Reply form for the Consultation Paper On the Clearing Obligation under EMIR (no. 3)

1 October 2014|ESMA/2014/1185 Reply Form

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - Clearing Obligation under EMIR (no. 3), published on the ESMA website.

Responses are most helpful:

i. if they respond to the question stated;

ii. contain a clear rationale, including on any related costs and benefits; and

iii. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **6 November 2014**.

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

i. use this form and send your responses in Word format;

ii. do not remove the tags of type < ESMA_CA3_QUESTION_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and

iii. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading ‘Disclaimer’.

General information about respondent

Are you representing an association?	Yes
Activity:	Investment Services
Country/Region	France

Introduction

Please make your introductory comments below:

<ESMA_CO3_COMMENT_1>

AFG opposes the suggestion to extend to NDFs the clearing obligation that is anticipated for many IRS and CDS instruments for the following reasons:

1. the size of the market is very limited and it is very difficult to suspect that it will bring any systemic risk: the FX NDFs only represent 2.7% of the average daily turnover of the OTC FX market;
2. the study conducted by ESMA shows that there is a very limited liquidity for NDFs; that is particularly true and evident for 7 or 8 of the 11 studied currencies, since two thirds to ¾ of the activity are concentrated on 4 or 3 currencies only;
3. the number of CCPs and CMs clearing NDFs for the account of clients is very limited and will not support the obligation to clear: there are only one EMIR authorised CCP and only 20 clearing members for NDF, of which only two currently support the FX NDF client clearing activity ;
4. the longer maturities (above 6 months) are totally illiquid and we suspect that it is not possible to have access to proper valuation based on real deals for them;
5. AFG is very much concerned with the negative impact of an obligation to clear NDFs; it would imply the necessity to hold in the fund's portfolio assets, cash or collateral accepted by the only working CCP, that are not included in the investment universe of the fund. Effectively NDFs are used in funds specialized on emerging markets and few (if any) bonds or shares of these markets are eligible collateral for LCH Clearnet Ltd.

We are surprised that ESMA in this consultation breaches the logic of its approach towards clearing obligation as developed in the preceding two consultations and fear that it might give a negative signal to market participants. As a matter of fact we do not understand the rationale of the proposition and see on the contrary many contradictions in ESMA's reasoning. We strongly recommend that ESMA abandon its proposal to impose an obligation to clear NDFs.

Furthermore, we understand that the consultation was issued in order to coordinate ESMA's and CFTC's actions regarding the clearing of the NDFs. We wish to emphasize the importance of ensuring alignment between Dodd Frank and EMIR in order to maintain a consistent market. Nevertheless, we question the fact that a majority of the NDFs are treated in local (Asia/Latin America) without a coordination of regulations and which can create a market fragmentation.

<ESMA_CO3_COMMENT_1>

1. The clearing obligation procedure

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

<ESMA_CO3_QUESTION_1>
AFG considers that each currency should be analysed individually. The introduction of a 12th currency, Peruvian Sol, illustrates the fact that a global approach on NDF cannot apply and that a more granular approach is required.
<ESMA_CO3_QUESTION_1>

2. Structure of the non-deliverable forward derivatives classes

Q2: Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

<ESMA_CO3_QUESTION_2>
AFG agrees with the specification of each class and supports the emergence of € or £ as new currencies eligible for settlement. Any action to develop European currencies must be encouraged from a political point of view.
<ESMA_CO3_QUESTION_2>

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

Q3: In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?

<ESMA_CO3_QUESTION_3>
AFG is very much impressed by the quantity and quality of data that ESMA was able to produce and we feel that, when confronted to article 5 (4) EMIR, they point to the conclusion that NDFs should not be subject to an obligation to clear. Let us review the criteria.
Standardisation: we agree that EMTA and ISDA have drafted a proper framework for NDF.
Liquidity:

- Proportionate margins: we consider that ESMA is not in a proper position to assess that margins are not to low based on the fact that Competent Authorities have examined that point when authorizing CCPs; it sounds like a self- declaration of conformity; §42 deals with the risk that margins might be too high and the decisive point is that competition between CCPs prevents it to happen; when there is only one CCP authorized to clear NDFs in Europe we cannot follow ESMA and accept that "this CCP is not in a monopoly situation at international level…" : there is no choice for market participants but to clear through this CCP, which is the definition of a monopoly situation. ESMA cannot issue a RTS based on speculations that other CCPs from third countries might be recognised under EMIR. RTS must be based on the situation existing at the time of its writing.
- Stability of the market size and depth: if the slope of the curve of FX transactions is impressive on figure 2, that of NDFs is far lower and we think that the drop of NDF activities on the second half of 2013 in London as shown in figure 3 is significant evidence of some instability of the market; furthermore we conclude from the experience of the Australian dollar that in one year (July 1985 to July 1986) the NDF lost liquidity when regulation became more flexible; we might be at the eve of a comparable phenomenon with Chinese Remninbi which is one of the 3 most active NDF currencies; in pour view these figures evidence a profound instability of the market.
- Market dispersion: We agree that 17 members is sufficient if they offer clients servicing (which is apparently not the case) to provide market dispersion; but once again, we do not share the speculation, in § 56, on the propensity of these members to connect to other CCPs that might one day be EMIR-recognised;
- Number and value of the transactions: if we follow the figures presented by ESMA, OTC FX contracts represent 9.9 or 12.2% of the OTC derivative market. NDFs account for 2.7% of the FX OTC market: NDF represent somewhere around 0.3% of the OTC derivative market. It is difficult to consider it as significant and the Roman principle that *de minimis praetor non curat* seems appropriate in this case. Even the figure of trading of $ 127 billion in April is not impressive when we realize that it is the peak level as evidenced in figure 3; the comparison with the total traded on one currency, sterling, on IRS on the same period is not relevant as it compares a global asset class, NDF with many different currencies and diversified risk, to a single sub category.

The breakdown per currency shows that depending on the figures presented, which are all proxies for real indications of Europe based NDF activity, 3 currencies (China, Korea, India) represent the vast majority of the deals and amount to ¾ of Euroclear cleared transactions. Those only might account for more than a couple of basis points in OTC derivatives.
Availability of pricing information: it is clear that the CCP will establish day-closing price in order to compute margin calls. They rely on contributions by CM, what is certainly questionable when reminding the temptation to manipulate prices in a far more liquid field as Libor. As 98% of the NDF contracts have maturities up to 6 month, there is no real liquidity, and hence price information, on longer maturities.
<ESMA_CO3_QUESTION_3>

Q4: For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?

<ESMA_CO3_QUESTION_4>

Yes. We acknowledge the fact that past 3 months the liquidity drops and that above 6 month price information will almost exclusively rely on contributions. We strongly recommend of the proposed clearing obligation to limit the scope to NDFs with maturities lower than 6 months.
<ESMA_CO3_QUESTION_4>

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

Q5: Do you have any comment on the analysis presented in Section Erreur ! Source du renvoi introuvable.**?**

<ESMA_CO3_QUESTION_5>
Yes. We thought we had understood the position of ESMA about the minimum number of CCPs. Even if AFG considers that the existence of a plurality of recognised CCPs offering total individual segregation services should be a prerequisite to any obligation to clear, it received the argument that it would be considered by ESMA as an element when assessing the delay before implementation of the clearing obligation. We confess that we are shocked that ESMA anticipates the recognition of other CCPs and does not extend the delay for implementation of the clearing obligation by at least 1 year to allow time for competing CCPs to develop their offer. We maintain that preparation for a clearing obligation is a heavy process and that it is not practical to switch to another CCP in the middle of the project.
Furthermore we are surprised that in §92 ESMA might be understood as taking into account the expectations of CCPs (who developed an offer for clearing NDFs) that there would soon be a clearing obligation to justify *ex post* their investment. The business plan of CCPs should in no way influence ESMA's decision towards clearing obligation under EMIR.
<ESMA_CO3_QUESTION_5>

Q6: Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.

<ESMA_CO3_QUESTION_6>
We would very much prefer to have an assessment of the threshold of 8 billion at a different date for NDF and for IRS classes and a longer delay for implementation of a clearing obligation for NDFs under EMIR.
<ESMA_CO3_QUESTION_6>

Q7: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_CO3_QUESTION_7>
We stress that the absence of any competition between CCPs for clearing of NDFs demands that a longer delay apply before the date of application of any obligation of clearing NDFs. This delay should be gained preferably by postponing the publication of RTS till after the recognition of other CCPs or by extending the phase-in period by at least 1 year.
AFG agrees with the suggestion to limit any front loading requirement to category 1 and 2 participants.
AFG is very much concerned that investors in funds specialized in emerging markets might be severely penalized by the introduction of a clearing obligation on NDFs. These funds do not hold eligible collateral and, if launched as UCITS, will not be able to exchange holdings against eligible collateral since ESMA guidelines prevent them to use received securities or cash as collateral with a CCP. We insist on a rapid review of the guidelines on ETF and other UCITS issues on that point. Otherwise the exposure of clients will not be hedged and they will suffer cumulative risks on issues and currency at all times.
<ESMA_CO3_QUESTION_7>

5. Remaining maturity and frontloading

Q8: Do you have comments on the minimum remaining maturities for NDF?

<ESMA_CO3_QUESTION_8>
In our view the remaining maturities have to be adapted to the fact that only NDFs with a maximum maturity of 6 months should be subject to clearing obligation.
<ESMA_CO3_QUESTION_8>

Annex I - Draft Regulatory Technical Standards on the Clearing Obligation

Q9: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_CO3_QUESTION_9>
AFG insists on the specific constraint that applies to UCITS funds: they cannot use eligible assets received through a collateral swap to fulfil their collateral requirement with the CCP. As a consequence imposing a clearing obligation would ruin many strategies on emerging markets that are highly regarded by many investors.
<ESMA_CO3_QUESTION_9>

Annex II – Impact assessment

Q10: Please indicate your comments on the Impact Assessment.

<ESMA_CO3_QUESTION_10>
AFG suggests that a specific assessment be made on the consequences that an obligation to clear would have on the risk level of funds specialized on emerging markets. We fear that it would impair the development of appropriate hedging strategies and impact the risk /return profile of the funds.
<ESMA_CO3_QUESTION_10>