Insurance Europe response to the European Commission's consultation on the review of the European Market Infrastructure Regulation (EMIR)

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Key messages:

- There are not sufficient possibilities for long-term investors such as insurers and pension scheme arrangements to transfer **non-cash collateral** with central counterparties (CCPs). Therefore, Insurance Europe believes that there are two possible solutions to address the concern of cash:
  1. Consider a **permanent exemption** from the central clearing obligation for both pension funds and insurance companies that use derivatives for hedging.
  2. Encourage **CCPs to develop tailored solutions** for both pension funds and insurance companies, allowing for non-cash collateral as variation margin.
- It should be clarified that EMIR does not apply to **insurance products**.
- The obligation for **dual-sided reporting** (DSR) should be removed and replaced by a requirement for one-sided reporting.
- The obligation to **backload closed trades** is costly and operationally cumbersome, while adding little value to the effectiveness of the EMIR regulatory regime.
- The delays in the finalisation of implementation rules for EMIR and lack of clarity around requirements have led to market players making assumptions and proceeding under uncertainty, and resulted in planning issues for the insurers concerned due to **unclear timescales and a lack of formal commitments**.

Answers to the questions:

Question 1.1:
i. Is there a need for measures to facilitate the access of CCPs to central bank liquidity facilities?

Yes.

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Question 1.1:
ii. If your answer to i. is yes, what are the measures that should be considered and why?

Insurance Europe believes CCPs should get access to central bank liquidity for the following reasons:

This would make CCPs more resilient. Central bank liquidity will help CCPs in times of temporary liquidity stress. Before central clearing, most counterparties in a derivative agreement had access to central bank liquidity, because they were banks. It would be illogical that now there is no choice but to be exposed to parties that do not have access to central bank liquidity. Central clearing leads to a further concentration of risks. Before, the risk was spread over more parties. As a consequence of the central clearing obligation, risks become, on average, better managed, but the tail risk is even higher. Tail risks would be mitigated by the availability of central bank liquidity. The access to central bank liquidity allows the central bankers to manage the macroeconomic pro-cyclicality of central clearing. For instance, in times of market stress, central bankers can expand the range of asset classes that can be used as collateral with the central bank. Central banks should then also extend oversight and perform stress tests on CCPs.

Question 1.2:
(a)
i. Are the clearing thresholds for non-hedging transactions (Article 11, Regulation (EU) No 149/2013) and the corresponding definition of contracts objectively measurable as reducing risks directly relating the commercial activity or treasury financing activity (Article 10, Regulation (EU) No 149/2013) adequately defined to capture those non- financial counterparties that should be deemed as systemically important?

No comment.

Question 1.2:
(a)
ii. If your answer to question i. is no, what alternative methodology or thresholds could be considered to ensure that only systemically important non-financial counterparties are captured by higher requirements under EMIR?

No comment.

Question 1.2:
(b) Please explain your views on any elements of EMIR that you believe have created unintended consequences for non-financial counterparties? How could these be addressed?

No comment.

Question 1.2:
(c) Has EMIR impacted the use of, or access to, OTC derivatives by non-financial firms? Please provide evidence or specific examples of observed changes.

No comment.

Question 1.3:
(a) What are your views on the functioning of supervisory colleges for CCPs?

No comment.

Question 1.3:
(b) What issues have you identified with respect to the college system during the authorisation process for EU CCPs, if any? How could these be addressed?

No comment.

Question 1.4:
(a)
i. Are the requirements under Article 41 EMIR and Article 28 Regulation (EU) No 153/2013 adequate to limit procyclical effects on CCPs' financial resources?

No.

Question 1.4:
(a)
ii. If your answer to i. is no, how could they be improved?

Insurance Europe believes that central clearing is inherently pro-cyclical. This cannot be solved other than through central bank liquidity, as explained above (see Q1.1).

Therefore, Insurance Europe is of the view that the standard margin requirements should not be increased with the aim to avoid pro-cyclical effects. The current level of margin required is already high and makes transaction costs high. In order to allow insurers to hedge their risks, no additional margin should be required. If it is determined that there would not be enough margin for times of market stress, then CCPs should be allowed to increase their main requirements during those times. In normal market situations, an increase in transaction costs should be avoided. Insurance Europe is furthermore of the view that some of the pro-cyclical effects are caused by clearing members and brokers, which often require higher margins than specified in the policies of the CCPs.

Question 1.4:
(b)
i. Is there a need to define additional capacity for authorities to intervene in this area?

No comment.

Question 1.4:
(b)
ii. If your answer to i. is yes, what measures for intervention should be considered and why?

No comment.

Question 1.5:
(a)
i. Have CCPs' policies on collateral and margin developed in a balanced and effective way?

No.

Question 1.5:
(a)
ii. If your answer to i. is no, for what reasons? How could they be improved?

Insurance Europe believes that CCPs' policies on margin requirements need to be improved.

While the EMIR collateral provisions may be acceptable, CCPs set more stringent requirements. In fact, in practice, CCP requirements are neither public nor transparent. CCPs insist on confidential collateral policies because of their competitive position and, furthermore, CCPs usually reserve the right to adjust the required margin at their discretion. Clearing members (CMs) also have their collateral rules, which are not transparent and often incentivise them to change collateral requirements as they see fit at a certain point in time. For example, what is considered good collateral at a certain time may be no longer be deemed acceptable at other times. These situations make it difficult for market players to manage the availability of sufficient collateral.

The clearing and collateral exchange process with the CMs is not completely clear. Clearing processes are insufficiently automated by CMs, which increases the chance of errors and/or delays. Complexity of administration increases because documentation differs in different locations.

Question 1.5:
(b)
i. Is the spectrum of eligible collateral appropriate to strike the right balance between the liquidity needs of the CCP and its participants?

No. The practical implementation of the margining obligations can create significant problems for insurers if CCPs accept only cash as collateral.

Question 1.5:
(b)
ii. If your answer to i. is no, for what reasons? How could it be improved?

As pointed out by the European Commission in a recent report[1] (hereafter the "EC report") there are not sufficient possibilities to transfer non-cash collateral with CCPs. Insurance Europe agrees with this assessment and is concerned about this.

While EMIR was designed to allow for a wide range of eligible collateral, in practice it is likely that most CCPs would only accept cash as variation margin. As a consequence, European insurers managing long-term products risk being forced to either:

- hold unnecessary amounts of cash (to the detriment of long-term investments)
- perform forced sales of assets when cash is needed
- monetise assets via the repo market (if not restricted by national regulations)
- or simply make less use of derivatives, which threatens the provision of long-term insurance products, for some of which derivatives are vital

Unfortunately, alternatives 2 and 3 encourage pro-cyclicality and threaten the significant counter-cyclical role that the insurance industry has traditionally played in periods of market stress. In addition, as experienced in the past, in periods of significant market stress the repo market tends to disappear. Therefore, if CCPs accept

[1] *REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL under Article 85(2) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non cash collateral as variation margins, as well as the need for any measures to facilitate such solution (link), published on 3 February 2015*

only cash as variation margin it is important that policymakers consider how to cope with the above-mentioned problems.

Policymakers had, in fact, anticipated the problem of cash requirements and exempted pension scheme arrangements (PSAs) from the clearing obligation. This exemption was designed to avoid forcing PSAs to "*hold cash reserves instead of higher yielding assets*" thereby reducing "*the total amount paid out by the PSAs as retirement income*".[2]

Because of the way that the exemption was defined in EMIR, its application to insurance companies managing long-term products has a very narrow scope and is therefore extremely limited. This ignores the fact that insurance companies are affected in the same way as PSAs. They also act as long-term investors and minimise the allocation to cash in the interest of their policyholders.

Therefore, Insurance Europe believes that there are two possible solutions to address the concern of cash:

1) Consider a permanent exemption from the central clearing obligation for both pension funds and insurance companies that use derivatives for hedging.
2) Encourage CCPs to develop tailored solutions for both pension funds and insurance companies, allowing for non-cash collateral as variation margin.

Question 2.1:
i. Are there any provisions or definitions contained within Article 1 and 2 of EMIR that have created unintended consequences in terms of the scope of contracts or entities that are covered by the requirements?

Yes, the definition of "derivatives" is a key step in laying down the scope of EMIR provisions. The current definition does not make it sufficiently clear that insurance products do not fall under its scope, since it does not explicitly exclude insurance products from the EMIR application.

Question 2.1:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Insurance products are means by which reinsurers take over global risks. While traditional reinsurance contracts are linked to the policy owner's proof of loss, some insurance products are linked to other payout triggers (eg physical, parametric triggers, such as earthquake/storm intensity).

Based on the definition of "derivative" and "derivative contract" in EMIR (Art. 2 point 5), a strong argument can be made that insurance products with specific payout triggers are not covered by the regulation, because they are not derivatives, but rather a form insurance. Explicitly excluding insurance products from the scope of EMIR is also appropriate since they have a fundamentally different nature, risks and regulatory law to financial derivatives. The underlying risk of these insurance products with specific payout triggers is insurance-event risk (ie risk of loss from natural catastrophes), which is not traded in the capital markets and for which, therefore, no transparent and continuous market prices exist. The lack of a traded underlying asset makes it difficult to build up synthetic hedge positions from traded financial instruments and thus prevents the creation of a derivative market which is disconnected from the holding of insurance risk. Moreover, insurance products are predominantly used for risk management purposes by holders of insurance risk.

According to Article 2, 1(a) of MiFID, the directive does not apply to insurance undertakings or undertakings carrying out reinsurance and retrocession activities. This is appropriate and necessary for the regulatory purposes and provisions of MiFID/MiFIR. But the definitions of Annex I Section C of MiFID have a direct impact on EMIR, which could in turn have an impact on the regulation of insurance products. MiFID was not intended

[2] *Compare with page 11 of the EC report*

to be used in this way and insurance products were not taken into account in the writing of MiFID. Thus, the definition in EMIR using a reference to MiFID is not sufficiently precise and should be adapted.

Therefore, insurance products should be excluded from EMIR. The removal should be accompanied by a new recital. Insurance products are contracts entered into between an insurance or reinsurance undertaking as defined in in Directive 2009/138/EC on the one hand and an insurer, reinsurer or coverage buyer which is neither a credit institution nor an investment firm on the other hand. They cover insurable risks, have effects similar to insurance, reinsurance and retrocession agreements and their counterparty risk is reflected in the calculation of insurers' capital requirement (SCR).

The relevance of this issue for the European insurance industry is high, since five of the 10 largest reinsurers are located in the European Union.

Insurance companies predominately use financial derivatives to carefully hedge parts of their restricted assets, which cover insurance companies' liabilities. In many European jurisdictions, insurers are even only permitted to carry out dealings in futures, options and other financial instruments if these are to serve as hedge, future purchase of securities or if any additional return is to be generated on existing securities, without performance of delivery obligations causing a shortfall of the restricted assets. Since the introduction of EMIR, many small and medium-sized companies are forced to reduce the use of hedging tools, because they cannot afford the administrative, operational and financial burdens of EMIR. Insurance Europe is worried, that as a consequence small insurers often sustain from using derivatives that are suitable to reduce risks on the asset side. We question that this consequence was originally intended by the EMIR regulation.

Question 2.2:
(a)
i. 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?

Yes.

Question 2.2:
(a)
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Insurance Europe believes that the access to clearing does not work well. Legal terms are one sided for the sell side. Legal documentation is too complex for smaller parties.

The new banking regulation has an impact on the OTC clearing business offered by banks. Legislation regarding solvency (CRD IV/Basel III) will lead to substantial price increases on the sell-side parties even before these rules come into force, because they have to set aside more capital for clearing risks they run on their buy-side clients. The continued uncertainty about how the market will work or how the legislation will change, and whether there will be a sustainable business model for clearing brokers in the future, may lead to a lower number of providers of clearing services and less competition, and thus a reduction in market access.

Because of these impediments, smaller parties may decide not to hedge their risks at all. It is important to note that for clearing members, providing clearing services is an additional, not really profitable and capital intensive service to clients, whereas clients need to contract with a clearing member because otherwise they have no access to the market.

Central clearing leads to increased standardisation of derivatives. At the same time, stricter regulations in the areas of capital requirements and proprietary trading create increased liquidity needs. Overall, market volatility is expected to amplify.

Question 2.2:
(b)
i. Are there any other significant ongoing impediments or unintended consequences with respect to preparing to meet clearing obligations generally in accordance with Article 4 of EMIR?

As a general concern, Insurance Europe would like to note that delays in the finalisation of implementation rules for EMIR, including in the area of frontloading obligations and central clearing of FX contracts, leads to a lack of clarity around requirements and requires market players to proceed under uncertainty with many assumptions in place.

As there is no official starting date for clearing, some insurers have found difficulties in engaging with their external fund managers (EFM), who would be facilitating any frontloading on their behalf. Being unable to get any formal communication/commitment on timescales from the EFMs on their clearing proposition/implementation plan has led to planning issues for the insurers concerned.

Question 2.2:
(b)
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

See Insurance Europe's answer to 2.2(b)i.

Question 2.3:
i. Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

Yes.

Question 2.3:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Insurance Europe believes that the obligation for dual-sided reporting (DSR) should be removed and replaced by one-sided reporting. One-sided reporting, like in the US, would offer the same, if not better, quality of data, while removing some of the practical and administrative challenges of DSR. More specifically:

- DSR reporting requires reports from each counterparty to be paired and matched in order to avoid double-counting. This creates the risk of duplication of trade data, making it more difficult for regulators to make meaningful use of information provided to repositories. The reconciliation of data is made more difficult by variations in how trade data is reported by different counterparties, due to differences in both the interpretation of reporting requirements and the exact elements and level at which the components of a trade are captured by counterparties' systems. This is further complicated by a lack of a globally agreed approach on the generation and exchange of unique trade identifiers (UTIs).
- De facto insurers often use service providers that report on their behalf, because they have better access to the data and it is more cost efficient for them to build the required systems. However, most often, service providers do not give any guarantees of the quality of the reports.
- In addition, some insurers have encountered challenges in the implementation of the transactions reporting. For example, EFMs have had problems with identifying and obtaining information about the

trades that had been recorded on the trade repository. The EFM is unable to obtain ongoing management information to allow members' sight and evidence of the trades that are being reported.

The obligation to backload closed trades is costly and operationally cumbersome, while adding little value to the effectiveness of the EMIR regime. More specifically:

- In practice, this would mean that for trades to be frontloaded, insurers will have to tear up and re-execute positions, sometimes manually re-entering the numerous information fields. .
- There are also challenges around the allocation of UTIs to historical transactions. In many cases, UTIs did not exist at the time of the trade, and would have to be allocated retrospectively. Obtaining agreement on this between two counterparties after the execution of the trade is problematic, and there are cases where counterparties no longer exist. This creates follow-on difficulties in terms of the ability to pair the data and its subsequent reporting to trade repositories.

As a more general comment, Insurance Europe notes that, because of the limited implementation time (approximately six months after final regulation was finalised), preparation for kick-off of the reporting obligation was an intensive project for all parties involved. This also led to a lack of supply by market participants that provide connection to the trade repositories and pushed up prices for reporting services.

Question 2.4:
i. Are there any significant ongoing impediments or unintended consequences with respect to meeting risk mitigation obligations in accordance with Articles 11(1) and (2) of EMIR?

No comment.

Question 2.4:
ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.5:
i. Are there any significant ongoing impediments or unintended consequences anticipated with respect to meeting obligations to exchange collateral in accordance with Article 11(3) under EMIR?

No comment.

Question 2.5:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.6:
(a)
i. With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

Yes.

Question 2.6:
(a)
ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

Central clearing and derivatives rules have divided the worldwide market for derivatives. Before EMIR, insurers could contract with all banks worldwide based on the same ISDA documentation. Now insurers have to meet locally diverging rules.

Question 2.6:
(b)
i. Are there any provisions within EMIR that create a disadvantage for EU counterparties over non-EU entities?

No comment.

Question 2.6:
(b)
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.7:
i. Have any significant ongoing impediments arisen to ensuring that national competent authorities, international regulators and the public have the envisaged access to data reported to trade repositories?

No comment.

Question 2.7:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.8:
(a)
i. Are there any significant ongoing impediments or unintended consequences with respect to CCPs' ability to meet requirements in accordance with Titles IV and V of EMIR?

No comment.

Question 2.8:
(a)
ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.8:
(b)
i. Are the requirements of Titles IV and V sufficiently robust to ensure appropriate levels of risk management and client asset protection with respect to EU CCPs and their participants?

No comment.

Question 2.8:
(b)
ii. If your answer to i. is no, for what reasons? How could they be improved?

No comment.

Question 2.8:
(c)
i. Are there any requirements for CCPs which would benefit from further precision in order to achieve a more consistent application by authorities across the Union?

No comment.

Question 2.8:
(c)
ii. If your answer to i. is yes, which requirements and how could they be better defined?

No comment.

Question 2.9:
i. Are there any significant ongoing impediments or unintended consequences with respect to requirements for trade repositories that have arisen during implementation of Titles VI and VII of EMIR, including Annex II?

No comment.

Question 2.9:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

No comment.

Question 2.10:
i. Are there any significant ongoing impediments or unintended consequences with respect to any requirements or provisions under EMIR and not referenced in the preceding questions that have arisen during implementation?

Yes. The provisions of EMIR for derivatives are not properly reflected in the calculation of capital requirements in Solvency II.

Question 2.10:
ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Solvency II defines capital requirements for the counterparty risk associated with derivative transactions[3]. The current charges are, however, calibrated based on a pre-EMIR OTC environment (without taking into account, for example, compulsory margining and haircuts). Given the emerging rules of full collateralisation, haircuts and initial margin, the counterparty default risk charge for derivatives complying with EMIR should be set at zero.

Solvency II defines a risk-adjusted value of collateral in the calculation of capital charges for counterparty risk. The risk-adjustment for collateral is based on a stress calibrated at a safety level of 99.5% over one year. However, EMIR recognised that the haircut should be based on a 10-day time horizon due to the possibility of replacing a derivative within that period. The provisions of Solvency II therefore overstate the risk and build in safety for multiple defaults in the same year.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 110bn, employ almost one million people and invest over €8 500bn in the economy.

[3] See Commission Delegated Regulation (EU) 2015/35 (link), especially Articles 189 (1) and (2), 192 (3), 199 as well as 200