International
Capital
Market
Association

ICMA

Asset Management and Investors Council

ICMA AMIC response to European Commission EMIR Review Consultation

Introductory comments

The International Capital Market Association's (ICMA) Asset Management and Investors' Council (AMIC) welcomes the opportunity to respond to the European Commission consultation on the European Market Infrastructure Regulation (EMIR).

The AMIC was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC members have only expressed interest in certain aspects of the review:
(1) the functioning of the clearing obligation in the areas of frontloading and risk compression;
(2) trade reporting; and
(3) the functioning of the pension scheme arrangement (PSA) transitional exemption from the clearing obligation.

On the clearing obligation, the EMIR review is useful opportunity to re-examine the effectiveness of the frontloading regime and the value of risk compression trades. The AMIC believes the frontloading requirement should be removed for all future classes of derivatives deemed subject to the clearing obligation and the treatment of trades that result from systemically risk-reducing processes should be exempted from the clearing mandate and rules governing the margining non-cleared derivatives.

With regard to trade reporting, the European Commission should consider moving to single-side reporting to improve the accuracy of data provided to regulators to allow improved monitoring of systemic risk.

On the pension scheme arrangement transitional exemption, AMIC members are convinced the exemption would benefit from an extension until a robust solution is found to allow non-cash variation margin to be used by pension scheme arrangements, or at least to restart the exemption to coincide with the start of the clearing obligation.

QUESTION 2.2: CLEARING OBLIGATIONS

(b)(i) Are there any other significant ongoing impediments or unintended consequences with respect to preparing to meet clearing obligations generally in accordance with Article 4 of EMIR?

Yes, with regard to frontloading and treatment of trades resulting from risk-reduction processes.

(b)(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Frontloading

The AMIC believes the frontloading requirement should be removed for all future classes of derivatives deemed subject to the clearing obligation. The AMIC believes alongside other trade associations such as the International Swaps and Derivatives Association (ISDA) that the frontloading requirement creates significant pricing and market risk management challenges, particularly where bilateral collateral terms differ from CCP collateral terms, which can impact financial stability. It also creates significant challenges for EU counterparties pricing trades in the absence of counterparty classification information especially when trading with non-European counterparties. Thus we believe that the obligation should be removed for all future classes of derivatives declared subject to the clearing obligation.

Even though counterparties (classed as Category 1 and 2 under current proposals from ESMA) entering into or novating OTC derivatives during the frontloading window will know the classes of derivatives that will be subject to the clearing obligation, the CCPs currently authorised or recognised to clear those derivatives, the date on which that obligation begins to apply and the minimum remaining maturity at that date above which the clearing obligation applies, market participants will be unable to accurately price trades that will be cleared at a future date – which will likely lead to a divergence in pricing and overall market disruption, and necessitate the introduction of documentation solutions requiring negotiation and agreement between counterparties.

<u>Frontloading – documentation issues</u>

Frontloading applies only to Category 1 and Category 2 counterparties. However, because Category 2 counterparties comprise financial counterparties (and alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties) not belonging to Category 1 which belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives is above EUR 8 billion, this adds an additional layer of counterparty classification not referenced in EMIR Level 1, and means dealer firms need to document which counterparties belong to such category. However, while the industry has made significant strides towards facilitating an industry-wide categorisation solution in the form of ISDA Amend, it is conceivable that some counterparties will not make use of the solution and firms will be required to engineer a large bilateral communication exercise with their counterparties which will be disproportionately expensive, and potentially confusing and time-consuming for smaller counterparties.

If dealers are unable to ascertain from their counterparty in which Category the counterparty resides, many dealers might feel bound to take a conservative default approach when dealing with uncategorised financial counterparties (FC) and having to deem many counterparties to be Category 2, incorrectly forcing the practical challenges of frontloading upon many entities that should have been excluded by use of the thresholds test. These problems are magnified with third country entity counterparties, since none of them will be aware of the requirements, nor willing or able to address those requirements.

It is also important to note that the requirement that FCs not falling within Category 1, undertake the threshold calculation at group level, will not be a simple process. As FCs, such counterparties will never have had to make such an assessment for clearing threshold purposes. The assessment will therefore be one which requires all FCs (other than Category 1) to: (i) identify what is their "group" for these purposes, (ii) establish arrangements with all such group companies to be able to access and collate information on OTC derivatives positions. This in itself is a material legal and operational project. It cannot be assumed that such data will be readily accessible. Experience of "group" assessments in the non-financial counterparty (NFC) context suggests that this is not a straightforward task.

<u>Frontloading – non-recognised CCPs</u>

Another major concern arises if firms clear OTC derivatives traded during the frontloading window at CCPs that have not yet been authorised or recognised by the time the clearing obligation enters into effect.

If firms clear OTC derivatives traded during the frontloading window at CCPs that have not yet been authorised/recognised by the time the clearing obligation enters into effect, those firms will have to extinguish their positions and re-open them on EMIR authorised/recognised CCPs, which will cause significant market disruption (especially as some firms may not have clearing arrangements in place with other CCPs).

In some cases it may not even be possible to extinguish the exact position and thus trades will be in regulatory breach. Firms will be required to flatten their positions by booking a new exactly offsetting swap and compressing the position (by recognising offsetting cashflows). But if a firm had a range of positions with equivalent cashflows in a non recognised CCP, some subject to FL and some not, and booked a new offsetting swap intended to offset and then compress those cashflows subject to FL, there would be no way to ensure the CCP would use the offsetting swap to offset and compress the cashflows subject to rather than those predating frontloading. In such cases post-frontloading cashflows could remain intact and in regulatory breach.

Trades resulting from risk-reduction processes

New and amended trades that result from systemically risk-reducing processes such as multilateral portfolio compression cycles which result from original trades prior to the implementation of the rules governing the clearing obligation or the margining of non-cleared derivatives should be exempt from the clearing mandate and bilateral margining rules.

If these post-trade risk reduction trades are not exempted this would:

(1) cause a divergence between the application of the mandatory clearing regimes of the CFTC (which specifically exempts amended transactions from the clearing obligation where the nature of the modification is a partial reduction in notional principal and all other terms of the trade remain unchanged) and EMIR;
(2) act as a significant disincentive for firms to participate in both multilateral and bilateral compression exercises, thus frustrating the key EMIR objective of reducing counterparty credit risk; and
(3) introduce new pricing risks for market participants.

Typically, there are two types of compression mechanisms: the replacement swap method and the amended swap method. Under the former, a compression cycle will result in the termination of existing derivatives which will be replaced with new derivatives, with the effect of reducing notional exposure between counterparties. Under the amended swap method, the notional value between counterparties is reduced by amending the original derivatives. In both cases, if the new or amended derivatives were to become subject to the clearing obligation, market participants would be presented with significant pricing risks. Therefore, ESMA should consider excluding from the clearing obligation and the margining of uncleared derivatives any replacement trades and amendments to trades (which could include notional increases or decreases) that result from portfolio compression and other post-trade risk reduction exercises.

QUESTION 2.3: TRADE REPORTING

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

Yes.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

The AMIC believes that the dual-sided reporting (DSR) regime introduced in Article 9 of EMIR has not delivered the objectives of the Regulation. DSR has fallen short of providing regulators with accurate data thus undermining the ability of regulators to effectively assess systemic risk. Alongside other trade associations, like ISDA, the AMIC believes that the adoption of a single-sided reporting (SSR) regime will significantly improve the quality of data available to regulators by reducing the operational complexity of the current framework, and removing the burden for less sophisticated derivative users to report, which will lead to a vast improvement in the availability of accurate data to regulators.

The primary objective of the EMIR reporting requirement is to provide regulators with increased transparency in OTC derivatives markets in order to better enable the monitoring and assessment of risks that pose a threat to the stability of the financial system. However, recent experience has shown that the EMIR DSR requirement has failed to provide regulators with an accurate set of data that allows effective monitoring of systemic risk, thus undermining a key part of the G20 objectives for the reform of OTC derivatives markets. We note, for example, that ESMA announced in April 2015 that “since February 2014, when derivatives reporting began in Europe, the six European Trade Repositories have received more than 16 billion submissions, with average weekly submissions over 300 million.” We question the value to ESMA of 300 million weekly submissions.

Alongside other industry actors, the AMIC believes that these problems can in large part be addressed by the adoption of an SSR regime, which we believe will significantly simplify the operational complexity associated with the current reporting requirements by removing the DSR requirement to match trades (both legal entity identifiers (LEIs) and unique trade identifiers (UTIs)) improve the quality of data available to regulators, reduce the operational complexity of the current reporting framework, lower costs, and in most cases remove the reporting burden for less sophisticated derivatives users particularly among AMIC members on the buy-side. We believe the simplification of operational complexities associated with DSR will lead to a vast improvement in the quality of data available to regulators.

We commend the ISDA design of an initial blueprint for a European SSR framework. This blueprint is the result of a collaborative industry effort comprising both sell- and buy-side trade associations and their members.

Meanwhile, many buy-side firms rely on their clearing member to report on their behalf – a process known as delegated reporting. However, inconsistent dealer delegated reporting contracts and offerings make it difficult for buy-side firms to reconcile across multiple sources, which creates a challenging operational environment and decreases data quality. Delegated reporting may in some cases lead to entities informally delegating 'their obligation' but failing to check the accuracy of their trade data. Delegation under DSR results in the same trade being reported twice, therefore the end result is the same as SSR but with added operational complexity.

We believe that SSR would remove the dependency between counterparties to report the trade consistently to achieve matching rates, and significantly lessen the operational burden for buy-side firms, which lack resources to reconcile across multiple sources. We believe data quality will improve if the focus shifted away from addressing DSR matching rates and towards improving economic and counterparty data under SSR, which we believe will yield a vast improvement in the availability of accurate data to regulators.

Switching to an SSR regime will result in a more cost effective reporting framework in the long term. We also believe that the initial switch over from a DSR framework should not result in undue costs being placed on market participants. Many buy-side member firms who have chosen to self report have already spent money on systems and building connectivity to trade repositories, but they believe that shutting down systems is an easier low cost solution than continuing to maintain systems, and investing in new builds and upgrades for DSR. Other buy-side firms with more complex portfolios believe that they will still need to maintain the ability to self-report a significant number of OTC bilateral trades between NFCs even under the proposed SSR regime. The main fabric of their existing reporting solutions should therefore be capable of being preserved.

Finally, reporting regimes for financial instruments across different sets of regulations should be aligned. There is already movement in other regulations to explore the efficacy of SSR. For example, in the Securities Financing Transactions Regulation (SFTR), ESMA is required to present an annual report to the European Parliament, the Council and the Commission on the efficiency of reporting, taking into account the appropriateness of single-sided reporting, in particular in terms of reporting coverage and quality as well as reduction of reports to trade repositories, and on significant developments in market practices with a focus on transactions having an equivalent objective or effect to a securities financing transaction. Therefore the adoption of a SSR regime in EMIR can serve as the basis for a model than can be used in other regulations, such as the SFTR.

QUESTION 2.10: ADDITIONAL STAKEHOLDER FEEDBACK

i. Are there any significant ongoing impediments or unintended consequences with respect to any requirements or provisions under EMIR and not referenced in the preceding questions that have arisen during implementation?

Yes, the scope and timing of the pension scheme arrangement (PSA) temporary exemption from the clearing obligation should be reviewed.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Although not specifically part of this review under Article 85(1), AMIC members believe that the EMIR framework would benefit from a review of the transitional provision under Article 89(1) for pension scheme arrangements (PSAs).

The AMIC agreed with the decision on 15 June 2015 by the Commission under Article 85(2) to extend the transitional period by two years: "the Commission considers that the necessary effort to develop appropriate technical solutions has not been made by CCPs at this point in time and that the adverse effect of centrally clearing OTC derivative contracts on the retirement benefits of future pensioners remains unchanged. The three-year transitional period referred to in Article 89(1) of Regulation (EU) No 648/2012 should therefore be extended by two years."

However, in line with Commissioner Hill's request for comment on this issue in his speech at the EMIR hearing on 29 May 2015, the AMIC believes that the Commission should consider revising the basic parameters of the transitional measure. This is because while PSAs continue to require an exemption from the clearing obligation, mandatory clearing has not even started yet.

As we learned at the hearing held in Brussels, the Commission announced that the first clearing rules for interest rate products could be in place by April 2016, with phase-in by counterparty category still applying. This means that as the transitional period started in August 2012, nearly four years of the maximum six year transitional period will have passed with no actual benefit to those making use of the transitional exemption.

The AMIC always believed that leaving the exemption to a transitional nature undermined the objective of allowing PSAs to use non-cash collateral for their hedging derivatives. Because CCPs and other actors were aware that the transitional period would end, there was much less incentive to develop non-cash collateral solutions for PSAs. Unfortunately it has created the situation where the CCPs could wait for the end of the exemption period and then plan to treat PSAs as any other financial counterparty using cash variation margin, particularly since four out of six years of the exemption will have passed before clearing even becomes mandatory. The AMIC believes that a durable solution needs to be found for the cash variation margin (VM) issue that works for PSAs, their clearing members and CCPs.

Therefore, the AMIC believes that the European Commission should amend the Level 1 text to remove the end date in the Article 89(1) transitional provision for PSAs, so it would last until a robust solution of non-cash variation margin for PSAs is found. The exemption should be subject to periodic reviews assessing the availability of non-cash collateral solutions for PSAs to ensure that the exemption is still required.

At the very least, the European Commission should "restart the clock" on the transitional exemption, so that it should re-start from the start of the clearing obligation, whenever that becomes officially mandatory, but at least from April 2016 to ensure that the maximum six years apply from a more appropriate starting point.

ENDS

13 August 2015