afme/
Finance for Europe

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The European Securities and Markets Authority
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The European Banking Authority
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The European Insurance and the Occupational Pensions Authority
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Submitted via: http://www.eba.europa.eu/

Dear Sirs

**Response to Second Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP**

AFME welcomes this opportunity to respond to the Second Consultation Paper on 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 "**Second Draft RTS**").

On 14 July 2014, we submitted a response to the First Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP (the "**First AFME Response**"), in which we set out a number of concerns which AFME members have in relation to the first draft RTS:

- on issues which are of direct relevance for prime brokerage businesses; and
- on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP as they would apply to swaps entered into by a securitisation issuer in connection with a securitisation ("Securitisation Swaps").

Key issues for prime brokers

With regard to the prime brokerage issues raised in the First AFME Response, we are concerned that these have not been addressed, namely: (i) to permit initial margin models to account for risk reductions and risk offsets provided by other products subject to legally enforceable netting arrangements and supervisory approval of the correlation assumptions; (ii) it would be beneficial to all parties to offer optional segregation of initial margin rather than to require mandated segregation; and (iii) a ban on rehypothecation should not be introduced. Further, the Second Draft RTS raises additional AFME prime brokerage concerns, which we have explained in detail in our response to the specific questions in the Second Joint Consultation which is set out in the Annex. In summary these are:

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- *the proposed concentration limits for initial and variation margin are unduly restrictive* and would introduce significant constraints, especially for smaller institutions. We suggest that the diversification requirement should only be applied to systemically important institutions for all asset classes; and

- *the requirement for initial margin collected to be segregated in a manner such that it is bankruptcy-remote from the third-party holder or custodian* would result in a de-facto ban on the use of cash as initial margin.

The European Commission's February 2015 Green Paper on Capital Markets Union ("**CMU**") indicates the importance of collateral fluidity and efficiency. In our view, these provide a mandate to address and remedy our concerns.

<u>Key issues for Securitisation Swaps</u>

One of the issues raised in the First AFME Response was the application of the draft RTS to Securitisation Swaps where the issuer is incorporated in a non-EU jurisdiction but which would otherwise have been a non-financial counterparty below the clearing threshold (i.e., a "**NFC-**") if it was incorporated in the EU. We note that the Second Draft RTS has now addressed this issue by providing that a third country entity should be classified as it were an EU entity for the purpose of determining whether parties which enter into derivatives with that third country entity will be required to post collateral. AFME welcomes this positive development.

Unfortunately, however, the other concerns which we raised in relation to the application of the draft RTS to Securitisation Swaps have not been addressed. This is disappointing, given that in the First AFME Response we set out in detail the reasons why it is difficult, if not impossible, for Securitisation Swaps to be structured in a way which would allow for the posting of collateral in accordance with the draft RTS. We also provided reasons as to why the structural features of securitisations and Securitisation Swaps already contain risk mitigation features which are consistent with the requirements of Article 11(3) of EMIR.

We also note that, on 8th June 2015, as part of his remarks addressing Capital Markets Union ("**CMU**"), Commissioner Jonathan Hill reinforced the need to promote a consistent European framework for simple and transparent securitisations by stating that he would publish an Action Plan in September which would "include a comprehensive package on securitisation …".

We therefore urge the Joint ESAs to co-ordinate with the Commission to ensure that the issues set out above are indeed addressed and remedied in the draft legislative instrument(s) being prepared for publication in September 2015.

<u>Conclusion</u>

In this letter, we have not repeated the issues discussed in the First AFME Response in detail. However, in addition to our new concerns, we do urge the Joint ESAs to consider the First AFME Response again as part of the consultation on the Second Draft RTS.

We also urge the Joint ESAs to take into account the ongoing EMIR review, to which AFME will be responding in due course.

Thank you again for the opportunity to provide our views on the Second Draft RTS. We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis.

If you have any questions, please do not hesitate to contact either Sid Ulker (sidika.ulker@afme.eu; +442077439305) with questions relating to prime brokerage or Anna Bak (anna.bak@afme.eu; +442077439314) with any questions relating to Securitisation Swaps.

Yours faithfully

**Anna Bak, Manager**
**Securitisation**

**Sid Ulker, Director**
**Capital Markets**

**Annex: AFME response to questions**

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

Under Article 4(1) MRM of the Second Draft RTS, initial margin models may account for diversification, hedging and risk offsets but only for uncleared OTC derivatives in the same netting set. As set out in the First AFME Response, we believe that this proposal is unduly restrictive because it would appear to prohibit cross-product margining, including that offered by prime brokers, under which the prime broker calculates the applicable initial margin requirement across multiple products (including cleared and uncleared derivatives and cash bond and equity positions) taking into consideration risk reductions and risk offsets between such products. .

Where these risk offsets reflect the position that would be achieved on a default of the counterparty (for example, where the prime brokerage agreement allows close-out netting across all products), the risk is reduced and the initial margin requirements should reflect this.

Prohibiting these offsets would lead to significant adverse consequences in that a prime brokerage client may be required to post significantly more collateral than appropriate given there may be lower risk across all products, reducing the efficiency of the service they receive.

We also note that enabling fluidity and facilitating the increased demand of collateral is a key objective within the European Commission's Green Paper on CMU. Introducing a margin regime whereby more collateral is held than necessary (through restrictions on cross-product margining) would result in less availability and fluidity of securities in the financial system, contrary to the objectives of the CMU.

We recommend that the Second Draft RTS be modified to permit initial margin models for uncleared derivatives to account for risk reductions and risk offsets provided by other products subject to legally enforceable netting arrangements and supervisory approval of model correlation assumptions.

AFME proposes the following amendment:

**Article 4 MRM**

1. ~~Initial margin models shall include only OTC derivative contracts not centrally cleared.~~ Initial margin models may account for diversification, hedging and risk offsets arising from the risks of OTC derivative contracts that are in the same netting set. Initial margin models may account for diversification, hedging and risk offsets (i) within the same underlying asset class referred to in paragraph 2 and not across such classes, or (ii) by reference to other products subject to legally enforceable netting arrangements and regulatory approval of model correlation assumptions.

***Concentration limits for initial and variation margins***

**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.**

The Second Draft RTS has recognised that participants may find it difficult to diversify the collateral that they post. AFME supports both concentration limits and the proposed solution in the Second Draft RTS with regards to government bonds. However, we note that the problems which arise from a restrictive concentration limit framework under Articles 1(7)(a) and (b) LEC are not limited to government bonds or to particular counterparties. This is consistent with Recital 27 of the Second Draft RTS, which is non-asset class specific: "*concentration limits on collateral might be burdensome for counterparties with small OTC derivative portfolios. Therefore, even though collateral diversification is a valid risk mitigant, non-systemically important counterparties should not be required to diversify collateral*".

The proposal of a 40% limit on securitisation, convertibles and equity and 10% limit in an exposure on other permitted collateral by entity name or by group would be unduly restrictive, especially for smaller institutions. It is important that investors are not forced to hold assets that do not correlate to their investment strategies. Further, these restrictions would lock-up certain types of collateral subject to special treatment even further (i.e. government bonds), exacerbating the impact on collateral fluidity and efficiency in the financial system.

We suggest that the limit on the diversification requirement (i.e. applying only to systemically important institutions) should apply for all types of eligible collateral. The limits as proposed introduce further collateral restrictions on an already collateral constrained financial system, such as balance sheet restrictions under the European prudential regime.

We suggest Article 7(1) LEC be removed and Article 7(4) LEC be amended to include all eligible collateral.

***Treatment of collected initial margins***

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

The Second Draft RTS proposes an obligation to segregate initial margin in such a manner so that it is remote from the default and insolvency of a third-party holder or custodian (as well as the counterparty). This requirement is of significant concern because it would not permit holding of cash through a third party, and would thereby result in a de facto ban on cash as eligible for IM, even though cash is listed as eligible collateral in the Second Draft RTS. We believe that this would be contrary to the BCBS IOSCO proposals, which clearly contemplate the importance of cash posting.

It is not possible to achieve the proposed requirements in respect of cash because the return of the cash is inherently linked to the solvency of the third party holder or custodian as banker. Third party holders/custodians treat cash received "as banker" and, as such, the collateral provider becomes an unsecured creditor of the third party holder/custodian. As such, the requirement removes the ability for custodians to hold cash collateral by imposing onerous reinvestment requirements.

Our understanding is that the intention of this requirement is to remove third party credit risk (i.e. the credit risk of the third party holder/custodian). Protecting the posting party from the default of the collecting counterparty would be achieved by segregating cash IM from the proprietary assets of the collecting counterparty. Neither the G-20 mandate nor the BCBS IOSCO framework envisage protecting margin from custodian related risk.

Further, introducing such an onerous restriction does not in fact remove third party credit risk. Third party credit risk is built into most collateral (for example, credit risk of the issuer is built into a corporate bond held as collateral). It is not clear why custodian credit risk is being treated differently in this regard. There are other routes to the mitigation of custodian risk which do not inhibit the ability to use cash collateral. The principle aim of this area of the margin requirements is to mitigate counterparty risk, not to address other credit risks inherent in the collateral.

We strongly suggest that posting cash as IM should be permitted as long as the other requirements of the Second Draft RTS, notably removing risk from one of the parties' defaulting, are satisfied. In particular, there should not be a ban on custodians holding cash IM and parties should have their own policies to deal with this risk (such as thorough due diligence and credit checking of custodians), as they are incentivised to do.

We endorse ISDA's proposed amendments as follows:

Article 1 SEG (p. 48)

1. Collateral collected as initial margin shall be segregated from proprietary assets of the collecting counterparty on the books and records of a third party holder or custodian, or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty. Such requirements to segregate the collateral from the proprietary assets of the collecting counterparty are satisfied where the collateral is held in an account in the name of the posting counterparty and is secured in favour of the collecting counterparty. The arrangements will also protect collateral other than cash from the default or insolvency of the~~,~~ third party holder or custodian.

2. Where the collateral is held by the collecting party or by a third party holder or custodian on behalf of the collecting party, t~~T~~he collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties ('individual segregation').

~~3. Where initial margin is collected in cash it shall be segregated individually, unless the collecting counterparty has legally binding arrangements in place to segregate it from proprietary assets.~~

~~4.~~ 3. The segregation arrangements shall ensure that the initial margins are available to the posting counterparty in a timely manner in case the other counterparty defaults.

~~5.~~ 4. A counterparty shall perform an independent legal review ~~at least on an annual basis~~ in order to verify that the segregation arrangements meet the requirements referred to in paragraph~~s~~ 3 ~~and 4~~ and always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

Art. 2 LEC (1)(d) (p. 39):

(d) cash accounts in all the acceptable currencies are maintained with a party other than the collateral provider for depositing cash collateral collected as initial margin and for crediting the proceeds of repurchase agreements on the collateral (and such cash accounts may include accounts maintained by a custodian in the name of the collateral provider);

Art. 2 LEC (1)(g) (p. 40):

(g) the collateral shall be transferable without any regulatory or legal constraints or third party claims, including those of the liquidator of the collecting counterparty or third party custodian (other than liens for fees and expenses incurred in providing the custodial accounts);

Finally, we are concerned that the requirement for an independent legal review to be carried out on an annual basis is impractical, costly and operationally onerous. This is because there may be a multiple jurisdictions to consider as well as different insolvency and netting regimes on the particular counterparty type. We would suggest keeping the legal review requirement but removing the obligation for this to be performed on a periodic basis.

**Question 7. Does this approach [with regards to re-investment of cash] address the concerns on the use of cash for initial margin?**

AFME agrees with the ESAs that the requirements should not restrict the use of cash as collateral for IM. We suggest that if cash is segregated from the proprietary assets of the collecting party then this is also sufficiently effective to ensure that the use of cash will not expose the counterparty to the credit risk of the collecting party. Further, reinvestment involves complexity, including the operational elements of the reinvestment and monitoring compliance with any eligibility constraints, such as concentration limits.

Finally, as explained in answer to Question 6, we emphasise the importance that the posting party should be able to take on credit risk on the custodian when the custodian holds cash IM.