Amafi Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

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CONSULTATION PAPER ON THE CLEARING OBLIGATION UNDER EMIR

AMAFI's response to the consultation paper of ESMA

Introduction

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 120 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

The Association has been following closely the preparation and implementation of EMIR and welcomes the opportunity to answer ESMA's Consultation on the Clearing Obligation under EMIR (no. 1).

1. The clearing obligation procedure

Q1. Do you have any comment on the clearing obligation procedure described in Section 1?

AMAFI totally agrees with ESMA's approach, which consists in grouping the analysis of the notified classes of OTC derivatives so as to minimise the set of consultation papers per asset-class (interest rate, credit, foreign-exchange, equity, etc.).

We consider this approach to be convenient and efficient.

The opposite approach, with a submission of separate draft RTS on the clearing obligation upon each CCP authorisation, would not be adapted to the stakeholders' operational and regulatory constraints nor to the applicable deadlines to be complied with.

AMAFI ■ 13, rue Auber ■ 75009 Paris ■ France
Phone : +33 1 53 83 00 70 ■ Fax : +33 1 53 83 00 83 ■ http://www.amafi.fr ■ E-mail : info@amafi.fr

2. Structure of the interest rate derivatives classes

2.1 Characteristics to be used for interest rate derivative classes

Q2. Do you consider that the proposed structure defined here for the interest rate OTC derivative classes enables counterparties to identify which contracts fall under the clearing obligation as well as allows international convergence? Please explain

Yes for the identification. AMAFI considers that the proposed structure defined here for the interest rate OTC derivative classes enables counterparties to identify which contracts fall under the clearing obligation. Indeed, for us, a sufficient level of granularity is critical in order to enable counterparties to assess whether a relevant product is subject to mandatory clearing.

As a matter of fact, we are of the view that the elements referred to by ESMA in paragraph 16 should allow determining which contracts meet the EMIR's criteria for the clearing obligation (i.e. level of standardisation, liquidity, availability of reliable pricing data).

However, we would recommend including unequivocally in the list of characteristics of the asset classes the capacity of an authorised or recognised CCP to actually clear the product. We think that CCPs should play an important role in disclosing the categories of clearable products with a sufficient degree of granularity. We recommend that CCPs be required to do so.

On the other hand, regarding the international convergence emphasised by ESMA's Consultation Paper, AMAFI is not convinced it is completely addressed by the proposed characteristics for the interest rate OTC derivative class.

Ensuring an actual level playing field would require an adjustment to the regime already in place within the context of the Dodd-Frank Act (DFA). We are of the opinion that the characteristics mentioned by ESMA should be complemented by some other characteristics required for interest rate swap to be mandatorily clearable under DFA (the trade start type, the day count convention and the notional amount).

2.2 Additional Characteristics needed to cover Covered Bonds derivatives

Due to the very short timeframe left for consultation, and considering the need to carefully examine the details of the standards, AMAFI is currently unable to answer it.

Q3. ***Do you consider that the proposal approach on covered bonds derivatives ensures that the special characteristics of those contracts are adequately taken into account in the context of the clearing obligation? Please explain why and possible alternatives***

Stakeholders (CCPs and covered bond derivatives users, in particular) are invited to provide detailed feedback on paragraph 38 above. In particular: what is the nature of the impediments (e.g. legal, technical) that CCPs are facing in this respect, if any? Has there been further discussions between CCPs and covered bond derivatives users and any progress resulting thereof?

Broadly speaking, AMAFI agrees that ESMA's proposed approach ensures that the characteristics of the covered bonds derivatives are adequately taken into account. Therefore, we accept the overall content of the proposed conditions referred to in paragraph 54 of the Consultation Paper.

However, AMAFI would like to provide comments on some of these conditions:

(a) *the counterparty to the contracts, which counterparty is not the cover pool or the covered bond issuer, ranks at least pari-passu with the covered bond holders (condition n° 2)*

We consider that this condition is the most crucial one.

We propose to make a distinction between the SCF (*sociétés de crédit foncier*) Covered Bonds Programme and the SFH (*sociétés de financement à l'habitat*) one since the legal issues at stake in these two programmes are partially different.

(i) The SCF Covered Bonds Programme

Pursuant to this programme:

- the assets (Export Credit Agency Guaranteed Loans) are within the balance sheet of the SCF entity since the receivables have already been transferred from day one by true sale to the SCF;
- the SCF enters into a swap agreement with a counterparty (his parent-company, for example) in order to hedge the market risk related to the covered bonds issued (currency and interest rate, notably) within standardised front swaps;
- the swap counterparty benefits from a preferential claim (legal privilege).

A portion of the wording of this condition ("ranks at least pari-passu with the covered bonds issuers") may raise issues of compliance with this proposed condition. Indeed, there is a clause included in the SCF prospectus (upon request from the rating agencies) which triggers the loss of the senior rank in the priority order when the swap counterparty is defaulting. Therefore, this clause may be an impediment to fulfil that condition as it is currently drafted.

Accordingly, AMAFI supports the proposed wording used by ESMA for this condition subject to a minor adjustment in order to address the problematic referred to hereinabove:

"the derivative counterparty ranks at least pari-passu with the covered bond holders as long as the derivative counterparty is not the defaulting party or the affected party; "

(ii) The SFH Covered Bonds Programme

SFH has also standardised front swaps and the issue of the trigger clause mentioned for the SCF scheme is also one for the SFH scheme. But there is also another issue linked to this scheme.

Pursuant to this programme:

- the assets (residential home loans) are not transferred to the balance sheet of the SFH entity but remain in the balance sheet of the parent-company;
- the hedging of such assets is handled through secured loans granted by the SFH entity to its parent-company, it being noted that such loans have the same financial features as the covered bonds;
- simultaneously, a collateral arrangement is concluded between the parent-company and the SFH entity. Accordingly, there is no market risk incurred by the SFH. The financial features to be paid to the covered bonds holders by the SFH are reflected by the cash flows to be received by the SFH from the parent-company (the borrower).

Such a scheme includes elements which may raise issues of compliance with the said proposed condition. Indeed:

- an event of default of the parent-company on the secured loan would result in SFH enforcing the collateral arrangement, which would trigger the transfer of the assets in its balance sheet;
- this situation would prompt market risks (currency and interest rates) to be managed by a hedging solution;
- the rating agencies require the SFH entity to anticipate this possible market risks by entering upfront hedging swaps (front swaps). Entering these front swaps creates market risks (interest rate and currency) on the SFH balance sheet;
- in order to overcome the market risks raised by the front swaps, converse swaps so called “back to back swap” are entered into, which aim is to neutralise the different SFH’s exposures. Upon an event of default of the parent-company under the secured loans, the back-to-back swaps will be terminated (the assets becoming the SFH’s ownership);
- back-to-back swaps do not benefit from any legal privilege as they are not required by law or regulation. Accordingly, the back-to-back swaps counterparty does not benefit from a preferential claim and is not entitled to rank pari-passu with the covered bonds holders. This could be an impediment to fulfil this condition as it is currently drafted.

That being stated, AMAFI considers that the carve-out regime of the front swap should be extended to the said back to back swaps in order to create a unique legal regime for the hedging derivatives entered into by covered bonds issuers.

(b) they are registered in the cover pool of the covered bond programme in accordance with national covered bond legislation (condition n° 3)

AMAFI agrees with this proposed condition to the extent that the net flows arising from the hedging transactions are taken into account in the calculation of the cover ratio (i.e. 105% for France).

(c) the covered bond programme to which they are associated meets the requirements of Article 129 of Regulation (EU) No 575/2013 (condition n° 5)

AMAFI agrees with this proposed condition.
However, we draw to your attention that there is a contemplated amendment of the Article 129 of Regulation (EU) No 575/2013.

(d) the covered bond programme to which they are associated is subject to a legal collateralisation requirement of at least 102% (condition n° 6)

AMAFI agrees with this proposed condition.

AMAFI wants to remind that the French legal collateralisation stands as of today at 105%.

2.3. Public Register

Q4. Do you have any comment on the public register described in Section 2.3?

AMAFI broadly accepts ESMA's views on the public register and its working process as described in Section 2.3.

Nonetheless, we are of the opinion that it is complicated to express specific comments at this stage since ESMA has not decided yet the exact scope of all the asset classes which will be subject to the clearing obligation. We consider that ESMA should accept further comments from the industry at a later stage, upon decisions on the exhaustive list of the OTC derivatives asset classes subject to the clearing obligation on the CCP already authorised.

Also, AMAFI shares the views of ESMA on the review of the clearing obligation process mentioned in paragraph 67. We agree that issuing a new RTS (or modifying an existing one) for removing an asset class (or contracts within an asset class) from the clearing obligation would be far too cumbersome from an operational viewpoint and may even raise risks to clearing members and/or CCPs, notably in case of loss of liquidity for a specific asset class. The clearing obligation process should be appropriate considering the urgency linked to the market evolutions.

Moreover, we suggest ESMA to include in the public register some information already required in the DFA and mentioned in our *answer to Q2*, so as to ensure a consistency between EU and US rules. This would enable to answer the concern about international convergence raised in Q2.

3. Determination of the OTC interest rate classes to be subject to the clearing obligation

Q5. In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

AMAFI is of the opinion that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives.

We consider as ESMA, indeed, that the OTC derivatives interest classes listed by the Consultation Paper meet the three criteria set in EMIR in view of determining the clearing obligation, i.e. (i) a high degree of standardisation of the contractual terms and of the operational processes, (ii) a high volume and a high liquidity and (iii) the availability of fair, reliable and generally accepted pricing information.

However, within the context of international convergence referred to by ESMA and welcomed by all stakeholders, AMAFI would like to underline that attention should be paid to a certain similarity for the maturity of the OTC derivatives interest rates asset classes subject to clearing obligations under EMIR and DFA.

4. Determination of the dates on which the obligation applies and the categories of counterparties

4.1 Analysis of the criteria relevant for the determination of the dates

Q6. Do you have any comment on the analysis presented in Section 4.1?

AMAFI shares the views of ESMA concerning the analysis presented in Section 4.1. In particular, we welcome the fact that ESMA imposes a clearing obligation on these asset classes on the basis of the existence of at least two CCPs available to clear the contracts belonging to such asset classes.

However, and for the same reason, we are concerned by the content of paragraph 145 of the Consultation Paper, which may imply that, in the future, ESMA would be entitled to launch a clearing obligation procedure even if the contemplated asset classes are cleared by a single CCP at the beginning of the clearing obligation procedure. Indeed, we opine that the clearing obligation of an asset class should be subject to the existence of at least two available CCPs in order to avoid any systemic risk and any monopoly situation, both being detrimental to the investors as well as to the market's efficiency and safety.

4.2 Determination of the categories of counterparties (Criteria (d) to (f))

Q7. Do you consider that the classification of counterparties presented in Section 0 ensures a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

AMAFI globally agrees that the classification of counterparties presented in Section 4.2. ensures a smooth implementation of the clearing obligation.

Nevertheless, we would like to raise some concerns on the proposed Category 2, which is large and heterogeneous. We are of the view that this category, combined with the proposed 18 month phase-in and 6 month remaining minimum maturity, presents some important risks, which would not ensure a smooth implementation of the clearing obligation for that category. On the one hand, the long period of 18 months may push a large number of counterparties of Category 2 to wait the last minute before sorting out their clearing arrangements with the risk of putting huge pressure on CCPs and clearing members to clear 18 months worth of trades in a very short period of time. On the other hand, the 6 month remaining minimum maturity proposed for frontloading is much too short as it would impose a frontloading obligation on almost all trades for a very long period of time, therefore implying significant difficulties to price the trades due to uncertainty about future clearing terms. Such uncertainty would likely have an impact on the tradability of some products, and hence on the market liquidity.

Please see our explanations and proposals in our *answers to Questions 8 & 9*.

4.3 Determination of the dates from which the clearing obligation takes effect

Q8. Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives

AMAFI globally agrees with ESMA's proposals, but we wish to point out some concerns on the proposed date of application for the counterparties included in category 2.

More precisely:

- AMAFI supports ESMA's proposal for category 1, that is an entry into force of the clearing obligation 6 months upon the entry into force of the RTS on the clearing obligation. Indeed, this rather short time-period is justified by the status of clearing member and by the fact that a large number of counterparties of this category already clear on a voluntary basis. We even consider that some of these clearing members may be in a position to clear all classes' right as from the entry into force of the RTS. Accordingly, some French financial intermediaries may decide to extend voluntary clearing before the expiration of the 6 month phase-in period;
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- AMAFI agrees with ESMA's proposal for category 3 (i.e. an entry into force of the clearing obligation 3 years upon the entry into force of the RTS on the clearing obligation). Indeed, we are of the view that this long time-period granted to non-financial counterparties does not raise any operational / regulatory risks for their counterparties (notably French financial intermediaries) given the fact that OTC derivative contracts entered into with such category 3 entities will never be subject to frontloading (pursuant to ESMA's proposal in the Consultation Paper);

- On category 2, AMAFI is of the view that ESMA's proposal, that is an entry into force of the clearing obligation 18 months upon the entry into force of the RTS on the clearing obligation, is questionable. We consider that category 2 counterparties should be encouraged to set-up clearing arrangements in a shorter timeframe. We recommend **reducing it to 12 months**. Such shorter time-period is justified notably by the fact that some entities belonging to this category 2 already have access to clearing, sometimes clear already, or in any case, should be in a position to secure access to clearing in such a timeframe (please refer to our *answer to Question 7* hereinabove).

5. Remaining maturity and frontloading

Q9. Do you consider that the proposed approach on frontloading and the minimum remaining maturity ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? If not, please explain why and provide possible alternatives compatible with EMIR.

Not completely. Even though AMAFI generally agrees with ESMA's proposals, we have concerns with issues linked to (i) the applicability of the proposed frontloading requirements to OTC derivative transactions entered into with category 2 counterparties and to (ii) the determination of the duration of the "remaining maturity" for OTC derivative contracts entered into during Period B.

More specifically:

- On the proposal not to apply frontloading requirements to OTC derivative contracts that are entered into with non-financial counterparties subject to the clearing obligation, AMAFI supports ESMA. Indeed, such proposal ensures that the long phase-in period granted to such counterparties (3 years) will not create any operational risk to financial counterparties entering into OTC derivative contracts with them (as we remind that frontloading requirements may create pricing uncertainty, consequently bid-offer spreads widening and, eventually, market instability).

- AMAFI also welcomes ESMA's proposal to divide the frontloading period into two different timeframes (Period A and Period B) and to ensure that no OTC derivative contracts entered into during Period A will be subject to frontloading requirements. Indeed, such proposal will address any uncertainties and negative impacts of frontloading. This is crucial for market participants as uncertainties and negative impacts linked to the frontloading are more significant during Period A than during Period B (as noticed by ESMA in the Consultation Paper).

- Nevertheless, AMAFI considers that ESMA should also propose not to apply any frontloading requirements to OTC derivative transactions entered into between and with category 2 counterparties during Period B, by proposing to mirror the minimum remaining maturity duration of 49 years and 6 months of Period A. Indeed, as mentioned above, frontloading requirements may create pricing uncertainty, consequently bid-offer spreads widening and, eventually, wide market instability due to the broad scope of that category. Today, there are no accepted techniques for determining how to price a derivative which becomes clearable at a future date (or for agreeing terms for future clearing). Therefore counterparties that are not clearing members will face uncertainties as to whether they will be able to find a clearing member and the terms of clearing at the time the clearing obligation becomes effective. Such uncertainty has an impact on the pricing of the trades. The large number of counterparties in this category and the long proposed phase-in period would exacerbate the risks on market liquidity and stability.

Hence, we recommend the following approach on frontloading:

(i) For category 3 counterparties, no frontloading obligation at all (as proposed by ESMA);

(ii) For category 1 counterparties, 49 years and 6 months of minimum remaining maturity during Period A and 6 months of minimum remaining maturity duration during Period B (as proposed by ESMA);

(iii) For category 2 counterparties, granting a minimum maturity of 49 years and 6 months for both periods which would result, in practice, in a non-application of frontloading.

6. OTC equity derivative classes that are proposed not to be subject to the clearing obligation

Q10. Do you have any comment on the analysis on the Equity OTC derivative classes in Section 6? What are your experiences in respect of such arrangements?

No. AMAFI shares the views of ESMA on the OTC equity derivative classes presented in this section.

7. OTC Interest rate future and option classes that are proposed not to be subject to the clearing obligation

Q11. Do you have any comment on the analysis on the OTC Interest rate future and options derivative classes presented in Section 7?

No. AMAFI agrees with ESMA's analysis on the OTC interest rate futures and options derivative classes presented in this section.

Q12. Please indicate your comments on the draft RTS other than those already made in the previous questions.

AMAFI wishes to raise an additional issue about swaps entered in connection with securitisation and other structured finance transactions, otherwise called "securitisation swaps".

AMAFI is of the view that the carve-out regime for clearing obligation that is hereby discussed for the covered bonds derivatives should be extended to the securitisation swaps. Therefore, we strongly support a clarification of the clearing obligation for securitisation swaps by ESMA in a dedicated RTS.

Q13. Please indicate your comments on the CBA.

AMAFI does not have any specific comment to provide on the Impact Assessment.