

**COMMENTS ON “SECOND CONSULTATION PAPER – DRAFT
REGULATORY TECHNICAL STANDARDS ON
RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE
CONTRACTS NOT CLEARED BY A CCP” ISSUED BY THE
EUROPEAN BANKING AUTHORITY**

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1. BACKGROUND AND SUMMARY

The goal of the technical standard is to set rules to be applied to the exchange of margins for non-cleared derivatives portfolios.

Our comments are divided in four parts. The first one describes a major flaw in the proposed regulation. The second one refers to other items that require clarification or corrections. The third part describes a margining approach that significantly decreases residual risk in a model-free way and incentivizes central clearing but is not allowed by the draft rules. The final part answers some of the specific questions set in the consultative paper.

2. GLOBAL RISK

In the consultation paper, the margining approach is split in two parts, first the *variation margin* (VM) and secondly the *initial margin* (IM). The variation margin refers to the posting of collateral to cover the present value of the OTC derivative portfolio. The initial margin refers to the posting of collateral to cover the potential change of value, in case of default, between the last variation margin posting and the moment when the surviving party is able to hedge the risks emanating from the default.

The split between those two parts of the margin process facilitate the analysis of the default dynamic in dividing the problem in two, but does not necessarily match the stated goal which is to protect the surviving party in a robust way. For the surviving party, the main goal is to avoid financial losses, the name given to those losses is irrelevant and the default process should be treated as one event. The split in several parts or sub-margins is relevant only if it is proved to be the most efficient approach.

The derivative portfolio in a netting set is a unique financial reality and dividing its risk management in two parts is already a modeling choice. That modeling choice, which has been done by the regulators, is a strong modeling assumption that need to be assessed. The consultation paper provides no clear rationale regarding the reasoning behind that policy choice. The risk management of OTC derivative portfolios should be considered globally and the split of the procedure in several independent steps or requirements should be considered only if a more global approach is not available.

The document mentions the choice between a schedule and an internal model approaches. A priori, a *model-free approach* would be the best choice. If one could design a procedure that guarantees the absence of financial impact on the surviving party in case of default of the other party, and this without resorting to any model,

that would certainly be a preferable approach. Such a possibility does not seem to be considered in the document. The ultimate risk-mitigation technique related to the credit risk of a portfolio of OTC derivatives is the automatic replacement of the contract with the defaulted party by a contract producing similar cash-flows with a non-defaulted party. If at the default of one counterpart, the bilateral instruments were automatically replaced by similar contracts with a different counterpart, the surviving party would not only be financially protected but also would be relieved of the burden of assessing the impact, finding a replacement portfolio and recovering the losses.

Unfortunately this best approach to risk-mitigation is excluded from the potential approaches by the technical standard that focuses independently on different parts of a decomposed version of the problem with specific constraints instead of analyzing the problem globally. In particular Section 4, Article 5.2 and Section 5, Article 1 create overly restrictive conditions. They prohibit taking into account the right way exposure between portfolio and collateral and using derivatives in the collateral portfolio. This is a major flaw in the proposed regulation, the impact of which has not been assessed. The general approach selected is local rules based instead of global principle based. This restrictive choice to risk-mitigation techniques weakens significantly the legitimacy of the standards.

3. DETAILS

Split between margin methods and collateral: In page 7 and in Article 5–2 (page 36), an early distinction between the “margin methods” and “eligibility and treatment of collateral” is made. As discussed in the previous section, those two issues should not be split but are part of the same problematic.

Documentation: Pages 9, 21, 33, 37. The draft regulation indicates, referring to the margin model used for non-cleared derivatives, that “All key assumptions of the model, its limitations and operational details must be appropriately documented” and that “[...] all the information necessary to explain the determination of a given value of initial margin in a way that a knowledgeable third party would *be able* to replicate the calculation [...]” Is the intention of this article to go beyond the “be able” and also covers “be allowed”? Can the margin methodologies be protected by patent and copyrights that even if technically they would be replicable, in practice market participants are not allowed to do so due to legal restrictions imposed by one of the parties or a third party. Shouldn’t the transparency and documentation requirements explicitly indicate that any party involved, including parties providing services to the two bilateral parties, is allowed to replicate and perform all the related computations without restriction? In the current state of the proposal it would be relatively easy for one party to implement a methodology, patent it and produce the required documentation but at the same time restrict other market participants, including regulators, in replicating the calculation.

Readily liquidated: Page 9. An OTC portfolio of derivatives is often a long term agreement between parties, with a horizon up to 30Y not uncommon. By entering into those long term contracts, it can be estimated that the parties had no intention to liquidate them in the short term. In some cases, the long term nature of the engagement can be an important aspect of the agreement. The requirement of collateral that can be “readily liquidated” does not match the parties’ intention. A better requirement would be to have the collateral which, over the original life of the defaulted portfolio,

provides cash flows of similar value. Recovering immediately the present value of the portfolio is one acceptable way to achieve this, even if not the best of them, but should not be the only method authorized.

Currencies: Article 1 LEC (a), page 38. For the purpose of this article, are digital currencies, e.g. Bitcoin, also considered as acceptable for collateral?

NGR: The *net-to-gross ratio* is ill-defined. It is described (page 62) as a ratio with the *gross replacement cost* (GRC) at the denominator. The gross replacement cost is itself described as the “sum of the current market values of all OTC derivative contracts [...] with positive values in the netting set”. If the derivatives all have a negative value, the GRC is 0 and the formula is ill-defined. Article IV 3. (c) should be reviewed.

4. CENTRALLY CLEARED INSTRUMENTS AS COLLATERAL

In this section we propose an alternative mechanism which improves the margin framework and promotes central clearing of part of the OTC derivative risk. Unfortunately this mechanism is forbidden by the draft standards.

Two institutions have contracted an OTC derivative which is in part very close to derivatives that can be cleared on a CCP. As an example, it could be an OTC IRS with customized characteristics which make it non-clearable on a CCP but has a risk profile very similar to the clearable IRS.

We describe the collateral mechanism from the point of view of one of the counterparty. The other can have a similar mechanism or a different mechanism, as the margin methodologies can be different between the two parties.

The party is member of a CCP clearing OTC derivatives. Out of its cleared portfolio, it choose one (or several) instruments that are transferred to a separate portfolio at the CCP – we call it a *client portfolio*. The original party has still the ownership of the portfolio. The CCP instrument is a good hedge for the non-cleared OTC instruments. For example if the party receives fix on a swap in the OTC non-cleared portfolio, he pays fix on a cleared swap with a similar maturity.

As part of the collateral agreement, in case of default of the party, the ownership of the CCP client portfolio is transferred to the non-defaulted party. In our example the other party was paying fix on the non-cleared OTC swap, that swap disappears due to the default. The non-defaulted party takes ownership of the cleared instrument and pays fix on it. Globally the situation is unchanged to the surviving party, except that the counterparty on the swap changes from the defaulted party to the CCP. Note that no model was required to assess the collateral acceptability. Up to here, it is a model free approach.

The two financial instruments will probably not be identical in term of cash flows. For that portion of the risk, which is the non-cleared OTC portfolio plus the cleared swap, a standard initial/variation margin computation would be done. The IM would be only for the *residual risk*, which would probably be very small. It is very important in that case to consider to global situation, including the original non-cleared portfolio and the collateral portfolio.

This approach provides better result for the surviving party as its risk exposure is only marginally impacted by the default; it also reduce significantly the model risk as the margin model is applied only to a residual risk, not to the raw exposure of the different parts.

5. QUESTIONS FOR CONSULTATION

Question 3.: Respondent are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models.

The proposed text is still ambiguous regarding the asset classes. The text seems to indicate that each contract should be assigned to one asset class, by opposition to each risk factor. The model may account for risk offset in one asset class. Does this mean that if an instrument has been assigned to one asset class but depends on risk factors typical from another asset class, the diversification effect of all risk factors related to that instrument should be taken into account? Or does it mean that only the risk factor associated to the assigned asset class should be taken into account and the others should be ignored? The current text does not provide an unambiguous description of the requirements.

Question 7.: Does this approach address the concerns on the use of cash for initial margin?

Cash is probably understood here as *electronic cash* and not as *banknotes cash*. It is not clear what the alternative to re-investment is for cash. The cash will always be at least in a cash account with a financial institution – e.g. a central bank. There is no alternative to re-investment for cash.

Does this article also allow the re-use of cash to invest in non-cash instruments? For example in short term bills or bonds?

Question 8.: Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.

FX risk is not different from other risks and cash is not different from other assets. There is no reason to make a difference for them. The fact that a VM is settled in cash does not settle the claim. It is only a collateral to guarantee future settlement. When receiving the VM in cash, one could argue that the receiver could convert the amount into the currency that settle the claim at best for him. This argument does not stand a further analysis, as in absence of default, the receiver of the VM has to return it in the original currency. If the instrument cash flows and the VM are not all in the same currency, the receiver of the VM will always have a currency risk. If the VM is not converted, in case of default, there is a mismatch between the VM amount in currency and the MtM, even in absence of movement in the market underlying the OTC derivative. If the VM is converted, in absence of default, the original amount in the original currency should be returned and the receiver of the VM face the currency risk of not being able to return the full amount in the original currency.

The treatment of the FX mismatch for VM does not match the requirements for a safe exchange of margin. The complexity around the cash for VM question arises from the segregation between the OTC portfolio risk and the margin portfolio risk, which is a fundamental flaw of the proposed regulation, as explained in the first section. As long as the flaw is not corrected, it will be difficult to propose a coherent and robust treatment of the FX mismatch.