therefore, exempting FX derivatives from central clearing would reflect, at least to some extent, international convergence in terms of the treatment of FX derivatives.

We believe that the same treatment should be applied to all FX forwards and swaps, irrespective of the maturity of contracts. A different treatment, depending on contract maturity, would add unnecessary complexity to the framework, which may significantly outweigh the potential benefits.

Question 15 (FX derivatives):

Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 15 (FX derivatives):

FX product types that are in scope of EMIR but are exempt from mandatory clearing under the Dodd-Frank Act, ie physically settled FX forwards and FX swaps, should be exempt from the clearing obligation under EMIR as well. This should be a full exemption, ie without tenor restrictions. In addition to the point of alignment across jurisdictions, the risk characteristics of these products make them unsuitable for clearing (as raised in question 33 in regards to settlement risk).

If ESMA's objective is to cover all FX derivatives, this might not be achieved on the basis of the proposed classes set out in Table 14 and 15. For example, it is not perfectly clear if FX Swaps (which are a combination of an FX spot and n FX forward and constitute the biggest volume within the FX market) would be covered by Table 15 or not. Additionally, more specifications should be given with regards to what the term "cash settlement" means in relation to FX transactions. The industry standard is "physical delivery" and pure cash settlement is not a commonly used settlement procedure (with the exception of NDFs). Moreover, the currency pairs defined in the tables are just a limited fraction of the wide range of currency pairs traded within the FX market. Even for cash settled FX trades the proposed settlement currencies seem not eligible in a European context, as a settlement in EUR needs to be covered.

We also consider that FX options are not appropriate for clearing. More precisely:

1) All non-vanilla FX options should not be eligible for clearing. This is primarily due to the large variety of product types and their limited liquidity.

2) The range of currency pairs needs to be restricted due to liquidity limitations faced by non-major currency pairs. We would advocate that the currency pairs would have to include two of the following currencies: EUR, USD, JPY, GBP, AUD, CHF and CAD. According to the BIS only these currencies achieve a minimum 5% daily share of the global foreign exchange market turnover.

2.5. Commodity derivatives

Comments on paragraphs 79 to 84:

Question 16 (Commodity derivatives):

What is in your view the best approach to specify the underlying assets within each OTC Commodity class?

Answer 16 (Commodity derivatives):

We believe that ISDA two-level classifications are appropriate to categorise commodity contracts. A one-level classification would also be sufficient, ie index or specific commodity/product exposure.

Question 17 (Commodity derivatives):

Do you consider that the main characteristics of the Commodity derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 17 (Commodity derivatives):

-/-

Question 18 (Commodity derivatives):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

Answer 18 (Commodity derivatives):

We believe that a range of commodity derivatives, facing significant liquidity constraints, should be kept out of clearing ie commodity class 11: Energy - Petrochemicals and class 12: energy – refined products. In addition, the non-liquid refined petroleum products, which are not clearable at the moment, should probably not be cleared in the future either.

Furthermore, we believe that only commodity derivatives denominated in USD, EUR or, to some extent, GBP should be cleared.

None of the option instruments should be cleared, regardless of currency.

3. Preliminary analysis of the readiness of asset classes vis-à-vis the clearing obligation

Comments on paragraphs 85 to 105:

Question 19 (readiness of the classes):

Do you agree with this analysis?

Answer 19 (readiness of the classes):

While we agree with the analysis put forward, we believe that ESMA should provide an indicative expected schedule for the clearing obligation for each asset class in order to facilitate preparation for clearing.

4. Determination of the phase in, and the categories of counterparties to which the CO would apply

4.1. Dates, phase in, categories of counterparties

Comments on paragraphs 106 to 115:

Question 20 (dates, phase in):

What would you consider to be the shortest delay to impose a clearing obligation to a class of OTC derivatives when there are several CCPs available? And when there is only one CCP available?

Please specify in your answer whether the cause of delay is due to operational issues (e.g. time for CCP/counterparties to be ready for the CO) and/or to market issues (e.g. time for a CCP to add a new product to its offering).

Answer 20 (dates, phase in):

Should several CCPs be available for clearing a certain class/type of derivative, then the shortest delay should be determined via discussions with both CCPs and clearing members as they know best how long it takes to be fully prepared for clearing. We estimate this will take at least 1½ years. However, should only one CCP be available for clearing a certain derivative type/class than we see significant concentration risk due to lack of competition. We estimate it will take at least up to 2½ years to allow sufficient time for the development of a more competitive clearing services market.

From a buy-side perspective a minimum timeframe of one year should be foreseen in order to get ready for clearing a new product. When defining a phase-in schedule, all aspects around preparation for clearing should be taken into account - particularly where external providers or a significant number of market participants are involved.

Question 21 (dates, phase in):

What would you consider to be a reasonable delay to allow CCPs which clear the same asset class or a similar Class+ to clear a new Class+?

Answer 21 (dates, phase in):

A reasonable delay would be 1 year.

Comments on paragraphs 116 to 119:

Question 22 (dates, phase in):

What should be the assumption regarding market share which the CCP would have to be able to assume? Should it be requested that each CCP be able to handle the whole volume to tackle the worst case scenario?

Answer 22 (dates, phase in):

CCPs should fully comply with the requirements imposed by EMIR and should be able and prepared to manage significant volumes.

Question 23 (dates, phase in):

What should be the elements (e.g. number of transactions, increase in risks, number of active counterparties, new jurisdiction involved) for ESMA to investigate, after consulting the NCAs responsible for CCPs authorisation, on the ability of the relevant CCPs to handle the expected volume and to manage the risk arising from the clearing of the relevant class of OTC derivatives?

Answer 23 (dates, phase in):

The relevant elements for ESMA to investigate should be at least: the number of transactions, risk scenarios under the estimated maximum volume cleared, the number of counterparties, the assessment of the financial stability of the CCPs and their respective members. National authorities should also be part of the investigation process as, for example, insolvency laws are spread along the various jurisdictions.

Question 24 (dates, phase in):

Should there be a default period of [x] months whenever there is a need for a CCP to upgrade its service considering incompressible internal/external validation processes? If not, how to evaluate the time to upgrade services based on the result of the criteria assessment?

Answer 24 (dates, phase in):

-/-

Comments on paragraphs 120 to 128:

Question 25 (categories of counterparties):

Please indicate your preference between the options presented. Would you rather use an option that is not detailed here? Under Options B and C, do you agree to base the clearing access approach on the asset class to which the counterparties have access? What should be the date on which clearing access/threshold calculation should be assessed?

Answer 25 (categories of counterparties):

As indicated in the general comments, there are major differences regarding the readiness of financial counterparties to enter into clearing. Often financial counterparties might be insurance companies, investment firms or asset managers with limited derivatives activity, very scarce resources and practically limited possibility to enter into clearing relationships directly with CCPs or with clearing members.

We believe that the key consideration when trying to define an appropriate implementation of the clearing obligation should be the level of preparedness of counterparties with respect to central clearing. In particular, we would like to highlight the fact that limited derivative activity is a good indication of the amount of resources that the counterparty can dedicate to the preparatory process for central clearing. For smaller market participants, with limited derivatives activity, margin practice is less widespread and investors need additional time to design and implement appropriate frameworks. The new margin requirements should not prevent these participants from trading derivatives, and the phase-in should ensure that they are still able to hedge against adverse market movements.

Against this background, we believe that option C would allow counterparties with limited derivatives activity to appropriately prepare for central clearing. The volume thresholds should be set with a goal of delaying the clearing obligation for all counterparties that may face challenges with being able to centrally clear in, for example, June 2014. This approach would also minimise the risk of market disruptions and of shutting down small counterparties from the derivatives market, by allowing them more time to develop the necessary processes so as to be able to centrally clear their derivative products.

At the same time, we believe that direct access to CCP as clearing members (**option B**) is also a good indication for assessing clearing preparedness. We would be supportive of such an option as well, but only to the extent that it is defined in such a way as to make sure that all counterparties with limited derivative activity (under **option C**) are

included in the phase-in and are allowed enough time to develop the necessary processes and procedures implied by the central clearing obligation.

Question 26 (categories of counterparties):

What would in your view be the appropriate timeframe for counterparties with / without access to clearing in the relevant asset class?

Answer 26:

We believe that counterparties without direct access to clearing should be given at least one extra year (12-18 months) after the clearing obligation for a given asset class comes into effect.

Comments on paragraphs 129 to 130:

Question 27 (categories of counterparties):

Do you agree that a key factor to take into account when defining the phase in for the counterparties to comply with the clearing obligation will be the number of clearing members offering client clearing services? Is the client clearing capacity of the CCP also a relevant factor? What could be the other criteria?

Answer 27 (categories of counterparties):

We believe that, indeed, the client clearing capacity of a CCP can be a limiting factor due to operational constraints, ie management of collateral of a significant number of segregated accounts under a full physical segregation model.

4.2. Minimum remaining maturity of the OTC derivative contracts referred to in EMIR Article 4(1)(b)(ii)

Question 28 (remaining maturity):

What are your views regarding the calibration of the remaining maturity of the contracts to be subject to the CO? What criteria should ESMA take into account when defining it?

Answer 28 (remaining maturity):

Ideally no trades entered into before the clearing obligation start date should be back-loaded; frontloading should apply to a very limited extent as these contracts will anyway fall under the risk mitigation requirements defined at global level by BCBS-IOSCO. Thus, we believe that any level of remaining maturity should be set as high as possible so as to minimise the amount of trades that would need to be back-loaded, both from an operational and a cost perspective (ie counterparties would need to pay their clearing brokers for each back-loaded trade, irrespective of the remaining time to maturity of the derivative).

5. The clearing obligation in specific cases

5.1. Contracts concluded with Covered Bond issuers

Comments on paragraph 136 to 138:

Question 29 (covered bonds):

Are there other specific features of the contracts concluded with covered bond issuers or with cover pools for covered bonds, to be considered by ESMA in the context of the clearing obligation?

Answer 29 (covered bonds):

Almost all European covered bond legal frameworks allow inclusion of derivatives in the cover pool with the purpose of hedging risks, essentially interest rate risks and currency mismatches. These derivatives, which are mainly plain vanilla cross currency and interest rate swaps, are also designed to survive the issuer's insolvency. In such a case, the source of payment will switch to the cover pool and the covered bond holders will need the hedging effect of the derivatives to continue to mitigate the risks of the cover pool. Hence, common master agreements are adapted or supplemented in order to ensure that the insolvency of the issuer does not qualify the counterparty to terminate the derivative contract. Furthermore, in some jurisdictions collateral posting is unilateral, ie the issuer never posts collateral for derivatives whereas the counterparty (which benefits from a preferential claim over the cover assets) does when required.

Question 30 (covered bonds):

What would be the legal or technical challenge faced by covered bonds issuers and CCPs, if a clearing obligation was imposed on some of the OTC derivative contracts included in the cover pools of covered bonds?

Answer 30 (covered bonds):

Our understanding is that, at present, CCPs are unable to differentiate between the derivative contracts of the issuing bank and those of the covered bond cover pool. Hence, either derivatives within the cover pool would be automatically terminated in the event of default of the covered bond or derivatives in the cover pool of a covered bond would be ineligible to be cleared through a CCP due to the fact that the derivative is designed to survive the insolvency of the issuing institution, whereas the standardised documentation requires that all derivatives be netted out at the time of the issuer's insolvency.

As described above, collateral posting for cover pool derivatives is often unilateral. Unfortunately, this technique does not fit central clearing systems which require bilateral exchange of collateral and, therefore, impede these privileged derivatives used for covered bond hedging purposes from being cleared through CCPs.

Question 31 (covered bonds):

Have CCPs developed solutions to be able to differentiate the derivative contracts of the issuer from those of the cover pool?

Answer 31 (covered bonds):

Our understanding is that, at present, CCPs are unable to differentiate between the derivative contracts of the insolvent issuer and those of the covered bond cover pool. Posting collateral by the issuer would increase the costs for the issuer (and this would ultimately be reflected in the interest charge for eg public sector and mortgage borrowers) and would also result in a double protection of the counterparty as it would both have access to the pool and risk coverage via initial and variation margins.

Question 32 (covered bonds):

Would an appropriate phase-in for these counterparties alleviate these challenges? If so, how?

Answer 32 (covered bonds):

From our point of view, a phase-in period would not change the fundamental problems mentioned above.

5.2. Foreign exchange OTC derivatives

Comments on paragraphs 139 to 140:

Question 33 (FX derivatives):

Within the foreign exchange asset class, for which type of contracts do you consider that settlement risk is the predominant risk, and what criteria or characteristics should be used by ESMA to identify those contracts?

Answer 33 (FX derivatives):

As highlighted in our answer to question 14, physically settled FX forwards and swaps predominantly exhibit settlement risk. There should be no differentiation within these product types (by tenor or other characteristics), but rather a wholesale exemption from clearing should be made.

5.3. Interaction of portfolio compression and the clearing obligation

Comments on paragraph 141:

Question 34 (Portfolio compression):

Are there ways in which the imposition of the clearing obligation in the EU could hamper the effectiveness of compression services? If so, please provide evidence of the potential impact. Are there ways in which exclusions to the clearing obligation could be defined which alleviate the problem without creating opportunities for avoidance?

Answer 34 (Portfolio compression):

-/-

5.4. How to withdraw a clearing obligation on a class or subset of it?

Comments on paragraphs 142 to 148:

Question 35 (Modification of a Class+):

For which reason (other than the fact that a CCP does not clear it any longer) do you believe that the clearing obligation of a class - or subset of it - would need to be removed? Please focus on the risks which could stem from a clearing obligation on contracts which would no longer be appropriate for mandatory clearing and provide concrete examples.

Answer 35 (Modification of a Class+):

The clearing obligation should be removed whenever reduced liquidity is noticed. We believe that if a certain market is limited and non-liquid, then there should be no requirement for clearing. If a class becomes so inactive that CCPs are not able to rely on robust prices then this can put both CCPs and clearing members in a risky position.

Question 36 (Modification of a Class+):

In case a clearing obligation would need to be reviewed, how crucial would be the time needed to dis-apply the clearing obligation?

Answer 36 (Modification of a Class+):

The obligation to clear should be dis-applied immediately, as any uncertainty related to the timeline to dis-apply the clearing obligation would generate significant market uncertainty. Any decision to cancel the clearing obligation should be taken rapidly. A delay of several months could be unacceptable, both for the CCP and the market, and should be avoided. The best way forward seems to be to set the criteria for mandatory clearing at a sufficient high level and the criteria in such a way that the decision can be taken fast, ie by removal from the Public Register.