

Answer to the Consultation Paper on the Clearing Obligation under EMIR (no. 3)

AMAFI's contribution

Introduction

Presentation of the respondent

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

The Association has been following closely the preparation and implementation of EMIR and welcomes the opportunity to answer ESMA's Consultation on the Clearing Obligation under EMIR (no.3), after having answered the two previous consultations

Introductory remarks

AMAFI agrees with most of the technical analysis provided by ESMA concerning the FX NDFs, as expressed in our answers to your questions hereinafter.

However; AMAFI questions the opportunity to set up a clearing obligation on FX NDFs as of today for the following reasons:

- **FX NDFs do not raise any significant systemic risks** and represent a rather marginal asset class. FX NDFs market, albeit important, is a relatively small component of the whole FX over-the-counter market – constituting only 2.7% of the market, according to the April 2013 Bank for International Settlements triennial survey. These FX NDFs generally present a rather poor liquidity (notably for longer tenors), which is linked to the fact that the currency pairs often involve emerging market currencies.
- **FX NDFs are not widely cleared.** There is only one single European CCP (i.e. LCH Clearnet Ltd) at the outset of the clearing obligation procedure. Despite ESMA's statements to the contrary, we do not have sufficient assurance that at least 2 authorised / recognised CCPs will offer these services in the near future.

In addition, currently there are only 20 clearing members clearing those instruments through LCH.Clearnet Ltd, of which only two of them support client clearing activity, while for instance, for interest rate OTC derivatives, there are a total of 110 clearing members, clearing through five CCPs.

Therefore, it means that about a hundred financial institutions, which fall under category 1 because they are clearing members for interest rate OTC derivatives, will have to find a direct or indirect clearing solution for FX NDFs products in a very short timeframe, which is almost impossible given all the processes necessary to obtain such a status.

As a consequence, AMAFI proposes to **postpone the clearing obligation** on FX NDFs until at least the following conditions are fulfilled: (i) at least two European CCPs propose to clear FX NDFs asset classes, (ii) the number of clearing members clearing FX NDFs and supporting client clearing activity significantly increases (even if we do not request for an increase up to the level of the IRS asset classes), (iii) the improvement of the liquidity of such asset classes, whatever the tenors, and (iv) it can be better demonstrated by ESMA that there is a systemic risk linked to the trading on FX NDFs.

1. The clearing obligation procedure

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

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

We consider this approach to be convenient and efficient.

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

We recommend the adoption of the same grouping approach should further sub-classes of an asset class be considered for mandatory clearing in the future.

2. Structure of the non-deliverable forward derivatives classes

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

Yes. AMAFI considers that the proposed structure for the foreign exchange non-deliverable forwards (FX NDF) classes enables counterparties to identify which contracts are subject to the clearing obligation.

More precisely, we agree with (i) the proposed clarified definitions for both FX NDF (cash-settled) and FX physically-settled forwards and (ii) the identification details (i.e. type, currency pair, settlement currency, settlement type and maturity) attached to the FX NDF subject to clearing obligation in this consultation paper.

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

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

Please see our introductory comments. AMAFI is not convinced of the existence of proven systemic risk which justifies the introduction of an immediate clearing obligation for FX NDFs.

Therefore, AMAFI considers that ESMA should postpone the clearing obligation imposed on the FX NDF classes mentioned in the Consultation Paper until a later stage.

This request is even more justified by the fact that the clearing obligation may also be challenged in the future for some FX NDF classes mentioned by ESMA. Indeed, in some emerging countries (e.g. Chile), market participants may decide in the future to favour physically-settled FX transactions instead of cash-settled FX transactions, either because there is a specific impediment for having such transactions cash-settled or even without such impediment because market participants of such countries want to avoid any clearing obligation.

Besides, as it is recalled in the Consultation Paper, “*the sustainability of the NDF market is closely interconnected with the regulatory framework and monetary decisions of the respective emerging-market countries*”, which implies that the viability of the FX NDF market may be challenged in the future depending on the regulatory and monetary decisions adopted (notably in such emerging markets). For all these reasons, the liquidity of some FX NDF classes (which is one of the criteria retained for triggering the clearing obligation), which is rather poor at this stage, may further decrease (more or less) substantially in the near future.

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

AMAFI understands the rationale of ESMA for seeking to include trades of up to 2 year tenor in the clearing obligation.

However our understanding is that as of today the majority of FX NDF trades are concentrated in the less than one year bracket, indeed a majority are transactions of 3 to 6 months. We therefore query whether there would be sufficient liquidity for FX NDFs of a longer tenor to impose a clearing obligation and again refer to our introductory remarks that a clearing obligation should only apply when it is considered there is sufficient liquidity for such trades.

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

Q5. Do you have any comment on the analysis presented in Section 4.1.?

AMAFI globally agrees with ESMA's comment on the analysis presented in Section 4.1.

Nonetheless, AMAFI is concerned by the content of paragraph 95 of the Consultation Paper. Indeed, in line with an idea already mentioned in the two former Consultation Papers related to clearing obligations, ESMA is seeking to launch a clearing obligation procedure even though the contemplated asset classes are cleared by a single European CCP (i.e. LCH Clearent Ltd, in our case) at the beginning of the clearing obligation procedure. ESMA justifies its decision on the basis that three additional European CCPs plan to start clearing NDFs before the clearing obligation enters into force.

In our opinion, the clearing obligation of an asset class should be subject to the existence of at least two available European CCPs in order to avoid any systemic risk and any monopoly situation, both being detrimental to the investors as well as to the market's efficiency and safety. As mentioned in our introductory comments, the clearing of FX NDFs asset classes by a single European CCP at this stage is one of the reasons invoked to request the postponement of the clearing obligations to be imposed on FX NDFs.

In the present case, AMAFI acknowledges that three CCPs established in third-countries are also clearing NDFs and that equivalence decisions have been made for the Singapore and Hong Kong regimes.

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

Yes. AMAFI agrees with the proposal to keep the same definition of the four categories of counterparties for the NDF classes than for the credit and the interest rate classes, as it is set out in the Final Report on the clearing obligation for interest rate swaps, pursuant to which the former category 2 has been subdivided into new categories 2 and 3.

AMAFI welcomes this new categorisation since it reduces the scope of the *frontloading* requirement. Indeed, transactions entered into with (new) category 3 counterparties will be exempted from *frontloading* and, as mentioned in our answers to the former Consultation Papers, *frontloading* requirements may create pricing uncertainty (the pricing which will be proposed to the client will take into account such *frontloading*), consequently bid-offer spreads widening and, eventually, market instability.

Nevertheless, AMAFI wants to highlight some difficulties related to the new quantitative threshold of EUR 8 billion (i.e. the amount of group's aggregate month-end average notional amount of non-centrally cleared derivative), which separates counterparties of categories 2 and 3:

- credit institutions will not be in a position to calculate this threshold, and therefore will rely on the valuations and statements provided by their counterparties as well as on some other external indicators or evidences;
- the requirement to calculate this threshold within the 3 months before the RTS for interest rate swaps enter into force (i.e. November 2014, December 2014 and January 2015) may lead to erroneous calculations and assessments – due to potential last-minute statements from some counterparties;
- so as to reduce the risks above mentioned, AMAFI considers that ESMA should consent to postpone the entry into force of the *frontloading* requirement (to at the very earliest 3 months from entry into force of the RTS), as already requested by ISDA.

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

If clearing for FX NDFs is intended to be made obligatory within the proposed timeline, and not delayed as per our recommendations, the proposed dates of application should be adjusted accordingly, particularly for Category 1 and Category 2 counterparties, to give parties sufficient time to deal with the issues raised in particular in question 6 above (proper classification of counterparties) and the issues raised in introductory comments (more than one European CCP provides the service, and more clearing members provide access to clearing for FX NDFs).

5. Remaining maturity and frontloading

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

AMAFI understands the rationale behind the ESMA's proposals, i.e. to lower the absolute levels of minimum remaining maturity for FX NDF since the maximum maturity of the FX NDF class is lower than the maximum maturity of the interest rate swaps class.

However, AMAFI disagrees with ESMA's proposal to set at 3 months the minimum remaining maturity for transactions entered into with counterparties of category 1 and /or category 2 during Period B.

Indeed, such proposal of a very short remaining maturity does not address our concern to ensure the exemption from the *frontloading* requirement of an important number of contracts entered into with counterparties belonging to categories 1 and 2 (in order to avoid the side effects of *frontloading* as mentioned in our answer 6 hereinabove). That is why AMAFI proposes to set at a 6 month time-period (instead of a 3 month time-period) the minimum remaining maturity for the contracts entered into with the said counterparties.

Annex I - Draft Regulatory Technical Standards on the Clearing Obligation

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

AMAFI has no particular comment to make on this question.

Annex II – Impact assessment

Q10. Please indicate your comments on the Impact Assessment.

AMAFI has no particular comment to make on this question.