

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

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

Questions for public consultation

Eurex Clearing is pleased to respond to the consultation following the FSB's survey on the G20 financial regulatory reforms. These reforms had ambitious targets to reduce the likelihood and impact of the types of issues which contributed to the Great Financial Crisis, as well as channels which exacerbated their effect.

Our response should be read as supplementary to those of CCP12 and EACH, to which we have contributed. In the brief responses below, we would like to draw attention to certain matters beyond those which are outlined in the CCP association responses.

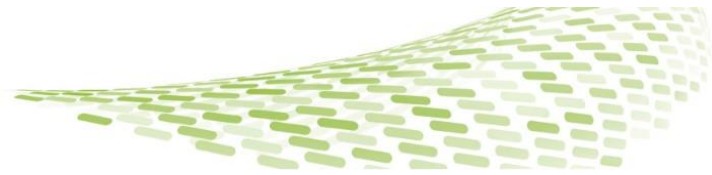
In terms of introductory remarks, we would highlight that while great progress has been made in key areas of the reform package, notably greater use of central clearing, other areas understood to require reform have not been fully addressed. As such, we would welcome both further analysis of the impact of reforms in future, as well as deliberation amongst policy makers and regulators on these matters. In particular, to draw clearer answers to the benefits and costs of the reforms, we would suggest that the global Standard Setting Bodies conduct further analysis on changes in product mix usage by affected institutions, possible improvements to trade transparency, and the bilateral margin framework once fully rolled out.

It is important to consider the relative costs and benefits of the new regulatory regime holistically, rather than purely costs, since this may ignore intended consequences of the reform package. Indeed, the goal of ensuring appropriate risk management standards, be they through bilateral or multilateral measures, was not necessarily expected to leave contracting and trading patterns untouched. The possible costs created were to be seen in the context of having created more robust and transparent markets – to the benefit of individual actors – as well internalizing possible costs from failure – to the benefit of the broader financial system and beyond.

We would reiterate the appreciation of the work conducted by global policy makers and regulators, including the SSBs. The survey marks another stage of the ambitious reform pack and ensuring it remains fit-for-purpose. While we consider that further work in the directions outlined below to be of great importance, we wish to be clear that this is in support of the goals of the reform package.

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 have less strong incentives to use central clearing?
- In addition to the association responses, we would highlight that in our view, which is corroborated by the survey results, clearing mandates are fundamental to the increasing in broader CCP use. As such, we would caution that other incentives, at least in their current



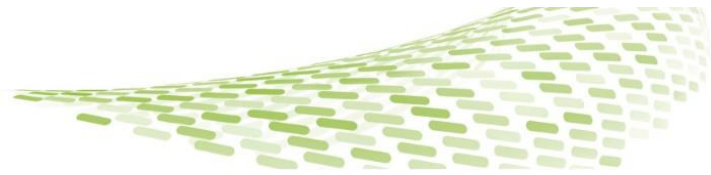
form, appear to be a very weak incentive. We agree that certain types of participants are less incented to clear, which implies that in certain cases uncleared OTC derivatives remain an economically preferred trading or hedging approach to standardized listed products or indeed cleared derivatives.

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 characterization of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

- In addition to the association responses, we would strongly support the view that the post-crisis reforms, in particular the clearing mandates, have contributed to increased central clearing. One consideration that we would add to the report's characterisation is the up-front cost of establishing and maintaining bilateral trading relations (KYC, netting opinions, master agreement and related annex negotiation, credit checks and limits, etc.), which we would expect to feature as a cost.

3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivize 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?

- We fully support the approach this question implies. We need to find a healthy balance between cleared and uncleared margin requirements in order to establish a healthy incentive structure across all asset classes for central clearing. While it is clear that specific types of different entities mean that rules will realize different effects, the goal should be to find optimal common ground. The association responses urge the authorities to complete the UMR regime, following which such questions would be more tractable to answer fully.
- It should be noted that according to the consultation, over 50% of respondents stated that "initial margin for cleared" is the largest *disincentive* to clear, while "initial margin for non-cleared" was seen as an incentive for central clearing by less than 20% of respondents (Figure D.2).
- We would also note that if bilateral margin requirements approach those charged by CCPs, this indicates that product liquidation periods are sufficiently short to enable greater central clearing of their risk.
- Looking at the regulatory landscape from a European perspective, consistency of regulatory objectives must prevail across asset classes. Having said that, the matter in question is whether the current coexistence between bilateral margin rules vs clearing obligations sufficiently accounts for a stringent approach towards market robustness through CCP infrastructures. This particular applies to the asset class FX, in terms of transacted volumes by far biggest market segment in the world. In full support of the intention of balancing out margin requirements for centrally and non-centrally cleared margin requirements, we would like to encourage a critical reflection on the intended target picture with an emphasis on how consistency can be achieved across all asset classes and in particular, in the space of FX products.
- Considering the great benefits CCPs create for the market and the wider economy, i.e. reduced risk and complexity, increased transparency and more safety due to neutrally calculated margin levels and being aware that a general approach may not be applicable on all parts of the markets, we would like to emphasize that we generally prefer solutions to



remove barriers to access to clearing over the introduction of exemptions.

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.
 - While the report and survey both note the importance of liquidity, we would add that this is fostered by complete markets. Thus, to ensure greatest efficiency and thus cost effectiveness of central clearing, the greater the scope of mandates in terms of major buyers and sellers should be considered.

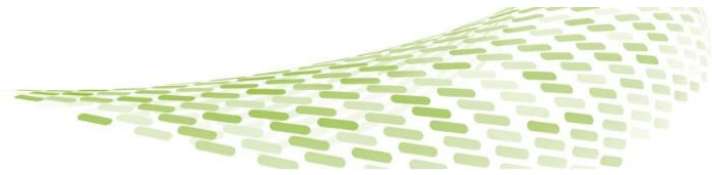
Markets

5. Is the consultative report's characterization 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 note that the authorities have considered other information sources, such as trade repository data to corroborate survey results. We would suggest that in future analyses, SSBs also consider the risk exposure in various sectors of the OTC derivatives market, rather than focus on notional figures. Notional figures could appear to overstate the degree of risk which is managed through CCPs, since there would appear to be a large gap between industry statistics on bilateral margin and public sector statistics on gross credit exposure¹.
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?
 - We would highlight the collective responses from CCP12 and EACH on this matter, and emphasise that direct access models can indeed address incentives to greater central clearing. In particular, if they are appropriately designed, they can additionally serve to address concentration concerns, including the reliability of porting and thus credit risk mitigation.

Reforms

7. Do you agree with the report's characterization of the effects of the following reforms on incentives to centrally clear?
 - a. *Central clearing mandates (both in terms of product and entity scope):*
 - b. *Minimum standards for margin requirements for uncleared derivatives*
 - Bilateral margin standards appear to be low with regard to serving as the primary incentive to clear, as outlined above. In any case, we would urge authorities to implement even those standards both for their own benefit of increasing the safety of the markets more broadly and to serve as an incentive for greater standardization and central clearing.

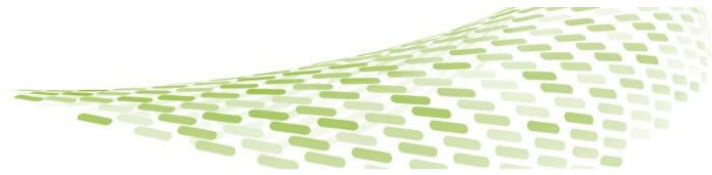
¹ https://www.bis.org/publ/otc_hy1805.pdf and <https://www.isda.org/a/oQmEE/ISDA-Margin-Survey-Full-Year-2017.pdf>



- c. *Minimum standards for credit valuation adjustment (CVA) risk;*
 - d. *Capital requirements for jump-to-default risk (including where applicable the Standardization approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));*
 - e. *G-SIB requirements; and*
 - f. *The leverage ratio*
- There are various aspects of the leverage ratio which is covered in the collective responses from CCP12 and EACH. We would however highlight that the leverage ratio was intended as a backstop for banks to ensure their resilience in a broader sense. As such, we would consider that maintaining the leverage ratio for bilateral trading exposure to be a prudent measure. In particular, to the extent that smaller firms face a systemically important institution bilaterally, ensuring that the bilateral exposure is captured by the back-stop leverage ratio serves to provide a degree of surety to the counterparties.
8. Do you agree or disagree with the consultative report's characterization 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?

Access

10. Do you agree or disagree with the report's characterization 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?*
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 that client clearing for some asset classes or market segments is concentrated in a small number of clearing members. While this can be a concern in other quarters in its different effects, for a CCP this is primarily a concern if the risk management is challenged by it. In particular, high concentration of indirect participation could lead to greater impact on clients in the event of a clearing member default, in particular if porting is difficult. For a CCP ecosystem, it is better to manage more frequent but smaller defaults than infrequent but massive ones. The concentration is potentially driven by other factors beyond the incentives to clear, and we would consider such a study by authorities should consider the broader causes for it. At first glance, the survey's conclusion of both great demand for central clearing services and the difficulties of access to central clearing for clients appear to be contradictory.



12. Do you agree or disagree with the report's characterization of the incentive effects created by up-front and ongoing fixed costs of:
 - a. *using clearing services?*
 - b. *providing client clearing services?*
 - Our comments and agreement are addressed in the collective responses, however we would highlight that our understanding is that fixed costs of bilateral uncleared trading relations are also considerable.
13. In light of the finding in this report that economic factors generally incentivize 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.
 - Although the smallest and least active financial firms may not pose a systemic risk to the market upon their default, they continue to be exposed to bilateral risk of their counterparties if they do not clear. Thus, while exemptions for smaller firms may be a commensurate reduction in compliance costs, it retains a greater degree of impact from the default of a dealer on real-economy or smaller institutions. We would welcome analysis from policy makers or regulators on whether or not very small firms' hedging needs can be addressed by more transparent or standardized instruments.