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**EACH response to the FSB, BCBS, CPMI-  
IOSCO consultation on 'Incentives to  
centrally clear over-the-counter (OTC)  
derivatives'**

September 2018

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## Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties Clearing Houses (CCPs) in Europe since 1992. EACH currently has 19 members from 15 different European countries and is registered in the European Union Transparency Register with number 36897011311-96.

EACH welcomes the opportunity to provide input to the FSB, BCBS, CPMI-IOSCO consultation on 'Incentives to centrally clear over-the-counter (OTC) derivatives'.

The central clearing of OTC derivatives is a pillar of the G20 commitment in response to the financial crisis. After the G20 commitment, the implementation of post-crisis reforms is still on going in jurisdictions across the globe. In the EU, the EMIR legislative framework, which put stricter requirements for EU CCPs, was adopted and other pieces of legislation (CCP Recovery and Resolution, EMIR review) are still under discussion in order to increase the resilience of EU CCPs. We support the work by the FSB, BCBS and CPMI-IOSCO to regularly assess the implementation of this commitment. It is important to analyse the effects of these reforms and to verify whether market participants have strong incentives to centrally clear OTC derivatives through CCPs. Unintended shortcomings which would weaken the financial stability should be identified and addressed.

We agree with the analysis of the Derivatives Assessment Team (DAT) that the changes in the OTC derivatives market are consistent with the objective of the G20 of promoting central clearing as part of mitigating systemic risk and making derivatives markets safer. The volume of mandatory clearing through CCPs has increased especially for interest rate and credit derivatives. Market participants increasingly understand the benefits of clearing through CCPs, as they play a unique role in the financial market by reducing and managing the counterparty risks, and the products cleared on a voluntary basis have risen. Clearing would help them benefit from the possibility to expand the number of its derivatives partners and from a risk management angle. This would create a more efficient and safer financial market.

## 1. Incentives

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Q1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

We agree that regulators, thanks to the implementation of post-crisis reforms worldwide, have put in place the right incentives to centrally clear OTC derivatives through CCPs. This is reflected in the increase of cleared products<sup>1</sup>, especially interest rate and credit derivatives. We

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<sup>1</sup> See BIS chart page 16 of the [consultation](#)

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believe that central clearing should be promoted also for specific categories of clients who have more difficulties to access these services. Market participants should think about practical solutions to remove these barriers instead of requiring a permanent exemption from clearing and regulators should enforce legislative frameworks which can help the access to clearing in a smooth way (e.g. phase-in periods to allow clients to arrange their structure to clearing). One example of how market participants are working towards finding a solution to access central clearing is the work to allow pension fund clearing currently under way in the EU. During the past months, the European Commission brought together stakeholders to discuss ways to find solutions to this issue. Progress has been made towards addressing the challenges that pension funds are encountering in clearing their trades<sup>2</sup>.

EACH believes that regulatory convergence can promote harmonisation with regards to clearing mandates and enhance financial stability.

It would be good if the **FSB could provide some more directional guidance on regulator priorities**, such as:

- Addressing the **risk of a continued reduction of clearing service providers**, and how to support making it generally attractive for entities to provide Clearing Services, or for CCPs to open for other types and more Members
- **Allowing Banks/CMs to offset segregated Client margins** posted and forwarded to CCPs from leverage ratio calculations Ensuring the completion at global of the staged introduction of **clearing mandates and bilateral margins for the non-cleared space**.

Q2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

EACH agrees that the relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear, however we believe that access to clearing services can be inhibited because of shortcomings in the implementation of regulations such as the Leverage Ratio Requirement under Basel III. In our opinion, barriers to central clearing should be removed for even small financial market participants to access counterparty credit risk management benefits of clearing.

Q3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

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<sup>2</sup> [https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-parliament-plenary-debate-revision-european-market-infrastructure-regulation-emir-refit\\_en](https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-parliament-plenary-debate-revision-european-market-infrastructure-regulation-emir-refit_en)

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EACH agrees with the views expressed in this consultation paper that the level of margin required for uncleared transactions will influence clients' decision on whether to centrally clear OTC transactions.

We would like to highlight from figure D.3 that it is clearly the 'counterparty risk management considerations' which ranked first amongst the top factors incentivising clients to centrally clear. EACH believes that margin requirements (MPOR and SIMM) need to be readjusted to give further incentives to market participants to use centrally cleared facilities and reap all benefits offered by CCPs. Given that the bilateral margin framework has not fully come into force (final measures should come into force in 2020), EACH believes the SSBs should first ensure that its full roll out and then, in a second step, evaluate its impact on the incentives to clear.

Q4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

EACH agrees with the points raised in the report and would add that, ultimately, cross-border deference mechanisms have definitely played a key role in the successful implementation of the G20 commitments. Following from G20 Leaders Declarations, the industry needs to ensure that the global nature of OTC derivatives markets is safeguarded and interconnected to avoid excessive costs imposed to market participants stemming from barriers preventing them to access to global liquidity hubs.

Several clearing members of CCPs operate in several different jurisdictions and are subject to an extensive number of rules and regulations which they all abide to. As previously stated, in the current market environment, regulatory convergence is of immense importance to global markets as it can promote harmonisation with regards to clearing mandates and enhance financial stability.

## **2. Markets**

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Q5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

We agree with the outcome of this consultation that liquidity towards cleared OTC derivatives would attract market participants. Furthermore, market behaviour has shown that liquidity builds where market participants can transact in the most efficient manner and where the regulatory environment enables them to conduct business in a safe and clear way.

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Consequentially, EACH believes that Uncleared Margin Regulations (UMR) will continue to incentivise market participants to move towards centrally cleared products, however this will only entirely realised once its fully implemented in 2020. EACH believes that margin requirements (MPOR and SIMM) need to be readjusted to give further incentives to market participants to use centrally cleared facilities and rip all benefits offered by CCPs. Only a complete and thorough assessment of the incentives to clear would then be possible.

Q6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

Client focused industry solutions aiming at enhancing service offering as well as promoting central clearing are deployed by clearing members of the CCPs. Further analysis on portfolio compression is needed in order to address potential unintended consequences.

Additionally, it's worth pointing out that regulatory uncertainty around the changes to the Basel III Leverage Ratio will continue to hinder small financial market participants from accessing counterparty credit risk management benefits of clearing. EACH believes that this regulatory initiative should be tackled in a timely manner. We would also support that clearing members be allowed to offset segregated client margins posted and forwarded to CCPs from leverage ratio calculations.

### **3. Reforms**

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Q7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

- a. central clearing mandates (both in terms of product scope and entity scope);
- b. minimum standards for margin requirements for uncleared derivatives;
- c. capital requirements for credit valuation adjustment (CVA) risk;
- d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
- e. G-SIB requirements; and
- f. The leverage ratio.

Yes, EACH generally agrees with the report's characterisation of the effects of the above reforms on incentives to centrally clear:

- **Clearing mandates** – EACH considers these to have been a key and necessary step to broaden the use of CCPs. Mandates are necessary to overcome the collective action problem to build up centrally cleared liquidity, as well as overcome the adverse selection problem that Too-Big-To-Fail or heterogeneous credit risk in the bilateral space may create.

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- **Bilateral margins** - Bilateral margins rules have been slow to start, and full application is still outstanding. Regardless of the incentives this may create for using CCPs, bilateral margin is a sensible safeguard to prevent uncollateralised risk and exposure building up between institutions.

In addition to those incentives, EACH would like to stress two additional incentives to central clearing:

- the robust response that CCPs provided during the recent financial crisis, which served as a great example of the benefits for users of using CCPs.
- the increase of liquidity being channelled through CCPs which has made clearing markets even more liquid and attracted further users for the benefit of the clearing community.

Q8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

EACH agrees with the report's characterization of the impact of these reforms on the incentives to provide client clearing services, however, we would like to point out that the report does not discuss/propose any next steps on how to address the shortcomings identified by the report in regulatory reforms implemented globally.

Q9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

In our opinion, the following points should be taken into account:

- Disincentives to central clearing for market participants need to be removed from prudential frameworks before regulators consider changing the scope of any clearing mandates.
- Improvements should be made with regards to the Basel Leverage Ratio.
- Regulatory convergence needs to be actively pursued to incentivise market participants to central clearing of OTC derivatives. Any regulatory race to the bottom will inevitably diminish the incentives for appropriate risk management and its associated long-term benefits to the market.

We would propose further guidance in order to address the risk of a continued reduction of clearing service providers. It is crucial to have in place legislative frameworks that attract entities to provide Clearing Services and allow CCPs to open for other and more types of Members.

## 4. Access

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Q11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

The example used in the DAT report (page 21) clearly illustrates that, for a particular market, the number of client clearing services providers has increased and client positions attributable to the five largest clearing members have fallen in recent years. Therefore, the trend for increasing concentration, as noted in the report is not uniform across markets and CCPs. However, where this trend exists, in specific markets, EACH does recognise that this is an issue of concern. EACH is eager to collaborate with the authorities to address the risk of a continued reduction of clearing service providers and to state how to support making it generally attractive for entities to provide Clearing Services, or for CCPs to open for more Members and also to other types of Members.

Q12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of: a. using clearing services? b. providing client clearing services?

EACH agrees with the report's characterisation of the up-front and ongoing costs of both using clearing services as well as providing client clearing services which could ultimately be reduced by regulatory initiatives (i.e. Basel III). However, we would like to highlight that central clearing services provide huge benefits in the context of counterparty risk management, position netting as well as operational efficiencies which are well perceived by market participants. It is also important to note that bilateral trading and risk management relations come with substantial upfront costs (establishing master agreements, obtaining netting opinions, conducting KYC, AML and credit checks, etc), and the relative values of these could be compared.

Q13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

EACH believes that with regards to the product coverage of clearing mandates, the scope has been extended in such a way that CCPs can still manage relevant risks and potential default management processes. Global consistency needs to be enhanced particularly with respect to the scope of clearing mandates.

With regard to entities, EACH considers that barriers to central clearing should be removed for even small financial market participants to access counterparty credit risk management benefits of clearing.

Q14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

EACH acknowledges the fact that not all financial products are suitable for clearing. As we have emphasised throughout the response, the need to incentivise market participants, through regulatory reforms, to move to central clearing would be facilitated by removing barriers to entry. EACH believes that exemptions for certain participants are therefore not necessarily the way forward. For instance, it must be borne in mind that for smaller institutions who are not centrally clearing, they would remain exposed to significant counterparty risk from the dealer/bank, contributing to the systemic impact of the dealer/bank default.

Central clearing enables all market participants to mitigate counterparty risk, reduce operational risk and funding needs by streamlining processes. In our opinion, all market participants should be able to have access to central clearing and benefit from the efficiencies that are provided. Such move would further reduce risk in the bilateral OTC market and enhance resilience of the financial sector. In addition, the greater completeness of markets in CCPs (e.g. through increased number of market participants) is an important factor in driving optimal efficiency.