European Association of CCP Clearing Houses

EACH response to the European Commission Call for evidence ‘EU Regulatory Framework for financial services’

January 2016

Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of CCPs in Europe since 1992. EACH currently has 20 members from 16 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH welcomes the opportunity to respond to the European Commission call for evidence 'EU regulatory framework for financial services'.

In the sections below we describe the measures that we believe could be taken in order to have a safer and more efficient financial market in the European Union (EU) including some evidence to substantiate our arguments.

A. Rules affecting the ability of the economy to finance itself and grow

Issue 1 - Unnecessary regulatory constraints on financing

Example 1.1 - Authorisation of new products and improvements to CCP's risk management models (EMIR)

Summary

EACH believes that the authorisation of new products (Article 15 of EMIR) and improvements to CCP risk management models (Article 49 of EMIR) should be streamlined in order to allow investors to choose from a wider range of innovative risk management products to hedge their investments or diversify their portfolios.

Empirical evidence

EACH believes that the EU could best support the development of new technologies and business models, to the benefit of integrated and efficient capital markets, if the current processes through which central counterparties (CCPs) launch innovative risk management products and improve their risk management models are rationalised.

CCPs are financial market infrastructures that reduce and manage the counterparty risks in financial markets by becoming the buyer to every seller and the seller to every buyer of an original trade. They perform this function through robust risk management tools, such as multilateral nettings, ex-ante collateralisation of market positions and a pre-agreed set of legal and operational rules in case of counterparty default.

During the recent financial crisis, CCPs demonstrated their ability to successfully manage a default and prevent contagion across market participants: following the collapse of Lehman Brothers the CCP with the largest exposure to Lehman only used 35% of its first line of defence (initial margin)[1]. As a result of the resilience demonstrated by CCPs during the crisis, regulators around the word agreed to support clearing through CCPs as a way to improve risk management in the OTC derivatives market. In the European Union, this requirement was implemented through the European Market Infrastructure Regulation (EMIR).

EMIR sets minimum standards regarding the governance arrangements of the way European CCPs conduct business (e.g. transparency), the capital they must hold and their risk management framework.

We believe that the authorisation of new products and improvements to CCP risk management models should be streamlined in order to allow investors to choose from a wider range of innovative risk management products to hedge their investments or diversify their portfolios. CCPs currently face the following challenges when launching a new product or improving their risk management models:

- **Timing** – The timing to approve new products is excessively long. Based on the experience of EACH members, it can, in some circumstances, take a CCP close to or longer than one year to get a new product approved.

- **Governance**
  - Repetition of assessment – The process currently followed by some regulators lead to the repetition of assessment which may not be directly related to the improvement proposed and which may have already been approved by authorities during the original EMIR authorisation of the CCP (e.g. Article 17).
  - Overlapping verifications - EACH believes that the current process to approve new products or authorise an enhanced version of the CCPs' risk models can sometimes lead to a situation where the same verifications occur more than once.

- **Legal certainty** - EACH members believe that the current approval process is exceedingly left to interpretation. This is particularly the case with regard to the review of risk models, stress testing and back testing (Article 49), where the meaning of 'significant' and the validation timeline are in our view open to interpretation by the national competent authorities. If *any* change is defined as 'significant', the ability for the CCP to introduce new products would be significantly slowed down. The resulting legal uncertainty may lead to differences of interpretations amongst national competent authorities and therefore apply different standards to different CCPs authorised in the EU.

  For example EACH would not expect a competent authority to consider 'significant' the introduction of one additional scenario to the stress test methodology, where the CCP may already be using some 150 scenarios. A requirement to obtain approval in this case would hamper the ability of the CCP to make innovative changes to enhance its risk management practices

[1] Roger Liddell testimony to the UK House of Lords European Union Committee on 9th February 2010 (http://www.parliament.the-stationery-office.co.uk/pa/ld200910/ldselect/ldeucom/93/10020906.htm)

<u>Suggested remedies</u>

EACH believes that addressing these timing, governance and legal concerns through a more efficient process to approve new products or to modify risk models will facilitate innovation in the EU and provide efficient risk management possibilities.. In order for the European market to fully benefit from these improvements, it will be crucial that the new improved mechanism is implemented as soon as possible. EACH believes that the improved implementation should not be tied to the completion of the full EMIR review.

EACH proposes the following remedies:

- **Timing**
  - The application of a **single, clear and official procedure** equally applied across all CCPs and all jurisdictions in the EU. The factors taken into account when determining whether a change to CCPs risk models should be deemed material or not (Article 49) should be disclosed by regulators. This will help CCPs streamline their business strategy and better adapt the calendars to launch new products and make new developments. This clarity will also improve the communication of CCPs with their clearing members.
  - The **assessments by the national competent authorities** should be specific to new additional service or activity.
  - A more detailed **description of the data and documents required** as part of the application with the regulators would facilitate the procedure and reduce the timeline.
- **Governance**
  - To clearly **define the role of each regulator** (national competent authorities, ESMA, etc.) in the procedure. In our opinion, the ESMA validation referred to under Article 49 should be a high-level check to confirm that the National Competent Authority (NCA) has properly carried out its review and addressed all relevant issues with regard to the CCPs' models, which, according to EMIR must also be validated by an independent party.
  - To **enhance the transparency around the schedule of College meetings** (with the publication of the dates) and increase their frequency (potentially once a month - meetings can be cancelled in the absence of material submission) to ensure visibility and avoid bottlenecks.
- **Legal certainty**
  - **A list of indicative criteria** to determine whether a change is deemed 'significant'. The factors considered when determining any material changes (Article 49) to a CCP's existing risk management framework should be disclosed by regulators to CCPs.
  - **The authority that is responsible** for determining whether a change is deemed 'significant' based on the list of criteria above. In our view, further to the provisions of Articles 49 and 19, the authority responsible for initially deeming a change 'significant' should be the NCA.

  - **A clear timeframe** for the responsible authority to decide on the qualification of the change.
  - **A clear description of the validation process**, including the order and timeframe in which the independent validation, the validation by the NCA and ESMA as well as the college opinion, should occur. In our opinion, the ESMA validation referred to under Article 49 should be an annual ex post check to confirm that the NCA has properly carried out its review and addressed all relevant issues with regard to the CCPs' models, rather than an ex-ante approval process.
- **Equal treatment and competition among CCPs** - EACH members believe that the same process for the authorisation of new products and improvement of risk models should apply across jurisdictions in the EU, rather than depend on the interpretation of national authorities. An unclear and lengthy approval process could particularly put the smallest CCPs at a disadvantage when trying to expand their activities.

We are of the opinion that **a change to the EMIR provisions is not necessarily needed to implement the above mentioned remedies**. We would rather advocate for a consistent and transparent approach which is subject to an accurate timetable and provides clarity around the role of each regulator and the way to discharge the responsibility for the decisions to approve changes under Article 49.

Example 1.2 – Diversification of CCPs' investment policy (EMIR)

Summary

Article 45 of EMIR states that no more that 5% of cash collateral, calculated over an average period of one calendar month, can be deposited on an unsecured basis. This condition leads CCPs to rely on the repo market in order to comply with the rule while maintaining the liquidity required for business as usual purposes. This means that large CCPs will take up a large part of the repo market on a daily basis, therefore reducing the ability of other market participants to use this source of liquidity.

In order to release some pressure from the repo market and from CCPs, EACH believes that CCPs should be allowed to further diversify the range of secured investments detailed in Article 47 of EMIR and Article 43 of EMIR RTS 153/2013, as long as CCPs take an adequate risk-based approach towards the products they invest in, in line with the capital requirements under the EMIR RTS 152/2013. As an example, CCPs' investment policies should be extended to allow investments in money market funds (MMFs) under certain conditions.

Empirical evidence

In the experience of some of our CCP members operating in the US, late in the day margin calls tend to be met largely in cash by US clearing members and therefore need safe, liquid and reliable outlets to invest securely the late cash-inflows. The prohibition under EMIR imposes material constraints on cross-border CCPs and can result in an increased risk profile if such CCPs are unable to locate high quality secured investment capacity for clients' and members' money.

Suggested remedies

We would like to encourage the European Commission to consider MMF as highly liquid financial instruments if they meet conditions such as:

- The fund must be appropriately registered by its competent authority;
- The fund must be sponsored by authorised credit institutions as defined and regulated under CRDIV and CRR, an investment firm authorised under MiFID II and MIFIR, an alternative investment fund managed by AIFMDs authorised or registered in accordance with the AIFM Directive, or third country equivalent firms and institutions;
- The fund shall be required to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request;
- The assets held by the MMF should be of the type that the CCP is permitted to invest in pursuant to its approved investment policies and paragraph 1 of Annex II.

EACH would like to suggest that the European Commission allow CCPs to treat regulated highly creditworthy buy-side firms as potential investment counterparties for the purpose of entering repo transactions for cash balances against high quality liquid assets. This would allow CCPs to further diversify their investment counterparty risk profile while providing additional liquidity to the repo market for buy-side institutions.

Issue 2 - Market liquidity

Example 2.1 – CCPs' access to central bank liquidity (EMIR)

Summary

EACH members support the possibility for CCPs to access central bank liquidity in order to promote the safety and efficiency of the markets. EMIR requires that CCPs have access to the necessary credit lines or similar arrangements in order to perform its services and activities. CCPs can obtain these either from central banks or commercial banks. In reality however, access to central bank liquidity is currently not implemented consistently across the EU.

Empirical evidence

Access to central bank money usually requires a banking license. Providing all CCPs across the EU with harmonised access to central bank liquidity creates not only a level playing field but also ensures an alternative source of liquidity for the CCP.

Suggested remedies

We believe that a banking licence should not be necessary to grant access to central bank liquidity. The access should include access to intraday and overnight facilities. The precondition for granting access should be the EMIR authorisation or recognition of CCPs.

EACH believes that a change to the EMIR provisions is not necessary if all central banks within the EU agree to provide access to such liquidity to the CCPs in their jurisdiction, as a complement to the objectives of EMIR. We understand that the final decision to grant access to central bank liquidity lies with the central bank.

EACH would like access to central bank liquidity to be seen as an additional tool, not mandatory under EMIR, a pre-requisite for authorisation or recognition or seen as a proxy for a liquidity deficit should a CCP not have access.

EACH believes that access to central bank liquidity should also be promoted as a global standard for CCPs domiciled outside of the EU.

Example 2.2 – CCPs' deposits at central banks (EMIR)

Summary

EACH members believe that CCPs should have access to accounts at central banks in order to deposit the cash they receive as margin requirements and default fund contributions. This would work as a very good measure to prevent procyclicality, as it would allow CCPs to have a different behaviour from its clearing members in the event of a liquidity stress.

Empirical evidence

In the critical days following a default, the CCP needs to liquidate collateral and use it to meet member VM calls. This creates the need for the CCP to store cash during this short period, as it cannot be tied up in investment activity. Currently the vast majority of these funds would have to be encumbered in secured investment activity with no more than 5% on average being placed on unsecured deposit. Of course, such a deposit would need to be a demand deposit in this situation, and there can be a capacity issue in finding a home for even this amount of cash at overnight rates.

Suggested remedies

EACH members believe that **CCPs should have access to accounts at central banks in order to deposit the cash** they receive as margin requirements and default fund contributions. This approach would assist CCPs in limiting their exposure to commercial banks and comply with the EMIR rule under which no more that 5% of cash collateral, calculated over an average period of one calendar month, can be deposited on an unsecured basis.

EACH would support the creation of a **technical working group** between the public authorities and the industry to perform the technical reassessment of these provisions.

Issue 3 - Investor and consumer protection

No EACH comment

Issue 4 - Proportionality / preserving diversity in the EU financial sector

No EACH comment

B. Unnecessary regulatory burdens

Issue 5 - Excessive compliance costs and complexity

Example 5.1 – Unlevel playing field with third-country jurisdictions (EMIR)

Summary

EACH believes that there are some provisions within EMIR that currently create an unlevel playing field for EU counterparties over non-EU entities. This is particularly the case for CCPs clearing derivatives products, which are considered to form a global asset class.

Empirical evidence

Regarding the implementation of the clearing obligation, in the global derivatives market, the fact that the clearing obligation has already been implemented in jurisdictions like the US puts the EU at a disadvantage.

Suggested remedies

In the opinion of EACH members, consistency and harmonisation of policy initiatives to avoid regulatory arbitrage and to ensure a level playing field across CCPs globally should be the primary objective.

EACH members support a prompt implementation of the clearing obligation for those classes of standardised OTC derivatives for which a clearing obligation has been proposed[2]. The clearing obligation is one of the key provisions in EMIR in order to ensure a safer and more efficient OTC derivatives market for the benefit of market participants and the economy as a whole. In order to avoid regulatory arbitrage between jurisdictions, we would therefore encourage ESMA and the European Commission to swiftly finalise the regulatory process for the proposed clearing mandates and ensure that this also happens going forward for future proposed mandates.

In order to ensure a level playing field and avoid excessive bifurcation of liquidity in OTC derivatives, we encourage the European Commission and ESMA to align, to the extent possible, the calendars for the entry into force of the clearing obligation for the first type of asset classes (scheduled for 21st June 2016) and the recognition process for CCPs from equivalent third country jurisdictions. We would also encourage the European Commission and ESMA to complete the authorisation and the recognition process for CCPs from equivalent third country jurisdictions.

Example 5.2 – Margin requirements

Summary

[2] Clearing obligation no1 for IRS in G4 currencies; no2 for certain CDS; no 4 for IRS in certain EEA currencies.

The differences in margin standards between the EU and other jurisdictions have created legal uncertainty for certain institutions active in those jurisdictions. Weaker margin coverage could result in margin arbitrage for identical products offered by CCPs which offer cross-border services and potentially result in a flow of business currently cleared in one jurisdiction to other jurisdictions.

Empirical evidence

Although margin standards for CCP cleared derivatives under EMIR and comparable legislation in other jurisdictions, such as the US Dodd-Frank or the Russian Regulation for CCPs (CBR Regulation 2919) are consistent with the PFMIs, they are not identical. Prudential rules (i.e. provisions on margin standards) in different jurisdictions may not satisfy an equivalence test if judged on a line-by-line basis.

The net result of a lack of harmonised international margin requirements would be to encourage the precise type of margin arbitrage that prudent regulators and clearing house operators have long and appropriately avoided.

Suggested remedies

This can be avoided through the authorisation of CCPs from jurisdictions that have equivalent margin standards. EACH would suggest to take a holistic, outcomes-based approach to assessing equivalence of margin standards to avoid weaker margin coverage for the CCP from clearing participants and end customers.

Issue 6 - Reporting and disclosure obligations

Example 6.1 – Trade reporting (EMIR)

Summary

Please note that one EACH member does not support the answer to this section.

In order to ensure that the information reported to trade repositories provides the various regulatory authorities with an accurate view of systemic risk, EACH supports a higher degree of legal certainty with regard to such guidance.

Empirical evidence

EACH understands that the purpose of the EMIR trade reporting provisions is to ensure that information on the risks inherent in derivatives markets are stored centrally and easily accessible to ESMA, the relevant competent authorities, the European Systemic Risk Board (ESRB) and the relevant central banks of the ESCB. EACH believes that there are still certain issues which should be addressed to achieve that purpose more efficiently.

EACH also notes that the various forms of guidance issued by ESMA have been helpful in addressing on-going reporting issues with a way to significantly improve the trade reports of various market participants subject to the reporting obligation set forth in Article 9 of EMIR.

However, in order to ensure that the information reported to trade repositories provides the various regulatory authorities with accurate view of systemic risk, EACH supports a higher degree of legal certainty with regard to such guidance.

Suggested remedies

This legal certainty should be achieved through the development of a complete and comprehensive set of RTS which details precise reporting requirements rather than attempts to add clarity through different versions of non-legally binding Q&A or information provided by ESMA to Trade Repositories.

Additionally, in light of the significant development costs and investment already made by CCPs, clearing members and market participants in meeting trade reporting requirements, EACH would request that sufficient and prescribed time is allowed to implement any changes made to the reporting requirements included in the RTS.

Example 6.2 – Reporting inconsistencies/duplications (EMIR)

Summary

Please note that one EACH member does not support the answer to this section.

EACH finds it difficult to establish what is the base line for the industry to comply with increasing reporting requirements. In the EU, there seems to be inconsistencies in the reporting requirements included in EMIR, MiFID and REMIT. The potential for inconsistent and/or duplicated reporting requirements is also felt at the global level, where the Financial Stability Board (FSB) plans to aggregate Securities Financing Transactions (SFTs) data and the International Organisation of Securities Commissions (IOSCO) plans to revise Unique Transactions Identifiers (UTIs).

Empirical evidence

An example of the incongruity between EMIR and REMIT is the 'Delivery point or zone' field for commodities contracts. ESMA's Validation Table of 27/04/2015 states that TRs shall implement a validation on this field such that, '[w]hen populated, this field shall contain an EIC code as specified in the EIC Area Codes (Y) code list and pertaining to a delivery point within the European Union.' However, ACER's Transaction Reporting User Manual ('TRUM') instructs counterparties reporting under REMIT to populate 'Delivery point or zone' with an EIC (Z) code when gas can be delivered at the relevant interconnection point. Therefore, a TR would be required to reject the trade under EMIR if the counterparty rightfully reported a Z code under REMIT.

An example of the incongruity between EMIR and the MIFIR proposals for market data reporting is the proposed requirement under MIFIR which requires decreases and increases in notional amount to be reported as new transactions. However, counterparties reporting under EMIR report this as modifications to the original contract.

With regard to scope of Article 9 (Reporting requirements), EACH has concerns about the reporting requirements for Exchange-Traded Derivatives (ETD) contracts. A complete record of all ETD contracts is already available from CCPs. The sheer number of ETD transactions has resulted in significant challenge for regulators and trade repositories to consume the data in a meaningful way. The requirement to report ETD contracts represents a major competitive disadvantage for European reporting entities compared to other jurisdictions like the US and is out of the scope of the original G20 mandate agreed in Pittsburgh.

Suggested remedies

EACH would encourage the Commission to align the trade reporting requirements under EMIR with the reporting requirements under MIFID II and REMIT in order to ensure greater consistency and data accuracy.

EACH would also suggest that the Commission review the Scope of Article 9 of EMIR and apply it to OTC derivatives only.

Example 6.3 – Reporting – Standards for new fields (EMIR)

Summary

EACH is concerned about the requirements to use new reporting standards different to the ones agreed internationally.

Empirical evidence

For example, FIXML and FpML have a practical way to record (e.g. notional schedule) and trying to introduce the concepts of original and current notional amount through EU legislation would make their prescribed fields unnecessarily different and ambiguous.

Suggested remedies

Using existing standards would avoid unnecessary translation of existing clear trade confirmation data into new concepts. Prescribed standards provide no additional increase in the data quality or validation of data.

Example 6.4 – Reporting of Initial margin/variation margin for ETD trades (EMIR)

Summary

EACH believes that ESMA's recent proposal to replace posted collateral by initial margin posted and variation margin posted does not achieve the aim of the reporting requirement.

Empirical evidence

For ETD and some OTC derivatives contracts, variation margin, which is a cash transfer from the participant which has made a loss to the participant which has made a profit, is not considered as 'collateral' held against the risk position.

Suggested remedies

In order to calculate total systemic risk, we would encourage ESMA to keep the existing fields and add initial margin required to be able to evaluate the risk exposure against posted collateral.

Issue 7 - Contractual documentation

No EACH comment

Issue 8 - Rules outdated due to technological change

No EACH comment

Issue 9 - Barriers to entry

Example 9.1 – Barriers to access CCP clearing services

Summary
Inefficient use of collateral or poor capital recognition of collateral use can negatively impact the ability of market participants to act as clearing members.

Empirical evidence
A key example of the above is the leverage ratio which does not recognise the segregated margin posted to CCPs as exposure-reducing. This reduces the capacity of clearing members to offer clearing services for derivatives to their clients. This also reduces the possibilities for clients to obtain back-up clearing members.

Another example of a barrier to access CCP clearing services is the need to ensure that at least two CCPs offer clearing in the same type of products. In certain cases, allowing one CCP to clear a particular product category could actually increase the size of the market and therefore make it more attractive for other CCPs to join the market at a later stage.

Suggested remedies
EACH members would like to encourage the European Commission to revisit the rules regarding mandatory use of the leverage ratio with respect to the recognition of segregated margin as being risk-reducing.

Also, EACH members believe that, when assessing whether a market is ready for the entry into force of a clearing mandate, ESMA should consider that there might be cases where market participants might not have the appetite for multiple CCPs servicing a particular product. Each clearing mandate should therefore be assessed on a case-by-case basis within the constraint of swift implementation.

C. Interactions of individual rules, inconsistencies and gaps

Issue 10 - Links between individual rules and overall cumulative impact

No EACH comment

Issue 11 - Definitions

No EACH comment

Issue 12 - Overlaps, duplications and inconsistencies

No EACH comment

Issue 13 - Gaps

Example 13.1 – Enforcement of collateral arrangements (FCD)

Summary

Collateral arrangements should be easily enforceable whether they are on the basis of title transfer or a security interest (and irrespective of the jurisdiction where the collateral is held and the jurisdiction of the grantor). The Financial Collateral Directive is useful in that regard but some improvements could be made.

Empirical evidence

For example, we understand that powers of attorney are automatically revoked on the insolvency of the grantor in some jurisdictions but not in others.

It has also been observed that even 'netting-friendly' jurisdictions may have inconsistent laws regarding:

(i) the scope of eligible parties allowed to use close-out netting: for instance, insurance companies or special purpose vehicles used by banks in the context of securitisation might or might not be netting-eligible, depending on the jurisdiction;

(ii) the eligible types of contracts: jurisdictions differ, for instance, in their assessment of whether physically settled derivatives should be netting-eligible; and the extent to which close-out netting is compatible with the *pari passu* principle: for instance, the applicable regime regarding knowledge by the solvent party of the approaching insolvency of the counterparty differs across different jurisdictions.

Suggested remedies

We would support a **Financial Collateral Harmonising Regulation as a long term aim, with convergence of existing practice under the Financial Collateral Directive as a medium term aim**. In order to improve legal enforceability of collateral (which supports effective risk management and efficient markets), we would welcome (in the long term) a review of the Financial Collateral Directive to make sure it is still fit for purpose, particularly in relation to cross-border arrangements.

An alternative would be the introduction of a European legal framework for the harmonisation of rules regarding the methods allowing for effective acquisition of securities and collateral interests therein and the regime regarding good faith acquisition, building on the Financial Collateral and Settlement Finality Directives. This could include looking at the different types of security interest which exist under the law of different jurisdictions and ensuring there is a harmonised position on how such security interests are taken. It could also encompass some of the ancillary arrangements which surround collateral arrangements.

D. Rules giving rise to possible other unintended consequences

Issue 14 - Risk

Example 14.1 – Portfolio margining (EMIR)

Summary

The current EMIR regulation allows financial instruments to be portfolio margined together only when their correlations are significant, reliable and resilient under stress. EACH believes that choosing correlations as a metric to measure the adequateness of the margin at a portfolio level can be statistically misleading for portfolio margin models. Our detailed views are included in the EACH paper 'EACH views on portfolio margining' available for download under http://bit.ly/1IkhUq9

Empirical evidence

Significantly and Reliably Correlated (Article 27(1) of the EMIR RTS 153/2013)

The concepts of 'significant and reliable' correlations are in our view difficult to define in a margin model. The correlation between any two underlying instruments can be made to look 'reliable' if we use a long enough window and 'unreliable' if we use a short enough window. EACH believes that even if two financial instruments have low or non-existent statistical correlation they can be safely portfolio margined, provided the other conditions set out in the introduction of this pa paper are met.

Reliability' and 'resilience' of correlations or an 'equivalent statistical parameter of dependence' (Article 27(2) of the EMIR RTS 153/2013)

EACH believes that the concepts of 'reliability of correlation' and 'resilience of correlation' are questionable. These terms have an ambiguous intuitive feel and are difficult to make precise.

When stress events occur, correlations generally increase, as they tend to track volatility. Breaking up portfolios into separate pieces due to perceived lack of 'reliability' or 'resilience' incentivises clearing participants to ignore the related diversification benefits. This is contrary to ensuring adequate systemic risk management.

CCPs have therefore faced certain challenges when complying with this provisions as for example, for the case of historical simulations, correlations are not explicitly modelled but are implicit in the model.

Economic rationale (Article 27(2) of the EMIR RTS 153/2013)
Demonstrating the economic rationale for a particular price relation in portfolio margining has generally proven difficult for CCPs. It is unclear whether it means that for each combination of products this economic rationale has to be delivered. Even if prices are uncorrelated, this leads to diversification in a portfolio and thus reduces overall risk. Since this is a scientifically proven fact, it unclear to us why should this not be taken into account.

Suggested remedies

EACH proposal for Article 27.1 and 27.3 of the EMIR RTS 153/2013
In addition to the possibility to perform portfolio margining in line with the criteria included in the EMIR RTS, **EACH suggests that the legislation also provides the possibility for portfolio margining to take place if the following criteria are met**:

- The CCP is able to demonstrate that its margin model is sufficiently robust to prudently model the risk of the financial instrument even when correlations may not be significant nor reliable. The main tool to accomplish this is back testing, including 'micro back tests', which are tests at the small portfolio level (e.g. outright positions and commonly traded spreads), in addition to tests at client or clearing member level.
- The CCP can demonstrate that the group of financial instruments to be portfolio margined can be hedged as one portfolio of risk during a default and/or auctioned in a reasonable period of time (as applicable), consistent with the liquidation process.

EACH proposal for Article 27.4 of the EMIR RTS 153/2013
EACH would also like to make it clear that, provided the above conditions are met, a CCP may recognise greater than 80% of the offsets provided by its model. If the above conditions are not met then the maximum amount of offsets that a CCP could provide would be limited to 80%.

EACH proposal for Article 49 of the EMIR RTS 153/2013
To require the CCPs to provide evidence that the target confidence level is achieved overall for aggregated results on portfolio level.

Example 14.2 – Exemption of cleared derivatives from bail-in powers (BRRD)

Summary
EACH requests the exclusion of liabilities arising from derivatives cleared through central counterparties from the application of the bail-in tool by resolution authorities. EACH members believe that a failure to do so would present major obstacles to the proper operations of CCPs, and in particular:

- It could severely damage the effectiveness of CCP's default management mechanisms.
- It could therefore increase systemic risk and risk contagion to other market participants following a default.

Empirical evidence

Impact on the safety and efficiency of CCPs

Clearing of trades through CCPs reduces systemic risk and risk contagion. This is largely as a result of the comprehensive risk management arrangements employed by CCPs. An important aspect of risk management is that in 'normal circumstances', a CCP runs a 'matched book' (i.e. loss-making positions to which the CCP is counterparty are always matched by profit-making positions). In the event of a default, CCPs have rigorous procedures for the closing-out of clearing members' positions to re-establish a matched book. These arrangements crystallise losses at the earliest possible stage and prevent contagion to other market participants.

The inclusion of centrally cleared contracts in the bail-in provisions would potentially prevent CCPs exercising such powers:

- A CCP would be unable to default a clearing member or liquidate a position with a clearing member simply because it is subject to bail-in provisions.
- This will place the CCP in a position where it holds an unmatched book (and without access to default resources to make good any shortfall), thereby increasing systemic risk.
- It could also substantially reduce the effectiveness of a CCP's default procedures (which are designed to recreate the matched-book in a default) if a CCP is required to deal with a contract on its 'bail-in' terms and could therefore increase risk contagion to other market participants.

Impact on systemic risk

Not excluding liabilities arising from cleared derivatives from the bail-in tool would also be contrary to the objectives of the latest regulatory reform aimed at strengthening the international financial system. In Europe, the European Regulation on Financial Market infrastructures (EMIR) includes several provisions aimed at ensuring the effectiveness of CCPs' default management arrangements, and more generally to increase the robustness of CCPs.

Suggested remedies

The Bank Recovery and Resolution Directive (BRRD)[3] excludes from the bail in tool liabilities with a remaining maturity of less than seven days owed to EU CCPs designated according to the Settlement Finality Directive. This limited exemption means that liabilities arising under contract transactions between the clearing member in resolution and the CCP with a remaining maturity of more than 7 days would be subject to the bail in tool, undermining the effectiveness of a CCP's default procedures.

CCPs have every incentive to re-establish a matched-book, in order to mitigate the potential costs to themselves and wider market participants.

[3] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN

EACH would like to suggest that EU regulators consider the following two options to pursue an exemption for all liabilities owed to a CCP: the 'no creditor worse off than in insolvency' principle and the exemption for secured liabilities.

'No creditor worse off than in insolvency' principle

The BRRD contains a general safeguard for 'no Creditor Worse Off than in insolvency' (Article 34 (g)). The reference to this clause is also made in Article 73 (b). Under normal insolvency procedure, following national (e.g. Part VII of the Companies Act 1989 in the UK) and EU-level (i.e. the Settlement Finality Directive) exemptions from normal insolvency proceedings, CCPs are able to close-out positions and apply margin and default fund contributions in accordance with their default rules. Under normal insolvency a CCP would ultimately become a potential creditor of a Clearing Member, with greater powers to close out positions, in order to establish a matched book and avoid exacerbating market risk, without the need of a 7-day time limitation. Should BRRD resolution powers be used to bail-in a liability owed to a CCP, this would leave the CCP as a creditor in a worse off position than in insolvency, which must be avoided. To the extent that this could be acknowledged in relevant BRRD Regulatory Technical Standards (RTS), it would serve to bring greater transparency and certainty to the status of liabilities owed to CCPs.

Secured liabilities approach

Article 44 (2) (b) of the BRRD exempts secured liabilities from the bail in tool. Liabilities owed to the CCP are secured by the margin provisions and the contributions of the clearing members to the default fund. We would therefore like to suggest that the EBA clarifies in the RTS that the liabilities owed to CCPs are exempt from the bail in tool on this basis.

Exemption of cleared derivatives from bail-in powers

In addition, it is worth noting that CCPs could be exposed to the risk that different resolution authorities take differing views as to whether cleared derivatives could be bailed in or not, which could then impact the enforceability of collateral and close-out netting arrangements by a CCP in a clearing member's default scenario. We believe that resolution authorities should take a consistent approach on this matter and exempt cleared derivatives from bail-in powers. Bailing-in liabilities owed to CCPs could present significant challenges to the proper operations of CCPs and undermine financial stability. As you will appreciate clearing of trades through CCPs helps to reduce systemic risk and risk contagion. This is largely as a result of the comprehensive risk management arrangements employed by CCPs. An important aspect of risk management is that in normal circumstances a CCP runs a 'matched book' (i.e. any loss-making positions to which the CCP is counterparty are always matched by profit-making positions). In the event of a default, CCPs have rigorous procedures for the closing-out of clearing members' positions to re-establish a matched book. These arrangements crystallise losses at the earliest possible stage and prevent contagion to other market participants. The inclusion of centrally cleared transactions in the bail-in provisions could potentially prevent CCPs exercising such powers. For example:

- A CCP may be unable to default a clearing member or liquidate a position with a clearing member simply because it is subject to bail-in provisions. This could place the CCP in a position where it holds an unmatched book (and without access to the clearing member's default resources to make good any shortfall), thereby increasing systemic risk.

- It could also impact the effectiveness of a CCP's default procedures (which are designed to recreate the matched-book in a default) if a CCP is required to deal with a contract on its 'bail-in' terms and could therefore increase risk contagion to other market participants.
- Furthermore it may result in market uncertainty if it was not clear that all liabilities owed to a CCP, including net sums due, were excluded from the scope of the bail-in power.

Issue 15 - Procyclicality

Example 15.1 – Procyclicality provisions (EMIR)

Summary

EACH believes that the existing requirements to limit the procyclical effects on CCPs' financial resources could be enhanced to adequately cover all markets and products.

Empirical evidence

EACH's members look to establish margin requirements that are necessarily prudent, while not being overly procyclical. In addition to the options permitted under Article 28 of the EMIR RTS, CCPs should utilise a variety of tools to manage procyclicality, depending on the product and the asset class.

The current procyclicality tools are not optimal for example for managing procyclicality for products that demonstrate significant changes in price and volatility during certain times of the year (seasonality). Failing to allow for CCPs to implement tools to primarily manage the procyclical risk of seasonal products in this manner may create additional risk, especially where seasonal factors outweigh historical volatility over a longer time horizon. New tools to address seasonal volatility represent the most effective way for addressing the procyclical nature of certain products and this option is unavailable under Article 28 of the EMIR RTS. We believe it is not feasible to include adequate procyclicality tools for every product that CCPs clear.

Suggested remedies

The procyclicality provisions in EMIR should be modified in order to ensure that they promote the final objective of adequate risk management, regardless of the tool used to mitigate procyclicality. Any rules that prescribe modelling approach should be removed from the regulation.

We would therefore recommend a revision of the RTS to incorporate a principles based approach.

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