

Phasing-in the trading obligation : ESMA CP section 8

This note sets out the Building Societies Association's brief response to one specific issue (Q13) dealt with in ESMA's CP (section 8) that is particularly relevant to our own members. We leave to other stakeholders to comment on other matters in the CP. As a trade association, we are unable to contribute on questions, including on compliance costs, that are targeted at individual firm or trading venue level : our members will have divergent experiences which cannot simply be captured at aggregate level.

The BSA and building societies

The Building Societies Association (BSA) represents all 44 UK building societies. Building societies have total assets of over £367 billion and, together with their subsidiaries, hold residential mortgages of over £289 billion, 22% of the total outstanding in the UK. They hold over £263 billion of retail deposits, accounting for 18% of all such deposits in the UK. They employ approximately 40,000 full and part-time staff and operate through approximately 1,550 branches.

Building societies are modest end-users of derivatives, for protection purposes only, as currently required by law. They do not, therefore, undertake swap trading or run any kind of derivatives business. In that respect, they are closer to most smaller non-financial counterparties than to the financial counterparties who are active players in derivative markets. By virtue of their modest profile of activity, the great majority of our members fall within EMIR Category 3.

The BSA belongs to, and works with, the European Association of Co-operative Banks. One important difference between UK building societies and many co-operative banks elsewhere in the EU is that building societies also compete with each other, and are not organised into networks with an apex bank that deals with wholesale markets. Consequently, building societies cannot avail of any of the intra-group exemptions provided in EMIR or MiFIR.

Section 8 : Phasing-in the TO

In Table 2 (page 47 of the CP) ESMA proposed an application schedule for the trading obligation (TO) to take effect in relation to the counterparty categories established under EMIR for the purposes of the clearing obligation (CO). As the great majority of building societies fall into EMIR category 3, the CO for IRD and CDS will only apply to them from 21 June 2019. We agree in principle with ESMA's alignment of the application date for the TO for Category 3 firms with the corresponding date for the application for the CO. But there is one further point arising from the Commission's subsequent review of EMIR.

Interaction with EMIR Review changes

The specification of the trading obligation in MiFIR was closely related to, and aligned with, the earlier specification of the clearing obligation in EMIR. MiFIR Article 28(1) applies the trading obligation to all financial counterparties (FCs) but only to **large** non-financial counterparties (NFCs) – where the level of activity exceeds the threshold defined in EMIR Article 10.1(b). So,

the scope of the MiFIR trading obligation mirrors (as regards counterparty categories) the scope of the EMIR clearing obligation as originally enacted.

The European Commission's 2015 EMIR Review led to the recognition that the application of the clearing obligation to very small FCs was proving unnecessarily burdensome, and accordingly in its legislative proposal text¹ of 4 May 2017 the Commission specifically proposes to exempt small FCs below an activity threshold of € 3 billion gross notional outstanding derivatives (i.e. the lower end of Category 3) from the CO. This proposal brings the EU more in line with other leading jurisdictions which had exempted their small FCs from the CO in the first place, and reflects a wide consensus among EU stakeholders, including as to the difficulties that very small FCs within the EU face in obtaining access to clearing.

Similar considerations may well apply to the TO. The benefit (in terms of increased transparency) from requiring very small FCs to transact derivatives only on organised venues or platforms will be marginal, as their level of activity is relatively low² (and comparable with that of small NFCs which are to be exempt from the TO). But the cost of the upheaval to existing patterns of bilateral transacting, and plugging into the infrastructure of organised venues, may be significant to the individual small FCs. In short, we doubt that this requirement adds any net value. The dominance of organised trading venues as the only way for large players to trade derivatives may over time change market practice so that bilateral transacting is effectively discontinued, but we question whether for small FCs any compulsion is really necessary.

Given the very close alignment of scope (as to both counterparties and instruments) between the EMIR CO and the MiFIR TO, the logical outcome of the Commission's proposal would be that very small FCs should also be carved out of the TO (on exactly the same basis as they are to be carved out of the CO, and on which small NFCs are already carved out of the TO). But we see at present no mechanism to achieve this – as the further step, to amend MiFIR Article 28(1) – was not included, whether by oversight or otherwise – in the Commission's proposal text.

Suggested next steps

The BSA argued cogently and consistently for the exemption of small or very small FCs from the scope of EMIR – see in particular our detailed response³ to the 2015 EMIR Review. We warmly welcome the Commission's EMIR Review proposal of 4 May 2017. And we argue that to fully carry through the logic already recognised within that proposal, the exemption for very small FCs should be carried across to the TO as well.

We therefore urge ESMA to consult with the Commission and the co-legislators with a view to including a suitable amendment to MiFIR Article 28(1) along with any other amendments to the proposal text that may be made during co-decision.

Building Societies Association

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¹ https://ec.europa.eu/info/law/derivatives-emir-regulation-eu-no-648-2012/upcoming_en

² Small building societies might only transact 3 to 5 swaps a year.

³ <https://www.bsa.org.uk/BSA/files/39/390d78f0-8057-4747-9ffa-b0eef08e4b11.pdf>