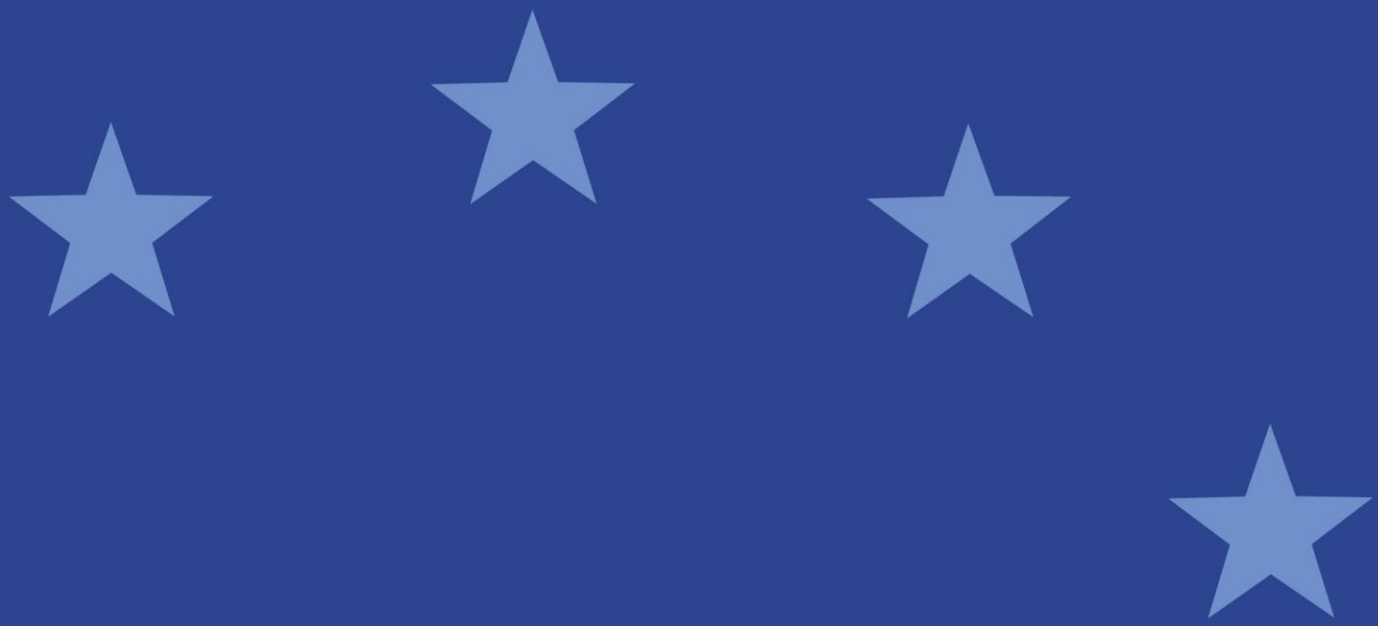
esma European Securities and Markets Authority

Reply form to the Consultation Paper on the Clearing Obligation under EMIR (no. 1)



11 July 2014|2014/799 Reply Form

European Securities and Markets Authority

Date: 11 July 2014
2014/799 Reply Form

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the questions listed in the Consultation Paper on the Clearing Obligation under EMIR (no. 1), published on ESMA's website.

Comments are most helpful if they:

- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

To help you navigate this document more easily, bookmarks are available in "Navigation Pane" for Word 2010 and in "Document Map" for Word 2007.

ESMA will consider all comments received by **18 August 2014.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

How to use this form to reply

Please note that, in order to facilitate the analysis of the responses, ESMA will be using an IT tool that does not allow processing of responses which do not follow the formatting indications described below.

Therefore, in responding you are kindly invited to proceed as follows:

- use this form to reply and send your response in Word format;
- type your response in the frame "TYPE YOUR TEXT HERE" and do not remove the tags of type <ESMA_QUESTION_1> Your response should be framed by the 2 tags corresponding to the question; and
- if you have no response to a question, do not delete the tags and leave the text "TYPE YOUR TEXT HERE" between the tags.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions which will be subject to the clearing obligation, as well as central counterparties (CCPs).

General information about respondent

Name of the respondent	Association for Financial Markets in Europe (AFME)
Are you representing an association?	Yes
Activity	Banking sector
Country/Region	Europe

Introduction

Please make your introductory comments below:

<ESMA_COMMENT_1>

1. Central banks and policy makers are calling for a revival of Europe's securitisation market. The European Commission's March 2014 Communication on Long-Term Financing of the European Economy explicitly noted the ability of securitisation to "unlock capital resources, increasing the ability of banks to expand their lending and finance economic growth." The regulatory treatment of securitisation in Europe is complex and under review.
2. However, while there have been significant positive changes in other areas of regulation affecting securitisation, representatives of key sectors of the economy (including the car industry, small- and medium-sized enterprises (SMEs) and mortgage lenders) remain concerned that new regulations will reduce their access to capital and raise the cost of financing.
3. The draft Regulatory Technical Standards on the Clearing Obligation under Article 5(2) of Regulation (EU) No 648/2012 in relation to interest rate swaps (the "**Draft RTS**") risk having precisely such a negative effect as a result of their significant implications for swaps entered into in connection with securitisation transactions (referred to collectively in this paper as "**Securitisation Swaps**").
4. In light of these significant implications, AFME and its members wish to make the following comments and proposals in connection with the Draft RTS.
5. AFME strongly supports the goals of strengthening systemic resilience in the derivatives market, and recently submitted a response to the Draft RTS on risk-mitigation techniques for OTC derivatives not cleared by a CCP (see AFME letter to the European Securities and Markets Authority, European Banking Authority and European Insurance and Occupational Pensions Authority dated 14 July 2014 (the "**Uncleared Swaps Response**") setting out certain proposals which, in AFME's view, were consistent with those goals. However, as indicated in the ESMA Consultation Paper 2014/799 accompanying the Draft RTS published on 11 July 2014 (the "**Consultation Paper**"), it is not the case that all OTC derivatives should be subject to the clearing obligation, and AFME and its members are strongly of the view that Securitisation Swaps are a category of derivatives for which clearing is not practical or necessary.
6. The comments and proposals set out in this response should be read in light of the significant risk mitigation features which already apply to Securitisation Swaps as outlined in the Uncleared Swaps Response. In particular, AFME refers ESMA to paragraph 6 of the Uncleared Swaps Response which sets out a technical description of how Securitisation Swaps are already structured.
7. It is important that ESMA continues to focus on the practical issues relating to the implementation of the rules and the overall purpose of reducing systemic risk. This response is

intended to continue the constructive ongoing dialogue with ESMA and to focus on the practical concerns and risks surrounding the implementation of the clearing obligation. AFME hopes that AFME's comments in this letter and any follow-up discussions will further shape the Draft RTS that are submitted to the European Commission. AFME would be very interested to have a meeting with ESMA to discuss the issues raised in this response.

8. This response focuses on those elements of the Draft RTS which are of most direct relevance for Securitisation Swaps. This response does not discuss in detail the more technical issues around frontloading and the timing of the phase-in of the clearing obligation.
9. Throughout this response, references to the "**Issuer**" are references to the special purpose entity which issues notes or other instruments to investors. References to the "**Swap Counterparty**" are references to the counterparty to the Securitisation Swap transactions entered into by the Issuer.

<ESMA_COMMENT_1>

1 The clearing obligation procedure

Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA_QUESTION_1>

The Two-Step Process

1. AFME understands that the determining of whether or not particular types of OTC derivatives are subject to the clearing obligation involves a two-step process.
    a. First, as noted in paragraph 9 of the Consultation Paper, a CCP must be authorised to clear a class of OTC derivatives under Articles 14 or 15 of EMIR. Such authorisation must then be notified to ESMA pursuant to Article 5(1) of EMIR.
    b. Secondly, Article 5(2) of EMIR requires ESMA to produce regulatory technical standards specifying, among other things, the class (or classes) of OTC derivatives that should be subject to the clearing obligation.
2. Although Article 5(2) does not expressly say so, the structure of Article 5 of EMIR therefore indicates that the classes of OTC derivatives which can be subject to the clearing obligation is a sub-category of those types of OTC derivatives which a CCP has been authorised to clear. That is, if a CCP has not been authorised to clear a particular type of OTC derivatives, OTC derivatives of that type cannot be subject to the clearing obligation.
3. This two-step process is consistent with paragraph 22 of the Consultation Paper, where it states that the starting point for the analysis of whether a contract is subject to the clearing obligation is the contracts that CCPs are authorised to clear, such that "derivative contracts that are *supported* by CCPs *and* that have their 7 characteristics meeting the scope of classes defined in section 3.2.4 will need to be cleared" (emphasis added). However, this two-step process is not clearly reflected in the Draft RTS. Thus, although the two-step process does clearly appear to be the intention

behind the framework of the clearing obligation in the EMIR level 1 text, there remains a degree of uncertainty.

4. Further, as evidenced in the reference to derivative contracts that are "supported" by a CCP (as opposed to for which a CCP has been authorised) in paragraph 22 of the Consultation Paper, there is a distinction between what a CCP is authorised to clear and what it is actually *able* to clear. This distinction also needs to be reflected in the Draft RTS. For a transaction to be accepted for clearing by a CCP, it needs to meet certain requirements in relation to both the legal and economic terms of the transaction. (For an example, see Schedule 2 of the LCH Product Specific Contract Terms and Eligibility Criteria Manual.) Because of the highly automated and standardised way in which CCPs accept transactions for clearing, this means that it may be that the terms of a transaction are such that it falls outside the technical requirements to be capable of being accepted for clearing by the CCP, even though the economic and legal effects of the transaction are no different from a transaction which would satisfy the requirements to be cleared by the CCP. However, this type of ineligibility should be distinguished from situations where the legal and economic terms of the transaction are such that it is impossible for it to be structured in a way that would make it eligible for clearing.
5. This is of particular relevance for Securitisation Swaps, because such swaps usually do contain legal, economic and structural features which mean that they do not fit within the requirements imposed by CCPs in order to be accepted for clearing. AFME submits that the features of Securitisation Swaps which mean that CCPs are unable to support such transactions for clearing means that they fail to satisfy the first step in the two-step process — that is, that no CCP is effectively authorised to clear that type of transaction. Recognition of this two-step process in the Draft RTS is crucial because, if a CCP is not able or not authorised to clear a particular type of OTC derivatives, it would become impossible for parties to enter into OTC derivatives of that type.
6. Accordingly, any regulatory technical standards (such as the Draft RTS) which are issued pursuant to Article 5(2) of EMIR should reflect or acknowledge this two-step process, and specify how it is to be determined whether the first step is satisfied.
7. AFME therefore proposes that Article 1(1) of the Draft RTS is amended to read as follows: "The classes of OTC derivatives listed in Annex I shall be subject to the clearing obligation to the extent that OTC derivatives of that class are accepted by a CCP authorised pursuant to Articles 14 or 15 of Regulation (EU) No 648/2012 for clearing."
8. This proposal follows a similar approach to that which has been adopted by the CFTC in the United States.

Features of Securitisation Swaps that make them unsuitable for Clearing

9. To illustrate the above discussion, as well as the responses to Questions 2, 3 and 5, below, the following paragraphs set out some of the key commercial, legal and structural features of Securitisation Swaps which make them unsuitable for clearing.

10. The payments under a Securitisation Swap are usually specifically tailored to match the various other cashflows in the overall structure. For example, in a traditional RMBS transaction, a basis swap may be used to exchange (1) the yield generated by the portfolio of securitised mortgages (which may be a mixture of fixed, floating or discretionary rates, which may themselves also change over time — for example as borrowers roll off fixed rates and choose new ones) for (2) a Libor- or Euribor-based amount which will match the coupon which the Issuer must pay on the notes it has issued to finance the purchase of the securitised portfolio in the first place. In order to ensure that the Issuer is fully hedged against interest rate risk, the (typically monthly or quarterly) payments made by the Issuer to the Swap Counterparty under the Securitisation Swap will therefore fluctuate so as to match the weighted average yield generated by the securitised portfolio. The notional amount of the Securitisation Swap will also fluctuate to reflect the aggregate balance outstanding of the securitised portfolio, which will also change over time as borrowers make scheduled principal repayments on their mortgages or sometimes make unscheduled principal repayments (for example, if the borrower wishes to remortgage with a new lender or a house is sold). In all such cases, it is not possible to specify in advance what the fixed rate and/or notional amount will be for a particular calculation period. Such swaps are, therefore, very different from the standard-form swaps discussed in paragraphs 80–87 of the Consultation Paper.
11. The same is true in many other Securitisation Swaps. Even though such swaps will often utilise elements from the standardised derivatives documentation published by ISDA, those standard terms will be modified in ways which make each swap unique. As a result, the payments due by the parties will often not be determined in a manner which is capable of being cleared by any of the CCPs which are currently authorised to clear interest rate or basis swaps. In this regard, Securitisation Swaps present exactly the same issues as those discussed in relation to covered bond swaps in paragraphs 26, 28 and 30(b) of the Consultation Paper.
12. It is not only the payment provisions of Securitisation Swaps that are subject to a high degree of variation. Because Securitisation Swaps form part of the broader web of contractual arrangements which make up the securitisation, many other amendments will commonly be made to the standard-form ISDA documentation to reflect the requirements of the overall transaction. Some common examples are as follows:
    a. *Termination rights:* The Swap Counterparty's rights to terminate the swap will usually be restricted to ensure that any such termination occurs as part of broader arrangements for dealing with the default of the Issuer or other unwind of the securitisation. In particular, the Swap Counterparty will not have the right to terminate the swap for its own default or insolvency. This presents an issue in the context of the clearing obligation, because the clearing frameworks which have been developed by CCPs and market participants to facilitate clearing under EMIR work on the basis that if there is a default by a clearing member (which, in the context of a Securitisation Swap, would almost always be the Swap

Counterparty), (i) the Issuer would not have a right to terminate the Securitisation Swap and (ii) the swap would automatically be terminated if and when the CCP decides to terminate the transaction between the defaulting Swap Counterparty and the CCP. This latter feature in particular causes a problem for Securitisation Swaps as it removes the Issuer's discretion to decide whether or not it wishes to terminate the swap and, if it does decide to terminate, the time at which such termination occurs. In circumstances where the Issuer is out-of-the-money, it may prefer not to terminate the swap, but rather suspend making payments to the defaulting Swap Counterparty. Even where the Issuer is in-the-money, it may still wish to delay terminating the swap, and in some cases may be contractually prevented from terminating the swap, until it has found a replacement Swap Counterparty. An automatic termination of the swap at the time the CCP decides to terminate the corresponding swap between the CCP and the defaulting Swap Counterparty would, therefore, have a significant impact on the overall securitisation transaction and would, in many cases, cause the structure to collapse. These risks are unlikely to be alleviated by the "default porting" mechanisms provided by CCPs to allow transactions with a defaulting clearing member to be ported to a different clearing member. Such porting would require the Issuer to establish a clearing relationship with the replacement Swap Counterparty within a short period of time. In practice, it is unlikely that an Issuer would be able to negotiate such documentation and obtain the necessary consents from other transaction parties in sufficient time to enable porting to occur. In many cases, it may not even be possible to find a replacement Swap Counterparty which is also willing to act as a clearing member. As discussed below, a number of other features of the clearing architecture are likely to mean that an entity may be reluctant to act as clearing member for an Issuer, particularly where such entity is not an originator or arranger for the original securitisation, such that in practice default porting would not be a viable solution.

b. *Termination payments:* The calculation of any termination payments may differ from the market-standard close-out methodologies in a Securitisation Swap. This is particularly the case in the context of a rated securitisation, where the rating agencies may require the termination payment in the case of a Swap Counterparty default to be amended to reflect the actual upfront payments made in connection with the entry into a replacement swap with a new Swap Counterparty rather than the standard ISDA close-out calculations (or indeed, the valuation procedures of a CCP). This creates a further problem in the context of the clearing frameworks, which work on the basis that the termination values calculated by the CCP upon the termination of the transactions between the CCP and the Swap Counterparty are also used as the termination values for the swap between the Swap Counterparty and the Issuer. This is an important feature of the "riskless principal" model which underpins the clearing frameworks, whereby the clearing member is not exposed to

any risk of mismatch between the amounts which it would receive or pay to the CCP upon termination of the CCP/clearing member transaction and the amounts which it would pay or receive upon termination of the Securitisation Swap. This is also an important feature in ensuring that the security arrangements forming part of the clearing framework and which insulate the Issuer from the credit risk of the clearing member (which is, of course, the whole point of the clearing obligation in the first place) work effectively. In a related vein, the clearing frameworks provide that the clearing member's obligations to the Issuer are limited recourse to the amounts which it receives from the CCP. Again, this is an important feature of the riskless principal model from the clearing member's perspective, but it may pose a concern for other parties to a securitisation as the Issuer would not have a residual claim against either the clearing member or the CCP for the amount of any shortfall.

c. *Limited recourse:* Many securitisation and structured finance transactions are structured on a "limited recourse" basis. This means that, in the event of a default by the Issuer, the other parties (including the Swap Counterparty) will only be entitled to the proceeds of the assets forming part of the structure, and once those proceeds are exhausted, the Issuer will have no further obligations to the creditors. In many transactions, particularly those involving an "orphan" SPV, this limited recourse feature is an essential requirement of ensuring that the Issuer is able to enter into the transaction in the first place. This is also inconsistent with the riskless principal model for clearing because the Swap Counterparty will remain liable to the CCP on a full recourse basis for all amounts owed under the corresponding swap between the Swap Counterparty and the CCP unless it is possible for that transaction also to be made effectively limited recourse to amounts paid by the Issuer under the Securitisation Swap. However, such a feature would be inconsistent with the philosophy underpinning clearing, and AFME is not aware of any CCPs which would accept transactions for clearing on such a basis. The only other solution involves the Swap Counterparty accepting risk of a shortfall in payments by the Issuer, which it is likely to be reluctant to do, particular where the clearing member is not connected to the originator or arranger in some way.

d. *Transfer by downgraded Swap Counterparty:* Many securitisations and structured finance transactions (including almost all rated securitisations) will also provide that if the Swap Counterparty is downgraded below a particular rating threshold, it is required to transfer the Securitisation Swap to a replacement Swap Counterparty. In the context of clearing, such transfer requirements may not always be compatible with the non-default porting mechanisms applying to cleared swaps, leading to conflict with the credit rating agency frameworks discussed in more detail below.

13. There are also features of the clearing framework which it is difficult, if not impossible, for an Issuer to comply with. The most significant of these relates to collateral.

a. If Securitisation Swaps are cleared, the CCP would require that initial and variation margin is posted by the Swap Counterparty in connection with those transactions. Under the riskless principal model, the Swap Counterparty would, in turn, require the Issuer to post at least the same amount of collateral in connection with that swap.

b. As discussed in AFME's Uncleared Swaps Response, the Issuer does not and cannot post collateral in respect of either initial or variation margin in relation to a Securitisation Swap. Rather, the Swap Counterparty will be a secured creditor of the Issuer, usually ranking either senior to or *pari passu* with the senior noteholders. This reflects the fact that, in most cases, the Issuer will not have access to eligible collateral which would comply with CCP requirements for collateral posting in the context of clearing.

c. Further, where the Issuer is in-the-money, the amount of collateral which the CCP would post to the Swap Counterparty, and which the Swap Counterparty would then post on to the Issuer would be calculated by the CCP using different assumptions and models from those which the credit rating agencies would use to determine the appropriate amount of collateral.

d. For the reasons discussed in the Uncleared Swaps Response, in practice, it would likely be very difficult, if not impossible, for the Issuer to enter into arrangements which would enable it to post collateral in connection with Securitisation Swaps. These are essentially the same issues as arise in the context of covered bond swaps as discussed in paragraphs 30(c) and 42–4 of the Consultation Paper. For the reasons discussed in the Uncleared Swaps Response, AFME and its members do not consider the collateral provider solution referred to in paragraph 43 of the Consultation Paper to be an economically viable solution, particularly given the other risk mitigation features which already apply to most Securitisation Swaps.

14. Finally, as discussed in paragraph 39 of the Consultation Paper in relation to covered bond swaps, in the case of a rated securitisation, the rating frameworks applied by the credit rating agencies mean the parties have relatively little freedom to agree to transaction terms that would enable Securitisation Swaps to be cleared. The rating frameworks used by credit rating agencies when providing a credit rating to a securitisation include an analysis of the impact of the creditworthiness of the Swap Counterparty. Indeed, many of the rating agency criteria with which Securitisation Swaps are required to comply are designed to insulate (or de-link) the securitisation from the credit rating of the Swap Counterparty. These rating criteria do not take into account the impact of central counterparty clearing, and making Securitisation Swaps subject to the clearing obligation would likely require the credit rating agencies to rethink their Securitisation Swap criteria completely. The primary objective of making swaps subject to the clearing obligation is to replace the exposure which the parties have to each other with an exposure to the CCP. In the context of Securitisation Swaps, the effect of the riskless principal model discussed above is that the credit rating agencies would need to analyse the risk and impact of CCP default on the

securitisation. However, unlike the position with uncleared swaps, where the Issuer and Swap Counterparty are free to agree whatever arrangements are necessary to meet rating agency requirements (and to price the transaction to take the impact of those arrangements into account), there is usually no ability to modify the CCP rules and procedures to the extent that they are considered incompatible with any rating agency requirements. Thus, unless the Swap Counterparty was willing to clear the swap on a non-riskless principal basis (which is unlikely), it may not be possible to structure a Securitisation Swap in a way which meets rating agency requirements. At this time, AFME is not aware of any analysis by the credit rating agencies on whether or not the riskless principal model for clearing would enable them to accord an appropriate credit rating to notes issued by securitisation Issuer, something which is obviously of particular importance in the context of traditional asset securitisation where it is necessary to obtain a AAA/Aaa rating on the senior class of notes in order to make the transaction economic.

15. Accordingly, if such swaps were subject to the clearing obligation, it would become impossible for the Issuer to enter into such swaps. This would essentially make traditional asset securitisation, as well as many other types of structured finance transactions which are essential to providing funding to banks and liquidity to capital markets impossible. This would clearly contradict the policy objective of reviving Europe's securitisation market, referred to in paragraph 1 of AFME's introductory comments. Traditional asset securitisation provides an important source of cheaper funding for banks, serving essentially the same purpose as covered bonds as discussed in paragraph 27 of the Consultation Paper.

<ESMA_QUESTION_1>

2 Structure of the interest rate derivatives classes

2.1 Characteristics to be used for interest rate derivative classes

Question 2: Do you consider that the proposed structure defined here for the interest rate OTC derivative classes enables counterparties to identify which contracts fall under the clearing obligation as well as allows international convergence? Please explain.

<ESMA_QUESTION_2>

Issues with analysis of used to determine classes of OTC derivatives

1. AFME and its members submit that the proposed structure for defining the classes of interest rate OTC derivatives is not consistent with the requirements of the EMIR level 1 text to the extent that it results in Securitisation Swaps being included in the same classes as "flow market" or "plain vanilla" interest rate derivatives.
2. Paragraph 16 of the Consultation Paper states that ESMA proposes to create a single class of OTC derivatives per product type. Two of the product types identified in that paragraph which are of particular relevance to Securitisation Swaps are fixed-to-float interest rate swaps (which are also described as plain vanilla IRS) and fixed-to-float swaps (also referred to as basis swaps). As described in the subsequent paragraphs of the Consultation Paper, each of these classes is further

defined by reference to a small number of characteristics, all of which relate to the pure economics of the transactions (as opposed to legal or other structural characteristics or characteristics relating to the purpose of the transactions).

3. The result of defining the classes by reference to a relatively small number of economic characteristics is that it each of these classes is very broad. In particular, some of these classes would include many Securitisation Swaps notwithstanding that, for the reasons discussed in the response to Question 1, above, both the economic and legal terms of many Securitisation Swaps would mean that they are not capable of being cleared by any CCP at the present time.
4. However, this approach of creating a single class of OTC derivatives per product type is not consistent with the requirements of Article 5(4) of EMIR.
5. As discussed in section 3 of the Consultation Paper, in considering whether a particular class of OTC derivatives should be subject to the clearing obligation, Article 5(4) of EMIR requires ESMA to have regard to the following criteria:
    a. the degree of standardisation of the commercial terms and operational processes of the relevant class of OTC derivatives;
    b. the volume and liquidity of the relevant class of OTC derivatives; and
    c. the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivatives.
6. Article 7 of Commission Delegated Regulation (EU) No 149/2013 (the "**RTS on OTC Derivatives**") provides further requirements which ESMA is required to take into account in relation to Article 5(4) of EMIR. In particular:
    a. Article 7(1) of the RTS on OTC Derivatives provides that ESMA should take into account:
        i. whether the contractual terms of the relevant class of OTC derivative contracts incorporate common legal documentation, including master netting agreements, definitions, standard terms and confirmations which set out contract specifications commonly used by counterparties; and
        ii. whether the operational processes of that relevant class of OTC derivative contracts are subject to automated post-trade processing and lifecycle events that are managed in a common manner according to a timetable which is widely agreed among counterparties.
    b. In relation to the criterion in Article 5(4)(b) of EMIR, Article 7(2)(d) of the RTS on OTC Derivatives provides that, among other things, ESMA shall take into account the number and value of the transactions, as well as the stability of the market size and depth in respect of the product over time.
    c. Finally, in relation to the criterion in Article 5(4)(c) of EMIR, Article 7(3) of the RTS on OTC Derivatives provides that ESMA shall take into consideration whether the information needed to accurately price the contracts within the relevant class of OTC

derivative contracts is easily accessible to market participants on a reasonable commercial basis.

7. Although Articles 5(2) and (4) of EMIR technically provide for the above criteria to be used to determine whether a class of OTC derivatives should be subject to the clearing obligation, it is implicit in this requirement that these are also the criteria that should be used to identify what should form a separate class of OTC derivatives or to distinguish between classes as a pre-condition to determining whether or not a given class should be subject to the clearing obligation.
8. A class of OTC derivatives should only include transactions that are sufficiently similar to each other that the analysis of the criteria in EMIR 5(4) and Article 7 of the RTS on OTC Derivatives applies equally to all transactions forming part of that class. It is clear from Article 5(4) of EMIR and Article 7 of the RTS on OTC Derivatives that the decision whether or not a particular class of OTC derivatives should be subject to the clearing obligation must take into account the matters specified in those articles. This would not be the case if the classes of OTC derivatives which are subject to the clearing obligation are so broadly defined that they capture transaction types (or sub-sets of transaction types) to which the analysis conducted by ESMA in relation to that class determination does not apply or transaction types which are not actually considered in that analysis.
9. The analysis set out in section 3 of the Consultation Paper in relation to all of the above criteria is not applicable to and does not accurately reflect the nature and terms of Securitisation Swaps. Rather, the discussion in that section is almost exclusively focussed on swaps traded in what is referred to as the "flow market" which is as noted in sections 3.2.1 and 3.2.2 of the Consultation Paper, a highly standardised and very liquid market.
10. In contrast, the analysis of the above criteria in relation to Securitisation Swaps is very different:
    a. *Degree of standardisation:* As discussed in the response to Question 1, above, the terms of every Securitisation Swap will be specifically tailored to meet the cashflow requirements of the portfolio of securitised assets to which it relates, and will often include provisions such as limited recourse and alternative collateral arrangements which are very different from the terms on which "flow market" (or "plain vanilla", to adopt the terminology used in paragraph 16 of the Consultation Paper) are traded. Further, in many cases, the determination and calculation of the amounts to be paid for each calculation period is not automated and requires input from other parties to the securitisation (such as the cash manager). Again, this is in contrast to the "flow market", where such calculations can largely be automated. For these reasons, Securitisation Swaps do not demonstrate a sufficient degree of standardisation either to form part of the same class as "flow market" interest rate and basis swaps, or indeed, in light of the features of Securitisation Swaps discussed in the response to Question 1, above, a separate class of OTC derivatives that should be subject to the clearing obligation. In this regard, Securitisation Swaps are in essentially the same position as covered bond swaps. As noted

in paragraph 39 of the Consultation Paper, this lack of standardisation is one reason why ESMA has determined that covered bond swaps should not be included in the same class of OTC derivatives as other product types.

b. *Volume and Liquidity:* The size of the Securitisation Swap market is a fraction of the size of the total market for interest rate and basis swaps described in section 3 of the Consultation Paper. Both in terms of the number of transactions and the aggregate notional amount of such transactions, Securitisation Swaps make up only a very small component of the overall market. For example, in paragraph 117 of the Consultation Paper, the gross notional amount of interest rate and basis swaps denominated in EUR is stated to be in excess of EUR 80 *trillion* (not counting swaps denominated in other currencies). In contrast, the aggregate issuance of European ABS issued in 2013 (including non-EUR denominated issuance) was approximately EUR 165 *billion*. Even at the high-point of ABS issuance in 2008, European ABS issuance was less than EUR 700 *billion*. Similarly, whereas the transaction count for the EUR-denominated swaps discussed above was in excess of 850,000 individual transactions, the number of Securitisation Swaps would also have been only a small fraction of this number. In addition, particularly in the case of Securitisation Swaps for rated securitisations, there is a relatively small number of institutions which are able to satisfy the credit rating agency requirements to be eligible as Swap Counterparties.

c. *Availability of Pricing Information:* Pricing a Securitisation Swap requires a lot more detailed information than pricing "flow market" transactions. Paragraphs 127–9 of the Consultation Paper identify the widespread availability of market data as indicating that the criterion in Article 5(4)(c) of EMIR is satisfied. However, to price a Securitisation Swap requires detailed information about the features and performance of the underlying assets which are the subject of the securitisation, as well as knowledge of the contractual documentation regulating the relationships between the transaction parties (which include various parties in addition to the Issuer and the Swap Counterparty). In the case of unlisted transactions, this detailed information is unlikely to be available to anyone other than the transaction parties themselves. Even in the case of listed transactions, obtaining and analysing this information is a much more time and resource intensive process than is the case for valuing and pricing "flow market" transactions. In particular, CCPs do not have the resources or expertise required to conduct this valuation process. This is of particular relevance given that for cleared swaps, it is the CCP's valuations which determine both collateral calculations and the termination values in the event of a Swap Counterparty default.

11. Accordingly, there are significant differences between the characteristics of Securitisation Swaps and the nature of the "flow market" transactions which form the basis of the analysis in section 3

of the Consultation Paper, indicating that it is not appropriate for Securitisation Swaps to be included as a class of OTC derivatives to be subject to the clearing obligation.

12. Although the two-step process discussed in AFME's response to Question 1 means that Securitisation Swaps should not be subject to the clearing obligation where no CCP is able to accept such transactions for clearing, for the reasons discussed in the response to this Question 2, AFME submits that, in order to comply with the framework established in Articles 5(2) and (4) of EMIR, the classes of OTC derivatives subject to the clearing obligation must also be defined in a manner which ensures that transaction types would not be subject to the clearing obligation without the application of the criteria in Article 5(4) of EMIR and Article 7 of the RTS on OTC Derivatives having been taken into account in relation to those transaction types. This is particularly the case given that the outcome of the analysis of various transaction types in sections 3, 6 and 7 of the Consultation Paper is that ESMA has determined that it is not necessary for *all* transaction types to be subject to the clearing obligation. As is effectively acknowledged by those outcomes, Article 5(2) of EMIR does not require that all OTC derivatives should be subject to the clearing obligation. It would be inconsistent with the careful analysis which has been undertaken of the various transaction types which are considered in sections 3, 6 and 7 of the Consultation Paper for other product types (such as Securitisation Swaps) which are not considered at all in that analysis to be subject to the clearing obligation without any analysis having been undertaken, even if a CCP were to provide for the clearing of such transactions. Unless ESMA positively concludes that making such product types subject to the clearing obligation would satisfy the aim of reducing systemic risk (in relation to which see AFME's response to Question 5, below), the clearing obligation should not apply.
13. There are essentially two ways in which it can be ensured that transaction sushc as Securitisation Swaps having features which distinguish them from the types of "flow market" or "plain vanilla" swaps which are discussed in section 3 of the Draft RTS are not included in the same classes of OTC derivatives those "flow market" or "plain vanilla" swaps.
    a. The first approach is to include more granularity in the way in which each class is defined. However, AFME notes from the discussion in section 2 of the Consultation Paper that ESMA has determined not to adopt this approach.
    b. The second approach is to prescribe that transactions having certain features are expressly excluded from the classes of OTC derivatives to which the clearing obligation applies. This is essentially the approach which has been followed in relation to covered bond swaps in Article 1(2) of the Draft RTS.
14. AFME therefore proposes the inclusion of a provision in the Draft RTS along the following lines:

    "The classes of OTC derivatives listed in Table 1 to Table 4 of Annex I shall not include contracts which satisfy all of the following conditions:

    (a) at least one party to the transaction (the "derivative counterparty") is a secured creditor of the other party (the "special purpose entity") in respect of the contract;

(b) the special purpose entity is not a financial counterparty;

(c) the obligations of the special purpose entity under the contract are limited recourse to the transaction security;

(d) the creditors of the special purpose entity (other than any security trustee or agent which has the power to enforce the transaction security on behalf of all the secured creditors) are contractually restricted from taking any action or step to commence insolvency proceedings in respect of the special purpose entity;

(e) either:

(i) the contact is entered into to hedge the interest or currency mismatches arising in connection with an identified asset or pool of assets or an income stream and the obligations of the special purpose entity in relation to any financial obligations; or

(ii) the payments under the contract are determined by reference to the payments or performance of an identified asset or pool of assets; and

(f) the special purpose entity is not a party to any other OTC derivatives which do not satisfy these conditions."

Definitions Required

15. Without prejudice to the broader issues and proposals discussed in the response to this Question 2, AFME also proposes a further minor clarification be made in the Draft RTS. Tables 1 to 4 of Annex 1 to the Draft RTS specify the seven characteristics which are used to define the classes of OTC derivatives which are subject to the clearing obligation. However, no further definitions are given of these characteristics. This has the potential to lead to uncertainty.

16. In particular, it is not clear what is meant by references to "Constant or Variable" in relation to "Notional Type". In paragraph 17 of the Consultation Paper, a distinction is drawn between "constant, variable or conditional" as categories of notional amount. Footnote 6 to that paragraph further clarifies that a swap will have a "conditional" notional amount where the notional amount of the swap is not a known number or schedule of numbers but may change based on the occurrence of some future event. This is in contrast to a "variable" notional amount, where the notional amount varies according to a predetermined schedule. The footnote acknowledges that the unpredictable nature of conditional notional amounts adds complexity to the pricing and risk management associated with such swaps such that, at this time, no CCP accepts such swaps for clearing.

17. As discussed in the response to Question 1, above, many Securitisation Swaps will have notional amounts that fall within the description of "conditional" in footnote 6 to paragraph 17 of the Consultation Paper, particularly those swaps which are often referred to by market participants as "balance guaranteed". This is also the case with many covered bond swaps, as is acknowledged in paragraph 33 of the Consultation Paper (albeit using a different description of "dynamic feature of

the notional amounts" rather than "conditional" notional amounts). By drawing a distinction between "constant, variable or conditional" notional amounts, and then only specifying "constant or variable" as the notional types which are subject to the clearing obligation, it is clear that the intention is that a swap with a conditional notional amount is not subject to the clearing obligation.

18. However, this should be clarified by appropriate definitions in the Draft RTS themselves. In the absence of such definitions, a swap meeting the description of having a "conditional" notional amount in footnote 6 to paragraph 17 of the Consultation Paper could also be characterised as having a variable notional amount, albeit not a variable notional amount as described in footnote 6 to paragraph 17. Thus, there is uncertainty as to whether swaps having a conditional notional amount that also satisfy the other parameters in Annex 1 are subject to the clearing obligation.
19. AFME therefore proposes that "constant" and "variable" be defined for the purpose of the "Notional Type" characteristic, with definitions based on those set out in footnote 6 of paragraph 17 of the Consultation Paper such that it is clear that swaps with a conditional notional amount are not classified as having a "variable" notional amount.
20. Finally, it is also unclear what is meant by "Optionality" in the tables in Annex 1 to the Draft RTS, which adds a degree of uncertainty as to the scope of the classes of OTC derivatives subject to the clearing obligation. This uncertainty is not addressed in the Consultation Paper, but should addressed in the Draft RTS.

<ESMA_QUESTION_2>

2.2 Additional Characteristics needed to cover Covered Bonds derivatives

Question 3: Do you consider that the proposed approach on covered bonds derivatives ensures that the special characteristics of those contracts are adequately taken into account in the context of the clearing obligation? Please explain why and possible alternatives.

Stakeholders (CCPs and covered bond derivatives users, in particular) are invited to provide detailed feedback on paragraph 38 above. In particular: what is the nature of the impediments (e.g. legal, technical) that CCPs are facing in this respect, if any? Has there been further discussions between CCPs and covered bond derivatives users and any progress resulting thereof?

<ESMA_QUESTION_3>

1. As discussed in AFME's response to Question 1, above, many of the features of Securitisation Swaps which make them ineligible for clearing are features which they share with covered bond swaps. For example:
    a. the swaps are entered into to hedge specific risks associated with the pool of assets which is the subject of the covered bond issuance or securitisation (see paragraph 26 of the Consultation Paper);
    b. the terms of the swaps are specifically tailored to match the cashflows arising from the asset pool to the payments due on the covered bonds or securitisation notes (see paragraph 28 of the Consultation Paper);

c. like the cover pool entity in a covered bond transaction, the Issuer does not hold or have access to CCP-accepted collateral (see paragraphs 30(c) and 42–4 of the Consultation Paper); and
d. as with a rated covered bond issuance, in the case of a rated securitisation, the credit rating agency methodologies require certain amendments to be made to documentation which means these transactions do not exhibit the degree of standardisation appropriate to be included in the same class of OTC derivatives as the other transaction types discussed in the Consultation Paper (see paragraphs 30(d) and 39 of the Consultation Paper and the discussion in AFME's response to Question 2, above).

2. Both covered bonds and securitisation serve a similar economic purpose in providing funding for bank lending. However, the special treatment provided for covered bond swaps, without corresponding treatment for Securitisation Swaps which are structurally very similar and serve a similar economic purpose results in favourable treatment for those jurisdictions in which covered bonds are a widely used asset financing technique compared with those jurisdictions where traditional asset securitisation is more common and is not consistent with the general policy objective of achieving a "level playing field".
3. For these reasons, AFME and its members submit that Securitisation Swaps should be treated in a similar manner to covered bond swaps and should be excluded from the classes of OTC derivatives subject to the clearing obligation.
4. Excluding Securitisation Swaps from the classes of OTC derivatives which are subject to the clearing obligation does not mean that such swaps would not be subject to any regulations designed to reduce risk in relation to such swaps. On the contrary, as uncleared swaps, Securitisation Swaps would be subject to the risk mitigation techniques under Article 11 of EMIR and any associated regulatory technical standards under that article. Such risk mitigation techniques, and in particular features of Securitisation Swaps which are consistent with the policies underpinning Article 11 of EMIR, were discussed in detail AFME's Uncleared Swaps Response.
5. Many Securitisation Swaps would not be subject to the clearing obligation anyway on the basis that in many cases the Issuer would be a non-financial counterparty below the clearing threshold (a "**NFC-**"). However, because of difficulties which can arise in interpreting the definition of "group" in Article 1(16) of EMIR, it is not always possible for the Issuer (or the Swap Counterparty) to determine conclusively that it is in fact a NFC-. Further, for similar reasons to those discussed in relation to covered bond swaps in paragraphs 46–7 of the Consultation Paper, relying on the Issuer being a NFC- in order for Securitisation Swaps to be excluded from the clearing obligation may lead to unequal treatment for transactions which are, in all other respects, essentially identical and which serve the same economic purpose depending solely on the status of the Issuer.

6. Accordingly, identifying what constitutes a Securitisation Swap for these purposes of excluding them from the classes of OTC derivatives which are subject to the clearing obligation should not be determined by classification of the entities which are parties to the transaction, but rather by reference to the features of the transaction which make it inappropriate for it to be included in the same classes of OTC derivatives as transactions which are subject to the clearing obligation.
7. Excluding Securitisation Swaps from the clearing obligation requires an appropriate definition of what constitutes a Securitisation Swap. For covered bonds, Article 1(2) of the Draft RTS requires that the covered bond programme is required to meet the requirements of Article 129 of Regulation (EU) No 574/2013. In the case of Securitisation Swaps, an appropriate definition of what constitutes a Securitisation Swap can be derived from the definitions of "securitisation" and "securitisation special purpose entity" found in Regulation (EU) No 575/2013 ("**CRR**"). An Issuer could be defined based on the definition in Article 4(1)(66) of CRR as follows:

   'securitisation special purpose entity' or 'SSPE' means a corporation trust or other entity, other than an institution, organised for carrying out a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator institution, and in which the holders of the beneficial interests have the right to pledge or exchange those interests without restriction.
8. In turn, a "securitisation" is defined in Article 4(1)(61) as follows:

   'securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.
9. AFME therefore proposes the inclusion of a provision along the following lines:

   "The classes of OTC derivatives listed in Table 1 to Table 4 of Annex I shall not include contracts entered into by securitisation special purpose entities in connection with a securitisation when such contracts satisfy all of the following conditions:

   (a) the derivative counterparty is a secured creditor of the securitisation special purpose entity and ranks at least pari-passu with the securitisation bondholders (other than in respect of payments due to the derivative counterparty (other than the return of collateral) where an event of default has occurred in respect of that derivative counterparty or the derivative counterparty has been downgraded below a particular rating threshold);

   (b) the derivative is used only for hedging purposes; and

   (c) the netting set does not include derivatives unrelated to the securitisation."

<ESMA_QUESTION_3>

2.3 Public Register

Question 4: Do you have any comment on the public register described in Section 2.3?

<ESMA_QUESTION_4>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_4>

3 Determination of the OTC interest rate classes to be subject to the clearing obligation

Question 5: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

Please include relevant data or information where applicable.

<ESMA_QUESTION_5>

1. See the response to Questions 2 and 3, above, for AFME's submissions as to why it is not appropriate for Securitisation Swaps to be included in the same class of OTC derivatives as "flow market" or "plain vanilla" transactions. Without prejudice to, and in addition to, the points discussed in AFME's response to those questions, to the extent that Securitisation Swaps are included within a class of OTC derivatives which is subject to the clearing obligation, AFME does not think that such inclusion does address appropriately the systemic risk associated with Securitisation Swaps.
2. On the contrary, AFME submits that there is little or no systemic risk associated with Securitisation Swaps which either needs to or can be effectively mitigated by making such transactions subject to the clearing obligation. Once again, in this regard, Securitisation Swaps are very similar to covered bond swaps, which similarly pose little systemic risk (see paragraph 31 of the Consultation Paper). In fact, some features of Securitisation Swaps actually mean that, if anything, making them subject to the clearing obligation may increase systemic risk in connection with those transactions.
3. As discussed in AFME's response to Question 1, above, a number of features of Securitisation Swaps are fundamentally incompatible with the "riskless principal" framework which underpins clearing for entities (such as an Issuer) which are not themselves clearing members of a CCP. Thus, if Securitisation Swaps are subject to the clearing obligation, it is likely that the Swap Counterparty acting as clearing member would have to agree to clear the trade without relying on the riskless principal model, particularly in the case of Securitisation Swaps for rated transactions where the riskless principal model is inconsistent with credit rating agency requirements in certain key respects. For example, the Swap Counterparty would need to agree to post collateral to the CCP in accordance with the CCP's requirements from time to time even though it would be unable to pass those obligations through to the Issuer. The Swap Counterparty would also not be able to rely on its obligations to the Issuer being limited recourse to what it receives from the CCP.

At the same time, the CCP would be unlikely to accept the Swap Counterparty's obligations to the CCP being limited recourse to what the Swap Counterparty receives from the Issuer. Thus, the effect of making Securitisation Swaps subject to the clearing obligation would be that the Swap Counterparty would be exposed to additional risks. Whereas it is currently exposed to losses if the Issuer fails to perform, it would now be doubly exposed because it would still be obliged to perform to the CCP, notwithstanding the Issuer's failure to perform. Conversely, the Swap Counterparty would also be exposed to additional risks if the CCP failed to perform, because it would be required to continue performing to the Issuer. This adds risk for the entity which is more likely to be systemically important (the Swap Counterparty) while providing relatively little, if any, additional benefit for the Issuer (which is very unlikely to be a systemically important entity).

4. This is not to say that the Swap Counterparty is currently running an unmitigated exposure to the Issuer. On the contrary, as discussed at length in AFME's Uncleared Swaps Response, Securitisation Swaps already contain effective risk mitigation techniques to protect both the Issuer and the Swap Counterparty from the risk of counterparty default. Those risk mitigation techniques would continue to apply to Securitisation Swaps, particularly where those swaps are not subject to the clearing obligation.

<ESMA_QUESTION_5>

4 Determination of the dates on which the obligation applies and the categories of counterparties

4.1 Analysis of the criteria relevant for the determination of the dates

Question 6: Do you have any comment on the analysis presented in Section 4.1?

<ESMA_QUESTION_6>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_6>

4.2 Determination of the categories of counterparties (Criteria (d) to (f))

Question 7: Do you consider that the classification of counterparties presented in Section 4.2 ensures a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_7>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_7>

4.3 Determination of the dates from which the clearing obligation takes effect

Question 8: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_8>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_8>

5 Remaining maturity and frontloading

Question 9: Do you consider that the proposed approach on frontloading and the minimum remaining maturity ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? If not, please explain why and provide possible alternatives compatible with EMIR.

<ESMA_QUESTION_9>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_9>

6 OTC equity derivative classes that are proposed not to be subject to the clearing obligation

Question 10: Do you have any comment on the analysis on the Equity OTC derivative classes presented in Section 6?

<ESMA_QUESTION_10>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_10>

7 OTC Interest rate future and option classes that are proposed not to be subject to the clearing obligation

Question 11: Do you have any comment on the analysis on the OTC Interest rate future and options derivative classes presented in Section 7?

<ESMA_QUESTION_11>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_11>

Annex I - Commission mandate to develop technical standards

Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

Question 12: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_QUESTION_12>

1. AFME does not have any further comments.

<ESMA_QUESTION_12>

Annex III - Impact assessment

Question 13: Please indicate your comments on the CBA.

<ESMA_QUESTION_13>

1. AFME does not make any comments in response to this question.

<ESMA_QUESTION_13>