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European Market Infrastructure Regulation
Regulatory Fitness and Performance (REFIT) proposal

Impact assessment (SWD(2017)148, SWD(2017)149 (summary)) of a Commission proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (COM(2017) 208)

Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the European Commission's impact assessment (IA) accompanying its above-mentioned proposal amending the European Market Infrastructure Regulation (EMIR), submitted on 4 May 2017 and referred to Parliament's Committee on Economic and Monetary Affairs. The IA accompanying a subsequent Commission proposal (COM(2017) 331), also amending the EMIR regulation, as regards the authorisation of central counterparties and the recognition of third-country central counterparties, will be analysed in a forthcoming initial appraisal.

This proposal[1] is part of the Commission's REFIT programme, which stands for Regulatory Fitness and Performance. One of the stated aims of this programme is to make EU law 'simpler, lighter, more efficient and less costly' (Better Regulation Guidelines of 2015, p. 91). EMIR, adopted in 2012, forms part of the European regulatory response to the financial crisis.[2] It specifically addresses the problems observed in the functioning of the over-the-counter (OTC) derivatives market from the 2007-2008 financial crisis onwards.

Problem definition

The IA clearly identifies the following three main problems in need of possible EU action, as well as their causes:

1) disproportionate compliance costs for some entities (namely, pension scheme arrangements, non-financial counterparties and small financial counterparties) and also as a result of some reporting requirements;
2) insufficient transparency;
3) insufficient access to clearing.

[1] For more information, see A. Delivorias, Regulation of OTC derivatives: Amending the European Market Infrastructure Regulation (EMIR), EU Legislation in Progress, EPRS, June 2017.
[2] See, A. Delivorias, European Market Infrastructure Regulation (EMIR): Regulation of OTC derivatives in the European Union, EPRS, June 2017.

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1. Disproportionate compliance costs

a) for pension scheme arrangements: this is a direct problem for approximately 15 000 pension scheme arrangements. Nearly all of them are Institutions for Occupational Retirement Provision (IORPs) authorised under the IORP Directive 2003/41/EC. The problem for these pension scheme arrangements is that they cannot transfer enough cash collateral[3] to central counterparties (CCPs) as variation margin needed to meet the clearing requirements, because they typically hold limited amounts of cash. CCPs have not found technical solutions that would allow them to accept non-cash collateral. The exemption from the clearing obligation for these counterparties expires on **16 August 2018**. If a solution is not found by this deadline, these entities would have to bear the cost of raising additional cash and future pensioners covered by these pension scheme arrangements would face a reduction in their future income (IA, pp. 22-26).

b) for non-financial counterparties: disproportionate compliance costs are a problem for less than 1 % of non-financial counterparties (424 entities out of 64 295 (IA, p. 28)). This is because only non-financial counterparties whose positions in non-hedging OTC derivatives exceed certain thresholds are subject to clearing and bilateral margin requirements. These are called NTC+, as opposed to NTC-, which are below the thresholds. For new contracts entered into by these NTC+ counterparties, the clearing obligation is due to take effect between **21 December 2018 and 9 August 2019** (IA, p. 128). The main problem for this group is that they are subject to clearing and bilateral margin requirements, even though they pose very limited systemic risk. Also, they are not subject to mandatory clearing in major markets, such as the US and Japan. The problem for the much wider group of approximately 64 000 non-financial counterparties active in derivatives markets (64 295, corresponding to 3 counterparties out of 4) seems to be different. This relates to the difficulty for market participants to determine whether they are above or below the clearing threshold, as a result of diverging regulatory practices, also relating to the application of the hedging definition. Overall, these are mainly small, less interconnected players at the periphery of the market (IA, p. 28).

c) for small financial counterparties: disproportionate compliance costs are a problem for a sub-set of entities – those who can be considered 'small' among the three main groups of financial counterparties (see Figure 1, p. 20, for the relative share):

- banks;
- other financial counterparties – investment firms authorised under MiFID (Markets in Financial Instruments Directive), insurers, life assurers, reinsurers, UCITS (Units for Collective Investments in Transferable Securities) investment funds, institutions for occupational retirement provision (IORPs), alternative investment funds (IA, p. 126, footnote 189); and
- the 'G16 dealers', which include mainly clearing members: 'Bank of America, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Morgan Stanley, Nomura, Royal Bank of Scotland, Société Générale, UBS, and Wells Fargo' (IA, p. 18, footnote 41).

For reference, CCPs in the EU have between 3 and 186 clearing members (IA, p. 106). According to the definition in the IA, *small* financial counterparties 'belong to a group whose aggregate positions in OTC derivatives are EUR 8bn or below.' (IA, p. 30). These entities argued that the costs to comply with the clearing obligation are for them disproportionate to the systemic risk they pose. The IA states that there is no publicly available data to estimate the number of small entities of this type (IA, p. 153).

d) due to the backloading obligation: counterparties are required to report historical trades by **12 February 2019**. Historical trades are derivative transactions concluded before 12 February 2014. The Commission considers this requirement 'virtually impossible to fulfil' and of little use (IA, p. 34).

e) due to intragroup transactions: the IA considers that in most cases these transactions do not entail a significant risk to the group and thus the reporting requirements appear disproportionate, particularly for

[3] Collateral is an 'asset or third-party commitment that is used by the collateral provider to secure an obligation to the collateral taker' (IA, p. 4).

smaller and non-financial counterparties; the Commodity Futures and Securities Commission in the US has excluded both non-financial corporations and small financials from this reporting requirement.

f) due to exchange-traded derivatives: exchanges already have most of the details of these transactions; the requirement to report exchange-traded derivatives to trade repositories is therefore considered burdensome and redundant in the IA;

g) due to double-sided reporting: the requirement according to which both counterparties have to report trades is considered burdensome in the IA.

2. Insufficient transparency

This problem seems to affect all counterparties having to report data to trade repositories. There are seven trade repositories in the EU (six listed in the IA (IA, p. 91), plus Bloomberg Trade Repository Ltd, authorised after the publication of the proposal). Companies and financial industry associations have complained that trade repositories' data is low quality and difficult to use. They attribute this to some regulatory failures, including the following: trade repositories are not required to validate and reconcile data between them; reporting requirements are insufficiently standardised, and there is no common methodology to aggregate data (IA, pp. 39-41). Moreover, the European Securities and Markets Authority (ESMA) considers fines for trade repositories to be too low and not dissuasive (IA, pp. 41-42).

3. Insufficient access to clearing

This problem affects mainly non-core market participants. According to the IA, these are all counterparties which fulfil the regulatory requirements for a direct access to clearing, but are not core market participants, such as CCPs, G16 dealers and, in the field of commodity clearing, some non-financial counterparties (NFC). The figures given in the IA are between 2 000 and 6 000 European counterparties, depending on the asset class (IA, p. 43). Elsewhere, 'small NFC+' and '(very) small financial counterparties' are mentioned (IA, p. 44). Small NFC+ appear to be a sub-set of the identified 424 NFC+. '(Very) small financial counterparties' are not defined in the IA. The problem encountered by non-core market participants is clear: direct access to clearing is economically not viable for participants with a limited volume of activity, which face disproportionately high costs. Moving on to the causes, according to the IA 'a large number of stakeholders mentioned the leverage ratio framework under Basel III and [the Capital Requirements Regulation] as the main reason why banks are not incentivised to provide client clearing services' (IA, p. 46). This obstacle is currently being considered by Parliament under the ordinary legislative procedure as part of a Commission proposal (COM(2016) 0850) to amend the Capital Requirements Regulation. Additional causes are not very clearly explained in the IA, but revolve around 'legal uncertainly related to default management procedures and cumbersome segregation requirements' (IA, p. 50; see also p. 47).

The overall consequences of the three main problems are clear: EMIR does not deal with systemic risk in the OTC derivatives market as effectively and efficiently as it could, and the regulatory and compliance burden is disproportionate. The IA cites additional problems that are not dealt with by the initiative and explains why this is the case (IA, pp. 143-147).

Objectives of the legislative proposal

The IA introduces general and specific objectives, which are used to compare the alternative options. These correspond to the identified problems and consequences. It is worth noting that the general objective and one of the specific objectives should be achieved 'without putting financial stability at risk', which acts as an in-built constraint.

The **general** objective is to 'ensure that the EMIR objectives are met in a more effective and efficient way and thus to reduce the risk of disproportionate regulatory and compliance burdens emanating from the application of EMIR, without putting financial stability at risk' (IA, p 51).

The **specific** objectives (IA, p. 51) are to:

- 'Reduce administrative burden and compliance costs without putting financial stability at risk' – elsewhere, this is phrased as 'Increase proportionality of rules without putting financial stability at risk', but there is no apparent contradiction between the two formulations.
- 'Increase the transparency of OTC derivatives positions and exposures'.
- 'Reduce impediments to access to clearing'.

Moreover, the IA defines **operational** objectives for the preferred options. While this complies with Better Regulation Guidelines, it is not easy to spot these seven operational objectives throughout the text (see IA, pp. 58, 60, 62, 67, 70, 71, 76). The hierarchy of objectives fulfils most of the requirements prescribed by the Commission's Better Regulation Guidelines, but it is not time-dependent, i.e. it is not 'related to a fixed date or precise time period to allow an evaluation of their achievement' (Better Regulation Toolbox, p. 80).

Range of options considered

The following table summarises the options retained by the Commission, as they are defined in the IA. Some initial observations on the range of options analysed by the Commission are provided below.

Table 1: Range of options selected by the Commission

Area	Policy option	Description
Pension scheme arrangements	Provide for a new transitional exemption.	'Amend EMIR to extend the transitional exemption beyond August 2018, with regular reviews assessing progress in developing clearing solutions for PSAs' (IA, p. 54) 'subject to a review based on input from the European Supervisory Authorities and the European Systemic Risk Board' (IA, p. 57), while ensuring that 'the ultimate aim for PSAs is central clearing as soon as this is feasible' (IA, p. 56).
Non-financial counterparties	Reduce the scope of the clearing obligation for NFCs.	'Introducing a higher clearing threshold that would only place the largest NFCs in scope of clearing requirements.' (IA, p. 56). 'One way of doing this is by applying the same clearing threshold as in the baseline scenario, but only requiring that those asset classes for which the thresholds have been exceeded and for which there is a clearing obligation should be subject to the clearing obligation.' (IA, p. 58).
Small financial counterparties	Narrower definition of small financial counterparties than currently defined as Category 3.	'Those very small financial counterparties for which central clearing is not economically feasible are exempted from the clearing obligation that stays in place for the other small financials.' (IA, p. 60).
Certain transactions	Fine-tuning the rules in the identified problem areas.	'Better calibrate some of the requirements: elimination of the requirement to report historic trades; to exempt intragroup transactions in which one of the counterparties is an NFC from the reporting obligation; to remove from the counterparties the obligation to report ETD transactions and give it to the CCPs; to alleviate the burden of EMIR reporting for small NFC.' (IA, pp. 62-63).
Insufficient transparency	Introduce new trade repositories' requirements and expand the scope of technical standards to further harmonise the reporting rules and	'The scope of technical standards is expanded to allow for the harmonisation of the form of the reports, the standards to be used, and the methods and arrangements for reporting, as well as for the harmonisation of trade repositories' procedures for the validation and reconciliation of data. Trade repositories are required to grant counterparties access to data reported on their behalf.' (IA, p. 67-68).

	procedures and ensure the transparency and quality of data.	
Insufficient fines for trade repositories	Increase the upper limit of the basic amount of fines.	The upper limit of the basic amounts of fines would be significantly increased (IA, p. 70). ESMA suggested a ten-fold increase.
Insufficient access to clearing	Clarify the interaction between EMIR default management tools and national insolvency laws and introduce a FRAND principle provision.	Providing for the insolvency remoteness of EMIR default management tools. Clearing members and clients that offer client and indirect client clearing should provide clearing services under Fair, Reasonable And Non-Discriminatory (FRAND) commercial terms.

Source: IA, European Commission

Additional options analysed and discarded by the Commission are described as the following:

- 'Submit pension schemes arrangements to the clearing obligation and oblige CCPs to accept non-cash collateral;
- Exempt non-financial counterparties from clearing and bilateral margin requirements;
- Exemption of all small financials as currently defined as Category 3;
- Significantly restructuring or removing certain reporting requirements;
- Expand ESMA's mandate to regulate the trade repositories;
- Introduce a minimum fine calculated as a percentage of the trade repository's turnover; and
- Oblige clearing members and their clients to offer clearing services to all counterparties required to centrally clear'.

The IA considers three options, including not changing the status quo, in seven areas. Overall, the range of options analysed appears fairly limited. For instance, at first sight, it seems that some sub-options could have been identified and further analysed, particularly when options are phrased in rather general terms.

Table 2: initial observations on the range of some options

Area	Initial observation
Pension scheme arrangements	The European Parliament (EP) has called on the Commission to examine a permanent exemption for market participants such as pension funds (EP resolution of 19 January 2016 on stocktaking and challenges of the EU financial services regulation, point 19). The IA examines this option and discards it, arguing that disadvantages outweigh advantages (IA, pp. 54-55). The IA choses instead to extend the transitional exemption for pension scheme arrangements beyond August 2018. The precise number of years is not analysed in the IA itself, but set in the proposal.
Non-financial counterparties	The EP has called on the Commission to extend and make more proportionate the provisions for non-financial counterparties (EP resolution on stocktaking and challenges of the EU financial services regulation, point 18). The Commission's preferred option in the IA corresponds to this call. This preferred option targets 93 non-financial counterparties out of 424 (22 %), that is, those which are active in more than one asset class. 85 NFC are active in 2 asset classes (20 %). 9 NFC+ are active in 3 asset classes (2 %) (IA, p. 151).
Small financial counterparties	The IA sets general principles and does not precisely define the new threshold for very small financial counterparties. However, on the interest rate derivative asset class, if the threshold were defined as financial with a volume of activity below €5 billion, this option would be beneficial for over 90 % of counterparties (5 365 out of 5 855) (IA, p. 153).
Certain transactions	The four types of transactions are bundled together, limiting the possibility to choose a different mix.

Source: IA, author

Scope of the Impact Assessment

The Commission assesses all options for their economic impact, meaning mainly a reduction in compliance costs and administrative burden – which are quantified (see below under 'SME test / Competitiveness') – and positive impacts on financial stability. The IA analyses in a short section the social impacts of the Commission's preferred options. These are understood as the increased job security for workers of small financial counterparties, non-financial counterparties and pension scheme arrangements; increased resilience of financial markets, with indirect benefit for the wider economy; and the avoided cumulated reduction in the retirement income of future pensioners covered by pension scheme arrangements. This was quantified as up to 3.66 % across the EU over 40 years in a study quoted in the analysis (IA, p. 24). Overall, the focus is on the advantages of the Commission's choices.

As for environmental aspects, according to the IA, '[n]o significant environmental impact is expected' (IA, p. 83). Beyond this sentence, there are some references elsewhere on commodity derivatives and emission allowance derivatives (for example, IA, pp. 28-29). Representatives of the Directorates General for Agriculture and Rural Development (AGRI), Climate Action (CLIMA), Competition and Energy (ENER) took part in the Impact Assessment Steering Group.

As far as territorial impacts are concerned, one aspect that is not analysed in this IA is the implication for this particular initiative of the United Kingdom's decision to withdraw from the European Union, following its notification of 29 March 2017 – one month before the publication of the proposal. For reference, 4 out of the 17 EU central counterparties and 4 out of the 7 EU authorised trade repositories are based in the UK. The IA accompanying a parallel proposal amending EMIR, and related to Brexit, will be analysed in a forthcoming initial appraisal.

Subsidiarity / proportionality

The regulatory options are checked in the light of the principle of proportionality, which is one of the stated guiding principles of this initiative. The first specific objective is also phrased as being to '[i]ncrease proportionality of rules without putting financial stability at risk' and applies to all problem areas, with the exception of insufficient fines for trade repositories, where this aim is considered not applicable (IA, p. 71, Table 8). All other Commission preferred options are also explicitly chosen on proportionality grounds. This reasoning applies to the proposed regime for pension scheme arrangements (IA, p. 57, table 2), non-financial counterparties (IA, p. 60), small financial counterparties (IA, p. 62), the selected transactions (IA, p. 66), the other new requirements for trade repositories (at least 'in the medium and long term', IA, p. 70), and access to clearing. Regarding access to clearing, the IA admits that the IA preferred action 'may require changes in the national insolvency laws' (IA, p. 75), which it considers justified. At first sight, however, it is unclear how such a change may be considered proportionate.

As far as subsidiarity is concerned, the IA contains a rather short reasoning, simply stating that EMIR objectives 'cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of actions, be better achieved at Union level' (IA, p. 51). No national parliaments raised any subsidiarity concerns by the deadline of 19 July 2017.

Budgetary or public finance implications

The IA states that the selected options do not have implications for the EU budget or for ESMA (IA, p. 82). The explanatory memorandum of the proposal reiterates this reasoning (legislative proposal, page 13).

The implications for Member States' public finances are not explicitly analysed. The IA provides evidence that national competent authorities, which in principle are best placed to advise on such implications, provided their input during the consultation process.

SME test / Competitiveness

The IA lists a number of benefits for SMEs, such as the simplification of reporting requirements and improved access to clearing, without, however, clarifying how many counterparties are indeed SMEs (IA, p. 81).

Competitiveness considerations come into the analysis through the reduction in compliance costs and administrative burden borne by some market participants, such as pension scheme arrangements, small financial counterparties and non-financial counterparties.

There is a quantification, which transparently acknowledges the uncertainties and assumptions. A useful table sums up the quantified and non-quantified costs (IA, p. 80). Focusing on quantified costs, ranges are provided. NFC would benefit from close to 80 % of fixed costs reductions and over 30 % of operational costs reductions. Financial counterparties, including small ones, would enjoy the remaining share of quantified fixed costs reductions. Pension scheme arrangements would enjoy most operational costs reductions (IA, pp. 78-80).

Simplification and other regulatory implications

The coherence with other pieces of law was analysed in the Evaluation that underpins the IA (IA, pp. 141-142), namely with reference to:

- the Market in Financial Instruments Directive II and Regulation, which are due to apply in January 2018;
- two proposals currently under consideration in Parliament, one amending the Capital Requirements Regulation; and one on the recovery and resolution of CCPs.

Additionally, the proposal concerned by the IA under consideration is linked to two others subsequently adopted by the Commission and currently under consideration in Parliament:

- the Commission proposal for a regulation amending EMIR as regards the authorisation of central counterparties and the recognition of third-country CCPs;
- the proposed decision on the Statute of the European System of Central Banks and of the European Central Bank, as regards clearing and payment systems.

Quality of data, research and analysis

The impact assessment was prepared under the leadership of the Commission's Directorate-General for Financial Stability, Financial Services and Capital Markets Union. DG FISMA involved a broad Impact Assessment Steering Group composed of 11 additional Commission departments. The preparation time lasted approximately 24 months. The starting point, as stated by the Commission, is May 2015, when the public consultation was launched (inception impact assessment). The end-point is the publication date (4 May 2017).

The impact assessment builds upon the evaluation of the EMIR Regulation 688/2012, which is annexed (IA, p. 114). The limitations of the analysis are acknowledged, for instance when some requirements are still not in place. The analysis relies on a broad range of recent and reliable sources, originating namely from the European Securities and Markets Authority, the European Systemic Risk Board and the European System of Central Banks; as well as from the Financial Stability Board and the Bank of International Settlements.

Stakeholder consultation

The IA identifies the stakeholders affected by the problems to be solved. These include: 17 EU counterparties (IA, p. 88-89); EU trade repositories (IA, p. 91); financial counterparties (see above, page 2); pension scheme arrangements and non-financial counterparties. Stakeholders had a number of opportunities to provide their input, including two on-line public consultation lasting for more than 12 weeks. Additional public hearings and meetings with stakeholders were organised.

Monitoring and evaluation

The Commission presents monitoring indicators and gives ESMA a central role in providing the data (IA, pp. 83-84). The main aspects of these indicators are subsumed in the reporting that ESMA shall present to the Commission according to the amended Article 85 of the EMIR Regulation. The IA adds some useful benchmarks that may be used in the future evalution. For instance, the Commission aims to increase participation in central clearing, especially via indirect and client clearing, by 20 %. An evaluation assessing the application of EMIR is planned in the IA by three years after the entry into application. This is also indicated in the proposed amendment to Article 85.

Commission Regulatory Scrutiny Board

DG FISMA met with the Commission Regulatory Scrutiny Board on 1 February 2017 and received a negative opinion on the draft impact assessment. This meant that DG FISMA was required to submit a new version of the IA, which it did one week later. This new version of the IA received a positive opinion without reservation. DG FISMA was requested to better specify the size of the problem and to be more transparent about the assumptions underlying the calculations. The final IA appears to deal with these issues.

Coherence between the Commission's legislative proposal and IA

The legislative proposal of the Commission follows the recommendations expressed in the IA. A number of options are only phrased in general terms in the IA and are further specified in the proposal. The proposal, for instance, specifies that pension scheme arrangements will benefit from a transitional exemption for three years after the adoption of the proposal, which the Commission can extend once by two years. In the proposal, financial counterparties and non-financial counterparties become subject to the clearing obligation if their aggregate positions for the months of March, April and May exceed the clearing thresholds. This particular aspect is not analysed in the IA. The way of calculating the threshold is the same for both type of entities.

Conclusions

The impact assessment clearly identifies the main problems in need of possible EU action, as well as their causes and consequences. This is matched by a coherent hierarchy of objectives, which, however, are not related to a precise time period. Moreover, the IA provides only two alternatives to the status quo, in the seven analysed areas. At first sight, this range of options appear fairly narrow. In some cases, the options are phrased in general terms (see table 1, above) and could have been specified in further sub-options. Nonetheless, the analysis builds upon the evaluation of the European Market Infrastructure Regulation, a wide consultation of stakeholders and recent data gathered from a wide range of official EU and global sources. The process appears to have involved a broad Impact Assessment Steering Group involving 12 Commission departments.

This note, prepared by the Ex-Ante Impact Assessment Unit for the European Parliament's Committee on Economic and Monetary Affairs (ECON), analyses whether the principal criteria laid down in the Commission's own Better Regulation Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.

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