

**EFAMA REPLY TO THE BASEL COMMITTEE ON BANKING SUPERVISION, THE COMMITTEE ON PAYMENTS AND MARKET INFRASTRUCTURES, THE FINANCIAL STABILITY BOARD AND THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (TOGETHER, 'THE COMMITTEES') CONSULTATIVE DOCUMENT ON INCENTIVES TO CENTRALLY CLEAR OVER-THE-COUNTER (OTC) DERIVATIVES.**

EFAMA<sup>1</sup> wishes to provide the views of the European funds and asset management industry in the perspective of the Committees consultative document on incentives to centrally clear over-the-counter (OTC) derivatives (the "Consultation").

As a principle, EFAMA supports every effort made to enhance financial market regulation which reinforces the stability of the financial system, of which EMIR is an important part at European level.

**General comments.**

Prior to replying to the consultation, we wish to make the following general remarks, most of the comments being oriented on mandatory central clearing.

Firstly, the **central clearing should neither be mandatory for smaller financial counterparties nor be considered in isolation**. It should rather be envisaged as another tool to manage appropriately risks inherent to the use of financial instruments.

In that perspective, we consider that three main principles are not duly represented and should **guide any further development in the derivatives' legal framework**:

(i) Investors' protection: if tax payers should be protected from a default of an investment firm investing proprietary assets, we believe that end-investors that are the same individuals as the tax payers should never provide a guarantee of any form to companies that are supposed to secure transactions or that are paid to execute services on behalf of their clients.

(ii) Access to information: Authorities and market participants should have readily access to relevant information. To achieve this goal, CCPs and candidate CCPs should provide their recovery and resolution plans immediately or in advance of any activity. Additionally, information on the transactions should be provided in a format allowing automated treatment down to the level of

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<sup>1</sup> EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 15.6 trillion managed by more than 60,000 investment funds at end 2017. Just over 32,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 28,100 funds composed of AIFs (Alternative Investment Funds). [www.efama.org](http://www.efama.org)

instruments through the allocation of ISIN codes<sup>2</sup>. These requirements would foster legal certainty and provide important data to adequately assess counterparty risk caused by Clearing Members (CM) or CCPs.

(iii) Collateral availability: Clearing is a valuable tool for managing counterparty risk, however pro-cyclicality of collateral requirements can have a destabilising effect on the market.<sup>3</sup> To guarantee the efficiency of the markets and allow the most efficient use of risk mitigation tools, the use of collateral should be facilitated. Certain market participants due to their nature or investment strategy may have difficulties in maintaining a pool of eligible collateral for cleared trades as this imposes a significant drag on returns. Therefore, assets eligible for collateral should be extended both in terms of asset classes recognised as eligible and for all market participants, including CCPs and central banks. Lastly, the legal framework applicable to all types of Financial Counterparties should permit the use of efficient portfolio management techniques allowing to transform assets in portfolios (such as corporate bonds or sustainable assets) into eligible collateral.

Secondly, even if we see the benefits of legislation on OTC Derivatives (especially EMIR in Europe) in terms of control of the systemic risk, we deem it **crucial for funds and asset managers to be subject to a fair and appropriate treatment**. In this perspective, a robust solution needs to be found for the margining issues. Otherwise, the application of those rules to funds and asset managers will not be in favour of the reduction of systemic risk in the financial system and will affect long term investments and increase the costs for end-investors. This would indeed be caused by the higher costs, immobilisation of assets and loss of return on cash collateral.

Lastly, we urge the Committees to propose **guidelines that support the objective of maintaining the liquidity in the financial markets**. The most important impacts are:

- The higher liquidity risk and a liquidity squeeze since more liquid assets are needed as collateral for derivatives transactions; and
- The higher risk of defaulting counterparties due to the lack or insufficient availability of eligible assets to deliver for collateralization purpose.

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<sup>2</sup> In that scope, please consider the work done by [ANNA-DSB](#).

<sup>3</sup> When market volatility rises so does the requirement to post collateral, therefore eligible collateral may be hard to find in the 'more volatile' environment, or exacerbate the volatile environment.

**EFAMA Replies.****Incentives**

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

We deem important to specify that a clear differentiation should be made between mandatory and voluntary central clearing. As expressed in our General Comments, most of the comments addressed in our replies aim at mandatory central clearing.

In that perspective, we fully agree with the fourth finding of the evaluation and the assessment that the incentives to centrally clear are less obvious for some categories of market participants, especially for smaller financial counterparts such as Collective Investment Schemes (e.g. UCITS and low-leveraged AIFs).

We see several impediments to the mandatory use of central clearing/

1. Concentration.

Concentration of market volume for clearing and margining services amongst small number of global banks is very apparent and has been highlighted by the Committee, in this analysis as well as in Committees analysis on Central clearing interdependencies dated 9 August 2018<sup>4</sup> (the "Report").

We also consider that such concentration creates more risks for end-investors for larger amount of transactions as they can:

- Be forced to stay in transactions against their financial interest or risk profiles; and
- Loose part or all their revenues on their investments; or
- Regain late access to their assets, in full or even only partially.

2. Pricing and offering

Pricing offered to firms is very much dependent on the type of portfolios and resultant relationships with their banking counterparties. The relation is assessed at a broader level, by different business areas within the banks and changes will occur as regulatory and economic impacts on profitability

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<sup>4</sup> See report at « <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD610.pdf> » and especially the following considerations expressed in the executive summary of the report:

"...2. Exposures to CCPs are concentrated among a small number of entities. The largest 11 out of 306 clearing members (as measured by prefunded financial resources contributions to the CCP) are connected to between 16 and 25 CCPs. This indicates that the default of a CCP's clearing member could result in defaults of the same entity or affiliates in up to 24 other CCPs included in this analysis.

3. The relationships mapped in this report are all characterised, to varying degrees, by a core of highly connected CCPs and entities and a periphery of less highly connected CCPs and entities. At the same time, even these less highly connected CCPs often maintain connections to at least one highly connected entity that indirectly connects the CCP to the central (more interconnected) part of the network structure."..

are factored in. It is inevitable that the losers will be smaller firms without the might of commercial incentive for the sell side.

The willingness of clearing members to offer clearing services <sup>5</sup>has also decreased partly due to capital and leverage rules. Smaller counterparties which have to clear are forced to utilise the services of banking counterparties whose commercial activities in this area have been significantly reduced.

In addition, CCPs all have or are developing subtly different models, making high level risk management very difficult to achieve and the comparison of fees and charges almost impossible. Clearing brokers themselves then offer different models to different clients to add to the complexity.

### 3. Access to clearing.

CCP Recovery and Resolution legislations are being developed late after clearing has been mandated, and depending on other factors as outlined above, may not be adequately implemented in time for a massive increase in clearing.

The impact of such situation has been demonstrated in practice in the run up to Variation Margin' requirements and related documentation prior to to the March 1 2017 deadline. Besides the delays to obtain the appropriate documentation, there simply wasn't bandwidth amongst dealers to accommodate the volume of necessary repapering and renegotiation with buy-side clients.

The issues with gaining access to clearing for smaller firms include limited derivative activity, very directional portfolios (like LDI or Pension Funds) constrained access to cash collateral and unfeasibility of direct access models for asset managers.

These issues are now are well known to policy makers and remain as much of an issue now as before as market innovation or regulatory imperative has not yet provided solutions.

2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

We are of the view that reforms imposed on the OTC derivatives market have brought more transparent and presumably increased markets' stability.

The main incentives for end clients are economic incentives through better access to market, increased liquidity and potentially reduced bid-offer spreads.

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<sup>5</sup> Clearing brokers numbers decreased approximately from 90 to 57 in 10 years partly as result of those capital requirements

However, our findings also evidence that costs, access capacity and margin type (such as cash collateral requirements) are strong disincentives to clearing. The various costs and constraints of clearing should be considered when assessing clearing benefits and not only transaction bid-offer spread. Overall the picture is mixed for end clients, which is highlighted in the report by the fact that use of voluntary clearing remains limited.

Lastly, we want to insist on the fact that the citizens are not sufficiently protected, insufficiently taking into account that the end-clients of an asset managers or a fund are citizens attempting to create some levels of savings.

3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

We consider that incentives to clear should come from the benefits of clearing itself, such as international operability.

We also consider that:

- The distinction between the regime applicable to financial counterparts subject to initial and variation margin from those subject to variation margins only should be maintained;
- Margin requirements should neither constitute an incentive to clear nor an indirect sanction in the absence of clearing; but
- Margins should rather constitute another tool to control counterparty risks as long as not all type of derivatives are centrally cleared.

Indeed, as recognised in the report, some categories of market participants (especially buy-side firms) are not able to centrally clear transaction or the total cost of transaction overpasses the benefits of clearing.

From the perspective of the European funds and asset managers' experience, we note that:

- At CCPs, only cash is accepted as variation margin.  
However, several funds are facing severe difficulties to transform assets held in portfolio into cash.
- At clearing members' level, we also noted in several occasions that some CMs impose more stringent eligibility criteria that increase the disequilibrium in disfavour of end-investors (which intensifies the liquidity squeeze further amplified for UCITS due to ESMA's Guidelines on ETFs and other UCITS issues - cf. Point 42 and 43j of ESMA/2014/937).

Therefore, we urge the Committees to recommend to:

- Deem eligible a broader range of assets at CCP and Clearing Member's levels such as:
  - o corporate bonds, which should be eligible in any circumstances to offer the broader possible range of eligible assets to avoid liquidity crunch especially in stressed periods;

- equities, which should be eligible for the same reasons despite their higher volatility that is however controlled by daily Mark-to-Market; and
- commodities such as gold in exceptional circumstances.
- Maintain a different regime of margins between large market users and smaller or less frequent market users;
- Encourage consistency in the application of rules related to asset transformation into eligible collateral and portfolio management techniques such as repos.

4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

We consider that factors affecting incentives to centrally clear are:

- price differential (better pricing in cleared liquidity pool),
- liquidity (more depth in the cleared pool),
- standardisation (higher for cleared trades) and operational ease,
- increased

However, we consider that there more factors reducing incentives to clear, especially for regulated investment funds such as UCITS

Firstly, our view is that the contractual framework between client and clearing members is biased towards clearing members, due to one sided documentation for cleared trades which in practice cannot be negotiated by buy-side,.

An illustration of this bias is shown in the Consultation: around 65% of clients estimate that they need more than 4 month to setup new contractual relationship with a clearing member while 87% of clearing members have the ability to terminate client clearing services within 3 months. Contractual framework should be adapted to allow easier access to end clients and more balanced relationship with clearing members.

Our members are providing contractual evidences that clearing members are using their position to add contractual clauses that go far beyond CCPs requirements and increasing transactions costs, such as the narrow eligible collateral set permitted to be posted with CCPs in respect of margin requirements on cleared portfolios. Despite their size, even large asset management institution have are still facing less favourable trade contractual conditions compared to previous bilateral contractual framework. We are convinced that smaller institutions have even worst contractual conditions.

Below, here is a set of limitation that are imposed on funds and asset managers:

- Ability for the clearing member to cancel unilaterally the trades.
- Ability to refuse collateral that even the CCP accepts
- Ability to unilateral increase fees

- Operational burden like intraday posting of margins which investor cannot perform due to daily NAV calculation
- Ability to request unilateral margin on top of what the CCP requests

We also note that CCP and clearing members have not provided a solution to transfer portfolio from one clearer to another and do not appear to try to implement such possibility despite the described portability regime and the related systemic risk in case of default without replacement.

### **Markets**

5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

We also consider that the consultative report is consistent with the experience of our members.

We generally agree with the liquidity is moving as the products are moved towards clearing. However, this does not constitute a generality as products like swaptions do not follow a similar trend as they are only supported by a limited number of clearing members making them difficult to clear.

6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

We recognise the existence of those efforts and initiatives.

However, we wish to raise to the attention of the Committees that those efforts should not be considered as the panacea to bring all market participants to central clearing as most of the proposed solutions are not applicable to funds.

Indeed, most of the funds do not have 500+ transactions, therefore are not reaching the threshold for compression.

Regarding direct access to CCPs, not all CCPs are providing such models and not all models are suitable for regulated investment funds.

In addition, access to new clearing models are not necessarily granted by clearing members to end users (clearing members are not be willing to develop some models due to uncertainties related to regulatory treatment or impact on their profitability as they developed previous model not yet amortised).

**Reforms**

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

- a. central clearing mandates (both in terms of product scope and entity scope);
- b. minimum standards for margin requirements for uncleared derivatives;
- c. capital requirements for credit valuation adjustment (CVA) risk;
- d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
- e. G-SIB requirements; and
- f. The leverage ratio.

From our perspective we consider, question by question that

- a. central clearing mandates (both in terms of product scope and entity scope).  
We consider that should not be mandatory for Small Financial Counterparties such as regulated funds like UCITS and low leveraged funds.
- b. minimum standards for margin requirements for uncleared derivatives.  
This can only be an incentive only for large market participants. Small Financial Counterparts should have more flexibility as clients are constrained by dealers' restrictions which are stricter than minimum regulatory standards and have ability to dictate terms to clients.
- f. The leverage ratio.  
LCR ratio are considered as disincentive to central clearing as they increase transaction costs and impair market liquidity.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

Please see our replies to questions 1 and 6.

As stated above and besides the difficulties faced by European funds and asset managers, we want to insist on the fact that incentives should aim at increasing voluntary clearing for smaller market participants and not in any circumstances force mandatory clearing on those market participants.

9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

We would like to take advantage of this exchange with the Committees at a global level to recommend that the European regime governing physically settled FX derivatives benefit from a real level playing field with the regime applicable in other jurisdictions, the US in particular.



Indeed, under Dodd-Frank regulation, OTC derivatives FX Forwards and FX Swaps transactions are exempted from both clearing and collateral exchange obligations as these transactions are very less prone to counterparty risk<sup>6</sup>.

Unfortunately, the EMIR regime does not propose such exemptions. Even if the draft EMIR Refit text currently being reviewed by the European Institutions proposes an exemption of variation margin exchange for certain counterparties, the extension of this rule to FX Swap is subject to intense discussions. Moreover, to ensure a complete level playing field, EMIR should exempt FX Forwards and FX Swaps from the clearing obligation at European level.

More globally, we would strongly welcome mechanisms of equivalence of clearing regime and recognition mechanisms across different regimes (i.e. UCITS funds clearing NA CDX on Ice Credit).

See also our replies to questions 1, 6 and 8.

**Access**

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

- a. accessing clearing arrangements; and
- b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

We concur with the analysis made by the Committees in its Section E1 and wish to remind the points raised in our reply to question 1 on the difficulties to access or maintain access to clearing.

We also wish to add an element of loss of opportunity to the elements of costs of clearing. Regulated European funds such UCITS funds are subject to strict borrowing and leverage rules, practically depriving them from borrowing capabilities. Therefore, every asset used as collateral is delivered on an "own asset" basis, with the direct consequence of the loss of opportunity to invest this asset.

Consequently, all difficulties characterised in the report are to be also considered in the perspective of a loss of opportunity, on top of the cost aspects.

Lastly, here again and in case the Committees wish to develop further incentives to clear OTC derivatives, we insist on the need to distinguish the application of the possible rules between large and small users and to not impose mandatory clearing on small market participants.

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<sup>6</sup> <https://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20determination%20pdf.pdf>

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

We agree with the Committees' assessment as described in the Section E4 of the report as well as the Committees' conclusions on the impacts of CCPs and CMs inter-connectedness as referred above (see also our reply to question 1)

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:

- a. using clearing services?
- b. providing client clearing services?

We agree with the Committees' assessment as described in the Section E2 of the report and figures provided in Figure E.4.

All in cost of clearing should be considered when assessing clearing benefits and not only transaction bid-offer spread. Fixed entry costs and skills required to access clearing are substantial and create disincentive to clearing for entities that cannot overcome entry barriers.

13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

As a representative of entities and more specifically European funds and asset managers, we consider that mandatory clearing has the following impacts:

- Concentration impacts
  - o Central clearing is forcing concentration on 3 to 5 CM due to a.o. the cost of implementation in systems and contracts;
  - o Even if there was direct access (and it is not yet the case), there is still severe level of counterparty concentration, hence increased counterparty risk
- The impact on collateral are higher as
  - o The extra collateral required by CM is setting higher pressure on liquidity;
  - o The asset eligible for collateral are more limited than in bilateral transactions
  - o There is no negotiation possible on eligible collateral and recall can be longer or more difficult to execute in CCPs or CM accounts;
  - o The collateral can be subject to haircut in recovery procedure, to the detriment of end-investors from their revenues.
- The introduction of mandatory "stay-protocols" or equivalent rules are
  - Against UCITS requirements to terminate immediately transactions;

- delaying the possibility to replace transactions with the collateral received;  
and
- The waterfall mechanisms can endanger the safeguarding of clients' assets.

However, we also note as explained above that there are benefits in:

- The pricing of certain transactions with some brokers;
- The general effort to support the global stability of worldwide financial markets; and
- The facilitation of the development of global operational process.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing?  
Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

Please see all our points above.

We urge the Committees to distinguish incentives for large users from smaller ones, only recommending voluntary clearing for the large users of OTC Derivatives.

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Brussels, 7 September 2018

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