European Securities and Markets Authority

The Chair

Date: 8 May 2014
ESMA/2014/483

Michel Barnier
Commissioner
Internal Market and Services
European Commission
BERL 12/181
B – 1049 Brussels
Belgium

Ref: Frontloading requirement under EMIR

Dear Commissioner Barnier,

I am writing to you to draw your attention to an issue that is linked to the clearing obligation and the frontloading requirement included in the Regulation (EU) No 648/2014 on OTC derivatives, central counterparties and trade repositories (EMIR).

The frontloading requirement is the obligation to clear OTC derivative contracts entered into after a central counterparty (CCP) has been authorised under EMIR and before the date of application of the clearing obligation. Therefore, the frontloading requirement implies that contracts concluded on a bilateral basis following the authorisation of a CCP might become subject to the clearing obligation before their expiration date. According to Recital 20 of EMIR, the objective of the frontloading requirement is to ensure a uniform and coherent application of EMIR and a level playing field for stakeholders when a class of OTC derivative contracts is declared subject to the clearing obligation.

In the analysis that we have conducted for the purpose of determining the future clearing obligations, ESMA has identified that this requirement may introduce significant uncertainties in the market with the consequences mainly borne by derivatives end-users. Those consequences are legal, operational and financial. The consequences are further detailed in Annex I, and the overall effect could well be a reduction in the incentive to hedge risks during a certain period (to avoid the consequences of the frontloading effect), which would in turn increase the un-hedged risks and would impact negatively on financial stability.

ESMA considers that the reduction of systemic risk, which is the overarching objective of the clearing obligation, can be questioned if this obligation introduces at the same time risks to market functioning and financial stability.

Resolving this issue is urgent because a first notification was received by ESMA on 18 March 2014 of a CCP authorised under EMIR to clear certain classes of OTC interest rate swaps and equity derivatives. Since that date, the counterparties which trade OTC derivatives contracts within those classes could in future become subject to the frontloading requirement. Other notifications have followed and we expect to receive more in the coming weeks as more CCPs clearing OTC derivatives are authorised under EMIR[1].

The frontloading window can be divided into two different timeframes as illustrated in Graph 1 below:

(a) Period A: between the notification of the classes to ESMA and the entry into force of the regulatory technical standards (RTS) on the clearing obligation;
(b) Period B: between the entry into force of the RTS and the date of application of the clearing obligation. Period B is equivalent to the phase-in period to be defined in each RTS for each category of counterparty.

The uncertainty and negative impact of frontloading are most significant in Period A. During this period counterparties will not know: 1) whether the notified classes of derivatives will be subject to the clearing obligation; 2) when the clearing obligation takes effect for them; and 3) which CCPs will be available for clearing these products. This lack of legal certainty, hence, introduces new risks and increases compliance costs for counterparties.

As of the start of Period B, counterparties will have legal certainty on the contracts which are subject to the clearing obligation, on the date from which the clearing obligation takes effect and on the CCPs available to clear the relevant classes of derivatives.

In order to mitigate the negative impact of the frontloading requirement during Period A, ESMA is contemplating to articulate the clearing obligation in such a way that frontloading may only apply to contracts entered into during Period B, while the contracts entered into during Period A would not be subject to frontloading. This means that contracts concluded in Period B may be subject to frontloading under some conditions, depending on the way the remaining maturity of the contract is framed. ESMA will consider these issues further when defining the parameters determining which contracts concluded during period B will be subject to frontloading. Possible solutions will be outlined in the public consultation paper which will be released prior to the finalisation of the draft regulatory technical standard on the clearing obligation.

With this letter I am seeking the European Commission Services' views on the above mentioned approach on frontloading. We are publishing this letter to ensure full transparency on this important matter. Since the European Parliament and the Council hold a right of objection on Regulatory Technical Standards, we are copying this letter to them, in order for them to consider this approach at their earliest convenience. Given the urgency explained above, an early reaction would be greatly appreciated.

[1] See the detail of the classes in the Public Register available under the Post-Trading section of: http://www.esma.europa.eu/page/Registries-and-Databases

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

CC: Sharon Bowles, Chair of ECON, European Parliament
Werner Langen, Rapporteur for EMIR, European Parliament
Yiannis Stournaras, Chair of ECOFIN, Council of the European Union

ANNEX I – Background and impact of the frontloading requirement

1. Since 18 March 2014 a number of CCPs clearing OTC derivatives have been authorised under Article 14 of EMIR and their competent authorities have notified ESMA of the classes of OTC derivatives that those CCPs are authorised to clear, in accordance with the procedure described under Article 5(1) of EMIR.

2. The classes of OTC derivatives notified to ESMA are presented in detail in ESMA's public register[2].

3. Since the notification dates, the counterparties that trade OTC derivatives contracts within the notified classes are subject to the possibility of becoming subject to the clearing obligation and thus the frontloading requirement. Hence, OTC derivatives contracts which have been concluded on a bilateral basis since the notification dates might become subject to the central clearing obligation before their expiration date. This is likely to impact a significant number of counterparties given that the notified classes include interest rate swaps, which is by far the biggest component of the global OTC markets, representing more than $500 trillion of notional outstanding amount (more than 80% of the total).

4. The frontloading requirement poses a significant challenge from a legal, operational and financial point of view, mainly because of the uncertainty that it creates. Indeed, a transaction that is centrally cleared is subject to a different collateral regime than a transaction that is not, and this has a substantial impact on pricing. This pricing uncertainty may have a number of effects such as a widening of the bid-offer spreads, difficulties or dis-incentive for counterparties to appropriately manage their risks, which may eventually increase risks and reduce market stability.

5. Besides, during the first part of the frontloading period (Period A i.e. between the notification of the classes to ESMA and the entry into force of the RTS on the clearing obligation), the counterparties do not know whether they will both have access to a common CCP that will end up clearing that contract. The adaptation of contractual terms to allow and adjust to the clearing requirements is also an element that increases the uncertainty linked to frontloading. This period may last between 8 and 15 months[3].

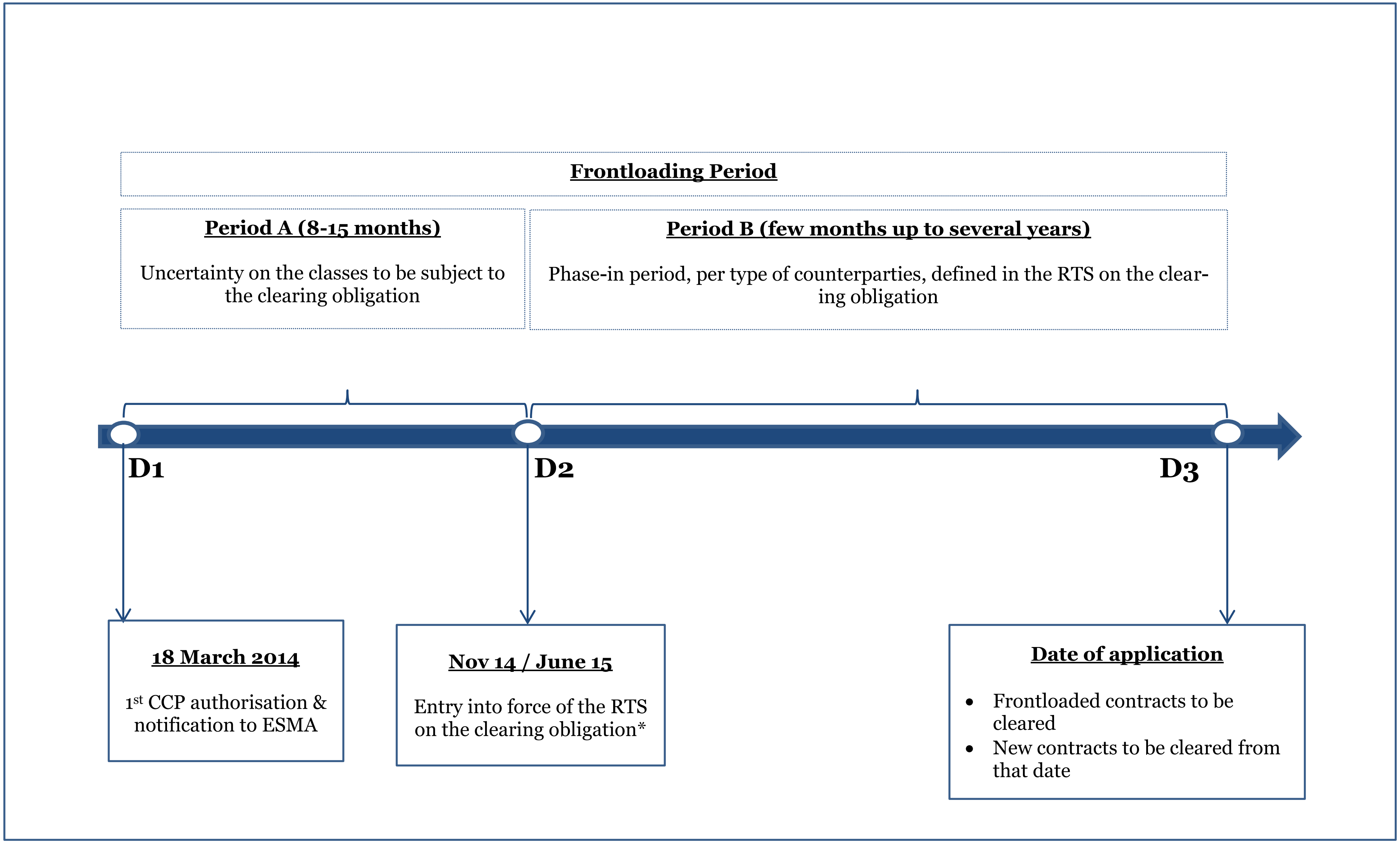
6. The impact of this uncertainty and the resulting challenges from a legal, operational and financial point of view are likely to be of particular magnitude for the end-users of OTC derivatives contracts, which are generally price takers and will therefore incur the cost of this uncertainty.

7. It should be noted that the uncertainty linked to frontloading is repeated for any new notification that ESMA receives, i.e. for each of the 11 European CCPs clearing OTC derivatives (unless they are authorised to clear a class already cleared by another authorised CCP). Therefore the risks and costs associated with frontloading are triggered not only by the authorisation of the first CCPs, but by most of the new and future CCP authorisations.

[2] The public register for the clearing obligation is available under the Post-Trading section of: http://www.esma.europa.eu/page/Registries-and-Databases

[3] 6 months for ESMA to submit the RTS to the European Commission for endorsement + [1-3] months for the European Commission to endorse the RTS + [1-6] months for the non-objection period of the European Parliament and the Council.

Graph 1: Illustration of the frontloading requirement and proposed approach



(*) if the conditions for the clearing obligation on those classes are met