Brussels, 05 September 2016

EACB Response to the
ESMA Consultation Paper
On the clearing obligation for financial counterparties with a limited volume of activity
September 2016

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 30 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4,200 locally operating banks and 67,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 81 million members and 805,000 employees and have a total average market share of about 20%.

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Introduction- General Comments

The EACB is the voice of the cooperative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the cooperative banks' business model. With 4,200 locally operating banks and 68,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The cooperative banks in Europe represent 78 million members and 860,000 employees and have a total average market share of about 20%.

The European Association of Co-operative Banks (EACB) welcomes the opportunity to contribute to the discussion around the draft requirements regarding indirect clearing. It does so because as it has several times been reported the smaller members in particular have serious difficulty in accessing CCPs both for reasons of (non) availability and cost. In general, the analysis of ESMA is in line with the positions we have already expressed in several occasions (see also our response to the in the Consultation Paper on indirect clearing under MiFIR and EMIR). In particular, the situation described in paragraphs 11 to 15 of the Consultation reflects the experience of our medium sized and smaller members. Indeed, we have received reports from our members that small banks have difficulty in finding swap providers prepared to deal with them (whether on cleared or uncleared basis), or being quoted two prices, a favourable one based on CCP clearing, and an adverse one based on traditional bilateral settlement. We have the feeling that the clearing obligation is, in isolation, only one – though probably the most important – part of a series of measures which are together having the unintended consequence of reducing small FCs' access to derivatives altogether. ESMA's current proposal, though welcome, cannot deal with the wider problem. We would encourage ESMA to carry out a wider study into this area.

It should be borne in mind that smaller cooperative Banks and Building Societies need derivatives mainly in order to hedge their interest rate risk on e.g. mortgages and other retail bank products at initial fixed rates.

Should no solutions become available, small banks, building societies and financial firms will de facto not be able to keep an efficient risk management activity (particularly for the interest rate risk) by means of trading OTC derivatives to hedge their positions. This hedging is a vital part of the retail and real economy focused business of cooperative banks, providing an essential managing tool that then allows those banks to effectively finance individuals and SMEs. Due to these problems, the clearing obligation is unintentionally forcing smaller financial firms out of the derivatives markets. This reduces competition and shifts market balance. Pushing these companies out of business would deteriorate the credit conditions of SME segment even further and thus jeopardize the fragile recovery of European economies. This would be inconsistent with the Capital Market Union policy agenda aiming to remove barriers to the free flow of capital in Europe and the variety of other policy makers' positive initiatives to stimulate economic growth in Europe.

With this in mind the EACB supports the exclusion from EMIR central clearing of all non-systemically important firms – that is also smaller Financial Counterparties (FC) and not just the Non- Financial Counterparties (NFC). Indeed, small and medium-sized FCs have severe problems to enter into clearing relationship, due to both cost and availability issues. Indirect or client clearing offerings have not proven to be successful due to legal and practical challenges. Only a small number of clearing members are able to offer to clear on behalf of smaller counterparties but at a cost totally disproportionate compared to the business of smaller players. In that regard, the EACB also draws to the Commission's attention that the current EU regime under EMIR is far more burdensome for small banks than in other major jurisdictions.

To address the issue the EACB proposal is, in principle, to exempt small credit institutions from the clearing obligation - at least in respect of hedging contracts only. In the EACB's view this principle provides the best and most proportionate trade-off between on the one hand systemic risk and financial stability considerations, and on the other hand minimising the burden and anti-competitive effect of EMIR on small institutions. This could be achieved through the on-going EMIR review process. As international comparisons indicate, there are various ways to implement this principle through specific exemption thresholds. The EACB's view is that the simplest and most satisfactory approach is to set an exemption threshold based on balance sheet size of the institution. We would propose to set this at € 8 billion – close to the equivalent exemption threshold of US$ 10 billion for small US banks. At the very least, this should be set no lower than € 5 billion.

Having said that, we fully support ESMA proposal to extend the phase-in period for the clearing obligation to the smallest financial counterparties (those in Category 3) as a short term solution that will allow changes in EMIR Level- 1 text to be considered.

Moreover, we would like ESMA to confirm our assumptions that 1) in case of transactions between a bigger financial counterparty and a smaller financial counterparty (which will be granted a longer phase-in period) the clearing obligation between these two counterparties will also be postponed for two years 2) the margin requirements for non cleared derivatives will be applicable on smaller financial counterparties if they come into force before the extended phase-in of the clearing obligation has ended. If that is the case, in our opinion, the coming info force of the margin requirements and the end of the phase- in of the clearing obligation should be attuned.

Please find below our detailed response to the Consultation Questions:

Responses to the Consultation Questions

Question 1: To which category of counterparties does your organisation belong: (1) in the context of the 1st Commission Delegated Regulation on the clearing obligation, and (2) in the context of the 2nd Commission Delegated Regulation on the clearing obligation?
While categorisation can be a dynamic matter, currently **almost all of the EACB members which face difficulties in accessing CCPs** fall into category 3 both for interest rate swaps and for credit default swaps (CDS). Their volume of activity in interest rate swaps is modest but considerable (still quite below the Cat 3 thresholds) while their volume of activity in CDS is rather negligible.

Question 2: **If you offer clearing services, please provide evidence on the constraints that would prevent you from offering clearing services to a wider range of clients.**
We understand that some larger banks have been considering the possibility to provide client clearing services but are still considering the viability of the service and/ or specific conditions under which this would be feasible/ economically viable.

As we have already reported (see also our response to the in the Consultation Paper on indirect clearing), despite the hopes of the European Institutions that indirect clearing would provide an alternative access route to CCPs, there has been no sign in that direction so far. Authoritative industry bodies such as FIA have tried to analyse this issue. FIA addressed this issue in their

June 2015 paper, identifying the requirement for the “leapfrog” payment as the major technical block to indirect clearing because of the possible conflict between this requirement and local insolvency law. FIA also advocated giving indirect clients a choice as to the level of segregation, and credit protection they wish to benefit from.

Having said that. we cannot conclude that removing the regulatory barriers will necessarily bring in a wave of indirect clearing services relevant to our smaller members. Just as with direct clearing, the business of low-volume end-clients may turn out to be inherently unprofitable. Moreover, there is always an additional and more general concern that any clearing provider could in future decide that the business is unattractive and find ways to exit. Already the direct clearing market has shrunk as a result of major firms withdrawing. This situation is likely due to:

- the distinctive role Regulation placed on the centralization of liquidity and risks via clearing;
- the lack of homogeneousness in the CCPs’ worldwide mutual recognition that made a number of Clearing Brokers (CB) re-consider whether to offer such services in future, and made the few ones remaining and offering such service demand higher fees.
- other regulatory initiatives which are burdensome on the “European model” of clearing, e.g. Leverage Ratio , Financial transaction tax, net stable funding ratio.

It should also be noted, that indirect clearing (if it ever works) could provide a useful mode of access to central clearing for small FCs, for whom dealing direct with a clearing member of a CCP is not cost-effective for either side. But indirect clearing still ultimately relies on the clearing capacity of CCP members – it does not, and cannot, of itself add any overall capacity. The contribution of indirect clearing could be that a small FC’s trades cleared indirectly would benefit from the CCP access, and better transaction processing costs, available to the much larger head client. At the same time, handling the indirect clearing must be sufficiently worthwhile both to the head client and to the clearing member that the head client uses – potentially there are two lots of transaction processing costs for each trade. Nevertheless, if all other circumstance are favourable, we agree that mitigating the specific regulatory obstacles to indirect clearing would be helpful – this is, we think, a necessary, but not a sufficient , condition for indirect clearing to emerge as a meaningful alternative for small FCs.

Eventually, the lack of players offering access to clearing indirectly is already showing the potential to lead to a concentration of positions/risk within very few Clearing Member, having the opposite effect of what EMIR originally intended. Such liquidity concentration is already evidenced in the market and will further develop when the clearing requirements kicks in. This has huge consequences (among others regarding pricing and liquidity) for smaller cooperative banks and building societies as well as for NFC- as it leaves them with more difficult access to hedging possibilities in general.

Question 3: **Have you already established clearing arrangements (1) for interest rate swaps? (2) for credit default swaps? If not, please explain why (including the difficulties that you may be facing in establishing such arrangements) and provide an estimation of the time needed to finalise the arrangements.**

Some of our members who still face difficulties have reported that they have been currently negotiating towards establishing a collective clearing arrangement with a clearing member, but there are still cases for which such an arrangement is not yet in place and it can not be ascertained when and under which conditions these will be finalised.

In addition, we would like to stress our agreement with ESMA’s observations in section 3. Figure 2 and Table 1 are especially instructive – they confirm, as the EACB and its members have previously argued – that the largest counterparties already account for the vast majority of derivative trades, and that – even in aggregate – the trades of small FCs are simply not significant in relation to the stated objectives of EMIR. The most telling figure is that fewer than the 500 largest counterparties account for 99.4% of IRS activity.

Moreover, the EACB strongly supports the conclusion in paragraph 41, based on interpretation of the Figure 3 and Figure 4 data, that an extension of the phase-in period for smaller FCS will not compromise the primary objective. It is clear that the most active high volume counterparties already have access to clearing, since they have already reported cleared trades – in the case of IRS this covers periods even before clearing became mandatory for large FCs. The fact that the IRS clearing obligation is now in force for Category 1 firms, and will be in force for category 2 firms by December 2016, means that the vast majority of actual IRS trades will be being cleared through CCPs by the beginning of 2017, regardless of what is decided for Category 3.

Question 4: **Please provide information and data you may have that could complement this analysis on the level of experience and preparedness of financial counterparties with CCP clearing.**

Since around the time that the clearing obligation took effect for Category 1 firms in June 2016, IRS providers have become reluctant to deal with small FCs which are not themselves ready for CCP clearing, and/or quote two prices for swaps, one- more favourable- based on CCP clearing, and one -more adverse- based on traditional non-cleared bilateral settlement. We take this as an indicator that by the middle of 2016 a very significant migration of the bulk of IRS trades into CCP clearing is taking place, well in advance even of the Category 2 deadline.

We support the reasoning in paragraphs 50 to 67, and the conclusions in paragraphs 68 to 70.

Question 5: **Do you agree with the proposal to keep the definitions of the categories of counterparties as they currently are and to postpone the date of application of the clearing obligation for Category 3? If not, which alternative would achieve a better outcome?**

The EACB agrees that the current category definitions should be retained, and the application date for Category 3 should be postponed. In case the extension of the phase-in will not be granted, maybe the definitions of the categories of counterparties should be revisited.

Question 6: **Do you agree with the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines?**

The EACB supports the addition of a further two years to the deadline for Category 3.
Having said that, the proposed approach is a temporary solution for a structural problem. We assume that the EC will use these two years to work on alleviating the structural barriers for clearing (e.g. the leverage ratio) and will come up with proposals for this.
In addition, as we have already mentioned, have the feeling that the clearing obligation is, in isolation, only one – though probably the most important – part of a series of measures which are together having the unintended consequence of reducing small FCs' access to derivatives altogether. ESMA's current proposal, though welcome, cannot deal with the wider problem. We would encourage ESMA to carry out a wider study into this area.
In addition, we would like ESMA to confirm our assumptions that 1) in case of transactions between a bigger financial counterparty and a smaller financial counterparty (which will be granted a longer phase-in period) the clearing obligation between these two counterparties will also be postponed for two years 2) the margin requirements for non- centrally cleared derivatives will be applicable on smaller financial counterparties if they come into force before the extended phase- in of the clearing obligation has ended. If that is the case, in our opinion, the coming info force of the margin requirements and the end of the phase- in of the clearing obligation should be attuned.

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

We are satisfied with ESMA's approach. We agree that Option 1 is preferred on cost benefit analysis grounds, as it avoids re-classification and also uncertainty for other counterparties pending publication of the final TS.

Contact:

The EACB trusts that its comments will be taken into account.

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