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Clearing the way towards an OTC derivatives union

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Ladies and gentlemen,

It is good to be back at a major ISDA event and I am delighted to speak for such a distinguished audience. My very first public speech as a chair of ESMA in 2011, a few days after I had started, was at an ISDA Annual General Meeting. At that time, we expected that the area of derivatives would become very important for ESMA and that the upcoming regulation and supervision would fundamentally change the derivatives market. Four and a half years later I can say that both expectations have become a reality. However, before expanding on this, I would like to first briefly talk about some general ESMA developments as they reflect very similar developments in the regulation and supervision of derivatives.

As you are probably well-aware, ESMA's main objectives are to enhance investor protection, and to ensure the stability and orderly functioning of financial markets. We achieve these objectives in two main ways: by writing the single rulebook for financial markets and then ensuring this rulebook is applied consistently throughout the EU, either by fostering supervisory convergence or through direct supervision of credit rating agencies (CRAs) and trade repositories (TRs).

As you very well know, ESMA has been extremely active since our establishment in developing an EU single rulebook in response to the financial crisis. For example, on the basis of mandates in primary legislation, over the last year we have issued more than a 100 draft technical standards and pieces of advice to the European Commission. Bringing greater transparency to the financial markets and improving the conduct of market participants cuts through all the Level 2 work we have delivered, for example, under, MiFID II/MIFIR, CSDR and EMIR.

ESMA celebrates its 5th birthday in 2016 and by then the bulk of creating the single rulebook resulting from the post-crisis regulatory reform will have been completed. In line with our strategy 2016-2020, ESMA's focus is shifting to implementation: we will allocate more resources to supervisory convergence activities and reduce them for single rulebook activities.

Ensuring stability and investor protection were the two main drivers of the regulatory response to the financial crisis. However, as said, the regulatory reform is also resulting in a single rulebook and provides opportunities for integrating EU capital markets. Hence, the consistent implementation of the regulatory reform should be an important building block of the Capital Markets Union (CMU).

EMIR rulemaking work is almost complete and the focus is now on ensuring a consistent implementation

EMIR constitutes an essential part of the European response to the financial crisis and to the G20 objectives of the 2009 Pittsburgh summit, along with MiFID II. Under EMIR, ESMA was mandated to develop a series of technical standards to specify the practical details of the requirements that would ensure the objectives defined in EMIR come to fruition.

Now that this rulemaking work is almost complete, the focus of the regulators, and ESMA in particular, is moving from developing a single rulebook to ensuring supervisory convergence when implementing these rules. Indeed, having a consistent application within the EU is key in ensuring that the overall objectives of EMIR are met and that there is a level playing field for all market participants.

I will come back to and discuss in more detail a few rulemaking aspects of EMIR that are being finalised and for which there are important discussions taking place. But for now, let me say we see it as one of our main priorities to make sure that the implementation of the new regulatory requirements is a success.

Just as now concerted efforts are being made towards creating a CMU, in the same spirit over the last few years we have worked towards, and are already well underway in establishing, what you could call an 'OTC Derivatives Union'. This OTC Derivatives Union achieves a high level of consistency across the EU, both in terms of regulation and supervision and provides a positive model for establishing an EU-wide CMU.

In order to illustrate this, let's take the example of the reporting requirements. There is one single set of reporting requirements for derivatives transactions under EMIR for the whole Union and one single supervisor ensuring TRs comply with those standards. The reporting standards provide the details on content and format, and additional clarifications are communicated through Q&As which should ensure a single reporting framework.

Other key elements implemented to ensure consistent regulation and supervision include the CCP colleges of supervisors, the fact that EMIR is, as you know from its acronym, a Regulation and not a Directive, and the fact that important decisions, such as the central clearing obligation and the trading obligation, will be taken at EU level.

Upcoming clearing obligation and access to clearing: a key milestone

Let me now come back to a number of rulemaking aspects under EMIR that we are currently looking into. I will first comment on the clearing obligation.

As you are all aware, Europe is now close to starting the implementation of the clearing obligation for OTC derivatives. Let me give you a quick reminder of the clearing obligation procedure defined in EMIR, which is based on a two-step process: first, ensuring that CCPs that will support the clearing obligation meet the higher EMIR standards, and then second, selecting which derivatives are fit for the clearing obligation.

The first milestone was achieved in 2014 with the first European CCPs being re-authorised under the EMIR framework. Half of the European CCPs clear OTC derivatives and almost all of them have since received regulatory approval from their national competent authorities confirming they comply with the higher standards embedded in EMIR.

Then, following the authorisation of those CCPs, ESMA started the second step. ESMA has analysed most of the OTC derivative contracts that are currently offered for clearing by European CCPs and consulted on its findings in order to determine whether they meet the relevant criteria for the clearing obligation. Those criteria relate to standardisation, liquidity, and availability of pricing information, with the overall objective being to reduce systemic risk. This work has been increasingly supported by data retrieved from the six European TRs.

As a priority, ESMA analysed and consulted on interest rate swaps, which represent the vast majority of the global OTC derivatives market, around 80 to 90% depending on the metrics used. ESMA then finalised its proposal on the clearing obligation for certain interest rate swaps denominated in EUR, GBP, USD and JPY and sent it to the European Commission on 1 October 2014. The Commission endorsement process took a little more time than foreseen as amendments to the draft regulatory technical standards were made. However, these rules were endorsed by the European Commission on 6 August 2015. The regulatory technical standards are now under scrutiny by the Council and European Parliament, as is required before they can enter into force, which could be around the year-end.

Beyond this first set of derivatives, ESMA has also consulted on the application of the clearing obligation to other types of derivatives. In particular, the rules proposing a clearing obligation for some European index credit default swaps are close to final and we hope they can be submitted soon to the European Commission. In addition, as you are also aware following the last consultation, rules proposing a clearing obligation for some interest rate swaps denominated in certain EEA currencies are also being considered.

We are thus confident that with the upcoming clearing obligation for interest rate swaps and credit default swaps, a significant reduction of systemic risk in Europe should be attainable, whilst facilitating further, and to the extent possible, consistency in the clearing mandates at an international level.

As already said in my introductory comments, our interest does not stop at the rulemaking stage: we are also focusing on making the implementation of the clearing obligation a success.

On this note, given the audience today which includes representatives from some clearing members, I would like to reiterate the point that we all have a part to play and that we need to ensure that there is the right level of access to clearing. We need to continue addressing the possible challenges that various market participants can face in establishing clearing arrangements. ESMA and the wider regulatory community are paying particular attention to the development of the offering of clearing services to a sufficiently wide range of counterparties, including the smaller ones.

Reporting requirements

Let me now turn to another big component of EMIR, the trade reporting requirements. EMIR reporting requirements have been in effect since February 2014. The six TRs are now processing over 300 million trade reports on a weekly basis. Although we are conscious of some of the challenges we are still facing, on which I am going to comment in a moment, we can say that the reporting system is up and running.

Looking at the big picture, I would say that no major hiccups have occurred in terms of reporting flows and connections with TRs and regulators. Moreover, we have been able to make good use of the reported data on many different fronts including, for example, for the assessment of the liquidity and volume of transactions for the clearing obligation under EMIR, for the calibration of transparency requirements under MiFIR, and for the analysis of the systemic relevance of non-financial counterparties (NFCs) for the related EMIR review report.

However, a year and a half after the introduction of any major data reporting system of such broad scope and scale, it would be rare to see a data quality we should aspire to in the longer term. Therefore, one of our main objectives as supervisor of TRs is to improve the quality of the data stored.

The practical experience acquired so far, together with the valuable feedback provided by the reporting community and TRs during the implementation phase, enables us to identify a number of shortcomings and limitations that need to be addressed so that EMIR reports better fulfil their objective.

There are three main areas of focus that have been part of the review of the reporting rules that ESMA is currently conducting:

- clarifying the description and purpose of certain reportable fields;
- reviewing existing fields so that they align to the reporting logic prescribed in the Q&A document or reflect specific ways of populating them; and
- introducing a number of new fields and values to reflect market practices of trading in specific derivative contracts or to accommodate specific regulatory requirements.

The review also aims at achieving a more consistent and harmonised population of fields and reporting of complex derivatives. But let me be clear: beyond clarifying and improving the rules, reporting parties need to comply with those that are actually in force, such as assigning a mutually agreed code to the transaction reported, the UTI, which is unfortunately not always the case. Therefore, we have agreed with the national competent authorities to increase supervision efforts on reporting standards.

Looking ahead, the EMIR review

Now looking ahead, as you know EMIR is already undergoing a review. Indeed, a review clause was included in the Level 1 text, as is usually the case with EU financial legislation.

ESMA is actively contributing to this review, given ESMA's statutory role and various mandates in EMIR. In addition, we have gained valuable insights into the many benefits, and some of the challenges, of this Regulation.

As a result, ESMA has drafted and submitted to the European Commission four reports on EMIR on 13 August 2015. Three reports were in response to a request from the European Commission, and the corresponding mandate included in the review clause of EMIR, on three specific topics. The fourth report was on additional issues and was a response to the public consultation the European Commission ran from May to August this year.

I will thus take this opportunity to briefly highlight some of the key aspects detailed in these four reports. First of all, in the EMIR Review Report no.1 on the systemic importance of NFCs, the main findings are around the definition of NFC and on the application of the hedging criteria in the calculation of the thresholds, which is prone to differences of interpretation. This risks an un-level playing field and not measuring properly the systemic relevance of NFCs. ESMA is therefore recommending removing the hedging criteria from the methodology used to determine the systemic relevance of NFCs. Of course, widening the scope of the transactions which would count towards the clearing thresholds would also imply that we need to recalibrate the thresholds themselves.

In relation to the second EMIR Review Report on pro-cyclicality, the report analyses the different options adopted by CCPs to cope with pro-cyclicality and recommends further specifying the rules for implementing the counter-cyclical tools for margins and collateral, including regular testing and transparency on the results.

Moving now to the third EMIR Review Report, the report had two objectives. First, it served as a response to the Commission's request on collateral margining and securing arrangements. The report indicates that the technical standard on CCP requirements does provide sufficiently granular details on these requirements. Therefore, although ESMA has identified some differences in CCP practices in implementing them, I am confident that we can address these through supervisory convergence or possible refinements of the technical standard.

The second objective of the report concerns the arrangements to secure client collateral, and more specifically the arrangements related to segregation and portability for which ESMA has a specific mandate to draft a report under EMIR. The report also elaborates on the issue of conflicts of law with regard to insolvency and suggests clearly indicating the rights attached to each account structure and using different margin periods of risk to incentivise more secure account structures.

However, considering that ESMA currently has a discussion paper open for consultation on this matter of margin periods of risk, the report is not specific on the incentives to attach to the different account structures in term of levels of margin. I will come back shortly to this discussion paper.

Last but not least, ESMA also drafted a fourth EMIR Review Report that elaborates on many different matters ESMA has faced during the implementation of EMIR, and in particular:

- The clearing obligation and notably the inefficient and rigid process based on regulatory technical standards, as a result of which it is impossible for ESMA to suspend the clearing obligation when changing market conditions might require this. We also recommend removing the frontloading requirement;
- Regarding the process for the recognition of third country CCPs we raise the question of whether a system of full reliance on third country regimes and third country supervisors is still appropriate. We suggest alternatively to use the tool of a technical standard to decide on the equivalence of a third country, and we suggest that ESMA be able to take into account additional risk-based considerations related to a third country CCP in order to deny or suspend recognition; and
- We also make some suggestions to ensure a more effective supervision and enforcement of TRs.

Equivalence of legal and supervisory regimes and the discussion paper on margin period of risk (MPOR) requirements

As mentioned a few minutes ago, I would like to briefly talk about the discussion paper published on 27 August 2015. The paper covers the liquidation period, also known as margin period of risk or MPOR, that European CCPs need to apply to client accounts under EMIR.

This consultation is performed in the context of the debate on the equivalence between the legal and supervisory arrangements for CCPs in the USA and the EU and the different requirements. However, this consultation is carried out without prejudice to the outcome of the European Commission's assessment in relation to its equivalence decisions.

With respect to differences, the US regime for CCPs foresees a minimum liquidation period for financial instruments, other than OTC derivatives, of only one day, although applied to client accounts on a gross basis. In the EU under EMIR the minimum liquidation period is two days, but margins may be provided on a net basis.

Under gross margining, clearing members must pass to the CCP enough margin to cover the sum of the separate margin requirements for each client's position, with no netting of exposures between clients. However, under net margining, the clearing members need only pass through sufficient margin to secure the net exposure across a set of clients whose positions are held in the same omnibus account, and so the clearing members may retain much of the client margins.

These differences between the EU and the US standards can thus lead to the risk of regulatory arbitrage. The European Commission has requested ESMA's recommendations on the corresponding provisions in the EMIR technical standard, including whether changes to the EU rules may be necessary. Consequently, ESMA has launched a review of the relevant provisions, with respect to client accounts only, to investigate whether it would be appropriate to revise the current regulatory technical standards in order to allow CCPs authorised under EMIR to apply a one-day liquidation period for financial instruments other than OTC in those cases where clients opt for individual segregation or gross omnibus accounts. In the cases of net omnibus and propriety accounts, the standards would remain unchanged at 2 days minimum MPOR.

Through this consultation, ESMA is requesting input and data from stakeholders in order to evaluate the opportunity to change the regulatory technical standards, to measure the potential impacts on margin levels, to define the scope of the amendments and to determine if some specific conditions should apply. This consultation on possible amendments to the corresponding requirements in the EMIR regulatory technical standards is running until 30 September and we would welcome your feedback.

Ladies and gentlemen, it is time to conclude. I have focused today on EMIR, although there are many other important regulatory topics regarding derivatives. For example, CCP recovery and resolution also requires a lot of attention, especially as central clearing requirements are being implemented. CCPs are becoming ever more important. However, I hope my remarks have provided you with further clarity on our efforts to ensure a successful and consistent implementation of this key piece of derivatives regulation.

Thank you very much for your attention.

I will now take a few questions.

Steven Maijoor
Chair