European Association of Co-operative Banks comments on

Discussion Paper

Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

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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 28 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 4.000 locally operating banks and 63.000 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 181 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 51 million members and 750.000 employees and have a total average market share of about 20%.

The Members of the European Association of Co-operative Banks (EACB) are pleased to comment on ESMA's *Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories*.

Key Points

Intragroup Transactions

The most important points regarding this ESMA discussion paper deal with the questions of the **pre-notification to the national authority and subsequent reporting of intragroup transaction to the trade repositories** (Questions 21 & 22).

We believe that the current Level-1 text makes abundantly clear that in order to use the **intragroup exemption, exempted groups only have to notify the competent authority <u>once</u> before entering into subsequent OTC derivative contracts**. A notification on a trade-by-trade basis was not intended by the prevailing legislation, as the competent authority may object within 30 calendar days to this exemption. If the regulator were to decide on each single intragroup transaction to be exempted, this would create unprecedented workload from the side of the regulator and would effectively prohibit the use of this intragroup exemption due to the legal uncertainty during the regulator's veto period.

Once the use of this exemption has been notified to the competent authority, intragroup transactions are treated in the same way as centrally-cleared OTC derivative transactions (IGTs) from a reporting viewpoint. **We must strongly underline that IGTs shall not be treated differently to centrally-cleared derivative transactions, as exactly the same information will be transmitted to trade repositories (TRs)**. We therefore believe that no additional disclosure requirements are obligatory for these types of transactions, as is intended in the Level-1 legislation. For further arguments, please see our answers to Question 21 and Question 22 below.

Indirect Clearing

Even though EMIR calls for fair and open access to the CCPs, becoming a direct clearing member will – in practise – require very high capital requirements that will certainly limit direct clearing members to big financial institutions. **Smaller financial counterparties (such as small to medium sized co-operative banks)** will most likely only enter into indirect clearing arrangements with a clearing member. Here we would like to underline that these are necessary for our smaller institutions to implement the necessary clearing and **should** therefore **not be burdened with too much "red-tape" which would create unnecessarily higher costs and create an unlevel playing field between bigger and smaller institutions.** This cost issue especially rings true when looking at the questions whether all indirect contractual clearing arrangements require individual account segregation. Costs for the end user and the size of the end user and its positions are important considerations for eventually providing individual segregation to end users.

Detailed Remarks

The Co-operative Banks have focused their answers on the topic of OTC Derivatives (Section III.I) of the Discussion Paper and would greatly appreciate, if our detailed views and comments are taken into account in the ongoing preparation of the regulatory and technical standards.

Q1: In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

Q2: In your views, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

On a general note, we are concerned about the possible unwanted extraterritorial effects of applying this criterion. Double and conflicting regulation and supervision should be prevented. This means that supervisors and regulators should attune their regulatory actions on a global level.

The most obvious case for us would be any derivative contract with the underlying asset being denominated in Euros. But in practice we believe that it will be hard to identify whether a single transaction is intended to evade EU rules or not. Only by looking at a multitude of transactions from specific third-country counterparties, one might be able to assess whether substantial effects on the EU might exist.

Going forward, we would appreciate concrete examples of cases in which the OTC contract has been concluded with a third country entity and where the counterparty shall have a clearing obligation. This elaboration should as well cover any other obligations that the counterparty may have to fulfil.

Q3: In your views, what should be the characteristics of these indirect contractual arrangements?

Even though EMIR calls for fair and open access to the CCPs, becoming a direct clearing member will – in practise – require very high capital requirements that will certainly limit direct clearing members to big financial institutions. Smaller financial counterparties (such as small to medium sized co-operative banks) will most likely only enter into indirect clearing arrangements with a clearing member. Here we would like to underline that these are necessary for our smaller institutions to implement the necessary clearing and should therefore not be burdened with too much “red-tape” which would create unnecessarily higher costs and create an unlevel playing field between bigger and smaller institutions. This cost issue especially rings true when looking at the questions whether all indirect contractual clearing arrangements require individual account

segregation. Costs for the end user and the size of the end user and its positions are important considerations for eventually providing individual segregation to end users.

With this in mind, we believe that one of the possible ways forward could be the already existing and widely relied upon standardised contractual documentations, such as the ISDA Master Agreements. These contractual documentations are generally accepted and/or recommended by trading or industry organisations because of their high level of standardisation and because they address key legal issues (in particular close-out netting) that are an important element for mitigating legal and counterparty risks.

It could therefore be considered to recommend that indirect clearing arrangements be based on these master agreements. The requirements should, however, not recommend or mandate the use of one type of master agreement. Rather, market participants must continue to have a sufficient degree of choice to select the master agreements and thereby also the applicable law best suited to their needs and operational capabilities. National examples for this include trades negotiated under the French "FBF Contrat Cadre" or under the German "Rahmenvertrag" which must be eligible for future clearing.

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

Q5: For a reasonable assessment by ESMA on the basis of the information provided in the notification, what period of time should historical data cover?

We understand that it was neither the aim of the G-20 nor the EMIR initiative to prohibit OTC derivatives. Market participants have valid reasons, for trading derivatives over-the-counter. Therefore, a too broad classification by ESMA, resulting in a prohibition of OTC Derivatives of the relevant class not being offered for clearing, would have an unforeseeable impact on market participants and their existing risk management and therefore should be avoided.

Secondly, ESMA should enquire whether the relevant CCP offering the clearing for a class of OTC Derivatives is able to provide market participants with a sufficient number of accounts, in particular individual segregated accounts (e.g. investment funds respectively investment management companies require those for mandatory segregation purposes).

Lastly, from a macroeconomic perspective, we would like to point out that when applying the clearing obligation to a certain class of OTC derivatives, at least at the first stage, there will probably be only one CCP able to clear this type of derivatives. As there will be a lack of competition, adequate supervision is needed to prevent misuse of this market position.

Q6: What are your views on the review process following a negative assessment?

We believe that there should be a minimum waiting period of at least one year following a negative assessment for resubmission of a notification.

Our reasoning is that that each submission triggers preparatory internal processes in our institutions that cause considerable costs. If a resubmission was allowed only after a minimal time period, this would result in continuous operational burdens for our institutions.

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, availability of pricing information?

On a general note, we support the use of standardised contractual terms and operational processes where possible. In order to identify the class of derivatives that should be subject to the clearing obligation, parameters to be referred to should not rely on the type of OTC derivatives but on a nominal threshold value, the underlying asset and its liquidity profile.

On a more detailed note, here are some remarks on the individual paragraphs:

- Paragraph 22(a): One key element could be, as answered in Question 3, the use of contractual terms already contained or used in various master agreements (or other agreements with equivalent terms).
  When identifying OTC derivative contracts market participants already agree on product related provisions, such as the so-called ISDA Equity Derivatives Definitions or the Annex for Equity Derivatives Transactions issued by the Association of German Banks. If ESMA chose a class of OTC Derivatives as clearing eligible without considering the applicable terms to the transactions, market participants would lose their ability to agree on terms in their mother language as well as on the applicability of Non-UK / Non-US law.
- Paragraph 22(c): CCP clearing is only possible with a sufficient degree of liquidity and/or sufficiently high trade volume. The thresholds to be set in this respect should therefore have a sufficient safety margin.
  - Liquidity is of utmost importance. We would very much welcome any clarification on the concept of liquidity ESMA plans to rely upon for evaluation of the clearing eligibility. Liquidity is referred to in many other regulations (MiFIR, CRD IV to name just two), but the market is lacking a clear and common understanding so far.
  - The number of transactions certainly is connected with liquidity, but ESMA (and EMIR) are right to differentiate between the two. While not able to pinpoint a minimum threshold for liquidity we believe that 100 transactions a day should be the lowest limit for the number of transactions.

Q8: What are your views, regarding the details to be included in ESMA Register of classes of derivatives subject to the clearing obligation (Article 4b)?

Q9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

On a general note, we welcome the establishment of a Legal Entity Identifier (LEI), because it would allow for a most efficient and unambiguous identification. Furthermore,

at this moment in time it is unclear to us whether the public register exclusive purpose is to include information on the classes of OTC derivatives.

On a more detailed note, we would like to highlight

- Paragraph 24(d): To avoid uncertainties and confusion, the term "currency" should be replaced by "settlement currency". Since the contractual terms applicable to an OTC Derivative also need to be considered, ESMA should also determine the type of legal documentation (definitions) in the public register.
- Paragraph 24(i): Problems of identification may appear in future because any other characteristic are not foreseeable. In order to abolish any ambiguity, CCPs may be directly involved. CCPs shall inform the counterparties with regard to information to be sent.

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

In the interest of legal certainty, the information that a specific non-financial entity has become subject to the clearing obligation should be available to all potential counterparties and/or notified to the public, e.g. by listing the identity (if possible by LEI) of the relevant non-financial entities in the register maintained by ESMA. If an entity is not listed in that register no counterparty should be held responsible for not centrally clearing a transaction with this non-listed counterparty.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

We can generally agree with ESMA's approach, but would like to highlight that it should be in the sole responsibility of a non-financial counterparty to report to its (financial) counterparties, if the threshold has been breached. We would welcome more precise standards from ESMA in this regard.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

Definition/scope of the confirmation

The meaning of confirmation, specifically the information to be covered, needs to be defined in order to avoid uncertainties and misconceptions. According to current practice and the prevalent understanding of market participants, the confirmation covers the key terms of the transaction ("term sheet", "pre-confirmation" or "affirmation") and not the complete transactional documentation and all details of the transaction.

It should also be clarified that the time limits to be defined by the technical standards apply to the initiation of the confirmation process – that is, the first sending of the confirmation and not the receipt of a counter-confirmation/affirmation/acknowledgment by the other counterparty or the matching.

Electronic- and non-electronic confirmation

The time required for an electronic confirmation can differ considerably depending on the type of transaction and market participants involved. For example, confirmations concerning bulk transactions are significantly more time consuming than confirmations concerning single simple transactions. Likewise, less sophisticated market participants (which would include a significant portion of market participants falling under the definition of financial counterparty in particular small and medium sized banks) will have a significantly less developed infrastructure (human resources, system capacity) for the processing of transactions and thus will generally require more time for processing transactions. ESMA needs to evaluate, if it is a rational decision to force e.g. small non-financial counterparties and small banks with a limited range of derivative exposure to implement and perform a confirmation process through electronic platforms. From our experience with the current electronic confirmation processes, we see there is a high effort to cope with when using electronic platforms as companies have to implement and maintain the systems environments as well as to educate and to employ specialists to work with these systems and its distinctions. For that to happen firms will face additional costs for systems and staff. Considering these impacts it is not clear, if small companies and banks will benefit from occasional derivatives contracts any longer when cost-benefit equation is weak in this point.

Consequently, the benchmarks set by highly sophisticated market participants and in relation to simpler transactions should not set the standard for all electronic confirmations.

Proposed time limits for timely confirmation

The suggested time limits proposed under paragraph 38(a) to (c) appear unnecessary strict and constitute challenges to conform to the requirements. The time limits seem to be based on benchmarks set by highly sophisticated market participants and in relation to simple transactions and thus cannot be applied to all market participants and in relation to all types of transactions. Moreover, the time to process a deal varies heavily depending on the amount of counterparties, what kind of counterparty (financial or non-financial) and platforms are involved in the process (e.g. novation process) and could be far away from the time schedule as proposed by ESMA.

The following limits would be more realistic and ensure a higher quality and efficiency of the confirmation process (a distinction between transactions involving financial counterparties and non-financial counterparties exceeding the threshold on the one hand and non-financial counterparties not exceeding the threshold on the other hand is not necessary/helpful in this context):

- Electronic execution/electronic processing: 24 hours (time limits should be expressed in hours and not days in view of transaction counterparties residing in different time zones)
- Non-electronic processing/execution: 120 hours (= 5 days)

For the avoidance of doubt we want to outline that a clear, responsible and prompt confirmation process is essential, but must be in line with effort and practical feasibility.

Aside from that we notice ESMA needs to set up a confirmation process for participants of the intragroup transaction exemption.

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

Foremost, the terms "outstanding" and/or "unconfirmed transactions "need to be clearly defined and differentiated. Not every transaction which is not confirmed is already outstanding.

A period of one month for "plain vanilla" derivatives should be sufficient and appears to be appropriate. However, market participants should be permitted to do the reporting in batches (once per month). This would greatly increase the efficiency of the processes and the accuracy of the data.

Q14: In your views, is the definition of market conditions preventing marking-to market complete? How should European accounting rules be used for this purpose?

Q15: Do you think additional criteria for marking-to-model should be added?

We can generally agree with ESMA's approach but would like some further clarification on the definition of an "inactive market".

Additionally, we believe that marking-to-model valuations do not have to be approved by the board, as the board is responsible for the general application of effective risk assessment procedures and not every single mathematical model.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

At this point in time it is unclear to us what would constitute a sufficient reconciliation of non-cleared OTC derivative contracts. Is it sufficient when a financial counterparty regularly delivers a list of outstanding trades to its non-financial counterparty and the non-financial counterparty can provide remarks?

With regards to ESMA's proposal, the suggested threshold of 300 transactions for daily portfolio reconciliations under paragraph 48 (b) is set far too low. As stated above, effective and efficient reconciliations require a significantly higher number of transactions. The threshold for an obligation should therefore be set at not less than 5.000 transactions.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

Foremost, portfolio compression should not be compulsory but enacted on a voluntary basis. But even in such a voluntary context it is not clear how portfolio compression would work in terms of non-clearable transactions. Trades that are not suitable for clearing could hardly be compressed, due to their complex and non-standardised structures. However, for an effective and efficient portfolio compression, the transaction threshold needs to be raised significantly (not fewer than 10.000 transactions). Likewise, the frequency (twice per year) is not suitable or feasible in all circumstances. Parties should not be required to take part in every single compression process because becoming a member is costly. A more flexible approach avoiding too rigid requirements would enable market participants to adjust their processes better to their specific circumstances.

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

The requirements will affect internal/operational processes as well as the contractual/legal framework (in particular issues addressed under paragraph 54 (c)). When defining requirements regarding the legal/contractual framework for dispute resolution mechanisms, the focus should not be on the level detail but rather on the efficiency and (legal) effectiveness of the provisions. The master agreements currently in use (e.g. the CSA, the German "Besicherungsanhang zum Rahmenvertrag" or ISDA's "Best Practices for the OTC Derivatives Collateral Process") already contain provision concerning dispute resolution, which have generally proven to be very effective. The solutions provided in the different master agreements may differ to some extent, in particular as to their level of complexity. However, such differences reflect the fact that many market participants prefer simpler solutions in view of their available resources and operational infrastructure. The requirements should therefore not prescribe specific combinations of instruments and allow a broader choice of solutions, including simple yet effective solutions.

The proposed timeframe (5 days) is too rigid. Especially in the case of more complex issues too much time pressure will be counterproductive

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

The legal settlement, third party arbitration or market polling mechanisms are each sufficient to manage disputes.

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

The proposed threshold is too conservative from our point of view. In order for authorities to focus on potentially serious and relevant developments, we would suggest

a threshold of at least EUR 30m and where the dispute is outstanding for at least 30 business days.

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

Q22: In your views what details of the intragroup transactions should be included in the information to be publicly disclosed by counterparty of exempted intragroup transactions?

Pre-notification to the national authority

We believe that the current Level-1 text makes abundantly clear that in order to use the intragroup exemption, exempted groups only have to notify the competent authority once before entering into subsequent OTC derivative contracts (at least 30 calendar days before the first transaction). A notification on a trade-by-trade basis was not intended by the prevailing legislation, as the competent authority may itself object within 30 calendar days to this exemption. If the regulator were to decide on each single intragroup transaction to be exempted, this would create unprecedented workload from the side of the regulator and would effectively prohibit the use of this intragroup exemption due to the legal uncertainty during the veto period by the regulator.

Content of the pre-notification

We are strongly of the opinion that the publicly disclosed pre-notification information should only contain the name and/or LEI of the entities that will use this exemption.

On-going reporting of intragroup transactions

The on-going transmission of information of intragroup transactions falls under the reporting obligation. The details of the transactions will be reported to trade repositories (TRs).

Once the use of the above exemption has been notified to the competent authority, intragroup transactions are treated in the same way as centrally-cleared OTC derivative transactions (IGTs) from a reporting viewpoint. We must strongly underline that IGTs shall not be treated differently to centrally-cleared derivative transactions, as exactly the same information will be transmitted to trade repositories (TRs). The information disclosed by the TRs to the public will therefore also cover these transactions like all others therefore eliminating the need for further disclosures.

We therefore believe that no additional disclosure requirements are obligatory for these types of transactions, as is intended in the Level-1 legislation. A double (or even more than that) reporting requirement to different entities must be avoided at all costs, as there are already well-designed trade reporting systems in place.

We further believe that according to Article 8 paragraph 1n (d) and paragraph 1j of EMIR the counterparty of an intragroup transaction which has been exempted from the requirement laid down in para. 1b shall publicly disclose information on the exemption.

From our point of view, the cited provision does not mean any obligation to publicly disclose any details of the transactions subject to the exemption.

ESMA should consider that details of the exempted intragroup transactions are only to be published if one of the parties is a non-financial counterparty (cf. Article 8 para. 1n (c) EMIR).

Contact

The EACB trusts that its comments will be taken into consideration. Should there be any need for further information any questions on this paper, please contact:

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