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FIA IDX keynote speech – ESMA's priorities for derivatives

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Keynote speech

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Ladies and Gentlemen,

It is a pleasure to speak at this year's FIA IDX conference and I'm honoured to be one of today's keynote speakers. I'm sorry I could not be with you in person but it's good to see that we are slowly moving back into more normal times.

Today I want to share with you ESMA's priorities around derivatives, focussing in particular on two elements:

- ESMA's recommendations for the review of the MiFID II/MiFIR framework; and
- ESMA's work on accompanying the transition to risk free rates in the context of the EMIR clearing obligation and the MiFIR derivatives trading obligation.

MiFID review – less complex but more effective rules

ESMA has worked over the last three years on an extensive review of MiFID II/MiFIR resulting in the delivery of twelve reports to the European Commission covering the whole scope of issues from secondary markets, to reporting and investor protection topics. We started our review process by assessing how MiFID II delivered against its objectives on market data issues back in 2019 and concluded the review process with the review of the MiFID II provisions on algo trading to be published shortly.

Our review reports assess how MiFID II has delivered against its objective of establishing sounder, more transparent and more integrated EU capital markets, also considering in many cases the impact of Brexit.

When developing our reports, we took a data-driven approach, building on either data reported to ESMA or ad hoc data requests. We have also extensively consulted on all our review reports and engaged in numerous dialogues with stakeholders, both in bilateral meetings or via our consultative working groups or dedicated roundtables.

With the MiFIR review proposals of the European Commission expected later this year, this is a good moment to recall ESMA's key findings and recommendations. In particular, while the current discussion largely focusses on the establishment of a consolidated tape, we see merit in a broader review of the legislative framework.

If I had to summarise our key findings and recommendations in only four words, it would be *less complexity, more effectiveness*. Of course, this doesn't do justice to a review process of three years, and I encourage those of you who haven't already done so to read our review reports and our detailed findings and recommendations.

I believe that this observation can be found in all our reports and that removing complexity from the legal framework while ensuring that the rules remain effective should be a guiding principle for the upcoming MiFIR review.

Let me highlight our findings and recommendations in a few areas to illustrate my point:

In the area of transparency, we concluded that the current regime based on complex provisions for waivers and deferrals did not result in improving the level of transparency and, at times, even resulted in a lower level of transparency compared to MiFID I. We therefore recommended a substantially simplified and streamlined waiver and deferral regime while maintaining the protection of large orders and trades particularly in less liquid asset classes.

One major recommendation here was to replace the current patchwork for supplementary deferrals granted at national level by a harmonised EU approach which would allow market participants to mask the volume of a transaction for a period of two weeks before fully disclosing the transaction.

I'm aware that some of you are concerned that our proposals may go too far and agree that transparency is not a goal in itself. At the same time, I believe our proposals are proportionate and will help improve the level of meaningful transparency and the level of competition while providing for the necessary protection for large trades. The experience in the US, where the CFTC relies on a similar, and even more demanding transparency regime for swaps, demonstrates that more transparency and well-functioning markets can go hand-in-hand.

Our review of the transparency regime also highlighted major data quality deficiencies. Improving data quality is high on our agenda since it is the basis for any evidence-based regulation.

For example, currently we don't have sufficiently granular information on the share of non-price forming transactions, both in publicly available post-trade data and in data reported to ESMA. This situation resulted in very different assessments by market participants and, as a consequence, very different perceptions on the policy recommendations for improving the functioning of MiFID II. Hence, in the ESMA RTS 1 and 2 review on which we are currently consulting we are making proposals to improve the publication and reporting of non-price forming transactions. While it might take some time until these changes are fully implemented, it will allow us over time to solve this long-standing issue.

Last, but certainly not least, over the last years, and following the constructive engagement with stakeholders, we recommended in our review report to recalibrate the transparency regime for commodity derivatives to better reflect market reality. Our proposals are also included in the consultation paper on the review of RTS 1 and 2. I strongly encourage you to provide feedback on this and the other proposals to improve the effectiveness of the MiFIR transparency provisions and thereby ultimately to improve market functioning.

In addition, in the area of commodity derivatives we made a number of suggestions in order for the regime to work more effectively. The majority of our recommendations for commodity derivatives, including the reduced scope of position limits, have been picked-up in the context of the MiFID II capital markets recovery package and we are now finalising the technical standards which we aim to submit to the Commission in November.

Finally, the review report on the cost of market data and the consolidated tape (CT) concluded that MiFID II did not deliver on limiting the costs for market data and on establishing a CT. There are a number of reasons why the market data provisions did not deliver. However, also here the main driver are complex rules that don’t work effectively.

No CT emerged over the last year since the current framework does not allow for the successful commercial operation of a CT. Moreover, data quality issues and the complex deferral regime for non-equity instruments did not provide for an environment conducive for the successful and commercially viable operation of a CT. Hence, while ESMA is supportive of a real time post-trade CT we consider that without creating the right framework and incentives we risk having this same discussion repeatedly. In particular, high data quality is a precondition for a successful operation of a CT for any asset class. For a CT for bonds and derivatives to deliver effectively, a more streamlined and harmonised deferral regime as highlighted a few minutes ago would be necessary.

Similarly, while MiFID II provides for guiding principles on the provision of market data, these rules didn’t deliver and the concerns on the high cost of market data which MiFID II aimed to address have actually increased over the last years. Complexity is also a driving factor here, even though less on the regulatory side but mainly in the market data policies of trading venues and market data providers. In order to ensure that the disclosure-based approach of limiting the cost of market data delivers, we have developed Guidelines further setting out our expectations on how market data providers should comply with the MiFID provisions. The Guidelines will start applying in January 2022 and we will continue to monitor closely developments in this area, including with a peer review on the Guidelines that we intend to commence in early 2023.

Given the topic of today’s conference, I cannot conclude on this first part of my speech without mentioning the UK’s withdrawal from the EU. 9 months have passed since the end of the transition period and the establishment of the EU and the UK as two separate markets. Thanks to the transitional measures put in place by the European and the UK authorities as well as the active preparation on the side market participants, it did not have a disruptive impact on financial markets nor undermine financial stability.

Regulatory divergence, however, between the EU and the UK, has started to emerge, including around MiFID II. With most of the initiatives currently discussed still at an early stage, the full effect remains to be seen. Given the interconnectedness of EU and UK markets, regulatory divergence, and its potential impact, will need to be carefully considered bearing in mind the objective of maintaining open and competitive European markets, preserving financial stability and orderly markets as well as high standards of investor protection. Looking forward, it will of course be key to ensure that the EU and the UK maintain close regulatory and supervisory cooperation.

Benchmark transition and its impact for the clearing and trading obligation

Following the high-level overview of ESMA's work on the review of MiFID II, let me now move to the second topic, the benchmark transition and what it means for the trading and clearing of OTC-derivatives and, more specifically, the derivatives trading and clearing obligations.

The derivatives trading obligation was also considered in the context of the review of MIFIR and, as you all know from the discussions over the last years, it also has a Brexit element to it. But this topic has much broader implications, which is why I would like to spend a bit more time on it.

As you all know, in the EU and in many other jurisdictions, both regulators and market participants have been working on moving away from certain benchmarks with the objective to increase contract robustness. Specifically, EONIA and LIBOR are due to cease soon, and are being replaced by new benchmarks, primarily the so-called Risk-Free Rates (RFR), such as €STR for the Euro.

Although there are still a number of steps to achieve and there is still a large portion of the market to shift, we are at a quite advanced stage of this transition and are getting closer to its final steps. Regulators across various jurisdictions, including ESMA as part of a joint communication for the EU, have been clarifying their expectations that counterparties should transition to the new benchmarks and stop trading derivatives referencing the old benchmarks, i.e. EONIA and LIBOR, including USD LIBOR, as soon as possible and at the latest by the end of the year.

Hence, we are in the very last months before the bulk of this transition is completed. As part of these final steps, ESMA has been working on revising the scopes of the clearing and trading obligations to adequately reflect this fundamental shift taking place in the financial markets. ESMA published a consultation paper earlier this summer and we are now in the process of assessing the feedback received.

To recall, and without going into too much detail, we proposed to remove the clearing obligation for EONIA, GBP LIBOR and JPY LIBOR, to extend the clearing obligation for SONIA for maturities up to 50 years and to introduce a clearing obligation for €STR. These changes appeared to be rather clear cases given the cessation of the old benchmarks and the state of progress with the transition to the RFRs for €STR and SONIA. Concerning the trading obligation, we did not suggest adding contracts referencing the new RFRs. Similar to the clearing obligation, we suggested to remove from the trading obligation derivatives referencing benchmarks that will cease to exist shortly, i.e. GBP LIBOR.

However, for both the clearing and the trading obligations, the situation for USD LIBOR and SOFR was not as clear. We suggested to keep USD LIBOR in the scope of both the trading and clearing obligations but invited stakeholders to express their views on the way forward.

At the time of the consultation paper, SOFR liquidity was still developing from a relatively low level, and the USD LIBOR market had largely not migrated. Yet, there are now a number of factors indicating that the transition has been making good progress, in particular thanks to the SOFR First initiative at the end of July and some of the communications to stop trading new risk referencing USD LIBOR by the end of the year that I mentioned earlier.

ESMA received close to twenty responses from a diversified range of stakeholders, including trading venues, CCPs, as well as representatives of the buy-side and of the sell-side. Overall, we received broad support for the analytical approach taken in the Consultation Paper, i.e. looking at the underlying data evidencing the shift to the new RFRs, considering changes to both the clearing and trading obligation at the same time, and engaging with regulators from third countries to facilitate international convergence to the extent possible.

We received two sets of opposing feedback with respect to USD classes and the timing of the application of the amended obligations. Some respondents were in favour of introducing USD SOFR classes now, while others were asking to reconsider these classes later, and in any case to provide long phase-ins to adapt to these changes.

I'd like to highlight that we are talking about a transition here, not about introducing a new clearing or trading obligation for a new segment of products in a less advanced market in terms of counterparties readiness to clear. In the latter cases, long phase-ins were introduced to ensure a smooth implementation.

The situation at hand is different since we are accompanying the benchmark transition within cleared markets. Hence, we are adapting the existing obligations to reflect the changes in the interest rate derivatives that entities are now trading and clearing.

In effect, liquidity is pivoting from the old benchmarks to the new RFRs, and so should the scope of the clearing and trading obligations. I can only reiterate the message from the EU authorities regarding the benchmark transition, that we expect counterparties to be prepared and to make the transition in due course.

Let me make a quick comment with respect to another aspect of the clearing obligation, this time with respect to the ongoing exercise concerning the EU clearing strategy, which is following a separate process with different timelines. I would want to essentially remind everyone of the clear communications from the Commission on the need for EU counterparties to reduce reliance on UK CCPs. Although the topic of today is different as it is about how EU counterparties would need to adapt their clearing arrangements in response to the benchmark transition, in particular when transitioning away from EONIA and onto €STR, this could also be an opportunity to continue reducing reliance on UK CCPs.

Going back to the benchmark transition, please note that we are now working on our final report taking into account the feedback received and finalising our proposals which we intend to submit this autumn. In addition, and as recommended by many stakeholders, we will have another look at the development of the trading and clearing activity over the last months. We will also talk to other regulators with the objective to coordinate as much as possible, both on substance as well as on timing.

Alas, this is one of the areas where we might end up with some temporary inconsistencies in the scope of the clearing and trading obligations. The process for delivering technical standards, which is not very flexible and relatively long, makes it challenging to perfectly synchronise the transition to the new benchmarks in the EU with the clearing and trading obligations in other jurisdictions.

This brings me back to the start of my speech. At times, complexity may not only undermine the effectiveness of our regulatory framework but in some cases, also the effectiveness of rulemaking in the EU. The EU's institutional set up is complex and can sometimes lead to lengthy processes compared to other jurisdictions. That being said, the complexity is sometimes simply a reflection of the inherent robustness of our decision-making process and accountability rules, which must be viewed as a strength, ensuring all the checks and balances are in place. Nevertheless, we could certainly reflect on ways to introduce more flexibility notably when we are seeking international consistency while preserving the strength of the EU's unique institutional set up.

Ladies and Gentlemen, I hope that you now have a better view on ESMA's priorities around derivatives. Thank you for your attention. I'm looking forward to answering your questions.