Review of European Market Infrastructure Regulation

BSA response to the European Commission consultation of 21 May 2015

12 August 2015

Building Societies Association

Overview

The BSA welcomes the opportunity to contribute to the Commission's review of EMIR, and we are pleased that the review goes wider than the narrow requirement in Article 85. We welcome the new thinking and openness on this subject from Commissioner Lord Hill.

The BSA belongs to the European Association of Co-operative Banks, and supports the comprehensive response being submitted by the EACB.

We set out below our members' experience so far during the gradual implementation of EMIR, which illustrates some of its shortcomings, and serious unforeseen consequences, as regards small credit institutions that use derivatives for protection only.

The BSA agrees that the systemic risks from unreported and uncleared OTC derivatives (which actually crystallised in 2008) need to be mitigated by measures such as EMIR. However, the imposition of mandatory central clearing on small and very small credit institutions is (and was) unnecessary - and therefore disproportionate -in order to achieve the financial stability objectives of EMIR as stated in Recital 4.

Non-financial entities already benefit from a threshold for exemption, based on systemic considerations, and the purpose of their OTC derivative use. A similar exemption for small and very small credit institutions should now be introduced following this Review, in line with global trends.

We support the new approach – *Better Regulation* – being pioneered by Commissioner Lord Hill and First Vice-President Timmermans. In a wide ranging speech on 26th March, Lord Hill observed wisely:

"I don't want to burden smaller, lower risk institutions with the same requirements we need for bigger, riskier ones…….Looking ahead, I am keen to build on this policy of differentiation."

We therefore call on the Commission to give effect to this in the context of EMIR by including an exemption threshold for small / very small credit institutions in any post-Review legislative proposal. We also call for measures, including to facilitate indirect clearing, to increase the range of clearing providers that our medium sized and larger members can use.

EMIR: UK building societies' experience

Building societies are the UK's mutually owned mortgage and savings banks. The BSA, which belongs to the European Association of Co-operative Banks, is the trade association of the UK's 44 independent building societies. While the largest building society has total assets exceeding € 200 billion, many are small. Nearly 30 fall below € 1 billion total assets, and more than 20 fall below € 500 million total assets.

Unlike most European co-operative banks, building societies are not networked or federated. There is no central institution nor an institutional protection scheme. So societies cannot benefit from the intra-group exemption in Article 3.

Derivatives are not part of building societies' core business at all – they are essentially end-users only. Building societies are permitted by UK law[1] to use derivatives only to manage the intrinsic risks of their business (e.g. interest rate mismatches on fixed rate mortgage or savings products) or to provide interest rate protection direct to their retail clients. They are not permitted to trade derivatives generally.

Consequently, the derivatives transaction volumes for building societies are modest in relation to their balance sheet size, and for small societies are very modest in absolute terms, and with one-way directionality. These features make the business relatively unattractive for clearing providers.

Societies' main need for derivatives is to hedge their interest rate risk on mortgages at initial fixed rates (and there is also an equivalent, but smaller, need to hedge fixed rate savings products where these are offered). Such mortgages, with the interest rate fixed for an initial period of up to five years, have been consistently the most popular type of loan in the UK for over a decade, as the BSA's statistics confirm[2]. Derivative protection needs to be closely matched to the underlying transaction, so societies have to be able to access flexible, over the counter, derivatives.

During 2014, fixed rate lending accounted[3] for 80-90% of societies' gross lending. Moreover, in the recent post-crisis low interest rate environment, the protection element in fixed-rate lending means that this would constitute the most suitable product in many / most cases.

Unless societies can use OTC derivatives to hedge their interest-rate risk, they will therefore be restricted to other forms of lending (where that is not precluded by the borrower's needs and/or conduct regulation – i.e. the "suitability" issue), apart from small tranches that can be matched with fixed rate savings products, or are tolerated as an open position. Even where a small society offers both fixed rate mortgages and fixed rate savings in comparable amounts, the timing of the product offerings may not coincide, so attempted matching may not work well – it may be far more satisfactory to hedge both products with OTC derivatives instead. Small societies who either cannot obtain clearing services at all, or can do so only at excessive cost, will thus be placed at a serious competitive disadvantage once mandatory clearing for interest rate swaps commences in 2016-17.

During 2012-2013, building societies found a reasonable range of clearing providers, and initial fee quotes were reasonable. But the market started to contract quite quickly. By early 2014, smaller societies were typically in negotiation to secure clearing services from one of two major clearing members prepared to take on smaller society clients.

[1] Building Societies Act, section 9A

[2] https://www.bsa.org.uk/statistics/mortgages-housing - BSA Mortgage Database Reports : Tables : Number of Loans, Value of Loans

[3] Ibid.

One, a major UK High Street bank, pulled out of derivatives clearing in May 2014, while the second, a global custodian bank, pulled out at end September 2014. Together these two actions left nearly 20 societies without their anticipated services.

Although the UK has high volumes of OTC derivative business, other clearing options for smaller end-users are extremely limited, and their sustainability is unknown. One major UK High Street bank will offer derivatives clearing only when bundled with other banking services, another's indicative pricing suggests a desire to deter rather than attract this business, while the fourth does not provide it at all.

Information from the market indicates that the major clearing providers understandably concentrate on the highest-volume and therefore most attractive clients. While a group of 15-20 societies and some small banks are currently in collective negotiation with one clearing provider, the cost remains high for small societies in relation to the volumes transacted – this is illustrated in the case studies below.

Even for our medium and larger members, for whom central clearing remains desirable both in terms of the effect on capital requirements, and because of mitigation of cumulative counterparty risk, the absence of diversity of supply, and of competition, is a serious issue. Societies using significant volumes of OTC derivatives need arrangements with more than one clearing provider (for resilience reasons), but this is proving difficult too. As indicated later in this response, there are just too few clearing providers ready to deal with medium and even larger end-users. In short, there is a market failure.

Since building societies cannot undertake proprietary trading at all, none have the infrastructure that would enable them either to become direct clearing members, or to offer indirect client clearing to smaller societies, even if that were legally possible. Nor has any other institution, to our knowledge, offered indirect client clearing in the UK.

General observations

The more fundamental problem is that derivatives clearing appears much less profitable, once capital costs are taken into account, than originally envisaged. The Financial Stability Board had already identified in early 2014 that, globally, most clearing activity was carried out by fewer than ten large banking groups. Moreover, the indirect client clearing model has evidently not worked, and we suspect is unlikely to work under current rules, as it will be uneconomic as an arms-length business.

The detailed reasons why capital and leverage requirements have undermined the provision of clearing services have been analysed by the Futures Industry Association in an excellent paper[4] published in June 2015. (As no BSA member is able to offer clearing services, we cannot comment on these technicalities from our own members' experience, but we draw attention to the clear and trenchant case made by the FIA.)

FIA stated (page 4)

EMIR and CRD IV do not mutually reinforce the G20 objective of increasing the extent to which derivatives are cleared via CCPs. Whilst EMIR seeks to promote central clearing, the CRD IV-mandated regulatory capital costs and leverage ratio requirements applicable to central clearing have directly resulted in clearing brokers leaving the industry, thereby reducing access to central clearing. The feedback from our members is that this trend will continue.

……………………………………………….

[4] https://europe.fia.org/articles/fia-europe-publishes-review-european-regulatory-reform

Whereas the European Markets Infrastructure Regulation (EMIR) aims to promote and mandate central clearing, the CRR requirements on exposures to CCPs result in relatively high risk weighted assets and leverage ratio constraints for clearers with exposure to CCPs.

This affects the business model and economics of clearing brokers - it remains challenging for clearing brokers to maintain a viable return on equity with respect to their business. This is impacting end-users, in the form of higher prices and entry barriers.

If these trends continue and clearing brokers' businesses are loss making, then it is inevitable that shareholders will demand that the institutions' capital be used in other parts of the business that generate a positive return.

Consequently, we have seen a number of clearers of client business exiting the market.

As highlighted by the FIA, our concern is that any clearing provider could in future decide that the business is unattractive and find ways to exit. Another major provider, a major international securities house, exited in this way in early May 2015 from derivatives clearing in Europe and the US. The degree of concentration must already be significantly worse than the FSB identified in 2014.

We are also aware that the **indirect clearing** model does not work under the present rules, though if it could be made to work, it should increase the range of clearing providers for medium-sized and smaller (and possibly even larger) end-users. The BSA has no direct experience of the current problems, but we commend the analysis and suggestions in the FIA's paper (pages 8 to 10).

In conclusion, as the FIA states :

Without a sufficiently diverse pool of clearing brokers via which end-users can clear their derivatives and to whom they can successfully port their positions in the event of a default of one of their clearing brokers, many of the key goals of EMIR are unlikely to be achieved.

Exempting small FCs : global trends

The question of a possible exemption from mandatory clearing for small or very small credit institutions was, we understand, considered during the development of EMIR, but was not reflected in the final text. Non-financial institutions, on the other hand, benefit from fairly generous exemptions under Articles 4 and 10. Recitals 29 and 31 are most instructive – Recital 29 recognises that in deciding whether a non-financial counterparty should be subject to the clearing obligation consideration should be given both to the purpose and scale of OTC derivative use, and Recital 31 also underlines the issue of systemic relevance. Article 10.4 then provides for technical standards to clarify which derivatives are "objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity" i.e. are for protection only – and these have been prepared by ESMA and adopted[5]. Elements of this approach could be used for small and very small credit institutions in accordance with the welcome steer towards proportionality and differentiation given by Commissioner Lord Hill.

The BSA also draws to the Commission's attention that the current EU regime under EMIR is far more burdensome for small banks than the equivalent in other major jurisdictions.

The principal example, of course, is the **USA**, where the equivalent central clearing regime introduced under the Dodd-Frank Act explicitly exempts categories of small banks that are end-users of derivatives for hedging purposes from the clearing obligation. This was effected by a

[5] See Article 10 of Commission delegated regulation 149/2013 :
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF

CFTC Final Rule (now Regulation 50.50) made in 2012, following consultation, with an exemption threshold of US$ 10 billion. The CFTC's documentation[6] also explains why such exemption is desirable and does not compromise the objectives of derivatives reform. We note in passing that the Commission's original proposal for EMIR (from 2010) promised[7] consistency with Dodd-Frank on scope :

In this context, this proposal is consistent with the recently adopted US legislation on OTC derivatives, the so-called Frank-Dodd [sic] *Act. The Act has a broadly identical scope of application. It contains similar provisions requiring the reporting of OTC derivative contracts and the clearing of eligible contracts.*

However, as we have now shown, in relation to the treatment of smaller financial counterparties, EMIR has failed to deliver the identical scope, or consistency, with Dodd-Frank that was promised. Small FCs in the US are exempted, but small FCs in the EU are burdened with an unnecessary obligation.

Switzerland, too, will exempt small financial institutions from the clearing obligation, by applying a clearing threshold – i.e. an approach comparable to EMIR Article 10. Although the legislation (FMIA / FinfraG) was we understand adopted in June, **including the principle of exemption for small financial institutions** (Articles 96, 98 and 99 of FMIA / FinfraG), the threshold for exemption remains to be set by the Swiss authorities.

In **Australia**, currently proposed rules[8] on mandatory clearing will **exempt financials below a high clearing threshold** (AUD 100 billion gross notional outstanding derivatives). In **Japan**, the range of financial entities subject to mandatory clearing is also narrower. In **Canada**, regulatory authorities are prepared to contemplate introducing some exemptions for small banks after reviewing the early information available from trade repositories. The **global trend** is clearly away from imposing disproportionate clearing obligations on small financials. Indeed, this consensus follows from the FSB's own 2010 Recommendations on Implementing OTC Derivatives Market Reforms[9] – where **Recommendation 8** is quite clear that the decision on whether or not to grant an exemption from mandatory clearing should be based on the potential for creating systemic risk.

BSA proposal

If the principle of carving out small or very small banks is accepted, in line with the global consensus, this could be achieved in various ways. **The BSA proposal, supported by the EACB, is in principle to exempt small credit institutions from the clearing obligation in respect of hedging / protection contracts only. In the BSA's view this principle provides the best and most proportionate trade off between on the one hand systemic risk and financial stability considerations, and on the other hand minimising the burden and anti-competitive effect of EMIR on such small institutions. What is most important at this stage of the Commission's review is to accept and adopt this principle.**

As the international comparisons indicate, there are various ways to implement this principle through specific exemption thresholds. The BSA's view is that the simplest and most satisfactory approach is to set an exemption threshold based on balance sheet size of the institution. At the very least, this should be set no lower than € 5 billion. A preferable figure, we suggest, is € 8

[6] http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf
[7] See section 1 on page 3 of Commission's Explanatory Memorandum in COM 2010 (484/5) : http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf
[8] http://download.asic.gov.au/media/3252197/cp231-published-28-may-2015.pdf
[9] http://www.financialstabilityboard.org/wp-content/uploads/r_101025.pdf

billion – closer, in fact, to the equivalent exemption threshold of US$ 10 billion for small US banks.

Responses to specific questions

BSA members, as end-users, have no direct experience of many of the topics covered in the specific questions in the consultation. Some of our colleagues in the European Association of Co-operative Banks, representing major integrated universal banks, are better able to cover these, so we support the collective EACB response, and restrict our responses to specific questions to a few items.

Question 2.2 : Clearing obligations

Q With respect to access to clearing for counterparties that intend to clear directly or indirectly as clients; are there any unforeseen difficulties that have arisen with respect to establishing client clearing relationships in accordance with EMIR? Please provide evidence or specific examples.

Yes, serious unforeseen difficulties have arisen for BSA members. These have been described above – see section headed "EMIR – UK building societies' experience". By way of evidence, we provide the following anonymised case studies.

Case studies

Case 1 : A small building society has total assets of around £140 million, with total mortgage loans of around £80 million. The society advanced over £20 million in 2014. If, say, 60% of that was fixed rate lending, its hedging requirement for the whole of 2014 would have been a gross nominal amount of £12 million – probably transacted in three tranches of £4 million spread over the year.

To provide context for the expected cost of derivative clearing, the society's retained profits for 2014 were around £500,000. The society has 22 employees, and the average salary (excluding the two executive directors) is £36,000. The society's total non-staff overhead costs are £800,000.

One clearing provider is still prepared to deal with small societies individually, but the minimum annual fee will be between £45,000 and £65,000. If the society takes part in the collective negotiations (by 15-20 small societies and some small banks) with another clearing provider, this cost could come down to £25,000 per annum (initially) – leaving aside up front set-up and legal costs. That is the cost of clearing the three or four derivative trades the society is likely to need each year. It is comparable with the cost of employing another junior member of staff.

These figures are characteristic of around 10-12 building societies each with total assets below £300 million. None is likely to need more than ten derivative trades a year. Nor are any of these entities, or trades, remotely capable of posing a risk to financial stability as described in EMIR Recital 4.

Case 2 : For a medium/large regional building society with assets around £2bn and a mortgage book of £1.5bn, its hedging requirement for 2014 was £60m with six £10m tranches spread across the year. Similar fee structures are suggested when compared to the smaller case study. Whilst a larger society of this type may be able to absorb a fee of the size suggested it is still not remotely capable of posing a risk to financial stability of the UK. More worrying is the experience of this type of society, which has seen three potential clearing partners either exit the market or refuse to work with an organisation of this size or regional location. This leaves one viable option and a second option with costs eight times those of the preferred clearer. Should their preferred clearer withdraw from the market then significant cost issues would occur.

The BSA would be very happy to assist the Commission staff by facilitating direct conversations with affected societies to explore further the situation highlighted by these summary case studies.

Q How could these be addressed?

The BSA proposal is to exempt from the clearing obligation small credit institutions – below a balance sheet total of at least € 5 billion and preferably € 8 billion – in respect of hedging / protection contracts only. In the BSA's view this provides the best and most proportionate trade-off between financial stability considerations, and minimising the burden and anti-competitive effect of EMIR on such small institutions. The principle of exempting small credit institutions is supported by the EACB.

Regarding indirect clearing, we commend the analysis and suggestions already provided by the FIA.

Conclusion

This EMIR Review gives the Commission the opportunity to make a big difference to the ability of smaller financial institutions across the EU to compete in certain key financing markets. In line with the welcome and far-sighted Better Regulation approach being pioneered by Commissioner Lord Hill and First Vice-President Timmermans, we urge the Commission to seize this opportunity and strike a blow for diversity, proportionality and competition, by exempting small financials from the burden of mandatory clearing, as other jurisdictions have already done.

Jeremy Palmer
Head of Financial Policy
jeremy.palmer@bsa.org.uk
+44 (0)20 7520 5912

York House
23 Kingsway
London WC2B 6LU

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 9: 24933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the government and parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets