THE INVESTMENT ASSOCIATION INVESTMENT MATTERS

THE INVESTMENT ASSOCIATION RESPONSE

SECOND CONSULTATION PAPER

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

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

We welcome the proposed clarifications to Article 2 GEN and agree that the margin requirements should not apply to Third Country Entities (TCEs) that would be non-financial counterparties below the clearing threshold if they were established in the EU.

<u>Suggestion:</u>

In addition we request the ESAs provide an exemption from the margin requirements for an entity's Over The Counter (OTC) derivatives with parties in "non-netting jurisdictions" for up to 5% of the entity's OTC derivatives (measured by notional amounts). "Non-netting jurisdictions" are those in which it is not possible to get a clean netting opinion.

<u>Explanation:</u>

For non-netting jurisdictions, market participants typically do not employ collateral as a risk mitigant. Without enforceable netting there is the risk that the administrator of an insolvent counterparty will "cherry-pick" from posted collateral to be returned in the event of insolvency, which will result in an increase in the risk in posting collateral. In the context of segregation, the consultation paper suggests (Recital 8) that "counterparties should identify alternative processes … such as relying on third party banks or custodians domiciled in jurisdictions where [the requirements of the RTS] can be guaranteed." However, a party in a non-netting jurisdiction (a "Non-netting Party") may be subject to local insolvency proceedings and such proceedings may affect the treatment of margin posted by or held (directly or indirectly) by the Non-Netting Party. Use of a third-party custodian in a different jurisdiction may not remedy issues with the legal enforceability of collateral.

Imposing the margin requirements on OTC derivatives with Non-netting Parties will severely limit such OTC derivatives. Such a limitation will cause significant disruptions in financial markets and prevent hedging and financial flows between the EU and Non-netting Jurisdictions. Moreover, requiring collateral collection may prevent parties from using more effective alternative mitigations such as limits to contain exposures, frequent re-pricing of trades, selling options and using short dated trades.

Moreover, while these OTC derivatives are important for individual Non-Netting parties and Non-Netting Jurisdictions, the overall volume of such OTC derivatives is relatively small compared to the total volume of OTC derivatives entered into by EU counterparties. By limiting the total volume of such exempt OTC derivatives to 5% of the firm's OTC derivatives, the ESAs will limit the systemic impact of the exemption.

Article 11(3) and Article 11(15) of EMIR allow the ESAs and the Commission flexibility in setting the scope of the mandatory margin requirements. Art. 11(3) is not expressed in terms that require a Financial Counterparty (FC) or Non-Financial Counterparty (NFC)+ to require an exchange of margin with respect to all their relevant contracts. Art. 11(3) requires FCs and NFC+s to have procedures for the exchange of collateral for the portfolio of contracts covered by Art. 11(3) but that does not mean that those procedures require margin to be collected for each and every contract. We believe the ESAs have recognised this flexibility by exempting OTC derivatives with non-EU NFC-s from the margin requirements. We ask that the ESAs use this flexibility in connection with derivatives with Non-Netting Parties.

In addition, we note that there is precedent in the US for the 5% exemption described above. In its cross-border guidance, the Commodity Futures Trading Commission (CFTC) exempted swaps from US transaction-level requirements if the swaps are between a non-US branch of a US swap dealer and a non-US counterparty (located outside Australia, Canada, the EU, Hong Kong, Japan or Switzerland) if the aggregate notional value of such swaps is less than 5% of the total and if the US dealer maintains records and addresses the risks that may arise from the non-application of the US transactional requirements.[1]

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

We note that the second consultation paper continues to propose that the variation margin requirement apply to Foreign Exchange (FX) forwards.

There are concerns around operational timing about this proposal, in particular, FX forwards. If one counterparty is out of the money on a transaction leading up to settlement date, it will have been obliged to collateralise the exposure of the trade. On settlement date, the final payment will also be required, however, due to the nature of the collateralisation process, the collateral would not have yet been returned and the collateral would not be able to be used to facilitate settlement of the transaction; thus exposing the paying party to a temporary period of uncollateralised risk. This may also create liquidity issues for the firm.

[1] CFTC, Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 FR 45292 at 45351. See also the CFTC Clearing Exemption, 78 FR 21750 at 21784 (Sec. 50.52(b)(4)(iii)) for another 5% exemption from certain requirements for swaps located outside the US, EU, Japan and Singapore.

In light of the above, there would be additional requirements on funds to hold cash of up to double the maximum negative exposure of a particular FX Forward, this will limit the fund's ability to trade and will be operationally cumbersome.

We believe that the March 2015 BCBS-IOSCO paper on Margin requirements for non-centrally cleared derivatives provides the framework for the European Supervisory Authorities to apply additional flexibility to the variation margining of physically-settled FX forwards. We also note that equivalent rules proposed by the regulators in the United States do not propose to impose variation margin on FX forwards. In our view, it is important that the domestic implementations of the BCBS-IOSCO framework are consistent with one another and do not dissuade pension funds from employing FX forwards to prudently manage foreign exchange risk. We believe that ESAs should reconsider this requirement.

A further general concern relates to the requirement to post margin within certain timeframes. This is expressed as an absolute requirement, whereas the text of Article 11(3) only requires counterparties to have in place risk management procedures which require the timely exchange of collateral. We note that the fact that the obligation under Article 11(3) relates to the establishment of risk management procedures which require certain outcomes is reflected in other Articles of the RTS. There is therefore no allowance for the fact that even the margin delivery timeframes may be breached for reasons beyond the control of the collector of the margin, such as where the poster does not post or settlement failure due to custodian or depository actions or delayed trade confirmation. In each of these cases the collector of the margin will potentially be in breach of the regulations as currently drafted even if their risk management systems are such as to require collection of margin within the timeframes specified. We do not think that this is the intention of EMIR.

We note that the ESAs have opted not to modify their approach on Initial Margin (IM) from the first Consultation Paper (CP) and that Article 1 EIM (3) would require counterparties to *"calculate and collect the total amount of initial margin within one business day"*. We request that the ESAs amend this language to provide that the collateral taker must make a demand for IM no later than the end of the business day following the execution of a new derivative contract.

The word "within" could be interpreted to suggest that the RTS is envisaging a rolling 24-hour period that starts to apply from execution of the relevant derivative contract, which could necessitate intraday collection of IM (e.g., where parties execute multiple contracts during a business day). Intraday posting of collateral is burdensome for both counterparties and would represent a substantial shift in current market practice. Since we do not believe that the ESAs intend such intraday collection of IM, we would appreciate clarity in the final text on this point.

The ESAs propose greater flexibility in respect of VM in the current Consultation Paper. Article 1 VM (3) requires that "[v]ariation margins shall be collected within three business days from the calculation date". In addition, Article 1 VM (4) provides that for all netting sets for which the collection of VM can exceed one business day, the margin period of risk shall be increased by the number of days in between the calculation and the collection. Lastly, Article 1 VM (5) provides that where the RTS do not require any IM to be collected, the collection of VM should not exceed one business day.

The Investment Association welcomes this additional flexibility. However, we note that because settlement periods for certain types of collateral permitted by the RTS are longer than one day, Article 1 VM is effectively prohibiting counterparties from using such forms of collateral, unless they agree to transfer additional amounts of IM in order to qualify for the three business day settlement period.

Further clarity is required on the obligations set out in Article 1 VM(3) and (5), in particular to take account of the settlement periods for non-cash securities.

We would expect a typical counterparty:

- To calculate its exposure at the end of day T.
- To call for variation margin during the day of T+1.
- To collect variation margin by the end of T+2 for high quality government securities settled on a Delivery Versus Payment (DVP) basis (or a longer settlement period for certain asset types).

On its face, Article 1 VM(5) requires the collection of variation margin by T+1. Whilst we believe it is possible to call for variation margin by T+1, the operational process required to source and transfer collateral means that it is not practicable to have transferred and/or have collected the variation margin by T+1; we note that this concern is expressed in the text of the consultation. It is our view that Article 1 VM(5) should be deleted and that the general rule in Article 1VM(3) should apply to all transactions (subject to our comment on collection below).

Both Article 1VM(3) and (5) impose an obligation to “collect”. It is not clear what ramifications there are for a collecting counterparty if (for example) an operational failure causes a settlement failure and the relevant timelines to be breached; we would welcome further clarity on this aspect of the draft rules.

One further issue the ESAs have not addressed in the current Consultation Paper is whether the VM collection requirement is deemed to have been met when the collecting party has exposures to the posting party that fall outside of the scope of the RTS.

For example a counterparty that has voluntarily posted IM on a title transfer basis and then receives a portion of that margin back as a VM payment (such that it remains a net poster of collateral). Has the counterparty satisfied the requirement to collect VM? From comments at the Public Hearing on the Second Consultation Paper held on 18 June 2015, we understand ESMA's view to be that the VM collection requirement would be met in this scenario, given that the rules are focused on whether there has been a transfer of value to satisfy the VM obligation, not the amount of the net exposure between the counterparties. We would welcome the ESAs' confirmation of this point. Given its significance, we suggest that specific reference to this matter is included in the RTS as a recital.

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

For an asset manager, where categorisation takes place at a Legal Entity Identifier (LEI) level, it is possible that certain entities under the umbrella of the asset manager will be required to meet margining obligations prior to others. From an implementation stand point this may represent an unintended consequence.

We support the introduction of the provision at Article 1 MRM (4) that stipulates that "[a]t the request of one the two counterparties the other counterparty shall provide all the information necessary to explain the determination of a given value of initial margin" in a way that permits the replication of the calculation.

We are also pleased to see the introduction of Article 6 MRM (2)(a), which provides that the documentation of the risk management procedures of a party subject to the RTS should be sufficient to enable the reader to "understand the design and operational detail of the initial margin model". However, we do not agree with the ESAs' proposal for the aforementioned information and documentation to be based on information which would be sufficient to enable a "knowledgeable third-party" to replicate the calculation or understand the design and operational detail of the IM model. We are concerned that this test is unclear and would be difficult to apply in practice. We suggest instead that the "knowledgeable third-party" test be deleted and that Draft RTS require that: (i) the information and manner of explanation under Article 1 MRM (4) be sufficient to allow "the requesting counterparty" to be able to replicate the calculation; and (ii) the documentation under Article 6 MRM (2)(a) be sufficient to ensure that "their counterparty" would be able to understand the design and operational detail of the IM model.

We also request clarification on the extent to which netting of IM is permissible under the Draft RTS. Article 1 GEN (3)(a)(i) provides that the collection of IM shall be "without the possibility of offsetting the initial margin amounts between the two counterparties". This provision appears to prohibit the netting of IM. In contrast, Article 4 MRM (3) provides that the total IM requirements for a netting set shall be "the sum of initial margin requirements calculated for the OTC derivative contracts assigned to each underlying asset class within the netting set". This reference to 'netting set' appears unnecessary and potentially ambiguous.

The Investment Association supports netting because effective netting arrangements lower systemic risk by reducing both the aggregate credit exposure of the posting party arising from any requirement to deliver margin and the trading costs for market participants. Moreover, permitting netting across a wide variety of offsetting exposures, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (1) allow entities to make efficient use of their capital; (2) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the derivatives markets; and (3) reduce complexity and settlement risk. Accordingly we support the netting of IM within asset classes of derivatives as contemplated in the BCBS/IOSCO Standards and encourage the ESAs to clarify that the RTS conform to the BCBS/IOSCO Standards in this regard.

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

In the current Consultation Paper, the ESAs recognise that some market participants might have constraints in posting collateral different from government debt securities and adopt the revised position that, for this particular asset class, the diversification requirements should only be applied to systemically important institutions or those with large collateral portfolios.

We appreciate ESAs' efforts to reduce the scope of the concentration rules, however we do not support the current formulation and believe a reconsideration is needed. We feel that the concentration rules go over and above the international standards set by BCBS-IOSCO, creating inconsistencies with rules set by other international regulators. Separately, we believe the current proposal would introduce significant unintended consequences and practical issues.

We set out below the unintended consequences these rules would present, firstly to all market participants, and secondly to pension schemes.

Issues with the current proposal relating to all market participants:

- We believe that the proposed issuer concentration limit, when applied to sovereign bonds issued by EU governments outside the Eurozone, would have significant adverse implications specific to users of non-euro-denominated OTC derivatives and would introduce material new risks. This would include, for example, derivatives denominated in British sterling, the Polish zloty, the Hungarian forint and the Swedish krona.

- The proposed concentration limits, when combined with the proposed FX haircut set out in paragraphs 6 and 7 of Annex 2, will disproportionately affect entities based in the European Union but outside the Eurozone.

- Derivative valuations are directly linked to the format of the underlying collateral that is used for margining the derivatives. It is not clear how derivative valuations would work in the situation where there is collateral mix of 50% in one jurisdiction and 50% in another jurisdiction or cash. It is likely that end-users would receive valuations based off the worse valuation curve in this scenario.

- The concentration rules are likely to result in rules that may not be possible to implement for transactions with buy-side clients with more than one asset manager and/or mandates. At best, if it can be implemented, we feel that it is likely to lead to significant delays in the settlement of margins, which is contrary to the overall objective of the RTS and prudent risk management.

  Our members currently post daily variation margin on a T+1 basis for most derivatives products. It is not clear how these complex concentration rules could be applied in situations when clients have more than one asset manager or more than one mandate. First, the calculations would need to be done across all asset managers, all mandates, and all groups of the buy-side client to determine if the initial margin collected goes above EUR 1bn to determine if the entity is in-scope for the concentration rules (Article 7 LEC 3(c)).

  Then, either simultaneously or immediately afterwards, a calculation must be done to calculate the total VM and IM across all asset managers, all mandates and across all groups, to determine how much of the total VM and IM goes above EUR 1bn (Article 7 LEC 2).

  Finally some form of further communication needs to happen across all managers and/or the client to ensure that the 50% concentration rule is met. It is difficult to envisage how this could be implemented in practice. If such requirements were put in place it is likely they would lead to significant delays to the settlement of margins, which goes against the objective of prudent risk management.

  We note that as banks are typically on the other side of the transaction with buy-side clients, this issue would impact not just the buy-side clients but also banks; who would be required to post collateral in the relevant format so that the buy-side client could meet the 50% concentration requirement rules on collateral that it collects.

- We are concerned the practical and timing implications of the complex concentration rules and question how they could be operationalised for transactions with end-users. Any end-user subject to the initial margin rules is likely to only become in-scope for the initial margin rules from 2020.

It is unlikely that an end user would have EUR 750bn of non-cleared derivatives, but it is possible that an end-user could have EUR 8bn of non-cleared derivatives. Based on this, an end-user could only become in-scope for any concentration rules from 2020 (based on Article 7 LEC 3(c)).

Once an end-user is in-scope for the concentration rules, it would apply to not only IM but also VM However it is not clear if this would apply to previously posted VM or just VM posted from the date when the entity becomes in-scope for the concentration rules.

If the rules are intended to be applied to all VM including previously posted VM this would create a “big-bang” date and it would likely create significant disruption. It’s not clear how market participants could readjust the collateral mix that has been already posted. Furthermore, readjusting the collateral mix for derivatives contracts would impact derivative valuations for previously traded derivative contracts.

If the rules are intended to capture only the VM posted from the date when the entity becomes subject to the concentration rules, it is not clear how this could work in practice. It is difficult to envisage how we could implement two different VM calculations taking into account different time periods.

Note that a transaction between a bank and an end-user would become subject to the concentration rules at the point when the end-user becomes an in-scope entity, as the bank is already likely to be a systemically important institution. Therefore the timing issue described above in relation to when the concentration rules would come into effect for a transaction would be an issue not just for the end-users but also for the bank on the other side of the transaction.

Issues with the current proposal relating to pension schemes (or pension scheme arrangements as defined in EMIR level 1):

- While the current ESAs’ proposal tries to bring into scope only systemically important institutions, Article 7 LEC 3(c) brings into scope entities that are not systemically important institutions. This Article brings into scope any counterparty that collects initial margin in excess of EUR 1 billion, which would capture large pension schemes.

  Pension schemes are not systemically important institutions and should not be treated as such. As part of their requirement to prudently manage risk, pension schemes use derivatives to manage financial solvency and reduce the risk that they become financially insolvent. Pension schemes are asset-heavy, do not take large amounts of leverage and are focused on managing their financial solvency to pay current and future pensioners’ retirement incomes.

- The impact of the concentration rules would be significant for pension schemes that are domiciled within the EU but not in the Eurozone, for example the UK. Pension schemes in the UK hold a significant amount of sterling UK government bonds (gilts). These gilts provide interest rate and inflation risk protection against the liabilities of UK pension schemes and therefore play an important role in managing their financial solvency.

  Other EU government bonds would not provide this protection against these liability risks as EU government bonds are not denominated in sterling and are not linked to UK interest or inflation rates. A UK pension scheme required to comply with the proposed concentration limits would likely have to convert some of its gilts into non-UK bonds, introducing additional currency risk, counterparty and financial solvency risk. The net effect of the concentration rules on large pension schemes would therefore be to increase risk, rather than reduce it, for pension beneficiaries, the sponsor corporate responsible for the employee pension schemes, and the financial system overall.

- The proposed concentration rules would force pension schemes to either take more risk or hold more cash, going against an EMIR level 1 policy objective. In order to comply with the concentration limit requirement without introducing currency risks, a UK pension scheme would need to hold cash instead of gilts. Holding cash would introduce significant performance drag for pension funds.

  The EMIR level 1 text already recognises that pension schemes do not hold cash and should not be forced to hold cash. The temporary relief for pension schemes from the central clearing obligation is a reflection of pension schemes' inability to post cash for variation margin required in central clearing. We feel that these concentration rules would effectively force large UK pension schemes to either a) take unwarranted risk or b) hold cash introducing significant performance drag for underlying pensioners.

We therefore believe that the concentration limits, even in their modified form, continue to be of concern and should be removed for pension schemes.

Many market participants satisfy their entire collateral obligation by posting government bonds issued by a single issuer because such bonds are highly liquid even under stressed market conditions. As a result, imposing a 50% concentration limit on such collateral would deviate from many market participants' current practices and create numerous practical difficulties. For example, it could necessitate counterparties posting securities of at least three issuers because it would be difficult for a party to manage an equal division of collateral between two issuers due to fluctuations in the value of the relevant government debt. It would likely also encourage counterparties to post cash rather than securities as collateral.

Additionally, imposition of a 50% concentration limit on high quality government debt could force market participants that, for example, hold principally securities issued by one government issuer to enter into collateral transformation transactions in order to convert a portion of the debt into another asset (generally cash) that they can post as collateral in compliance with the concentration limits. Such transformation transactions are costly, involve their own risks, and can effectively result simply in shifting risk from one collateralised market to another collateralised market.

We also note certain inconsistencies in the drafting of the relevant provisions, as set out below:

- Recital (27) of the draft RTS suggests that none of the concentration limits apply to entities which are not systemically important or have a collateral portfolio greater than EUR 1 billion , whereas Article 7 LEC makes it clear that it is only the concentration limits in respect of government debt which only apply to these entities. We request that the ESAs amend recital (27) accordingly.

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

We are concerned that the independent legal review requirement, if performed on an annual basis, would represent a significant and onerous operational cost. Our members should be able to rely on the netting opinions published by ISDA, the concept being that they can discharge this obligation by checking that there are ISDA netting opinions covering the jurisdiction(s) in question and confirming that the netting is operational and effective.

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

The Investment Association supports the amendments made in the second consultation paper to clarify that an independent legal review in respect of segregation arrangements operates at the level of arrangements “in each jurisdiction” (Article 1 SEG (5)).

In comments made at the Public Hearing on the Second Consultation Paper held on 18 June 2015, representatives of the ESAs indicated that the “independent legal review” referred to in Article 1 SEG (5) could be completed by an independent department within the same legal entity (i.e., the legal function). This position is reinforced by the comment in the explanatory text for consultation that notes the need to comply with the “fundamental due diligence principle of producing an internal assessment of the reliability” of those agreements. We would encourage the ESAs to clarify this point by appending the following wording to the drafting of Articles 1 SEG (5) and 2 OPD (2): “[…].The independent legal review may be performed by the counterparty’s internal legal function or external legal counsel.”

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

We would encourage further clarity on what can be purchased and a list of collateral that is deemed eligible by the ESA's. We consider this provision creates unnecessary counterparty risk.

In respect of the approach taken in the Second Consultation Paper, we support the ESAs' efforts to develop a framework in which it is possible to post IM in the form of cash (to the extent it can be effectively segregated). We are not convinced, however, that market participants will in practice be able to make use of this possibility, given the cost implications that will arise and the complexities of managing collateral requirements where market movements will impact the value of collateral which has been converted from cash into securities, and the application of haircuts. In addition, there are also issues relating to the possible breach of the segregation requirements during the period between when the cash is posted and when it can be converted.

<u>Suggested Language:</u>

Article 1 REU (p. 48, 49):

1. The collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.

2. Initial margin posted in cash can be (A) held in cash if segregated from the proprietary assets of the collecting party or (b) re-invested by the collecting counterparty or the custodian only for the purpose of protecting the collateral poster (or re-invested by a custodian holding initial margin on behalf of the posting party), and subject to an agreement between the counterparties. The re-invested collateral shall be treated in accordance with Articles 1 LEC and 1 SEG [segregation and eligibility].

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

Suggested Language:

Annex II (6) and (7) (pp. 57, 58):

6. "Where the agreement between the two counterparties includes a termination currency, the counterparties shall apply a haircut of 8% to the market value of the non-cash assets where the collateral posted as initial margin is denominated in a currency other than the termination currency. Where the agreement does not identify a termination currency, the haircut will apply to the market value of all the non-cash assets posted as collateral for initial margin. Parties may specify different termination currencies for each party. "

7. "Where the agreement between the two counterparties includes a transfer currency, the counterparties shall apply a haircut of 8% to the market value of the non-cash assets posted as collateral for the unsettled variation margin where the collateral is denominated in a currency other than the transfer currency of the variation margin. Where the agreement does not identify a transfer currency, the haircut will apply to the market value of all the non-cash assets posted as collateral for the unsettled variation margin. Parties may specify different transfer currencies for each party. "

Explanation:

The language clarifies that cash collateral is not subject to the 8% haircut. This is consistent with Recital (11), p. 19, which indicates that cash collateral is not subject to any haircut.

In addition, the proposed language makes it clear that each party can specify its own termination currency and transfer currency. This is important because there are funding challenges if firms are forced to post in a termination or transfer currency which does not match what is available to them.

For example, for a Japanese entity posting IM in Japanese government bonds ("JGBs"), the termination and transfer currency should be Japanese Yen ("JPY") rather than US Dollars ("USD"), which is likely to be the default termination and transfer currency for US-based dealers. In this scenario, the Japanese entity would post JGBs and the US entity would post US Treasuries ("UST"). If the agreement specifies USD as the termination/transfer currency, then the US entity would not be able to accept JGBs without imposing the additional 8% haircut on the collateral posted by the Japanese entity, and the Japanese entity would have higher funding costs if it delivered USTs.

To avoid this, our proposal would be to designate a termination and transfer currency for each party that can match the collateral they are expecting to post. Continuing our example, we would designate the termination currency and the transfer currency as JPY where the termination amount (before applying any IM) was payable by the Japanese entity to the US entity, and USD where it was payable by the US entity to Japanese entity.

We have previously noted that the proposed 8% haircut to the market value of assets where the collateral currency is different from the settlement currency should not apply to cash collateral. Cash is the most liquid type of collateral that market participants can post such that even in stressed market scenarios cash retains its liquidity. We, therefore, very much welcome the approach the ESAs adopted in the Second Consultation Paper, which clarifies that “[a]s cash for VM is considered the pure settlement of a claim, this should not be subject to any haircut”.

Nonetheless, the provision setting out the proposed 8% haircut with respect to VM refers to “assets posted as collateral” and does not clarify that such assets are non-cash assets only.

Similarly, the ESAs should amend Annex II, paragraph 5 of the draft RTS to carve out cash IM subject to the 8% haircut. At present, neither the VM nor the IM provisions identify the types of assets that are subject to the 8% haircut, and we are concerned that these provisions could cause confusion for market participants that are trying to implement them.

Finally, we note that the ESAs have replaced the references to the “settlement currency” in the First Consultation Paper with references to the “termination currency” (with respect to IM) and to the “transfer currency” (with respect to VM). The meaning of the term “transfer currency” is unclear, particularly as counterparties may divide their transactions into separate currency portfolios and post collateral in the currency of those portfolios.

The Investment Association continues to be concerned that the draft Regulatory Technical Standards (“RTS”) are unduly burdensome on EU pension funds and other institutional investors undertaking currency hedging, to the extent of discouraging some investors from undertaking this prudent risk management activity.

Currency hedging by pension funds is almost universally undertaken with a portfolio of foreign exchange forwards and foreign currency swaps (as referred to in Article 5 GEN (a) and (b)), since these instruments offer pension funds the ability to tailor contract maturities to meet their own liquidity schedules, unlike for example vanilla futures contracts. Furthermore these instruments allow for well-established risk mitigation techniques, including diversification by counterparty to reduce pre-settlement risk, master agreements with netting clauses to minimise pre-settlement risk in the event of default, and the use of Continuous Linked Settlement effectively to eliminate settlement risk.

Specifically, the combination of the following factors makes the RTS excessively burdensome:

1) the inclusion of pension funds within the definition of “financial counterparties” (Article 1 GEN 1);
2) an exemption for collecting initial margin on foreign exchange forwards and foreign exchange swaps (Article 5 GEN (a) and (b)) but no equivalent exemption for variation margin;
3) the maximum threshold for parties to agree not to collect variation margin (the “minimum transfer amount”) being set at EUR 500,000 (Article 4 GEN 1) which is unlikely to provide any relief for pension funds since a currency hedging portfolio of EUR 100 million would be modest in the context of EU-wide pension funds, and a daily currency move of 0.5% would not be excessive;
4) the phase-in requirements for variation margin being on a shorter timescale, than that for initial margin such that all counterparties will be required to comply by 1 March 2017 (Article 1 FP 6 (b)).

It is counterintuitive that pension funds (either directly or via a professional manager) undertaking a responsible risk management activity should be required to comply with variation margin requirements, on a timescale faster than that being applied to initial margin requirements, and to have to do so despite a likely aggregate notional amount of non-centrally cleared derivatives which would wholly exempt them from initial margin requirements. Since the requirement to collect and receive collateral on a daily basis will be sufficiently operationally burdensome to deter some clients altogether, this proposal seems set to increase, not decrease risk within EU pension funds.

We consider this requirement is at odds with international standards. In the United States, foreign exchange forwards and foreign exchange swaps have been exempted from regulation as "swaps" by the Secretary of the Treasury and therefore are not, and will not be, subject to margin requirements for uncleared swaps, absent Congressional action. The RTS would therefore require EU banks to exchange variation margin on foreign exchange forwards and foreign exchange swaps with a counterparty in a third country, when there is no such requirement imposed on banks established in the United States or elsewhere. This would put EU banks at a competitive disadvantage.

We would propose the following range of additional amendments to the RTS, starting with that which we believe would be the most effective:

1) exempt pension funds from the RTS, in a manner analogous to the exemption granted to pension funds from central clearing requirements for certain over-the-counter derivative contracts; failing which
2) apply the EUR 8 billion minimum aggregate average notional amount of non-centrally cleared derivatives to variation margin as well as initial margin;
3) materially increase the EUR 500,000 minimum transfer amount threshold in Article 4 GEN 1 to e.g. EUR 5 million or a percentage of the notional amount of exposure to a single counterparty such as 5%; failing which
4) align the implementation timetable for variation margin with that for initial margin, so as not to impose the greater implementation burden on those least likely to benefit.

We urge the European Supervisory Authorities to re-consider the proposed requirement for counterparties to exchange variation margin on foreign exchange forwards and foreign exchange swaps entered into by pension funds that are objectively measurable as reducing investment risks directly relating to the financial solvency of these funds.