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

A. Respondent

Name: European Association of Cooperative Banks

Country: Belgium

Category: please use the table below

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

B. Introduction – General comments

We welcome the opportunity to point out the cooperative banking sector's position on certain issues of particular importance related to the clearing obligation. We deem that the level 2 EU legislation should strive to combine the needs for regulation of intermediaries with those of preserving the diversity of the banking industry and cater for the peculiarities of local, cooperative and retail banks, possibly by concretely applying the principle of proportionality. Please note that we answer a selected number of questions which are of particular concern to us.

Comments on paragraphs 18 to 30:

We agree on the approach set out under paragraphs 18 et seq. In particular, we completely support the analysis in paragraphs 27 et seq. regarding the need to find a balanced approach which impedes circumventions and yet ensures that the clearing obligation is defined in such a way that all contracts captured by the obligation can actually be cleared by a CCP and for all counterparties subject to the obligation: The proposed two-pronged approach based on the definition of the classes in reliance on key characteristics combined with further, more detailed specifications to be applied on the level of the Public Register appears to be able to strike the right balance while providing for sufficient flexibility.

In this context it will of course be essential that the definitions and more detailed specifications are always designed in such a way that it is guaranteed that only such transactions become subject to the clearing obligation for which

clearing services are available for all market participants. Otherwise, the clearing obligation would effectively constitute a product prohibition.

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:

We would clearly favour Options A or B over Option C as these ensure the greatest degree of certainty for market participants. Option B would have the advantage of offering a flexible solution to address the problem of a loss of liquidity.

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:

Yes.

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:

All of the options may result in a very broad albeit rigid and inflexible definition of the class: Admittedly, settlement currency and geographical area are valid characteristics for defining and distinguishing single names CDS. However, these features as such, by themselves or jointly, are insufficient to clearly circumscribe a class of single name CDS which are more likely to be eligible for clearing than others which do not share these features: In the case of single name CDS the eligibility for clearing cannot be based on abstract features but will always depend on whether a CCP actually accepts the CDS in respect of the specific single name. In practice, the range of single names in relation to which CCPs will offer clearing services will be limited to a number of entities for which there is sufficiently broad/liquid market. The settlement currency and geographical area will only be secondary factors in this connection.

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:

Option B would be preferable since it would offer the requisite degree of certainty and flexibility.

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:

Yes

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:

Yes

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:

The clearing obligation should focus on those interest rate derivatives which are already being cleared by CCPs in sufficient volume. As in the case of CDS it should also be considered to include comparable classes which are to be subject to clearing obligations in other jurisdictions

Comments on paragraphs 59 to 70:

The criteria and categories proposed differ significantly from current practice and understanding. Any approach based on these criteria is likely to produce definitions of categories or sub-classes too general and ambiguous for the purpose of defining the scope of a clearing obligation for certain types of equity derivatives.

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:

All Options presented may result in considerable ambiguities and should therefore be reconsidered. Any attempt to categorise equity derivatives will be challenging because of the specific nature of the market.

A possible approach may be to use the inclusion in a designated major index as of a certain point in time as a means of classification

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:

Both the settlement currency and the geographical zone are, by themselves or jointly together, are inadequate criteria for any categorisation in this context. . In any event it would be necessary to clearly define what has to be understood to constitute the settlement currency and also how to address situations with more than one settlement currency.

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:

See our comments on paragraphs 59 to 70 as well as our responses to Questions 10 and 11 .

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:

See our comments on paragraphs 59 to 70 as well as our responses to Questions10 and 11 .

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:

We consider it necessary to specify that spot or forward sale-purchase operations having currencies themselves as an object do not fall within the notion of "financial instruments" under MiFID and, therefore, should be excluded from the scope of EMIR. The difference between a "derivative" (financial instrument) and currency sale-purchase operation lies in the object of the contract. Indeed, if the object of the operation is the "currency" as a material thing ("physically" settled) – even if the price is determined according to an exchange rate – there is no case for qualifying it as a financial instrument; on the contrary, if the object of the operation is a differential ("cash" settled), this would fall within the notion of a derivative financial instrument. The first case in fact entails a mere sale-purchase transaction the objective of which is typically to find currency for commercial needs, without any demand for financial elements connected to derivative contracts.

In line with the above, we do not see FX forward "physical settled" transactions as derivative instruments. As a consequence they should not be subject to a clearing obligation.

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:

See answer 14

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:

As in the case of equity derivatives, a classification of commodity derivatives will be extremely challenging in view of the specific nature of the market. Very different and varied factors can be of considerable significance in this context. For example, we noticed that the table does not appear to take into account differences in the specific market structure of energy transactions, such as the relevant grid/hub in transactions concerning natural gas.

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:

In view of the challenges described above, for the time being, we find it difficult to identify suitable candidates for clearing.

Comments on paragraphs 85 to 105:

We largely agree on the analysis under paragraphs 85 to 105. We would add or underline the following observations:

- *The number or percentage of transactions which are processed electronically via confirmation matching platforms should be a key indicator for the eligibility of a certain type of transaction for the clearing obligation since access to and use of confirmation matching platforms is generally a prerequisite for clearing.*
- *The existence of master agreements and standard confirmation templates is by no means a valid indicator for eligibility for clearing: Even "bespoke" transactions are generally entered into under a master agreement and standard confirmation templates generally afford a significant degree of flexibility for the counterparties to adjust transactions to their specific needs.*

Question 19 (readiness of the classes):

Do you agree with this analysis?

Answer 19:

We share the analysis that interest rate swaps and index CDS appear to be better suited for the introduction of a clearing obligation than other types of OTC-derivatives. This is also mirrored in the phase-in of starting dates for the reporting requirement of transactions and the confirmation deadline for bilateral derivatives. However, this only applies to the extent it is ensured that the scope of the clearing obligation is defined in all instances with sufficient clarity and does not inadvertently capture types of transactions which are not suited for clearing.

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:

In order to ensure a uniform and coherent application of the clearing obligation and a level playing field for market participants, we consider that the clearing obligation should only be imposed when there are at least two European CCPs, as well as more than one Clearing Member, available for each asset class.

When there is only one CCP available, we do not consider the clearing obligation as feasible, since as in such case - as mentioned in paragraph 111 of the Discussion Paper - there is no competition and the monopoly could impede access to clearing for all the counterparties. Therefore, in such case, a reasonable phase-in period is needed.

In the context of this question, we also wish to underline that small financial counterparties, as many cooperative banks are, encounter remarkable difficulties to access CCPs and to find Clearing Members ready to accept them as direct/indirect clients on reasonable and non-discriminatory terms. Clearing Members still seem to assess if and what kind of services to offer and the relevant economic conditions for the service supply.

In particular, the Clearing Member Industry, at the moment, is not yet ready to commit to clients to provide an Indirect Clearing Service, for the following main reasons:

- *at this stage the Indirect Clearing Model is not supported by any live or launching CCPs offering client clearing;*
- *it is still unclear how an Indirect Clearing Model would be reflected in the underlying legal agreements, in the capital and balance sheet implications, and in terms of risks associated with the indirect clearing model.*

This being the case small banks – which will not be able to access compensation neither through indirect agreements nor as Clearing Members (or Clients of a Clearing Member) – 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.

Therefore, the clearing obligation should be imposed only when the consistent application of all models of access to a CCP is equally ensured (as provided in art. 4 of EMIR).

In any event, the minimum period for the necessary preparations by the market participants should not be less than 12 months. The period would need to be significantly longer, if only one CCP were to be authorised.

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:

In view of the systemic role of CCPs will play, it should be clearly preferable to avoid the concentration of all cleared transactions in very few CCPs. To ensure a sufficient degree of competition and resilience as well as adaptability of

the market infrastructure to any changes in the market structure, including market disruptions, it should also be highly desirable that CCPs are not only able to absorb the existing demand but are also capable to adjust their capacity to an increase of the demand. Ideally, CCPs should also be able to absorb the market volume of any failing CCPs. Consequently, the potential market share all existing CCPs should be able to cover will have to be significantly greater than 100% of the actual market. Thus, each CCP will have to be able to offer an adequate capacity buffer. The less CCPs there are, the greater such reserve capacity has to be. Where there are only two CCPs it would appear to be prudent to expect that each of the two CCPs is able to absorb the transaction volume of the other.

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:

Yes, such default period appears to be necessary in the interest of certainty.

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:

We prefer Option C. It allows the application of a different phase-in, taking into account the needs of those financial counterparties that carry out trade in OTC derivatives of small size (which potentially do not impact significantly on systemic risk). Options A and B do not allow to act out such distinction, as they place all financial counterparties more or less on the same level.

Furthermore, it is appropriate to consider the very purpose of trading in derivatives. In this regard, we would like to point out that, under specific law and statute provisions, certain financial counterparties – such as some cooperative banks - cannot carry out "short selling" operations, nor, as for derivatives, can they assume speculative positions. Therefore, by statute, derivatives are used for hedging purpose only.

This being the case and taking it together with the issue we raised under question 20 (small cooperative banks having difficulties to access to clearing on reasonable and non-discriminatory terms), a proper period of time must be foreseen to fulfil the clearing obligation. Should such a period not be foreseen, these banks will de facto be forced to quit trade in derivatives and therefore they will not be able to carry on performing an efficient risk management activity (particularly as for 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.

Assuming that option C will be pursued, we can agree to base the phase-in period of the clearing access on the asset class and threshold as provided for non-financial counterparties in accordance to art.11 of Commission Delegated Regulation (Eu) No. 149, as below:

(a) EUR 1 billion in gross notional value for OTC credit derivative contracts;

(b) EUR 1 billion in gross notional value for OTC equity derivative contracts;

(c) EUR 3 billion in gross notional value for OTC interest rate derivative contracts;

(d) EUR 3 billion in gross notional value for OTC foreign exchange derivative contracts;

(e) EUR 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not provided for under points (a) to (d).

In order to control if the position exceeds the threshold, reference should be made to the last reporting to the Trade Repository or to the competent Authority at least 3 months before the date when the clearing obligation enters into force in order to achieve transparency and certainty over the applicability of the phase-in period.

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 consider appropriate a phase-in period of – at least – 12 months starting from the date when the clearing obligation takes effect. This 12 month phase-in period is required in order to grant the relevant counterparties the necessary time for the establishment of the operational and legal framework for clearing.

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:

For us, a key factor to take into account when defining the phase-in for the counterparties to comply with the clearing obligation, is the number of Clearing Members offering ***both indirect and direct*** *clearing services. As mentioned in answer 20, the Clearing Member Industry, at the moment, does not seem ready to commit to clients to provide an Indirect Clearing Service.*

The client clearing capacity of the CCP is also a relevant factor. As mentioned in paragraph 20, in order to ensure a level playing field for market participants the clearing obligation should be imposed only when the consistent application of the several models of access to a CCP is equally ensured (as provided in art. 4 of EMIR).

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:

We deem appropriate a remaining maturity of 12 months.

In addition, the legal, operational and practical challenges market participants will face regarding frontloading of transactions should not be underestimated. In particular, market participants will be facing severe difficulty in valuing transactions which may potentially become subject to frontloading (and thus a completely different collateral regime). It therefore seems advisable to limit the scope of the frontloading as much as possible and also provide for adequate timelines for market participants to effect such frontloading.

Comments on paragraph 136 to 138:

Derivative contracts concluded with covered bond issuers for the cover pool of a covered bond play an essential role in the financial market. They offer issuers the possibility to grant loans to their clients even if the characteristics of a loan (currency, maturity, coupon type) differ from those of the refinancing covered bond. Therefore cover pool derivatives enable banks to fulfil an important function in the global economy. In addition, the use of cover pool derivatives results in a reduction of interest and currency risks for the covered bond investors. Derivatives for cover pools solely pursue the purposes of hedging transactions, reducing risks and stabilizing the cover pool.

The counterparty benefits from a dual recourse. The first claim is against the covered bond issuer. Moreover, national covered bond legislations require that a counterparty's claim has to be covered at all times, which means that the second recourse is against the cover pool. This preferential claim on the cover pool ranks pari passu with the covered bond holders, which fully compensates the necessity to collect collateral in order to mitigate the counterparty risk (both initial margin and variation margin).

The different legal requirements in the national covered bond laws and additional important unique features such as individual rating triggers or unilateral collateral posting agreements require a special, often tailor-made, documentation, which makes covered bond derivatives not clearable through CCPs.

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

We would like to point out that mainly in the context of collateral posting, these types of contracts have specific features that differ from most other types of derivative contracts.

Regarding paragraph 136 of the Discussion Paper, we would like to suggest that when the legislators of the EU states that an administrative institution "should take something into account" it borders more on a legal obligation for the said institution rather than being merely an encouragement. Furthermore, an exemption might not be stipulated or "foreseen" by the Regulation, but it is not excluded either.

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

If a clearing obligation was imposed on some of the OTC derivative contracts concluded with covered bond issuers or with cover pools for covered bonds the result would be that those contracts could no longer be used, since no CCP can handle the fact that the contract ***shall not (according to the contract)*** *be terminated in the event of the issuer's default.*

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

No

Question 32 (covered bonds):

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

Answer 32

No, not unless the CCPs develop technical solutions. Furthermore, even if the technical solution is in place, rules for collateral posting would also have to be adjusted to take account of impediments faced by covered bond issuers or cover pools in providing collateral as mentioned in recital 24 of the Regulation (and answer 29). Therefore, addressing one part of the problem, without addressing the other half of the problem will not solve anything.

A brief overview on the collateral issue: The challenges regarding collateral is that almost all European covered bond legal frameworks allow derivatives in the cover pool with the purpose of hedging risks, essentially interest rate risks or currency mismatches, that may arise from the usual activity of an issuer.

But, covered bond legislative frameworks in Europe provides that collateral posting for cover pool derivatives is unilateral. The reason for this is that the counterparty is benefiting from a preferential claim over the cover assets, which is addressing the collateral issue as foreseen in recital 24 of the Regulation. This technique does not fit central clearing systems which require bilateral exchange of collateral and, therefore, impedes these privileged derivatives used for covered bond hedging purposes from being cleared through CCPs.

However, we believe it is important to highlight that derivative contracts concluded with covered bond issuers or with cover pools for covered bonds ***are*** *collateralised bilaterally – not in the way that is done by CCPs* ***but in a indirect way*** *– i.e. the counterparty posts collateral for the benefit of the covered bond issuer (or the cover pool) whereas the covered bond issuer (or cover pool) does not, because the counterparty has a preferential claim on the cover pool, ranking pari passu with the covered bond holders, which fully compensates the necessity for the counterparty to collect collateral in order to mitigate the counterparty risk (both initial margin and variation margin). Bear in mind, that covered bond cover pools are constituted of very high quality assets which must fulfil restrictive legal requirements with regard to asset types, LTV, asset matching, etc.*

Hence, we urge ESMA to duly take into account the impediments faced by covered bond issuers or cover pools in providing collateral in a number of EU jurisdictions and to consider unilateral collateral posting for covered bond privileged derivatives as an accurate and appropriate exchange of collateral.

We also believe that this particular risk mitigation technique should not be compensated by higher risk weightings which would be deemed unfair and would add unnecessary financial burden on this asset class which has turned out to be vital for the European banking industry especially during financial turmoil.

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:

As stated in recital 19 of EMIR, "the predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely, in particular, on preliminary international convergence and mutual recognition of the relevant infrastructure".

Therefore EMIR itself acknowledges, on the one hand, that the settlement risk is the main risk in FX transactions and, on the other, the existence of arrangements capable of mitigating this kind of risk. Since settlement risk is the risk that one party delivers the currency it sells but does not receive the currency it buys, we see physical settlement as the predominant risk of FX derivatives.