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1. Introduction

Article 85(3)(c) of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories[1] (EMIR) as amended by Regulation (EU) 2019/834 (EMIR REFIT)[2] mandates the Commission to report to Parliament and Council on whether trades that directly result from post-trade risk reduction services (PTRR services), including portfolio compression, should be exempt from the clearing obligation referred to in Article 4(1) of EMIR. The report should take into account the extent to which those services mitigate risk, in particular counterparty credit risk and operational risk, the potential for circumvention of the clearing obligation and the potential disincentive to central clearing.

This report takes into account input received from a report by the European Securities and Markets Authority (ESMA), responses by stakeholders to ESMA's public consultation and discussions with stakeholders. ESMA's report was adopted on 10 November 2020[3]; it was prepared in cooperation with the European Systemic Risk Board (ESRB)[4], and takes into account the results of a public consultation[5].

2. What are post-trade risk reduction services?

There is no harmonised or widespread definition of PTRR services. Nevertheless, there are some common features which would allow PTRR services to be described, in a non-exhaustive way, as procedures or mechanisms by which counterparties reduce one or more types of risks of a portfolio, keeping their market exposure neutral and with the intervention of a PTRR service provider as a third party.

The only PTRR service defined in European law is portfolio compression, which is defined as a "*risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with*

1 OJ L 201, 27.7.2012, p. 1.

2 OJ L 142, 28.5.2019, p. 42.

3 ESMA, Report to the European Commission, Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 10 November 2020, ESMA70-156-3351, ESMA70-156-3351 Final Report PTRR Services - Article 85(3a) of EMIR (europa.eu).

4 ESRB, ESRB opinion on ESMA's report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 12 June 2020, ESRB opinion on ESMAs report on post trade risk reduction services with regards to the clearing obligation (europa.eu).

5 ESMA, Consultation Paper, Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 26 March 2020, ESMA70-151-2852, esma70-151-2852_consultation_report_ptrr_services_-_article_853a_of_emir.pdf (europa.eu).

another derivative whose combined notional value is less than the combined notional value of the terminated derivatives"[6].

ESMA focused on two PTRR services: portfolio compression and portfolio rebalancing. ESMA summarises the main characteristics of them (see table below) in its report.

	Portfolio Compression	**Portfolio Rebalancing**
Main purpose	In principle to reduce notional amount outstanding and the number of transactions and, thus, operational risk.	Reduce counterparty credit risk.
Mechanism	Wholly or partially terminate trades and (eventually) replace the terminated derivatives with new trades often with reduced notional.	Injecting new trades to reduce the risk of the portfolio. No trades are terminated and replaced and the notional is increased rather than decreased.
Underlying Portfolio	Cleared or uncleared portfolio.	Uncleared or mixed portfolios.
Market neutrality	Transactions executed applying symmetric tolerances to all participants.	Market neutrality is ensured by inserting equal amounts of buy and sell exposures.

Based on ESMA Report to the European Commission on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 10 November 2020, ESMA70-156-3351, [ESMA70-156-3351 Final Report PTRR Services - Article 85(3a) of EMIR (europa.eu)](), p. 14.

This raises several questions. First, the descriptions of portfolio compression and portfolio rebalancing in ESMA's report are broad and descriptive. Any potential exemption would however have to be carefully framed. It is further unclear how they relate to the definition of portfolio compression in the acquis. Second, although PTRR services have been around for several years, they are still developing. Moreover, they are not used in isolation, but may be, and indeed often are, combined. It seems to be common practice, for example, to compress OTC derivatives portfolios following portfolio rebalancing exercises and, thus, to use both services combined. This may alter the impacts, including those examined in this report. The bigger the risk tolerances that are

6 Article 2(1)(47) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, OJ L 173, 12.6.2014, p. 84–148

applied in portfolio compression, the more that a typically risk neutral exercise changes its characteristics and could have portfolio rebalancing-like effects.

3. ESMA Report

ESMA’s report focuses on portfolio compression and portfolio optimisation/rebalancing. It concludes that portfolio compression and portfolio optimisation/rebalancing are useful tools to manage risk in both cleared and uncleared portfolios.

According to ESMA, current figures on compression do not provide a way to assess the extent to which the clearing obligation has hampered PTRR services, as they are undertaken in accordance with the existing regulatory requirements. ESMA considers that this implies that more complex trades are used in compression and rebalancing in order to avoid the clearing obligation.

ESMA concludes further that exempting certain transactions that result from portfolio compression and rebalancing exercises would help to increase the use of these PTRR services and contribute to reducing risk. ESMA considers that such an exemption would allow for legacy trades to be more easily compressed, could increase participation in PTRR services of counterparties less interested in participating today and reduce the complexity in the market by using simpler trades for rebalancing.

ESMA considers that, in the absence of compelling evidence or reasoning to the contrary, the positive effects outweigh, inter alia, the increased operational burden on market participants and regulators, and the increase in gross risk in the non-cleared netting sets (in case of portfolio rebalancing). ESMA further notes that the mere function of allowing PTRR transactions to be exempt from the clearing obligation when related to uncleared portfolios of transactions would not reduce the amount of transactions cleared with the CCP because those transactions would not exist otherwise. Indeed, according to ESMA, the risk in portfolios would currently be offset with the use of instruments not subject to the clearing obligation. An exemption from the clearing obligation would therefore, in ESMA’s view, allow risk to be offset with standardised contracts which would otherwise fall under the clearing obligation and which are less risky than the instruments currently used. This would in turn reduce the risk of compressed or rebalanced uncleared portfolios.

In order to avoid that such an exemption from the clearing obligation be misused, ESMA suggests a series of requirements for the provision of PTRR services[7] as well as certain conditions to benefit from the exemption from the clearing obligation, differentiating between conditions for portfolio compression on the one hand[8] and portfolio rebalancing

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[7] ESMA, Report to the European Commission, Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 10 November 2020, ESMA70-156-3351, ESMA70-156-3351 Final Report PTRR Services - Article 85(3a) of EMIR (europa.eu), chapter 8.1, para. 332.

[8] ESMA, Report to the European Commission, Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 10 November 2020, ESMA70-156-3351, ESMA70-156-3351 Final Report PTRR Services - Article 85(3a) of EMIR (europa.eu), chapter 8.2, para. 333 to 338.

on the other hand[9]. The suggested exemption is therefore narrower for portfolio compression, where the exemption from the clearing obligation should only apply to PTRR trades directly resulting from compressions of uncleared transactions (primarily legacy transactions, i.e. trades that are uncleared today but would technically be subject to the clearing obligation and rebalancing transactions). In the case of portfolio rebalancing, the exemption would apply more broadly, as ESMA proposes exempting transactions resulting from the rebalancing of uncleared portfolios as well as those resulting from mixed portfolios compounded of centrally cleared and uncleared trades. This broader application of the exemption would allow risk management across portfolios, impacting OTC derivatives which are already centrally cleared.

4. Commission's assessment

In order to make an informed decision on whether any trades that directly result from PTRR services should be exempt from the clearing obligation, Article 85(3)(c) of EMIR requires the Commission to take into account the three following aspects:

a) The extent to which PTRR services mitigate risk, in particular counterparty credit risk and operational risk;
b) The potential for circumvention of the clearing obligation if an exemption was to be granted;
c) The potential disincentive to central clearing if an exemption was to be granted.

In addition, given that the clearing obligation has been introduced following an international commitment of the G20 to contribute to safer and more resilient markets, this report also considers the quantitative evidence on the benefits of PTRR services and on whether any new risks could be caused by introducing such an exemption.

a. Extent to which PTRR services mitigate risk, in particular counterparty credit risk and operational risk

It is generally understood that PTRR services aim to reduce the risk in the overall portfolio and all risk-reducing transactions must reduce the bilateral risk in the portfolio into which they are booked.

First, regarding portfolio compression, ESMA indicates that such services aim to reduce the number of contracts, the gross notional or some other measure of risk without materially affecting the market risk of the portfolio. This might ultimately reduce systemic risks, by reducing the number of trades, line items and/or notional exposure between counterparties. This is in line with international work, e.g. the International Organisation of Securities Commissions (IOSCO) describes the outcome of compression as, "*diminished operational risk for individual market*

[9] ESMA, Report to the European Commission, Report on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a)), 10 November 2020, ESMA70-156-3351, ESMA70-156-3351 Final Report PTRR Services - Article 85(3a) of EMIR (europa.eu), chapter 8.3, para. 339 to 347.

participants which may, in turn, lessen systemic risk and enhance overall financial market stability"[10].

The role of portfolio compression is acknowledged in EMIR. Article 11(1)(b) of EMIR in conjunction with Article 14 of Commission Delegated Regulation 149/2013[11] recognises that portfolio compression mitigates risk and mandates it for non-centrally cleared OTC derivatives. Recital 30 of that Delegated Regulation further reads: "*Portfolio compression may also be an efficient tool for risk mitigation purposes depending on circumstances such as the size of the portfolio with a counterparty, the maturity, purpose and degree of standardisation of OTC derivative contracts. Financial counterparties and non-financial counterparties that have a portfolio of OTC derivative contracts not cleared by a CCP above the level determined in this Regulation should have procedures in place in order to analyse the possibility to use portfolio compression that would allow them to reduce their counterparty credit risk.*"

Second, ESMA indicates that portfolio rebalancing aims to reduce the imbalances within portfolios created due to the impossibility of netting credit exposures of cleared trades against bilateral trades across different asset classes that are not eligible for clearing. As such, portfolio rebalancing is based on new OTC derivatives being entered into to reduce counterparty risk by reducing a certain risk (i.e. interest rate or currency risks) identified between two counterparties without changing the trades in the underlying portfolio. Market participants view this as a way to reduce systemic risk by decreasing the overall exposure in the market between counterparties.

Nevertheless, the ability of both these services to reduce risks is limited in some aspects. Rebalancing exercises would not necessarily reduce operational risks as the new OTC derivatives entered into (and allowed with an exemption to remain in the bilateral sphere) could create additional operational risks. Furthermore, even when using plain vanilla OTC derivatives instead of more complex derivatives to replace or amend trades in a portfolio rebalancing exercise reduces risk in the uncleared space, that portion of OTC derivatives would not be managed by CCPs which could increase risk in the combined system. Indeed, if exempt from the clearing obligation, such OTC derivatives would not profit from the risk management that central clearing offers. That could increase overall risk in the centrally cleared and in the uncleared space combined even where the risk in the uncleared space would have been reduced to some extent by the rebalancing exercise.

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10 FR09/2015, 28 January 2015, p. 13, FR01/2015 Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives (iosco.org).

11 Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP, OJ L 052, 23.2.2013, p. 11.

The data provided by ESMA illustrates the widespread use of portfolio compression and portfolio rebalancing among the industry. The report does not however quantify the risk mitigation (counterparty credit risk and operational risk) provided by those services. The assessment is based on a thorough theoretical assessment rather than empirical data which could allow a more holistic analysis and identification of potential shifts in risk. It should be recognised though that such an assessment is not easy given that an exemption is not yet in place, but a quantitative assessment of similar exemptions in third-countries, which ESMA refers to in the annex to its report could shed further light. While portfolio rebalancing mitigates risk within the rebalanced portfolios themselves, the overall mitigation of risk seems difficult to assess when taking a more systemic view. While ESMA has provided a sound theoretical analysis of the potential issues and provided some data on the use of these services, it is not (yet) sufficiently clear that the advantages of exempting transactions resulting from PTRR services from the clearing obligation outweigh potential risks.

b. Potential for circumvention of the clearing obligation

Article 85(3)(c) of EMIR requires that the European Commission's report considers whether an exemption from the clearing obligation for PTRR services has a potential for circumvention of the clearing obligation.

On the one hand, ESMA points out that PTRR services currently avoid the clearing obligation by ensuring that the resulting trades do not belong to a category of OTC derivative subject to the clearing obligation, e.g. more complicated swaptions instead of plain vanilla derivatives. Should such derivatives originating from PTRR services be exempt from the clearing obligation in the future, counterparties engaged in PTRR services could use these simpler and more standardised instruments. ESMA considers it unlikely that such an exemption would lead to the circumvention of the clearing obligation, as such derivatives would have never been concluded without the exemption. Only the exemption would make it possible to use them for PTRR purposes in the non-centrally cleared space. ESMA views such derivative transactions as merely "administrative". They would not be entered into for any other reason. According to ESMA, an exemption would not incentivise market participants to use this technique as a way to avoid central clearing as it would not affect OTC derivatives under the clearing obligation resulting from ordinary trading activities.

On the other hand, some stakeholders note that an exemption to the clearing obligation would open up significant possibilities for regulatory arbitrage and ‘clever’ trading to extract OTC derivatives currently in cleared portfolios and to bring them into the uncleared space. This could act as an incentive for the circumvention of the clearing obligation leading to more rather than less risk.

To avoid any such circumvention of the clearing obligation, ESMA recommends developing conditions for any exemption from the clearing obligation. Such conditions could limit any exemption to certain OTC derivatives, e.g. legacy trades, or to certain PTRR services. ESMA also suggests introducing some requirements for PTRR services, e.g. they should be market risk neutral, reduce the bilateral risk in the portfolio into which it is booked, and be carried out by an independent service provider.

Although the requirements for and conditions to the exemption from the clearing obligation that ESMA proposes might limit the possibilities of using such an exemption to circumvent the clearing obligation, further analysis is needed. In particular, the idea of mixed (centrally cleared and uncleared) OTC derivatives portfolios being included in portfolio rebalancing services benefitting from the exemption from the clearing obligation, and to combine PTRR services in the uncleared space with transactions to shift risk to central clearing (see end of Section 3) would alter the relationship between the centrally cleared and the uncleared space, and the fact that different risk mitigation tools should be used in the centrally cleared and the uncleared space.

Further analysis of the possible liquidity shifts from the centrally cleared to the uncleared space should also be considered.

c. Potential disincentive to central clearing

The market is split as to the potential disincentive to central clearing that may arise from an exemption from the clearing obligation for trades resulting from PTRR services. ESMA concludes therefore that while there is no evidence that there would be a risk of disincentive of the clearing obligation this should be monitored carefully in order to ensure that if any risk were to materialise it could be addressed by further regulation and/or supervisory measures.

Should the exemption from the clearing obligation represent a cheaper option in the future in terms of capital and margin costs to hedge trades in the bilateral space, this could lead to a disincentive to central clearing. In such circumstances, to clear bilateral only could be more economical viable in terms of capital and margin costs, the larger the netting set.

Voluntary central clearing shows that this potential disincentive does not fully fall away: It is quite evident that counterparties that could centrally clear an OTC derivative but choose not to do so, make that choice because bilateral clearing is economically reasonable for them. Moreover, a possible reduction of liquidity would disincentivise participation in central clearing.

The impact of PTRR services in terms of a possible disincentive to clearing is inconclusive. Taking into account divergent stakeholder views as well as ESMA's report, further analysis by ESMA would be beneficial, in particular on the impact on incentives to central clearing which are strengthened where there is more liquidity in the centrally cleared space.

5. Conclusion

In EMIR, the co-legislators opted for central clearing as a key element of the G20 commitments which should be the primary risk mitigation tool for plain vanilla OTC derivatives under the clearing obligation. Other, not as far reaching risk mitigation techniques should be used with regard to other OTC derivatives not falling under the clearing obligation. Both, central clearing and PTRR services thrive in their respective spaces. Generally, certain OTC derivatives should only be exempted from the clearing obligation where the risks of granting such an exemption are smaller than the risks of keeping the situation as it is today.

ESMA, in cooperation with the ESRB, has undertaken an extensive and thorough analysis of PTRR services. Nevertheless, there remain important open questions. In particular, some of the aspects of the report require further quantitative assessment and analysis in order for the Commission to be able to make a more informed decision on any potential proposal for legislative change.

In particular, the following issues need further consideration:

- The definition of PTRR services, e.g. how different types of PTRR could be defined more concretely;
- The possible interlinkages between PTRR services and the impact of their combined use on the aspects raised in this report;
- The materiality of the risk of the circumvention of the clearing obligation, especially possible market practices that could be used to conduct such a circumvention;
- Possible conditions limiting the risk of such misuse of a possible exemption from the clearing obligation;
- The incentives to centrally clear taking into account a possible exemption from the clearing obligation;
- Evaluation of potential liquidity shifts from centrally cleared to uncleared space.

Further work on the abovementioned issues, in particular on the definitions of PTRR services and to collect more quantitative evidence, would enable a more comprehensive and well rounded assessment of the issues, which could feed into the general EMIR assessment report, which should be submitted to the European Parliament and the Council by 18 June 2024[12].

[12] Article 85(1) 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