HSBC

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To the Joint Committee of the European Supervisory Authorities

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Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (The RTS)

We welcome the further consultation by the European Supervisory Authorities (ESAs) and have been participating in the development of industry responses, including that by ISDA. We therefore limit comments in our own response to issues that are of particular importance to HSBC.

HSBC is one of the world's largest banking and financial services organisations with assets of USD2,634 billion as at 31 December 2014. Headquartered in London, HSBC serves customers worldwide from around 6,100 offices globally.

HSBC supports the objective of reducing systemic risk, and wants to operate in safe markets. Market participants have at their disposal a set of tools to manage systemic risk, such as central clearing, appropriate capital levels and margin. They should be allowed to use all tools in the most efficient fashion.

Summary of questions for consultation

Question 1. Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

HSBC agrees with the change in proposed treatment of non-financial counterparties domiciled outside the EU. However, the change from collection only of collateral to an exchange of collateral is an unwelcome development. Aside from it being unclear how moving assets outside of the EU aids EU financial stability, this is likely to cause issues in emerging markets that don't have the infrastructure to comply with EU rules and leads to an increase in risk when transacting with parties in non-netting jurisdictions.

Question 2. Respondents are invited to comment on the proposal in this section concerning the timing of calculation and delivery of initial and variation margins.

HSBC is supportive of the ISDA comments on this topic.

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We would like to reinforce the points made by ISDA around the complexity of the IM calculation and timing of margin calls with geographically diverse counterparties.

Today, variation margin is generally calculated no later than the business day after the trade (or valuation) date. There are practical challenges which mean it is not possible to meet this timetable for the calculation, agreement and exchange of initial margin. The calculation of initial margin is more involved than that of variation margin and it is also likely to take longer to identify and resolve differences.

Therefore, it would seem realistic to expect initial margin calls to be calculated no later than 3 days after the trade (or valuation) date to take into consideration issues of the geographic spread of trading relationships. Collateral exchange of both IM and VM will be in line with the standard settlement cycle for the relevant collateral.

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.

HSBC is supportive of the ISDA comments on this topic.

In terms of the allocation of trades into assets classes, the wording in the draft regulatory standard could cause confusion. Paragraph 1 could be interpreted to require that risk factor netting can occur across the portfolio as long as the risk factors are segregated by asset class, whereas Paragraph 3 seems to suggest that trades need to be bucketed and calculations run at the asset class level, prohibiting risk offsets between trades allocated into different asset classes.

We would suggest that this is clarified to require that the total initial margin requirements for a netting set shall be the sum of initial margin requirements calculated for each asset class on the derivative contracts within the netting set.

Question 4. Respondents are invited to comment on whether the requirements of this section concerning concentration limits address the concerns expressed in the previous proposal.

HSBC is supportive of the ISDA comments on this topic.

Question 5. Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.

HSBC is supportive of the ISDA comments on this topic.

HSBC is already subject to a regulatory requirement to obtain legal opinions on the enforceability of close-out netting in multiple jurisdictions around the world; the legal review should be aligned to avoid differing requirements.

Whilst we acknowledge that the ESAs have followed the international timetable and encourage global consistency, we remain concerned by the number of new collateral agreements that will need to be put in place for 1st March 2017 when variation margin becomes mandatory for all in scope entities. For this reason, we would recommend that the implementation of variation margin is also phased in.

Question 6. Respondents are invited to comment on the requirements of this section concerning the legal basis for compliance

HSBC is supportive of the ISDA comments on this topic

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

Under normal circumstances, we do not expect dealers to post cash as initial margin. Where dealers do post cash it is likely to be because operational or market issues impair their ability to source suitable securities, with the view of substituting the cash as soon as reasonably practicable. In these circumstances, we do not consider the reinvestment option offers a workable solution and could result in a de facto ban of using cash as initial margin.

HSBC undertakes robust due diligence on customers and custodians and is required to hold capital against cash placed on deposit. Additionally, HSBC undertakes credit assessments before placing funds on deposit. This provides adequate mitigation against the risk of using cash as initial margin in the short term and in the exceptional circumstances in which it will be used. Given there may be rare circumstances when we are left with no choice but to post cash, we are keen that the rules over posting cash are workable in these circumstances.

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

We agree that the FX risk between posted collateral and the margin requirements, both IM and VM, should be recognised. However, we do not agree that a haircut is the best way to achieve this.

Unlike cleared futures, in OTC transactions variation margin is not a "settlement" of a claim, it is a "due payment" under the agreement. All variation margin is held in a client account in the form in which it was posted, and the assets posted (including cash) are returned in the same form when necessary.

The economically correct way to capture the FX risk of any mismatch is to recognise it in the Initial Margin calculation, because the correlation between the FX risk of collateral posted in any currency and the value of OTC derivatives position in the same currency can be relied upon in a default or stress situation. Therefore we support the ISDA proposal to recognise foreign exchange risk offsets and risk increases between the unsecured exposure and the collateral.

Other Observations

Harmonisation and Equivalence

The OTC derivative market is global by nature. Therefore, any material divergence between the European framework and those of other regimes will increase market fragmentation, reduce market depth and liquidity and increase price dispersion. That is why HSBC considers that harmonisation is still needed.

An example would be the treatment of equity options between different regulatory bodies. European requirements state that all equity options fall within the scope of margining, whereas within the US regulatory system some options and forwards are excluded from the scope of margining. Consequently, EU firms may be rejected from the US market if they have to collect initial margin on these instruments whilst US firms do not.

Therefore, we are of the opinion that for such products – namely equity options and derivatives on eq – the ESAs should indicate that the collateral requirements will be applicable according to a specific timeline. We would propose 1st December 2020 as a starting date for mandatory initial margin and variation margin exchanges to give sufficient time (1) for the other major jurisdictions to impose equivalent collateral rules.

Intragroup Transactions

The intragroup exemption is only available for transactions between HSBC's EU entities where such entities face affiliates established in non-EU jurisdictions where an implementing act on equivalence has been adopted by the Commission in relation to that non-EU jurisdiction under Art. 13(2) of EMIR.

We request that the regulation provides for a transitional exemption for cross-border intragroup transactions with affiliates established in a third country. We refer to ISDAs suggestions with regard to the duration of such exemption. If such exemption were not granted it would be particularly difficult for banks, like HSBC, that operate on a subsidiarised basis including subsidiaries in non-netting jurisdictions and could lead to banks externalising more risk.

HSBC would need to have such intragroup exemptions in place by 1st September 2016 and absent clarity on equivalence, transactions with non-EU affiliates might not qualify and suggest that the EUR 50m margin threshold should be available intragroup in line with the regulations between consolidated groups

Non Netting Jurisdictions

It is not clear how the recommendations for "non-netting jurisdictions" (jurisdictions in which a regulatory standard netting enforceability opinion is not possible to attain) will work in practice and including margin requirements on derivatives with internal and external counterparties located in these jurisdictions will have the effect of restricting business. It is likely that trading activity with non-netting jurisdictions will become more expensive or cease. This is of particular significance to banks with global businesses

We request that the ESAs provide an exemption from margin requirements to post collateral in non-netting jurisdictions to allow a transitional period of time for the relevant jurisdictions to adopt suitable legislation. We refer to ISDAs comments in this regard.

Relying on third-party banks or custodians will not have any positive effect if the insolvency law of the third-country counterparty does not recognize the effect of such segregation. This is why for instance the impact of any collateral that might be posted in this circumstance would not be taken into account when computing the CVA risk charge.

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HSBC considers that such requirement could increase the systemic risk in the transactions with counterparties located in jurisdictions where the close-out netting is not enforceable and would recommend to remove the obligation to post collateral in the context of transactions entered into with counterparties domiciled in jurisdictions in which it is not possible to guarantee the effectiveness of the segregation agreements.

We would suggest that banks be rather required to explain at the simple request of its supervisors why there is no "alternative process to post collateral".

Agreement of Models

The draft RTS have introduced a requirement for counterparties to agree the model being used between themselves. It is not clear what this would involve. We would suggest that models are disclosed to counterparties prior to trading, rather than agreed.

Yours sincerely,

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