EACH
European Association of CCP Clearing Houses

EACH response to the ESMA Consultation Paper "Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a))"

June 2020

Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 19 members from 15 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the ESMA Consultation Paper "Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a))" (hereinafter called "The consultation").

EACH understands that the request to ESMA made by the European Parliament and the Council of the European Union to submit a report on PTRR services was mainly due to certain concerns related to the portfolio compression practice. However, we would like to highlight that is our opinion that, in recent times, the discussion among stakeholders has shifted, and the previous calls for an exemption from the clearing obligation for the trades that result from portfolio compression seems to have been changed to calls for an exemption from the clearing obligation for trades resulting from portfolio rebalancing. We would therefore suggest ESMA to carefully consider this subject and the changing nature of the request of certain stakeholders when producing its report.

The **key messages** expressed by EACH in this response are the following:

1. **Skeptical about the exemption from the clearing obligations** – EACH is skeptical about the need to exempt from the clearing obligation PTRR trades that are a direct result of the compression exercise (be that bilateral or multilateral). For those financial instruments that fall within clearing obligations, the simple use of a PTRR service is not a reason to exempt them from the clearing obligation. As detailed in our response below, when analysing the potential exemption from the clearing obligation of trades that result from PTRR services, we encourage authorities to consider at least the following aspects:
    - Bilateral exposure profile of uncleared trades
    - Impact on financial stability
    - Impact on the G20 reforms
2. **PTRR services have both benefits and risks** – EACH is aware that PTRR services are a useful tool to improve the understanding of exposures and risks in trading books and help reduce margin and capital requirements. However, we would like to underline that an inappropriate supervision may lead to PTRR services to be used to manage particular exposures towards a counterparty, for example, rather than simply cleaning up trading books once trades are completed. In addition, operational risks related to the use of PTRR services should not be underrated.
3. **Need for a more precise definition of portfolio rebalancing** – We suggest to clearly distinguish the concept of portfolio rebalancing from the one of portfolio compression, and in particular we would suggest to define portfolio rebalancing as '*a practice by which market participants transfer their exposure allocation – without changing it*

substantially – between existing or new counterparties in order to adjust exposures between their counterparties, either to reduce risk held against a particular counterparty or to bring overall exposures down'.

4. **PTRR services are not a replacement for central clearing** – While EACH welcomes the benefits of PTRR services, we are also mindful that they do not reproduce certain key aspects of central clearing. Although CCPs as well use PTRR services, it is essential to underline that such services come *in addition* to the usual CCPs' risk management and cannot substitute it.
5. **No exemption from clearing obligations at international level** – Currently, in the EU as in most key jurisdictions, there is no exemption from clearing for PTRR services trades concluded after the entry into force of the clearing obligations.

Section 3 – Post Trade Risk Reduction Services

Question 1: Would you agree with the description of the benefits (i.e. reduced risks) derived from PTRR services? Are there any missing? Could PTRR services instead increase any of those risks? Are there any other risks you see involved in using PTRR services?

Yes, EACH agrees with the description of the benefits derived from PTRR services described in the consultation. In addition to the description provided, we would suggest considering the following additional benefits and risks of PTRR services:

<u>Benefits</u>

- **PTRR services help improve the understanding of exposures and risks in trading books** – PTRR services help clean up trading books and thereby enable a simplified reading as to where the exposure and risk stand. Even before the great financial crisis, PTRR services and similar inhouse practices were promoted by regulators to ensure they and brokers could have a sensible understanding of where the exposures really were.
- **PTRR services help reduce margin and capital requirements** – The reduction in notional outstanding and net exposures provided by PTRR services mean that margin, funding and capital requirements themselves are reduced to the benefit of other economic activities that can be undertaken by the same market participants. This is a key dimension to the popularity of these services which have helped market participants mitigate the required increase to make the financial system more resilient.

<u>Risks</u>

- **Risk of broker services moving into PTRR services** – If inappropriately supervised, PTRR services could be used to manage particular exposures towards a counterparty for example, rather than simply cleaning up trading books, after trades are completed. We note that the line can be quite thin on ways to differentiate both services and believe some conditions elaborated further in the consultation to be an appropriate way to distinguish them, rather than a way to prevent a circumvention of the clearing obligation.

- **Operational risk of PTRR services** – More generally, we note that the clearing obligation has not hindered the development and expansion of PTRR services, both in the uncleared and cleared space. However, we note that the popularity of such services also means that any error carried out by the operator could have a substantial impact on its users.

In addition, we would like to add that, among the types of PTRR services, we find also **portfolio rebalancing** (or "**counterparty risk rebalancing**"), which is a different exercise if compared to portfolio compression. In our opinion, the way the consultation deals with portfolio rebalancing by saying that "*in other PTRR services, such as rebalancing, new transactions are entered into to reduce counterparty risk by reducing the exposure between two counterparties and this is viewed by market participants as a way to also reduce systemic risk by decreasing the overall exposure in the market between counterparties"* does not adequately differentiate portfolio rebalancing and portfolio compression.

Instead, we would suggest to adopt the following **definition of portfolio rebalancing**: *a practice by which market participants transfer their exposure allocation – without changing it substantially – between existing or new counterparties in order to adjust exposures between their counterparties, either to reduce risk held against a particular counterparty or to bring overall exposures down.*

Finally, whilst acknowledging the benefits of PTRR services, we are skeptical about the need to exempt from the clearing obligation the trades that result from PTRR services. We encourage ESMA to look at the overall impact on risk, rather than at different types of risks and benefits independently.

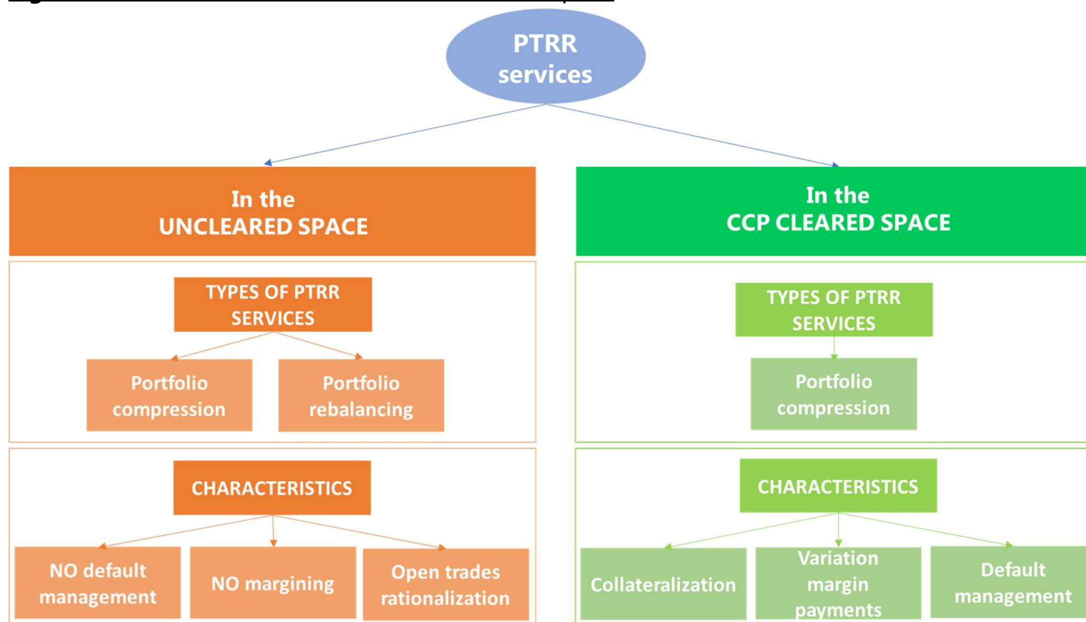
Against this background, **it should be clear that PTRR services cannot be perceived as a replacement to central clearing**. While we very much welcome the benefits of PTRR services as regards resource optimization[1], operational risk[2] and the default management process[3], we are also mindful that they do not reproduce key aspects of central clearing such as neutral risk valuation and heightened standards for collateralization (see Figure 1 below). Although CCPs as well use PTRR services, **it is essential to underline that such services come *in addition* to the usual CCPs' risk management and cannot substitute it.**

[1] Resource optimization – the reduction in notional outstanding and net exposures means that margin, funding and capital requirements are reduced to the benefit of other economic activities that can be undertaken by the same market participants. Compression streamlines the portfolios by eliminating line items making member and client books smaller, cleaner and far more efficient from a margin and capital requirements standpoint.

[2] Operational risk reduction – as the number of trades is reduced, the potential operational risk linked to dealing with multiple transactions is reduced; counterparty risk may also be reduced, as trades across multiple counterparties can be offset reducing the open risk in bilateral relationships.

[3] We suggest authorities to consider the potential effects on financial stability due to the impact on default management, as a result of potentially smaller and 'cleaner' portfolios.

Figure 1: PTRR services in cleared and uncleared space



3.1 Portfolio compression

Question 2: Would you agree with this description of portfolio compression? Please explain the different compression services that are offered and how they may differ from the description above. Are there today viable alternatives to using PTRR services to achieve a similar outcome?

Yes, EACH agrees with the description of portfolio compression included in the consultation. Portfolio compression – which does not change the underlying sensitives to the trading book – is a very common practice within CCPs and happens automatically, as participants need to specifically opt out to avoid compression.

However, we would like to underline once again the **importance of making a clear distinction between portfolio compression and portfolio rebalancing**. We indeed believe that by explaining that "*In other PTRR services, such as rebalancing, new transactions are entered into to reduce counterparty risk by reducing the exposure between two counterparties [...]*", the consultation paper does not fully describe the difference between the two services.

We would therefore suggest to introduce a more precise definition of portfolio rebalancing, as detailed in our answer to Question 1, i.e. "*a practice by which market participants transfer their exposure allocation – without changing it substantially – between existing or new counterparties in order to adjust exposures between their counterparties, either to reduce risk held against a particular counterparty or to bring overall exposures down*".

Question 3: Without changing the market risk of the portfolios, how different can the transactions included in the portfolio compression exercise be? Would the market risk be changed at all by the applied tolerances and if yes, how can the portfolio remain

market neutral? What tolerance levels are often applied and could/should restrictions be placed on tolerances?

Market risk neutral portfolios

EACH Members believe that theoretically an unlimited combination of transactions could be included in compression cycles and netted, without changing the market risk of the portfolio.

Tolerance levels

EACH considers that the level of tolerances is important as it will determine the amount of trades which will be matched and netted. In other words, the more different the trades, the higher the tolerance level to facilitate matching.

Question 4: Should there be a clearing exemption for PTRR trades that are a direct result from a portfolio compression? If not, why? Is there a difference between bilateral and multilateral portfolio compression for the sake of an exemption?

Skeptical about exemption

EACH is skeptical about the need to exempt from the clearing obligation PTRR trades that are a direct result of the compression exercise (be that bilateral or multilateral). As previously mentioned, PTRR services are employed both in the uncleared and the cleared space, yet separately.

Nevertheless, it is crucial to highlight that, in the cleared space, PTRR services do not substitute the usual risk management but come in addition to it. Furthermore, in the clearing space all the positions are collateralized – unlike in the uncleared part of the market which falls below the UMR threshold – and dealt with according to the CCPs' risk management procedures (e.g. posting of initial margin, variable margin payment, etc.).

EACH therefore welcomes the risk-reduction function of PTRR services exercised in the uncleared market for those instruments that, for certain reasons, are not cleared. However, for those instruments that fall within clearing obligations, EACH is of the opinion that the simple use of a PTRR service is not a reason to exempt them from the clearing obligation. While EACH understands how moving risks back to the bilateral world would help reduce collateral requirements for individual brokers, we believe the overall impact on financial stability to be negative.

Against this background, when analysing the potential exemption from the clearing obligation of trades that result from PTRR services, we encourage authorities to look at the overall impact on risk, rather than at different types of risks independently. We suggest that authorities consider at least the following aspects:

- **Bilateral exposure profile of uncleared trades** – We encourage authorities to analyse whether exempting from the clearing obligation trades that result from PTRR services could potentially facilitate a reduction in bilateral counterparty risk exposure and whether a transfer of mandated trades out of central clearing would be in line with the G20 objectives to reform the OTC derivatives markets.

- **Impact on financial stability** – We also encourage authorities to study the extent to which 'vanilla risk' resides outside clearing as a result of an exemption to the clearing obligation in conjunction with reductions in bilateral counterparty risk that can be derived from the use of PTRR services. This should give authorities a well-rounded view of the overall impact of financial stability.
- **Impact on the G20 reforms** – We suggest authorities to consider the situation by which uncleared portfolios would always have a mix of 'vanilla' and 'exotic' trades going-forward, creating perpetually mixed portfolios and this would be opposed to the intentions of the G20 reforms which sought to shed light on overly complex OTC derivatives markets.

Difference between bilateral and multilateral portfolio compression for the sake of an exemption

EACH does note that, theoretically, the smaller the number of participants and the higher the probability that an individual firm could essentially determine itself whether or not its trades should be cleared.

However, it is EACH's opinion that, from a financial stability perspective, the number of market participants involved (i.e. whether the market is bilateral or multilateral) **does not make a difference** – as the resulting vanilla trade would still be moved back to the bilateral world.

3.2 PTRR services using offsetting transactions

Question 5: Would you agree with this description of PTRR Services? What other forms of PTRR services exist? What do they do? How do they work? Are there any other viable alternatives to PTRR services, if yes, why are they not sufficient?

Although generally in line with the description of PTRR services, EACH considers that the consultation paper does not fully grasp the nuance of **portfolio rebalancing.** EACH therefore believes that a **more appropriate definition of portfolio rebalancing** is needed and which, as already mentioned, refers to the *"practice by which market participants transfer their exposure allocation – without changing it substantially – between existing or new counterparties in order to adjust exposures between their counterparties, either to reduce risk held against a particular counterparty or to bring overall exposures down"*.

Question 6: Without changing the market risk of the portfolios, how different can the transactions included in the PTRR exercise be? What tolerance levels are often applied and what restrictions could/should be placed on tolerances (if applies)?

As stated in our answer to Question 3, we agree that the way the tolerance levels are defined can have a significant impact on the way PTRR services can be used and to what objectives. With regards to new PTRR trades towards the CCP, off-setting and neutralizing the delta risk itself would not require specific tolerances.

Question 7: Is the requirement under EMIR of portfolio compression sufficient to mitigate the risk of build-up of transactions and how is the market managing this risk today?

Portfolio compression is an important tool to mitigate the build-up of transactions. It is important to distinguish different types of transactions under PTRR services and to conduct a thorough assessment of each specific type before including it into the definition. The use of portfolio rebalancing effectively manages to either reduce risk held against a counterparty or bring the overall portfolio exposures down.

In addition, while portfolio compression uniquely addresses the add up of line items which make books complicated to identify exposures and decrease capital and margin requirements, **none of them addresses counterparty credit risk, and it should be clear that PTRR services cannot be perceived as a replacement of central clearing**.

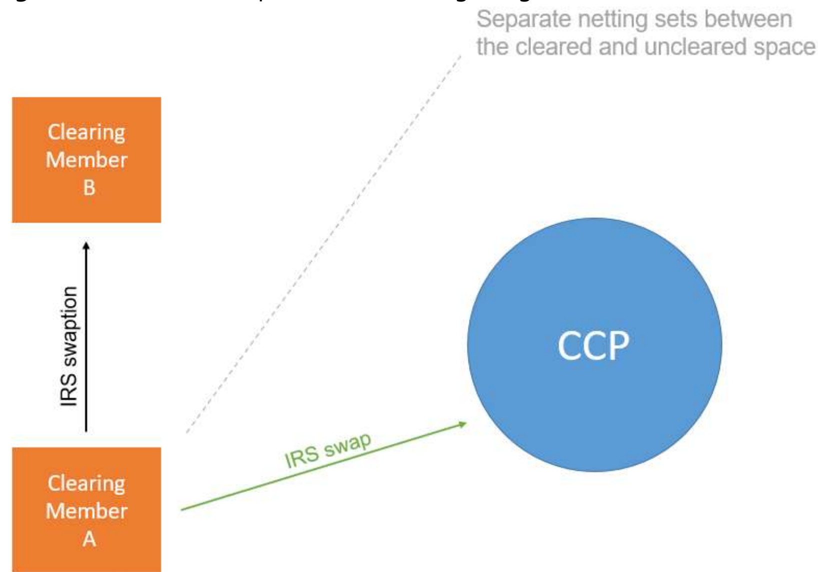
While we very much welcome the benefits of PTRR services as regards resource optimisation and operational risk, we are also mindful of key aspects of central clearing such as neutral risk valuation and default management that are fundamental to prevent destabilizing effects on financial markets. Rather, we believe **portfolio compression to be complementary to central clearing**, as these services are also widely used for cleared portfolios too.

Question 9: Should there be an exemption from the clearing obligation for PTRR trades (other than portfolio compression) that are a direct result from a PTRR exercise? If not, why?

As explained in the answer to Question 4, although we are aware and supportive of the risk-reduction function of PTRR services exercised in the uncleared market for those instruments that, for certain reasons, are not cleared, EACH is skeptical about the need to exempt by default from the clearing obligation the trades that result from PTRR services which fall under the clearing obligation and urge authorities to duly consider the consequences of the circumvention of the clearing obligation on financial stability.

A common example given to explain the impact of the clearing obligation on some PTRR services are swaptions (i.e. options on swaps), which consist in a right to exercise into a swap. In the simplified example that can be found in Figure 2, our swaption has 2 types of sensitivities: sensitivity to the underlying & sensitivity to the *volatility* of the underlying. As the market moves, market participants need to keep re-hedging their portfolio as outlined in paragraph 20 of the consultation. In the case of an Interest Rate Swaption, the market participant may want to regularly hedge itself against the underlying interest rate, whilst keeping its exposure to the volatility. The market participant would therefore enter into a standardized Interest Rates Swap (IRS) to hedge the interest rate exposure. This vanilla swap is subject to the clearing obligation. The market participant has to face two netting sets, one netting set for the uncleared space and one netting set for cleared space, which is less efficient in terms of capital costs than if it could net them altogether.

Figure 2: Without exemption from clearing obligations



However, it should be noted that the market participant could have also 1) hedged the delta with complex trades, which can remain uncleared in the same netting set but subject to higher capital costs, or 2) chose to clear the swaption or chose a similar ETD product. As both trades would be netted and cleared in the CCP, the capital and collateral costs would be even lower. Note that **all scenarios are currently coherent with the objectives of the G20 reforms**, to support a shift towards central clearing, which is more cost/capital effective for the market participant. In line with the incentives to clear, there is indeed an additional cost in entering into swaptions and keeping them in the uncleared space.

However, **the current proposal to exempt trades resulting from PTRR services seeks to exempt the delta hedge covered by a vanilla swap from the clearing obligation** – thereby weakening the clearing obligation itself (as de facto less exposure would be covered by central clearing), but also the incentives to clear (as there would be a cheaper option to hedge the swaption in the bilateral space).

Figure 3: With exemption – Step One

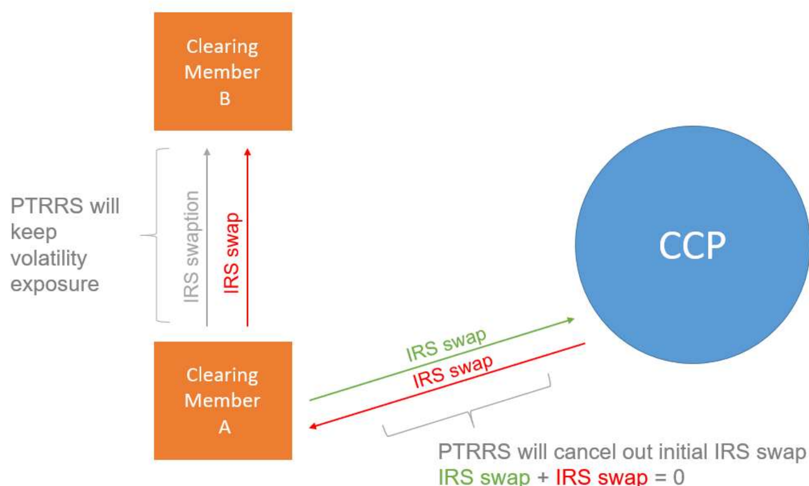
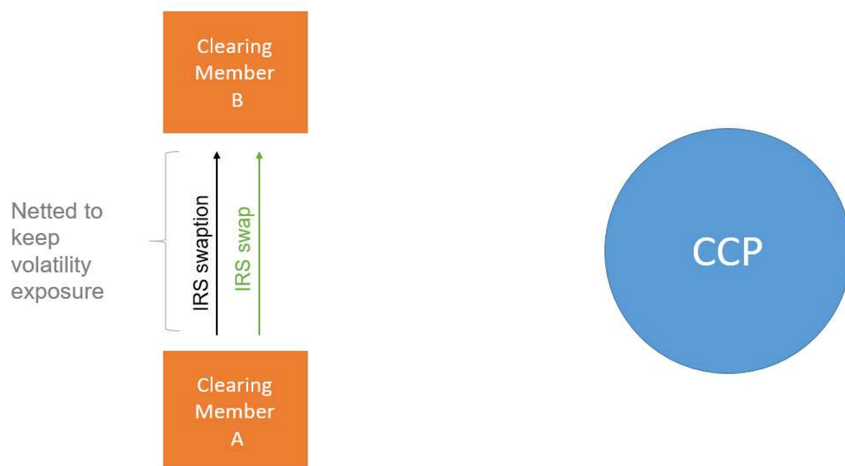


Figure 4: With exemption – Step Two



We urge regulators to reconsider the impact of shifting such trades into the bilateral space, as they would no longer benefit from the stabilising effects of central clearing and the strict third-party risk management framework of CCPs. We would also highlight that, as the initial margin requirements for the uncleared space are continuously delayed, the financial system may not have the consolation that other forms of collateralization of exotic trades would be implemented, as most participants will be below the thresholds.

Exempting from the clearing obligation the trades that result from PTRR services would therefore result in a situation by which uncleared portfolios would always have a mix of 'vanilla' and 'exotic' trades going-forward, creating perpetually mixed portfolios and where this would be opposed to the intentions of the G20 reforms which sought to shed light on overly complex OTC derivatives markets, which were source and catalyst of the last financial crisis.

3.3 Potential offsetting cleared trades

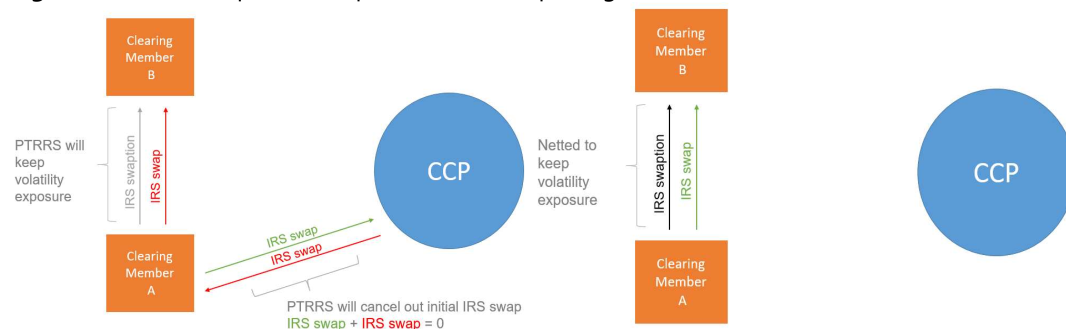
Question 10: Is there a PTRR service today including offsetting transactions with a CCP?

We are unaware of a PTRR service including offsetting transactions with a CCP, in order to move away risk into bilateral portfolios.

Some have argued that an offsetting trade towards the CCP could avoid shifting swaps away from CCPs, as it would add a new trade towards the CCP.

Instead, as outlined again in Figure 5, EACH understands that the PTRR services would enter an offsetting delta hedge (in red) towards the CCP and would actually net it against the existing vanilla trade (in green) in the cleared portfolio. After the PTRR run, both trades are effectively terminated and there is no longer any exposure towards the CCP. Therefore, EACH is concerned that the offsetting transaction could be used to extract vanilla trades away from the CCP.

Figure 5: With exemption – Step 1 (left) and Step 2 (right)



This scenario is particularly complex and unlikely from an economic perspective, as additional trades would likely result in hikes in Initial Margin requirement until the next compression cycles. To avoid this, most proponents of a clearing exemption call for the offsetting CCP trades to be pre-compressed (or terminated) to avoid the additional costs of entering a new trade into the CCP.

Therefore, as the offsetting transaction would be entered by the PTRR service to net (i.e. terminate) the existing cleared vanilla trade, EACH is skeptical that such a condition would help limit the negative impact of exempting trades resulting from PTRR services.

Question 11: Assuming there would be an exemption to the clearing obligation:

- **i. Could PTRR services conduct offsetting opposite trades in the counterparty's cleared portfolio and if yes, should it be mandatory to enter into such offsetting transactions?**
- **ii. Would the PTRR transaction in the non-cleared portfolio then remain between the counterparties or be terminated (netted)?**

EACH is skeptical regarding the need to exempt trades resulting from PTRR services from the clearing obligation and the conditions outlined to that effect.

(i) As highlighted in our answer to Question 10, without the clearing obligation, the offsetting trade with the CCP would be netted against an opposite vanilla trade in the cleared portfolio, essentially extracting vanilla trades away from already cleared in the CCP. Two firms could then indeed enter a technical Interest Rate Swap into their bilateral portfolio.

However, we believe it would be very hard for supervisors to differentiate, from the practical point of view, between trades which are entered to stay in the CCP portfolio and trades which are to be netted off. Exempting PTRR services from the clearing obligation may open the market into trading practices and structures that aim to take advantage of this treatment.

(ii) Yes, the trades would then be netted in the non-cleared portfolio, leaving the vanilla swap outside of clearing to fulfil its risk-reducing role in that portfolio.

Section 5 – Is the clearing obligation hampering the use of PTRR services?

5.2 PTRR services avoiding the use of derivatives subject to the clearing obligation

Question 14: Do you think an exemption from the clearing obligation for transactions resulting from PTRR services would increase the use of PTRR services? Please explain.

As PTRR services have significantly grown over the past ten years, we do not believe the clearing obligation on the vanilla delta hedges of complex trades to have hampered the use of those services.

Question 15: Do you think an exemption from the clearing obligation is not needed for legacy portfolios and PTRR services generally? To what extent can the use of plain vanilla transactions in PTRR services be replaced with the use of non-plain vanilla transactions, or should this be avoided? Please explain.

EACH **supports the exemption** of legacy trades from the clearing obligations.

It is indeed our understanding that today legacy trades are exempt from the clearing obligation and that most legislative changes impacting PTRR services in other jurisdictions have clarified that the obligation to clear trades resulting from PTRR services did not impact trades concluded before mandatory clearing applied.

However, **no jurisdiction has decided in favour of an outright exemption from clearing for trades concluded after the clearing obligation applied**.

Providing the regulatory framework exempting compression mechanisms for legacy trades could be valuable in support of the benchmark transition efforts over the next 1-3 years. We would note the following explanatory text from the recent proposed rulemaking in the US: "*One reason that the agencies are permitting amendments resulting from compression exercises is to reduce the operational burden associated with IBOR replacements. While protocols to amend non-cleared swaps that reference an IBOR or another discontinued rate*

are in development, there is a possibility that counterparties may choose to replace portfolios of IBOR-based, non-cleared swaps with replacement swaps generated through compression exercises."[4]

More importantly, as outlined in our answer to Question 9, there are other options at hand than using a vanilla trade to hedge a complex trade. First, the hedge could also be done via another complex trade. While such trades are indeed riskier than plain vanilla trades, they are not necessarily riskier than the complex trade they were hedging in the first place.

Another and more efficient option in terms of risk reduction and capital costs would be to clear both the complex trade and its vanilla hedge into the same cleared netting set, which out of the three options is by far the less risky and the most efficient in terms of capital. The clearing obligation makes this option the most risk reducing and supports the incentives to centrally clear. Removing it, however, would make bilateral clearing cheaper without the appropriate risk safeguards of central clearing.

Section 6 – Risks with an exemption from the clearing obligation

6.1 The G20 Commitments and the global position

Question 16: Would an exemption to the clearing obligation contradict the G20 commitments? Please explain

Exempting vanilla trades resulting from PTRR services would weaken the clearing obligation itself (as de facto less exposure/risk would be covered by central clearing), but also the incentives to clear (as it would provide a cheaper option to hedge the swaption in the bilateral space). EACH believes that such an exemption would risk transferring mandated trades out of central clearing, essentially reversing the G20 objectives[5].

As mentioned in our answer to Question 4, the presence of a mix of vanilla' and 'exotic' trades in uncleared portfolios would contradict the intentions of the G20 reforms which sought to shed light on overly complex OTC derivatives markets by supporting a shift to central clearing. Higher bilateral margin and capital requirements for OTC trades, in addition to the netting efficiencies of CCPs, were supported by policymakers to incentivise banks to standardise their trades, to charge appropriately where complexity is necessary and seek to reduce the uneconomical complexity in their portfolios.

We strongly urge regulators to reconsider the impact of shifting such trades into the bilateral space and no longer benefit from the stabilising effects of central clearing and the strict third-party risk management framework of CCPs. We consider such a shift to be a substantial set

[4] https://www.occ.treas.gov/news-issuances/federal-register/2019/84fr59970.pdf

[5] EACH recalls the Pittsburgh Declaration signed in September 2009 where G20 Leaders agreed that "*all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest*".

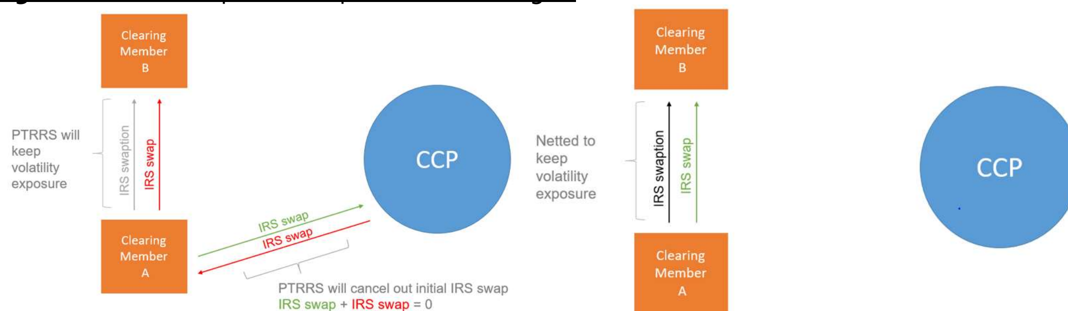
back to the G20 reforms, only ten years after a financial crisis which had exposed the deep weakness of opaque and uncleared derivatives markets.

6.3 Circumvention of the clearing obligation

Question 17: How could an exemption to the clearing obligation for PTRR trades lead to a circumvention of the clearing obligation? Please explain.

As vanilla trades resulting from PTRR services would be exempt from the clearing obligation, less trades would be subject to the clearing mandate, thereby weakening the 'obligation' in itself and the G20 objectives (see Figure 6 below, same ad Figure 5).

Figure 6: With exemption – Step 1 (left) and 2 (right)



Moreover, as outlined in our answer to Question 10, such trades could be used to extract vanilla trades already in cleared portfolios, thereby reversing the shift towards central clearing.

6.3 Would a clearing exemption discourage central clearing?

Question 18: Would you consider introducing an exemption to the clearing obligation as an incentive not to clear transactions that technically are covered by the clearing obligation. If yes, why?

As explained in our answers to Questions 9 and 15, an exemption of vanilla trades resulting from PTRR services would not support a shift of the bilateral risk into central clearing, but rather discourage clearing because of the presence of a cheaper but riskier option to hedge complex trades in the bilateral space. The exemption would therefore come to the benefit of individual brokers, but to the detriment of the overall financial stability agenda.

6.4 Reduced collateral

Question 19: Are there risks with reducing collateral? Even if complying with regulatory requirements, could this lead to such capital being used to increase risks, possibly systemic risks?

Reducing collateral is precisely one of the consequences of "risk reduction" services. While a reduction of notional amounts would not lead to situations where the market is under-collateralised and vulnerable in times of stress, it does make the capital and collateral costs for the market participant cheaper. As previously outlined, an exemption from the clearing obligations for PTRR services would make hedging in the bilateral market cheaper for brokers because of the lower use of collateral (see Figures 7 and 8 below).

However, should this result in a substantial shift of risk towards the bilateral space, EACH would like to recall once more that PTRR services do not bring the financial stability benefits of central clearing. PTRR services clean up line-by-line items but do not evaluate and collect the appropriate collateral needed to face counterparty credit risk, nor do they have comprehensive default management processes to address eventual defaults. In this context, EACH is sceptical that such an exemption would help better to manage counterparty credit risk for the financial system as a whole.

Figure 7: Without exemption

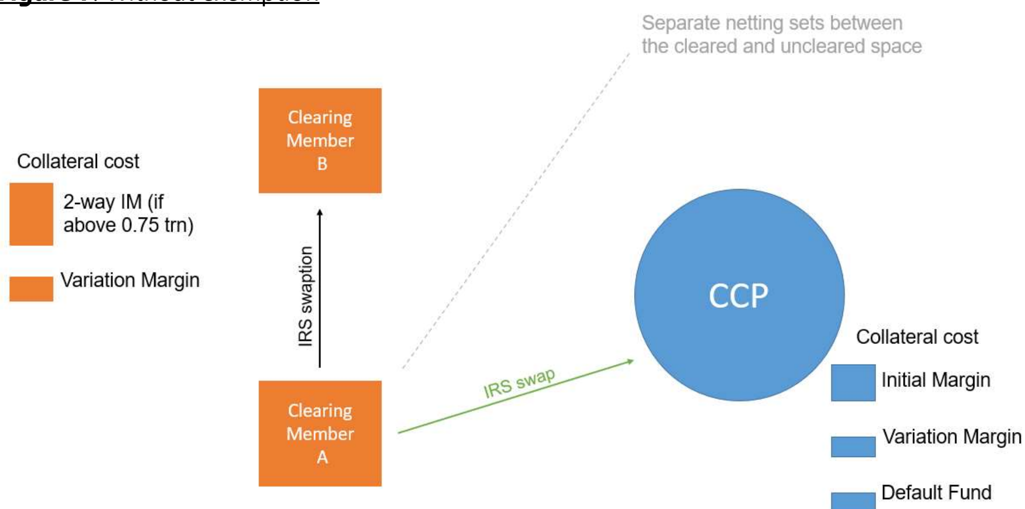
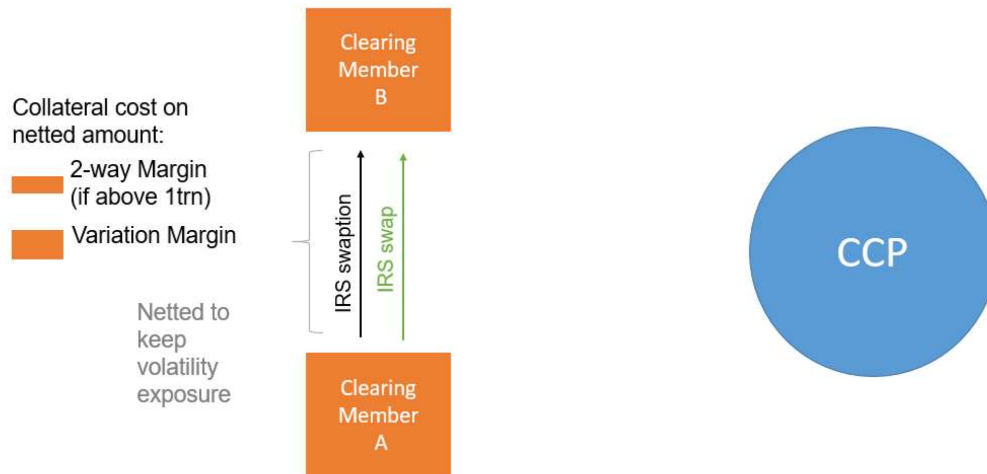


Figure 8: With exemption



Section 7 – International position regarding the application of the clearing obligation to PTRR transactions

Question 20: Are there other jurisdictions where PTRR trades have been exempted from the clearing obligation? Please explain the features of any such exemption. Do you use any of those exemptions, and for what type of trades?

It is important to note that there is no separate EU market for portfolio compression services, but rather a global market subject to strong network effects. Portfolio compression is therefore a current and wide market practice used both for cleared trades within a CCP and, separately, for individual portfolios in the uncleared space. The global nature of this market means that the higher the number of market participants that are permitted, able and willing to participate, the higher the value of the services for the firms themselves.

Currently, in the EU as in most key jurisdictions, **there is no exemption from clearing for PTRR services trades concluded after the entry into force of the clearing obligations**. Although the absence of such exemption does not appear to have hindered the development of the practice, this materially limits the scope of PTRR services in the bilateral space on the one hand and in the cleared space on the other hand. This was done intentionally to disentangle the highly standardized trades for central clearing from the more complex exotic trades to be dealt with under the bilateral margin rules as per the G20 reforms. In the EU today, all trades concluded prior to the clearing obligation can be compressed using portfolio compression services. However, new trades cannot be used to change the nature of the exposure of portfolios composed of old trades and be exempt from the clearing obligation.

While a number of jurisdictions – Canada[6], Hong Kong[7], Singapore[8] and Australia[9] – have decided to clarify that legacy trades prior to the clearing obligations are exempt, no major jurisdiction has opted for an outright exemption from the clearing obligation of new trades resulting PTRR services.

This is notably the approach followed by the US, where there is a "no action relief"[10] letter from the CFTC exempting new swaps resulting from multilateral compression exercise **if the original swap was executed prior to the applicable compliance date of the clearing requirement**, and a new proposal[11] that, under the uncleared margin requirements, legacy trades can retain their status following compression cycles.

Section 8 – Possible conditions or requirements for PTRR

8.1 List of possible conditions or requirements

Question 21: Should conditions, similar to the ones as outlined above, apply to a possible exemption under EMIR for PTRR transactions? Should other conditions apply? Would the answer depend on the type of PTRR service? Please explain.

EACH is skeptical that the conditions outlined do not influence the primary intention or risks created by the exemption. As described in our previous responses, the proposed exemption reverses the incentive structure of the G20 OTC derivative reforms.

8.2 Potential conditions applicable to PTRR services?

Question 22: Is there a difference between bilateral and multilateral portfolio compression justifying an exemption to the clearing obligation only to apply for multilateral portfolio compression?

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[6] Proposed NI 94-101 Mandatory Central Counterparty Clearing of Derivatives and Proposed Companion Policy 94-101CP Mandatory Central Counterparty Clearing of Derivatives: https://osc.gov.on.ca/documents/en/Securities-Category9/SecuritiesLaw_csa_20150224_94-101_roc-derivatives.pdf

[7] Frequently Asked Questions on the Implementation and Operation of the Mandatory Clearing Regime: https://www.sfc.hk/web/EN/files/SOM/OTC/FAQ%20CLearing%20Rules%2020181213.pdf

[8] Securities and Futures Act (Chapter 289) - Securities and Futures (Trading Of Derivatives Contracts) Regulations 2019: https://sso.agc.gov.sg/SL/SFA2001-S134-2019?DocDate=20190313

[9] ASIC Derivative Transaction Rules (Clearing) 2015 Explanatory Statement: https://www.legislation.gov.au/Details/F2015L01960/Explanatory%20Statement/Text

[10] No-Action Relief from Required Clearing for Swaps Resulting from Multilateral Portfolio Compression Exercises, CFTC Letter No. 13-01, 13 March 2013: https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKEwiR5dy1s7rmAhURTsAKHY6LB0QQFjAAegQIAxAC&url=https%3A%2F%2Fcftc.gov%2Fcsl%2F13-01%2Fdownload&usg=AOvVaw0PPFeOA61J63gHkgBSyYXp

[11] Margin and Capital Requirements for Covered Swap Entities: Notice of Proposed Rulemaking: https://www.occ.treas.gov/news-issuances/bulletins/2019/bulletin-2019-53.html

As a higher number of participants involved does not in itself respond to the risk having vanilla trades moved back to the uncleared space, we do not believe that differentiating bilateral vs. multilateral portfolio compression would help limit the risk of regulatory arbitrage. Such risk remains the same if two or more participants are involved.

Question 23: Should only uncleared transactions be included in portfolio compression in order to qualify for the clearing exemption? How would a possible limitation to uncleared transactions limit the effectiveness?

EACH understands that the exemption discussed concerns trades resulting from PTRR trades and not trades entering PTRR runs.

If trades resulting from a PTRR run of uncleared trades are vanilla, the only thing that it shows is that 'vanilla risk' is still present in uncleared portfolios. This effectively shows that the G20 objective of untangling standardized risk which should be cleared from more exotic types of risk has not been achieved.

In this context, EACH is skeptical that such a condition would be helpful to avoid shifting back vanilla standardized trades into the uncleared bilateral space.

Question 24: To benefit from an exemption to the clearing obligation, should PTRR trades be strict risk neutral or should there be tolerances for small changes in the risk of portfolios? How would you define what is an acceptably small change in risk?

PTRR services should not change the market risk of the portfolio, and in that respect market-risk-neutrality would ensure rebalancing cycles within tolerances.

However, we do not consider that such a condition could prevent standardized vanilla trades from being moved away from the clearing mandate, although it may influence the matching rates in PTRR runs.

Question 25: To benefit from an exemption to the clearing obligation, to what extent should parties to a PTRR exercise be able to be changed, i.e. not limited to the original counterparties? Would the answer depend on the type of PTRR service? Please explain.

Being skeptical about exempting PTRR services from the clearing obligation, we do not consider that such a condition could prevent standardized vanilla trades from being moved away from the clearing mandate, although it may influence the selection process for permission to participate in such PTRR services runs.

Question 26: Should there be a requirement for PTRR services to reduce risk for a clearing exemption to apply? Should it apply to all PTRR services? If not, please explain why. How would a successful PTRR exercise be measured?

The aim of PTRR services is to reduce overall risk and exposure. As previously outlined, EACH welcomes the risk-reduction function of PTRR services exercised in the uncleared market for those instruments that, for certain reasons, are not cleared, but does not see how the

requirement for PTRR services to reduce risk for a clearing exemption to apply could help supervisors avoid regulatory arbitrage.

Question 27: Could PTRR services increase exposure or risk on a participant basis? Would the answer depend on the type of PTRR service provided? How should the PTRR service provider limit any possible increase in notional amount or risk? Please explain.

EACH agrees that PTRR services should not result in a participant being worse off had the exercise not taken place and notes that this condition could help avoid PTRR services becoming new brokerage services. However, we do not find it helpful to address the risks of circumventing the clearing obligation.

In addition, as noted in previous responses under portfolio rebalancing, a sub-portfolio between two parties might be allowed to rise provided that both parties experience equal or greater offsetting declines in their sub-portfolios against other counterparties.

Question 28: How could a limitation like “no participant worse off” be defined?

It could be defined by using a participant’s worse off metrics involved in evaluating pre/post risk exposures which should be no greater following the PTRR services cycle for every counterparty versus beforehand.

However, we do not consider that such a condition could prevent standardized vanilla trades from being moved away from the clearing mandate.

8.3 PTRR service providers

Question 30: Do you consider that a PTRR service provider should be specifically licenced or authorised? Would this depend on the remits of the services provided? Would it be sufficient to provide requirements on the service provided, i.e. on transaction level rather than entity level? What do you see as the benefits of regulating PTRR services? Would this create any impediment or barriers?

We believe that compression cycles should be performed **independently by CCPs** – which perform portfolio compression as part of their netting activities – **or other providers for the bilateral space**, meaning than none of them should be influenced by risk factors provided by other market participants. For those trades that cannot be cleared, one way to ensure such independence could be by putting in place a suitable governance framework that mandates the “automatic” treatment of outputs (i.e. no manual intervention or de minimis). However, for what concerns those trades that instead can be cleared, we are skeptical that such condition would help avoid a circumvention of the clearing obligation if exempting trades resulting from PTRR services by default were legal, although bringing PTRR services providers under supervisory scrutiny may have benefits. Moreover, we strongly question the capacity of supervisors to analyze each and every transaction.

Section 9 – Cost Benefit Assessment

Question 31: What would be the cost-benefit of exempting PTRR transactions (replacement and risk mitigation services through offsetting trades such as rebalancing) from the clearing obligation?

While EACH does not have the ability to conduct a quantitative cost-benefit analysis, **EACH is skeptical with regard to the alleged risks of refraining from such an exemption**:

- **Default competition risk** – With the obligation to clear vanilla trades resulting from PTRR services, netting sets are today clearly separated between the vanilla trades in the CCP and the exotic trades in the bilateral space. Allowing vanilla trades to go back to the bilateral space would create mixed portfolios which would be particularly difficult to untangle in case of default. Exempting trades resulting from PTRR services would actually increase the default competition risk.
- **Liquidity risk** – While completing variation margin payments maybe be strenuous for brokers, we have doubts as to how exempting PTRR services trades can help address concerns around the impact of variation margin on liquidity. Instead, ESMA could consider expanding the Antiprocyclicality Measures to the bilateral space.

To conclude, **EACH is skeptical that the benefits from exempting such trades outweigh the risks to the financial system**.