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WFE response to the EU Regulatory Framework for Financial Services: Call for Evidence (Call for Evidence)

Introduction

The World Federation of Exchanges (WFE) is a global trade association that represents 64 publicly regulated stock, futures, and options exchanges, as well as the CCPs operated by our member exchanges[1]. WFE promotes the development of fair, efficient, and transparent markets, and we work with policy makers, regulators, and standard-setters around the world to support the development of effective rules and standards for exchanges and market participants.

The WFE acknowledges that the Call for Evidence is focused on understanding the impact of six years of legislative overhaul on the EU market and on EU market participants and, in particular, whether there are any unintended consequences, conflicting objectives and/or unintended barriers to new market entrants as a result of this. The WFE further understands that submissions will quite rightly be assessed against EU-specific objectives including promoting the economic and financial stability of the EU and promoting the competitiveness of the EU economy. Given that several WFE member exchange groups are also members of other, more regionally relevant, trade associations (such as the Federation of European Securities Exchanges (FESE)), the WFE will not seek to duplicate the EU-focused commentary that will be provided by them.

However, the WFE, on behalf of operators of regulated exchanges and CCPs that operate in other jurisdictions, welcomes the opportunity to provide its perspectives on the call for evidence insofar as:

- the EU's implementation of global regulations that may impact on the attainment of broader international financial stability objectives; and
- aspects of EU financial market regulation that may have unintended consequences for other non-EU markets and participants.

Summary

The European Market Infrastructure Regulation (EMIR) not only promotes, but in certain circumstances mandates, central clearing. Further, the Markets in Financial Instruments Directive and Regulation (MiFID2/R), and the Benchmarks Regulation, rightly bring further regulation to parts of the market that have not previously had consistent or coherent oversight. Additionally Basel III / the Capital Requirements Directive IV (CRD IV) seeks to strengthen the capital position of key market participants. These are all sensible and correct objectives.

However, our concern is that certain aspects of particular pieces of international and EU legislation and regulation do not appear to work collectively to effectively achieve the broader post-crisis G20 mandate of more on-market trading and greater use of clearing houses. In particular:

[1] The WFE membership lists can be found here http://www.world-exchanges.org/home/index.php/members/wfe-members

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Leverage Ratio, Segregated Margin and the Impact on Market Liquidity and the Clearing Mandate

Central counterparty operators, clearing member banks and clearing house end-users have publicly advocated that the proposed approach to the calculation of the supplemental leverage ratio[2] (SLR) within Basel III will have materially adverse consequences on cleared derivatives markets, end users, and market participants. This concern is not restricted to the EU and has also been raised with the Basel Committee on Banking Supervision (BCBS) as well as the banking regulators in the US. Whilst we acknowledge Mark Carney's recent comments[3] at a meeting with the European Parliament's ECON committee – where he stated that this is an area that should be a priority for the Financial Stability Board (FSB) going forward – we nevertheless feel it is important to highlight the potential effects on market liquidity and market participants within the context of the Call for Evidence.

With regards to clearing, the failure to recognise the exposure reducing effects of segregated margin could lead to a number of negative effects. This includes reducing the economic viability for market participants to provide third party clearing services, thereby potentially reducing the number of available general clearing members (GCMs). According to an industry letter to the BCBS in October 2015[4], the effect on GCMs has been that many have already stopped GCM services, and others are re-assessing their business models as a result. This risks concentrating further the choice of who clients can clear through, which in turn could impede the portability of client positions - critical in a default situation - and generally reduce choice and increase cost for end clients in managing their risk. Such risks and others have been addressed in a recent CMC/MFA letter[5], also to the BCBS, specifically relating to the effects on commodity markets and the wider real economy.

As regards trading, the effect of the extension of the regulatory perimeter within MiFID2/R and the interplay with other pieces of legislation (specifically the Capital Requirements Regulation - CRR) will likely be to impose more stringent regulatory capital requirements on key market liquidity providers (such as market makers)[6] as well as end users such as those in the commodities space. If the warnings of the market making and commodities communities are correct, it is not unreasonable to therefore expect some reduction in on-venue liquidity as a result.

It therefore seems to us that, in aggregate, an inappropriate application of these various pieces of legislation and regulation could lead to it becoming more difficult (or expensive) for end-users to manage their risk through central clearing if there is a continued and sustained paring back of client clearing being offered, as has been evidenced to date. We also consider there a risk of a reduction in liquidity on organised markets, harming price discovery and transparency and further making it more difficult for end users to effectively manage their business exposures through hedging activity. All of these appear contrary to the wider international / global objective for a greater focus on risk reduction and financial stability via more on-venue trading and through promoting greater central clearing of derivatives.

We understand that the Basel Committee is considering modifying the Current Exposure Method (CEM) to allow offsets for segregated margin, and that European regulators are similarly considering revising the approach to leverage ratio determination to recognise the exposure-reducing effect of segregated client margin. The WFE strongly supports this and stands ready to further discuss its views and concerns as appropriate.

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[2] Inasmuch as it fails to appropriately recognize the exposure-reducing effect of segregated margin for centrally cleared derivatives

[3] http://conservativeeurope.com/news/swinburne-questions-bank-of-england-chief

[4] Exchanges and market participants' letter to BCBS re leverage ratio

[5] CMC/MFA letter to BCBS on effect of leverage ratio on commodity market participants

[6] FIA EPTA position paper on the effect of the CRR on market making firms

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CRD IV Framework: RWA and HQLA and the Effect on Emerging and Developing Economies

As the implementation mechanism for Basel 2.5 and Basel III, the EU's CRD IV and the CRR are intended to make banks – and thereby financial systems – safer and more resilient. Amongst other goals, they aim to strengthen the quality and quantity of bank capital in order to improve risk coverage and tighten liquidity requirements. Whilst understanding – and sharing – regulators' concerns regarding global financial stability, there are nevertheless spill-over effects of these regulations on capital markets, particularly on emerging and developing economies (EMDEs).

First, the adopted standard for estimating risk-weighted assets (RWA) intensifies global (and European) banks' costs of trading and holding positions in EMDEs. Insofar as these assessments are based on global credit ratings, and given that these markets are usually less liquid and more volatile than advanced economies, their relative ratings are typically lower. Thus, global banks' willingness to invest in these assets decreases, as their costs in terms of capital requirements surge. The resulting effects (in terms of traded volumes and liquidity) on EMDEs - especially in corporate and sovereign debt markets - will be significant.

Additionally, in the case of globally active institutions, we note likely issues relating to home-host conflicts. For example, it is expected that risk models will be defined at the parent-country (home) level – in this case, the EU. Exposures to foreign assets – particularly sovereigns – will be evaluated based on the ratings provided by an External Credit Assessment Institution (ECAI). The parent bank's measurement of risks and assignment of capital on a consolidated basis will affect – and very likely define – its foreign (EMDE) subsidiaries' policies and asset management strategies.

Thus, in order to minimize consolidated capital charges associated to their EMDE subsidiaries' operations – and to offset their own risk perceptions – it is possible that globally active institutions encourage their subsidiaries to reduce investment in local, lower rating assets and securities, in an attempt to reduce their consolidated capital charges and thereby pursue their own investment and risk management strategies. In addition to the potential costs in terms of local capital market development, these pressures are likely to foster foreign-currency imbalances. The liquidity requirements and the associated pressures to hold high quality liquid assets (HQLA) may further exacerbate these risks, given the relative scarcity of HQLA in EMDE markets and the (rather undifferentiating) bias of the CRD IV Framework in favour of EU sovereigns.

To conclude, we note that it is important to not underestimate the critical role that global institutions play in EMDEs. They are usually key liquidity providers and also play active roles as market makers; as such, the effects as described could be significant on those markets. This may move us towards an equilibrium that is not desirable from the standpoint of global financial development and stability – i.e. one in which financial stability in advanced economies is attained at the expense of EMDEs' capital markets and, ultimately, real sector development.

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Equivalence Determinations and Impact on Third Countries

Whilst the wider post-crisis reform agenda has been set at a global level, the detail of the implementation has largely been left to national competent authorities. We acknowledge that a major challenge for national regulators in executing the post-crisis reform agenda has therefore been how best to regulate financial markets that are international in nature within a national regulatory remit. This has resulted in legislation with varying degrees of extra-territorial impact and the concept in some jurisdictions of third-country equivalence, with some evidence of market fragmentation – particularly in global derivative markets - occurring as a result[7].

With regards to ***EMIR***, the WFE has already, on behalf of its membership, publicly expressed its concerns about both the lack of transparency and delays in the equivalence determination process for third-country CCPs and the impact that the resultant uncertainty has on the markets in which those CCPs operate[8]. Whilst there has been laudable progress with the recent recognition of a further 5 jurisdictions (Switzerland, Canada, Korea, South Africa and Mexico), there are a number of non-EU countries still awaiting recognition with no clear timetable for when this will be accomplished.

Further, we note that, under EMIR, if a trade is conducted on a regulated exchange in a third country it is by definition deemed OTC. Whilst we acknowledge there is an equivalence determination process (for the purposes of ensuring that derivatives trades executed on non-EU markets are regarded as exchange-traded rather than OTC[9]), we note that not a single market has as yet been designated as equivalent for these purposes. As such our concern is not just that non-financial counterparties trading on these third-country markets may find themselves subject to a clearing obligation that they should not be subject to, but also that it may reduce EU entity participation in these non-EU markets. We acknowledge and applaud that the Commission has already identified and sought to partly address this problem through amendments to EMIR introduced in the recently adopted Securities Financing Transaction Regulations (SFTR), however remain concerned about the risk of possible delays in equivalence determination for the reasons above.

With regards to the ***Benchmarks Regulation***, we acknowledge the progress recently made, specifically on third-country regimes. In particular, that Benchmarks provided by non-EU countries will need to operate under "recognition" or "endorsement" regimes based on the IOSCO Principles (the Principles), and including a partial equivalence regime. We applaud this move in a sensible direction. However, we also note that the practical implications of the new legislation are yet to be determined. Inconsistencies in the text and the resulting lack of sufficient clarity may lead to conflicting interpretations that disrupt the market. We note this in particular in the context of the functioning of the "recognition" or "endorsement" regimes. Whilst we welcome the helpful reference to the Principles being a basis for the "recognition" regime for third country benchmarks, we note that stringent interpretation of the requirement that compliance with the Principles must be at least "*equivalent to compliance with the requirements established under the (EU) Regulation*" may – in the worst case scenario - effectively deem this potentially positive development void. A number of administrative requirements enshrined in the recognition procedure could also make it economically disadvantageous for third country benchmark providers to seek the EU recognition. We therefore encourage the European Commission, ESMA and national competent authorities to adopt a pragmatic approach in the course of the implementation of new rules, reflecting the complexity of the benchmarks sector and ensuring undisrupted functioning of cross-border markets. We stand ready to provide input to its implementation as required.

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[7] http://www2.isda.org/news/cross-border-fragmentation-of-global-derivatives-end-year-2014-update

[8] WFE Letter to European Commission's Lord Hill on EMIR Equivalence Determinations

[9] article 2(7) and amended article 2(a) of EMIR

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Indirect Clearing Provisions and Impact on Third Countries

We are particularly concerned by recent proposals regarding derivatives traded on non-EU markets and cleared by non-EU CCPs[10]. As you know, ESMA's proposed rules for indirect clearing arrangements will apply to exchange traded derivatives (ETDs) within the meaning of MiFIR[11], whilst derivatives traded on non-EU markets are currently treated as OTC derivatives. From the point that the relevant market is considered to be equivalent to a regulated market[12], the relevant instruments will be treated as ETDs under MiFIR, at which point ESMA's rules on indirect clearing would apply.

However, where that market is cleared by a non-EU CCP, the local insolvency law or regulatory framework may prevent a) the relevant clearing member from opening - at the CCP - the separate accounts prescribed by ESMA's rules for each client and indirect clients; and/or b) a clearing member from being able to transfer the positions and assets to another client on a client default, or to liquidate the assets and return the balance to the relevant indirect clients as also prescribed in ESMA's rules.

As such, we are concerned that the effect of the proposed rules is such that indirect clients will be prevented from using EMIR recognised non-EU CCPs, either because a) the CCP itself is not able to provide the specific protections required by EMIR, or b) firms in the clearing chain required to provide access to the CCP are not able to provide such protections.

We understand and applaud the goal of providing robust protections to indirect clients. Unfortunately, the regime - as currently proposed - will reduce the ability of indirect clients to access foreign markets and for EU brokers to retain their current EU client relationships in such markets. We note that protections already exist for indirect clients when accessing non-EU markets and CCPs that are recognised under the existing legislative framework (in MiFIR and EMIR). Imposing additional requirements for markets and CCPs which have been granted recognition is therefore unnecessary and will serve to undermine the policy objective behind the equivalence process under the existing EU regulatory framework.

In summary, without amendment, our concern is that the proposed rules will pose significant legal, commercial and operational challenges for participants and for indirect clients established in the EU, and risk shutting such indirect clients out of global markets. This would reduce their ability to manage risk and damage liquidity in such financial markets. It is also possible that the associated commercial pressures relating to the proposed rules would make indirect clearing arrangements within the EU prohibitively expensive and again reduce the ability for indirect clients to manage risk and damage liquidity in the financial markets.

CCP Recovery and Resolution

Finally, we note that CCP Recovery and Resolution is an area that the European Commission has been considering and will likely issue EU proposals on in 2016. This is a topic on which there has rightly already been substantial international discussion – including WFE's own position paper[13] issued in October 2015 – alongside generally acknowledged international standards such as the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs). Given the international nature of markets, we therefore encourage the European Commission, in its consideration and development of EU specific proposals, to continue to

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[10] ESMA consultation paper on indirect clearing arrangements under EMIR and MiFIR (ESMA/2015/1628)

[11] An "exchange traded derivative" for these purposes is one which is traded on an EU regulated market or a non-EU market which is considered to be equivalent for the purposes of the trading obligation under MiFIR.

[12] pursuant to Article 28(4) of MiFIR

[13] WFE Position Paper: CCP Risk Management, Recovery and Resolution

engage with international bodies to ensure that any proposals are consistent with, and complementary to, wider global standards.

Conclusion

In conclusion, the WFE and its members understand EU regulators' desire to enhance the regulatory framework as much as possible in order to minimise risk to EU markets. However, we would caution that it is not necessarily appropriate in all instances to extend the regulatory perimeter as far as the EU has done, and this may result in unintended consequences that are inconsistent with broader global objectives. Nonetheless, given where we are at present, we encourage the Commission:

- In **general terms**, to continue engaging with other international agencies such as IOSCO and the BCBS to ensure EU legislation is complementary to – and consistent with – wider global standards, which in turn should act to minimise cross-border regulatory differences;

- In the case of **the leverage ratio**, to continue to build into its considerations the effect on market liquidity and the effect on end-clients' ability to manage risk of ineffective or inappropriate implementation;

- In the case of the **EU's assessment of CRD IV and CRR**, to:

    - reconsider the approach towards the use of – and reliance on – global ratings provided by rating agencies (in CRD IV and CRR terms, ECAIs) as *the* risk assessment tool for (sovereign) exposures of consolidating foreign subsidiaries; and

    - evaluate consolidation requirements and practices.

- In the case of **equivalence matters**, to as far as possible mitigate the impact of the extra-territoriality and equivalence determinations by:

    - standardising as far as possible the process for equivalence determinations;

    - producing at least indicative timetables for the relevant processes;

    - enhancing the transparency of the processes and the equivalence requirements; and

    - taking note of, and building in adherence to, wider international standards when developing and implementing EU rules, where relevant and appropriate.

- In the case of **indirect clearing**, to:

    - ensure that the requirements on non-EU CCPs are flexible enough such that the outcome required under the EU regulation is met whilst not requiring line-by-line compliance; and

    - ensure the requirements are drafted in a manner that does not result in significant disruption to established market access models or otherwise operate in a manner that prevents indirect clients established in the EU from accessing the global financial markets to meet their risk management needs.

The WFE stands ready to further discuss any aspects of this response should that be helpful in the Commission's consideration of these important issues.