Incentives to centrally clear over-the-counter (OTC) Derivatives

A post-implementation evaluation of the effects of the G20 financial regulatory reforms

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AFG's

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Incentives

1. *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 with the finding that some categories of clients have less strong incentives to use central clearing than other categories where clearing may have complementary beneficial impacts on regulatory capital ratios.

For those clients who do not have such capital ratio optimization incentives, less active end clients in derivatives usage, incentives to clear are mixed and may not be sufficient to compensate operational complexity and costs introduced by central clearing. Access costs of clearing often balance incentives that reduce benefits to use central clearing.

Beyond cost and operational burden to access central clearing, effective capacity to clear transactions depend on clearing limits and capacity granted by clearing members. For directional portfolios, clearing members may be willing to restrict credit lines granted to end clients, in particular as the result of balance sheet costs imposed by the leverage ratio.

2. *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?*

We agree with the finding that different type of clients have different incentives to clear.

Main incentives for end clients are economic incentives through better access to market, increased liquidity and potentially reduced bid-offer. However findings also evidence that costs, access capacity and margin type (such as cash collateral requirements) are strong disincentives to clearing. All in cost of clearing should be considered when assessing clearing benefits and not only transaction bid-offer spread.
Overall, the picture is mixed for end clients, which is highlighted in the report by the fact that use of

voluntary clearing remains limited.

3. *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?*

Margin requirement for uncleared derivatives reduces differences between non-cleared and cleared transactions in terms of risk management process. However, greater flexibility granted in the type of margin posted gives advantage to uncleared derivatives when clearing is not mandatory. In order to increase incentive to clear, CCPs and/or Clearing Members should allow market participants to post their Variation Margins (VMs) in assets rather than cash.

We believe that the EMIR injunction for CCPs to find solutions with pension funds to circumvene the cash margin requirements of them has not demonstrated any progress and that it is unlikely that any solution will be proposed in the coming future from the CCPs.

Furthermore, while we are positive on the direction of the measures taken by the regulators to reduce the counterparty risk, we do not believe that making the uncleared derivatives overly expensive compared to cleared derivatives as an incentive to clear is necessarily the best way to achieve the goals. An assessment should also be given to the systemic risk caused by an excessive concentration of volumes into a few places.

4. *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.*

Contractual framework between client and clearing members is biased towards clearing members. An illustration of this bias is shown in the report: around 65% of clients estimate that they need more than 4 month to setup new contractual relationship with a clearing member while 87% of clearing members have the ability to terminate client clearing services within 3 months. Contractual framework should be adapted to allow easier access to end clients and more balanced relationship with clearing members.

We found that clearing members are using their position to add contractual clauses that increases systemic and costs. Large institution have negotiated those contracts and are still dissatisfied and smaller institutions have worst contracts.

Among these we see the following:

- Ability to cancel unilaterally the trades. Ability to refuse collateral that even the CCP accepts;
- Ability to unilateral increase fees;
- Operational burden like intraday posting which investor cannot perform;
- Ability to ask and to increase unilateral for additional margin on top of what the CCP requests.

We have found that CCP and Clearer have not provided a solution to transfer portfolio from one clearer to another and do not appear to try to implement such possibility.

Short-term termination notice period embedded in clearing members contracts raises systemic risk concerns. In case of a clearing member default, other clearing members have the ability to use their early termination rights to leave a CCP and avoid contributing to losses that could considerably increase risks for end users.

On OTC vs Billateral:

From a prudential perspective the cleared derivatives creates risks that OTC contract do not have. To assess which is better we need to look at weighing the benefit of have the credit risk of a CCP vs the following additional risks:

- Bilateral contract cannot be cancelled unilaterally in most cases and thus should be considered a better for long term hedging purposes
- The collateral and initial margin can be increased unilateraly, bonds can be made ineligibles and cash deposit bear banking credit risks.

Eventually, capacity of clearing members to early terminate transaction with their clients is a clear difference with non-cleared OTC derivatives where counterparties do not have such right. Clearing members early termination rights do not favor clearing.

Recovery and resolution regulation of CCPs should be set to that end users have the ability to understand and manage their exposures to CCPs. Unlimited (or uncapped) margins haircutting present an risk that is not manageable for end clients (in particular when clearing members have the ability to call for additional margins) and should therefore be prohibited.

Markets

5. *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?*

6. *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?*

Industry efforts such as direct clearing membership model still present many uncertainties (CCP exposure within recovery or resolution process, specific capital requirements, effective cost…) at this stage to allow for conclusions.

In addition, access to new clearing models are not necessarily granted by clearing members to end users (clearing members may not be in capacity to bear develop costs for all models and/or may not be willing to develop some models due to uncertainties related to regulatory treatment).

Reforms

7. *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.

8. *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?*

9. *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?*

Additional conditions imposed by clearing members on top of those of CCPs create economic risks for end users (liquidity risks on additional margins, activity continuity risks on additional early termination provisions…) that creates strong disincentive to clear.

Posting margins in cash is not natural for end clients that are holding assets and hedging risks with cleared derivatives. They have to perform transformation of assets into cash to post margins. Doing so exposes them to liquidity risks that also creates a strong disincentive to clear.

Progress should be made to allow end clients:
- accessing CCPs in a more straightforward way (i.e. with no or very limited set of additional conditions from clearing members), potentially through a review of the principal to principal model
- posting margins in assets rather than cash to allow them reduce liquidity risks induced by clearing activity

Possibility to post variation margins in assets rather than cash would offer a strong incentive to centrally clear transaction.

Access

10. *Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:*
    a. accessing clearing arrangements; and
    b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

We agree with the report's characterisation of the difficulties evidenced for small clients (financial and non-financial) or with directional derivatives activity in accessing clearing arrangements and/or conducting hedging activities given restrictions imposed by clearing members but also CCPs (VM in cash)

11. *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?*

We agree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks, which could raise concern during periods of stress.

12. *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?

All in cost of clearing should be considered when assessing clearing benefits and not only transaction bid-offer spread. Fixed entry costs and skills required to access clearing are substantial and create disincentive to clearing for entities that cannot overcome entry barriers.
Furthermore, there is little incentive for institutions to propose client clearing services to numerous small clients.

13. *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.*

14. *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.*

Objective of mandatory clearing is to reduce systemic risk. Entities with limited activity on derivatives or reduced risk profile, such as UCITS funds and AIF with limited leverage, do not present systemic risks but have to bear heavy implementation costs of clearing. We are of the view that financial entities having limited activity on derivatives should be exempt from clearing obligations while not being penalised by higher uncleared costs. Higher uncleared costs do not generate benefits to anyone and has in many circumstances like for most of small actors not the intended goals of incentivising to clearing. Consequently, high uncleared costsand high costs to access clearing may have the undesired incentivise to reduce the use of the derivatives instruments as a relevant hedging instrument.