

EXPLANATORY MEMORANDUM FOR EUROPEAN UNION LEGISLATION AND DOCUMENTS

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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

ANNEX to the 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

COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT
Accompanying the document 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

COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT Accompanying the document 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

SUBJECT MATTER

1. The financial crisis highlighted deficiencies within the over-the-counter (OTC) derivatives markets which traditionally have been an opaque part of financial markets, traded bilaterally between firms rather than over exchanges. In particular, the financial crisis highlighted the following two deficiencies:
 - a. Counterparty credit risk – the web of relationships in the OTC market means the risk of default of a major market participant can have systemic implications. AIG highlighted weaknesses in the management of counterparty risk, when a credit downgrade required AIG to post collateral it could not afford.
 - b. Transparency – the financial crisis (e.g. the failure of Lehman Brothers) demonstrated that market participants and regulators did not have sufficient visibility of exposures in the OTC market, making it difficult for regulators to monitor risks arising from derivatives exposures and causing unwillingness to trade in stressed markets.
2. To address these issues, G20 leaders agreed the following at the Pittsburgh summit in 2009¹: “To this end, all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements”. At the 2011 Cannes G20 summit², it was declared “we call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) together with other relevant organizations to develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012”. The European Regulation for Market Infrastructure (EMIR) on OTC derivatives, central counterparties and trade repositories adopted on 4 July 2012 is the EU response to the G20 agreement. The regulation is directly applicable in EU member states and came into force on 16 August 2012.
3. EMIR ensures that information on all European derivative transactions is reported to trade repositories and accessible to supervisory authorities, including the European Securities and Markets Authority (ESMA), to give policy makers and supervisors a clear overview of activity in financial markets. The Regulation also requires standard derivative contracts to be cleared through Central Counterparties (CCPs), counterparties to exchange margin (collateral) for trades that are not cleared through CCPs and establishes stringent organisational, business conduct and prudential requirements for CCPs.
4. On 23 November 2016, the Commission published a report of its review of the application of the Regulation (required under Article 85(1)). The report concluded that there is general support for the core objectives of EMIR of promoting transparency and standardisation in derivatives markets and reducing systemic risk through its core requirements set out above. However, the report identified a number of areas where the EMIR requirements could be adjusted without compromising on the objectives of EMIR in order to:
 - a. Simplify and increase the efficiency of the requirements; and

¹ <http://www.g20.utoronto.ca/2009/2009communique0925.html>

² <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html>

- b. Reduce disproportionate costs and burdens on financial institutions and non-financial institutions (NFCs).
5. On 4th May 2017, the Commission published its legislative proposal to amend EU Regulation 648/2012. The Regulation introduces changes that simplify and increase the efficiency of the EMIR requirements by:
 - a. Making amendments to the clearing obligation. This introduces changes to the definitions of financial and non-financial counterparties and how the clearing obligation applies to them. The amendments also extend the temporary exemption for pension funds from central clearing requirements and remove the frontloading obligation on certain derivative contracts that were entered into or novated before the application of clearing requirements.
 - b. Streamlining and improving trade reporting, including removal of the obligation to report historical trades (backloading).
 - c. Increasing access to clearing. This requires clearing member banks who provide access to clearing services to do so under fair, reasonable and non-discriminatory terms. The amendments also clarify that assets covering positions recorded in a client account are protected in insolvency.
 - d. Introducing a mechanism to temporarily suspend the clearing obligation (i.e. the requirement that any contracts subject to the clearing obligation have to be cleared through CCPs)
 - e. Facilitating the predictability of CCP margin requirements
6. Discussions of the legislation proposal have commenced in the European Council and are expected to start soon in the European Parliament.
 - a. Changes to other EU legislation: Not applicable

SCRUTINY HISTORY

7. EMIR was cleared from scrutiny following a Commons report on 12 October 2011 and from the Lords EU Committee on 3 May 2011. An EM on Commission EMIR report 14828/16 was submitted on 19 December 2016. It was cleared at Sift by the Lords EU Committee on 12 January 2017 and by the Commons European Scrutiny Committee on 11 January 2017.

MINISTERIAL RESPONSIBILITY

8. The Chancellor of the Exchequer has responsibility for United Kingdom policy on European Union monetary and economic issues. The Foreign and Commonwealth Secretary and the Secretary of State for Exiting the EU are responsible for overall United Kingdom policy towards the European Union.

INTEREST OF THE DEVOLVED ADMINISTRATIONS

9. The regulation of financial services is a reserved matter under the UK's devolution settlements and no devolved administration interests arise. The devolved administrations have therefore not been consulted in the preparation of this EM.

LEGAL AND PROCEDURAL ISSUES

- i. Legal basis

10. The proposed legislation falls under Article 114 of the Treaty on the functioning European Union.
11. The Justice and Home Affairs opt-in is not a consideration in relation to these legislative proposals.
 - ii. European Parliament Procedure
12. The Regulation is adopted by the Ordinary Legislative Procedure, with the joint agreement of the Council (Qualified Majority Voting) and the European Parliament.
 - iii. Voting procedure
13. Qualified Majority Voting (QMV).
 - iv. Impact on United Kingdom Law
14. The Regulation will be directly applicable in the UK on the date that it comes into force (on the twentieth day following its publication in the Official Journal of the European Union). Minor changes to UK legislation, notably FSMA 2000 and Part 7 of the Companies Act 1989 will be necessary, but no substantive changes are anticipated.
 - v. Application to Gibraltar
15. The Regulation will be applicable to Gibraltar.
 - vi. Fundamental rights analysis
16. No fundamental rights issues arise from this proposal.

SUBSIDIARITY

17. The proposal will require ESMA to update or develop technical standards. The Treasury will seek to ensure that the appropriateness of each of the proposed powers is being carefully considered.

POLICY IMPLICATIONS

18. On 23 June 2016, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. The government respected the result and triggered Article 50 of the Treaty on European Union on 29th March 2017 to begin the process of exit. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will also continue to negotiate, implement and apply EU legislation.

19. The Government fully supports the implementation of G20 commitments that aim to increase the safety of OTC derivatives markets and welcomes the European Commission's proposal that seeks to address deficiencies in EMIR and to ensure that businesses and end-users can access OTC derivatives market to hedge risks to their business.
20. The Government will seek to ensure that the proposal remains consistent with international standards such as the international Principles for Financial Market Infrastructure (PFMIs). It is important that any changes to EMIR remain consistent with the implementation of the G20 agreement across G20 partners and between EU Member States to prevent regulatory arbitrage and competitive distortions.
21. The Government considers it as a priority to make the regulatory regime for participants in OTC derivatives markets more proportionate where this does not weaken financial stability. In this regard, the Government welcomes the proposed extension to an exemption for pension scheme arrangements from the requirement to centrally clear. The Government also supports the objective of reducing the reporting burden on firms and making central clearing requirements more proportionate for corporate (non-financial) counterparties and small financial counterparties. The Government also welcomes proposals from the European Commission to reduce reporting costs while ensuring that authorities have the data required to monitor risks to financial stability.

APPLICATION TO THE EUROPEAN ECONOMIC AREA

22. The regulation will apply to the EEA countries

CONSULTATION

23. The European Commission undertook a public consultation³ on the implementation of EMIR between 19 May and 13 August 2015, receiving 172 responses from a broad range of stakeholders.
24. Additionally, the European Commission conducted a wider call for evidence⁴ in the framework of the Capital Markets Union initiative between 30 September 2015 and 31 January 2016, in which 278 respondents raised claims about provisions in EMIR. The UK has been fully engaged in this process and also provided a response to then Commission. The European Commission's work concluded in the EMIR report published on 23 November 2016.

IMPACT ASSESSMENT

25. The Commission undertook an impact assessment 8890/17 ADD 3, on the legislative proposal. The impact assessment concluded that the proposed amendments will reduce compliance costs and burden imposed on market

³ http://ec.europa.eu/finance/consultations/2015/emir-revision/docs/consultation-document_en.pdf

⁴ http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf

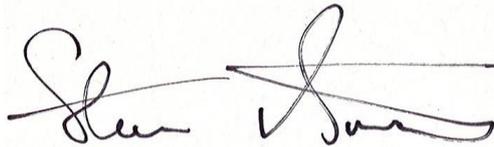
participants without adversely affecting financial stability. Commission estimates of potential savings range from EUR 2.3bn (£1.94bn) to EUR 6.9bn (£5.83bn) in fixed one-off costs and from EUR 1.1bn (£0.9bn) to EUR 2.66bn (£2.25bn)⁵ in operational costs across the European Union.

FINANCIAL IMPLICATIONS

26. There are no direct financial implications of the Commission proposal on either the budget of EU nor for the UK Exchequer

TIMETABLE

27. Discussions on the proposed legislation have commenced in the European Council and are expected to start soon in the European Parliament. The timetable for the negotiation of the proposed Regulation through the Council will be determined by the Presidency.

A handwritten signature in black ink, appearing to read 'Stephen Barclay', written over a light blue horizontal line.

STEPHEN BARCLAY
ECONOMIC SECRETARY TO THE TREASURY

⁵ The European Commission notes a number of limitations affecting the reliability of their estimates. These include that i) estimates are only valid at the current point in time and requirements that will apply at a later stage have not been taken into account; ii) calculations are based on the limited amount of data that is publicly available and on anecdotal market intelligence which may not accurately capture the diversity and specificity of the counterparties at play; iii) estimates are based on the assumption that cost reductions are passed on to end-users; and iv) minimum adjustments from measures to increase the quality of data have not been included.