SSDA and DBA response to ESMA's Consultation Paper Clearing Obligation under EMIR (no. 4)

10th of July 2015

General comments

The Swedish Securities Dealers Association, SSDA, and the Danish Bankers Association, DBA, (the associations) welcome the opportunity to respond to ESMA's Consultation Paper on Clearing Obligation under EMIR (no. 4). The members of the SSDA and the DBA together account for a large share of the market for derivatives denominated in SEK and DKK.

The associations consider OTC derivatives central clearing to be an important tool to reduce systemic risk where it is present, and thereby strengthening the broader financial system. Central clearing is, however, appropriate only for standardized products that are traded in deep and liquid markets. For other products, central clearing may not be appropriate, and forcing clearing in such markets could negatively impact the stability of the financial system. Thus, when considering the imposition of a clearing obligation for certain products there needs to be a clear case of systemic risk to be addressed, and the obligation should be preceded by a thorough analysis of which products to include.

With regards to the proposals in the consultation paper for imposing a clearing obligation on certain derivatives denominated in SEK and DKK, we believe that i) the introduction of mandatory clearing for these small markets is unnecessary, ii) the analysis conducted in the consultation paper may be flawed, both because of low quality of data used, but also due to questionable assumptions and conclusions, and iii) introducing mandatory clearing based on possibly flawed analysis is undesirable and could have unpredicted consequences, particularly in the context of extensive voluntary clearing already undertaken by the larger market participants.

We have some doubts whether there is an issue of systemic risk that needs to be addressed in these markets. These derivatives are relatively small and are traded in minor markets. We also note that all major banks in Sweden and Denmark already clear voluntarily, given the economic incentives put in place for systemically important counterparties. The benefits of imposing a clearing *obligation* are, in other words, limited.

We further believe that the analysis presented in the consultation paper is possibly flawed as certain data appear to us erroneous, insufficient or one-sidedly presented. It does appear that the data used is the result of a very short assessment period, and includes trades which we suspect are possibly not relevant in the context of evaluating mandatory clearing. In short, we are not confident in its accuracy. The angle chosen to present specific material may also lead to wrong conclusions, for example when it comes to the size of the market. Finally, there is also, in our view, a too simplistic definition of liquidity. Our concerns are described in more detailed in our answer to question 4.

Introducing mandatory clearing based on this potentially flawed analysis is undesirable and could have unpredictable consequences. It could create concentration risk since there are only a limited number of truly active clearing members in these markets, thereby creating vulnerabilities in a default scenario, especially if products are not truly liquid. It could also bring adverse consequences for many small financial counterparties which already have difficulties in finding access to CCPs. There is a risk that these counterparties will reduce hedging activities in the future, thereby increasing risk in the system overall. There are also related consequences of this decision to these markets resulting from MiFID II regulation, in particular the obligation to trade mandated derivatives on trading venues. The liquidity of these markets is already poor, and adding additional regulatory requirements will deter participants further.

Taken together, in light of these issues and concerns with the data, and the possible risks of negative consequences from a clearing obligation, we suggest that ESMA at this stage do not impose a clearing obligation for the derivatives denominated in SEK and DKK.

Question 1: Do you have any comment on the clearing obligation procedure described in this section?

There is a need to clarify the process for removing a clearing obligation for a certain class of derivative should such a need arise. Furthermore, there should be means to temporarily suspend a clearing obligation in extreme circumstances.

Question 2: Do you have any comment on the structure of the interest rate derivative classes described in this section?

We agree with the structure but question more generally the clearing categorization per group of currencies as presented in the consultation paper rather than per individual currency. This could potentially lead to incorrect conclusions. For example, the analysis of section 5.3.2 ("Criteria 2(b): Stability of the market size and depth – EMIR 5(4)(b) and RTS 7(2)(b)") claims that, whilst the non-G4 currencies "only represent 10 per cent of the total volume of OTC interest derivatives", this non-G4 segment can still be considered significant due to the fact that the interest rate derivatives market itself is very large. However, this overlooks the fact that the AUD and CAD markets alone – not included in the consultation paper – constitute a very large proportion of the non-G4 segment. The "EEA currencies" presented in the consultation paper represent a mere 1.6 per cent of the global IRS market. The DKK market represents 0.1 percent, which is hardly something of systemic importance.

Moreover, by aggregating these different markets into a single data set, much individual nuance is overlooked. For example, the graph in Figure 2 (p. 20) which appears to show a steady growth in the EEA derivatives markets disguises the fact that, as shown in Table 2 on page 14, the turnover in NOK IRS fell from USD 8.3 billion to USD 2.56 billion between 2010 and 2013.

The EEA currencies grouping does not reflect any natural business relationships. Should there be any grouping, the distinction between the Nordic currencies and the other currencies in the proposal seems more natural and reflects the business reality for certain (but not all) players on those very different markets.

Question 3: Do you agree with the principle that, in the context of the clearing obligation, systemic risk should be considered only at the aggregated EU level, but also at country or even institutional level?

While we consider that systemic risk at cross-country level is the more important, we agree in principle that systemic risk could be considered also at country or institution level. However, whether an institution constitutes a systemic risk is an issue already subject to numerous regulatory requirements to reduce systemic risk in larger financial counterparties, and it hardly seems relevant when considering a clearing obligation under EMIR. Since the larger financial counterparties already clear their derivatives, the introduction of mandatory clearing hits smaller institutions particularly and disproportionately hard.

Moreover, a single product should only be considered a systemic risk if that product in itself constitutes an important and widely comprehensive systemic link in the system.

Question 4: 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.

As elaborated in our introductory remarks, we question on a more general level the need to introduce a clearing obligation for derivatives denominated in SEK and DKK as proposed in the consultation paper.

In addition, if a clearing obligation is to be introduced, it needs to be based on data of high quality and thorough analysis, so as not to introduce new risks and/or damage sensitive and important market segments. In particular, it is of utmost importance that the liquidity analysis is correct and that the data used is of highest quality spanning a reasonably representative period. In this respect, we see a number of shortcomings in the data used and in the analysis presented in the consultation paper. We question the findings with regards to derivatives denominated in SEK and DKK for which a clearing obligation is proposed. In our view the markets are smaller and less liquid than shown by the analysis.

We see the following shortcomings:

The small amount of data presented is gathered over a very short period of time, leading to low quality of data - a “snapshot” which ignores seasonality and is insufficient to represent the market as a whole. Thus the data cannot be considered to be representative.

We also question the use of TR data, especially extrapolating conclusions based on data from a single month. Reporting obligation under EMIR does not seem to work as intended and it could therefore be questioned whether the data is reliable. We also believe that the data includes trades which are not relevant in the context of evaluating mandatory clearing, either because they are intra-group trades, or trades with cover pool entities (which are excluded from clearing). As such, the volumes relevant to this analysis may be overstated.

As one example of the probable inaccuracy of the data, we know that one bank alone traded more OIS swaps than the total number shown in the consultation paper. Some of the other conclusions drawn, based on the data, such as the apparent “high” liquidity in 15 year SEK IRS, are also somewhat of a surprise to the participants active in those markets.

Such data should be used with great caution.

Some of the presentation of the material also seems somewhat misleading: the claim that “the segment of the non-G4 currencies can still be considered significant” (at 10 percent of the total volume of OTC derivatives) seems irrelevant, given that the large majority of that volume, 84 percent, is made up of currencies which are not considered in the consultation paper (CAD and AUD). For similar reasons, the conclusions reached in paragraph 49 seem inappropriate, since they suggest that derivatives denominated in DKK and SEK are actually very small classes and, as shown in later figures and tables, very local/national classes (thereby contradicting the likelihood of any systemic risks).

Likewise, the presentation of liquidity in Table 18 compares maturity buckets of different lengths as if they were equivalent measures (in this table, individual years – 1,2,3,4 etc. – are compared with a single combined block of years “11-15”).

Furthermore, the statement in paragraph 52, that “they (IRS and FRA denominated in EEA currencies) represent an important share of the volume in OTC interest rate derivatives denominated in the non-G4 currencies" seems exaggerated with regards to IRS, given that it has a share of just 16 per cent of the total non-G4 IRS volume. As mentioned in our answer to question 2, we do not think that Figure 2 gives a correct picture of the growth of the market, and that grouping the derivatives denominated in different currencies in this way hides the development in specific currencies, and risks giving an incorrect picture.

The conclusion regarding market dispersion could also be questioned. The assumption in paragraph 68, that "a clearing member of a certain CCP can be active in the market with respect to all the classes that this CCP clears" is questionable. We do not agree with the conclusion in paragraph 71 that "This important number of clearing members supports the idea that market dispersion would likely be sufficient in a default". In our opinion, there are only a very limited number of truly active counterparties when it comes to the derivatives denominated in SEK and DKK.

The analysis of CCPs is intended to convey impression of the depth and support of the participants in the clearing system. However, Nasdaq OMX currently clears only SEK IRS and no clearing has started in NOK, DKK and EUR IRS. Neither are 98 clearing members participating in these markets at LCH and, of those who have cleared Nordic IRS, the low level of participation beyond a core group makes it unlikely that there would be broad support in a default situation (since many members' low participation means they have little to lose in refusing to bid for default positions, or other incentives to participate).

Furthermore, looking at table 11 on page 26 and the conclusion ESMA is drawing in paragraphs 96-98 there seems to be some inconsistency. It is concluded that a very large majority of the daily turnover in OTC interest rate derivatives is denominated in the domestic currency and thereby showing a significant sensitivity to activity in the corresponding classes. However, as table 11 shows, only 5 per cent of the daily turnover in the Danish market is attributed to derivatives denominated in DKK. It is difficult to see how removing OTC interest rate derivatives denominated in EUR implies that a very large majority of the daily turnover is denominated in DKK.

Additionally, it is concluded that the daily turnover in OTC interest rate derivatives denominated in DKK is predominately taking place outside Denmark, showing a level of interdependency with the activity in the corresponding asset classes in the rest of the EEA. However, table 11 shows that 70 per cent of interest rate derivatives denominated in DKK takes place in Denmark. This is difficult to reconcile with the conclusion ESMA is drawing in paragraph 98.

This conclusion is repeated in paragraph 103 which refers to figure 3 on page 28 showing the volume (trade count) broken down by geographical location of the counterparties. Although the data used for this figure is gathered from European trade repositories - which as mentioned above is not the most reliable data - figure 3 still confirms the predominance of Danish counterparties active in DKK. Figure 3 shows that above 60 per cent of trades in interest rate derivatives denominated in DKK takes place in Denmark, compared to the 70 per cent that table 11 shows. Based on figure 3 and table 11, it is therefore difficult to understand how ESMA can ultimately conclude that the majority of trades in interest rate derivatives denominated in DKK takes place outside of Denmark and thereby displays an important level of interdependency with other markets.

The consultation paper bases its claim of "liquidity" partly on the concept of "number of days without trading" (section 5.3.4 – Criteria 2(d): Number and value of the transactions – EMIR 5(4)(b) and RTS 7(2)(d)). This data is presented in Table 18 (page 35). The limitation of this approach is that it gives no indication of how many trades are actually traded on a particular day – it might only be one trade in a day; moreover, any market in which there are *any* days without a single trade can hardly be defined as "liquid", as would be more readily understood in the financial markets.

Table 18 also gives a potentially inaccurate picture of the activity in SEK IRS for years 11-15, since the figures are aggregated and therefore exaggerates the perceived liquidity. As mentioned above, in particular we question the accuracy of the statement in paragraph 123, that IRS denominated in SEK demonstrate an important level of activity up to maturities of 15 years (we wonder whether 10 year swaps with a slight forward start might have been included in these numbers for 11-15 years, but because the individual tenors are grouped together, it is not possible to evaluate further).

Should inaccurate data lead to mandatory clearing in these small derivatives markets, there could potentially be a number of negative consequences. It could create concentration risk as there are only a limited number of truly active clearing members, creating vulnerabilities in a default scenario. This is especially the case if products are not truly liquid. There are also many small financial counterparties that already have difficulties to find access to CCPs. There is thus a risk that these counterparties will avoid hedging interest rate risk, which would increase risk in the system overall. There are also related consequences to these markets resulting from MiFID II regulation, in particular the likely obligation to trade mandated derivatives on trading venues. The liquidity of these markets is already poor, and adding additional regulatory requirements will deter participants further.

Further, it should be noted that DKK fixed-to-float interest rate swaps with a shorter maturity are primarily used as hedging instruments for Danish mortgage bonds and therefore implicitly reduce systemic risks.

In light of these issues and concerns, and the potential risk of negative effects, we think new data of better quality needs to be available if it is to be used as a basis for imposing a clearing obligation.

Question 5: Do you consider that the proposals related to the definition of the categories of counterparties are appropriate in light of the criteria set out in EMIR?

As elaborated in our introductory remarks, we question on a more general level the need to introduce a clearing obligation for the derivatives denominated in SEK and DKK as proposed in the consultation paper.

If a clearing obligation is to be imposed, we see a problem for small financial counterparties which only enter into a couple of interest rate swaps per year. Since there are no alternative means of hedging in the Swedish or Danish markets and since using EUR futures (bunds, bobl, schatz) provides far from perfect hedging, these small financial counterparties would be less likely to hedge interest rate risk. This in turn could increase risk in the financial system.

In line with the objectives in the EMIR regulation, we are of the opinion that the clearing obligation in SEK and DKK, were it to be imposed, should be limited to (and among) the systemically important financial counterparties. Indeed, the small financial and non-financial counterparties trading for mostly hedging purposes should be exempted for the following reasons:

- The compliance with the clearing obligation would be too onerous compared to the size and ancillary purpose of trading relative to their own activities (i.e. hedging).
- Many small Swedish and Danish financial counterparties would be drawn into the clearing obligation scope as a result of the SEK and DKK clearing obligation, since they do not trade in other currencies.
- These small players may face difficulties to find a clearing member ready to offer the clearing service for a small portfolio of clearable trades, as clearing members are pulling out from offering client clearing. The situation is aggravated for Nordic players as the number of

Nordic clearing members is relatively small compared to the large number of small institutions that would have to be on-boarded at the same time.
- There is a risk of unintended consequences such as reduction or disappearance of the interest rate risk hedging.

In order to avoid this situation we would like to propose the introduction of a fifth category for these small financial counterparties that should be excluded from the clearing obligation. The trigger for this category could be aligned with the already existing criteria used for other EMIR requirements. The criteria set out for the purposes of determining applicability of the requirement to exchange initial margin could be used appropriately to delimit the scope of the SEK and DKK clearing mandate too (i.e. EUR 8 bn of average notional amount on group basis for the same determination periods of the year). It is essential not to multiply the criteria and determination periods for various parts of EMIR compliance which would otherwise create a burden disproportional with the objectives of the regulations.

Question 6: Do you consider that the proposed dates of application for the different categories of counterparties ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

As elaborated in our introductory remarks, we question on a more general level the need to introduce a clearing obligation for the derivatives denominated in SEK and DKK as proposed in the consultation paper.

If a clearing obligation is introduced, we welcome that an extra period of three months to the phase-in period is proposed in case the two RTS on clearing obligation, for derivatives denominated in G4 and in the EEA currencies, are adopted shortly one after the other.

In addition, we think that additional phase-in time is justified for the derivatives denominated in EEA currencies, due to the limited size of these markets in comparison to the G4 and also to be able to accommodate the needs of smaller actors in these markets.

A general comment we have on the implementation of the phase-in arrangements is also that we note that the burden of the phase-in implementation has been entirely left on the market participants that will have to exchange various kind of status information for various purposes at various times (i.e. criteria for clearing G4 IRS, EEAs IRS, CDI, margining VM, margining IM etc. are different). The multiplicity of the criteria and times at which they should be applied, and thus the amount of data to be exchanged, is not in line with the principle of proportionality of the burden with the objectives of the regulation. The criteria for various phase-in arrangements under EMIR should be streamlined so that unique criteria is applied for all phasing-in/applicability purposes under margining and clearing regimes, and that the associated information is exchanged at one single point in time (or the uniform period of the year). It would be appropriate that the authorities themselves centralize the relevant information and process it to determine the compliance dates on which the in-scope entities could rely.

Question 7: Do you have any comment on the approach envisaged for frontloading?

The frontloading requirement effectively means that there will be strong pressure to commence clearing before the date of application of the clearing obligation, which will cause particular problems for these small derivatives markets. Sufficient time must therefore be allowed for before frontloading is required.

In connection with frontloading, it should also be taken into account that clearing in the frontloading period may take place on a third country CCP which may not subsequently be approved as a recognized CCP under EMIR. In that connection we note that we see some activity in Scandinavian currencies on CME Inc.

Question 8: Do you have any comments on the cost-benefit analysis?

No comments.

Question 9: Do you have any comments on the draft RTS not already covered in previous questions?

Access to clearing services for all types of financial market participants is fundamental for mandatory clearing to work. However, direct access to CCPs is generally limited to larger institutions. Smaller participants may often need to rely on indirect clearing, and yet at this point there are no arrangements at all for such clearing. For this, it is important to reassure potential providers that there are proper economic incentives and an insolvency framework which caters to the requirements in EMIR for indirect clearing to be offered, which seems questionable currently. We would urge ESMA to look into this issue in their ongoing review of EMIR.

The proposal takes adequately into account the characteristics of covered bonds derivatives. However, some fine-tuning could be done to ensure a more workable approach both in this respect and in the risk mitigation scheme for non-centrally cleared derivatives.

Regarding Art. 1(2) (f) we believe it should be sufficient to have a de facto 2 per cent over collateralization and not a necessity to have a legal requirement in each jurisdiction.