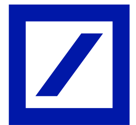
Deutsche Bank



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2015-07-10

Re: *Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP*

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to provide comments on the above consultation. Overall we believe that the draft regulatory technical standards (RTS) represent a substantial improvement on the April 2014 version. In particular we welcome the change in treatment of third country non-financial counterparties beneath the clearing threshold (NFCs-). The draft requirements are now more balanced and are broadly consistent with the Basel Committee on Banking Supervision – International Organisation of Securities Commissions' (BCBS-IOSCO) final recommendations. However, we do still have a number of concerns around some elements of the draft RTS.

Our key comments relate to:

- **Non netting jurisdictions:** Counterparties should not be obliged to post collateral to counterparties in jurisdictions where netting is not enforceable. Such a requirement would increase risk for EU counterparties in spite of the overarching policy objective of reducing it. The suggestion to use alternative measures like international custodians raises additional complexities around multi-jurisdictional insolvency regimes. Where transacting in non-netting jurisdictions – which are often fast growing emerging markets – is made more difficult by the RTS, EU counterparties may be put at a competitive disadvantage compared to local or international banks.

- **Cash collateral reinvestment:** Given its high quality fungible nature, cash must be allowed to be posted as initial margin (IM) without the requirement to reinvest it in eligible securities in order to satisfy segregation requirements. The objective of the G20 framework is not to address custodian risk. Attempting to do so via the RTS would

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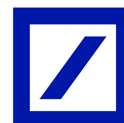


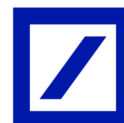
introduce a de-facto ban on posting cash IM and may hinder the original objective of the G20, i.e. mitigating counterparty credit risk.

- **FX haircut:** The final RTS should make it more explicit that the foreign exchange (FX) haircut is only applicable to non-cash. It should also state that FX risk for cash or collateral VM may be included in the IM calculation instead of calculating an FX Haircut.
- **Collection of margin:** To account for time zone differences and standard settlement cycles for certain collateral types, sufficient time must be allowed between calling and collecting margin. Counterparties should be allowed to apply more conservative requirements as they deem appropriate but if necessary up to three local business days should be available, i.e. t+3, especially for less systemically significant counterparties.

We have made several other comments which aim to clarify and enhance the workability of the requirements and highlight issues where further international coordination is required to ensure regulatory convergence and a level playing field. We would be happy to provide any further information on these points and the points above if required.

Sincerely yours,

Daniel Trinder
Global Head of Regulatory Policy



I. GENERAL COMMENTS

Minimum standards

The RTS should aim to set down minimum standards. However it must be clear that these regulatory minimums should not prevent counterparties from applying more conservative standards where institutions deem it appropriate for risk management purposes. The RTS should always therefore explicitly state that more conservative requirements can be applied around haircuts, margin collection deadlines, collateral diversification requirements etc.

Competitive distortions

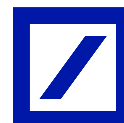
Under the European Markets Infrastructure Regulation (EMIR), all un-cleared over-the-counter (OTC) derivatives are in scope of the requirements. However, the product scope appears to be narrower under the US Dodd-Frank Act (DFA) which gives rise to a potential unlevel playing field between Europe and the US. For example:

i. Some US non-bank swap dealers may not have to collect variation margin (VM) on physically settled FX forwards and swaps. While it has been suggested that supervisory guidance in the US may instead generally subject FX swaps and forwards to VM requirements it is not clear that this guarantees a level playing field. Supervisory guidance may not always cover the entire universe of swap dealers, e.g. if there are US swap dealers which are not prudentially regulated. The potential competitive distortion arises, in that European banks may not be able to offer short-dated FX hedging to the thousands of European financial counterparties who currently trade uncollateralised FX. On the other hand, US banks may only need to take collateral where 'prudent' and so would be able to offer uncollateralised trading to the same market, since exposure risks have been demonstrated (in data provided by ISDA to regulators) to be very low. As a result, European non-bank financial counterparties may either be able to switch their trading relationship to a US bank or may only be able to continue to trade FX if they are able to post VM. For European financial counterparties this would mean (when compared to their US peers) that they generate lower returns because they have to disinvest in order to fund potential VM calls and also incur additional costs because they need to develop and operate operational and infrastructural capabilities to fund, deliver and hold collateral.

ii. Physically settled bond forwards and equity options are not swaps or security-based swaps for purposes of the DFA. This means that a US swap dealer transacting with US clients may not be required by law to collect IM or VM. The effect of including equity options in scope varies depending on the level of IM to be charged. This difference in product scope potentially puts European counterparties at a competitive disadvantage compared to US counterparties when transacting with the same clients as the clients may be able to choose a broker based on whether they will charge IM/VM, compared to a broker who is not mandated to do so.

Credit Support Annexes (CSAs)

There are a substantial numbers of clients who would be impacted by the mandatory VM requirement who are currently trading without CSAs (which means that they do not post or collect collateral) but where exposures are low. According to CSA aggregated data compiled by ISDA for 5 banks there were over 21,000 clients (categorised as either financial counterparties or NFC+) without CSAs where the mark-to-market (MTM) exposure is between -5 million USD and +5 million USD. This would require banks to on-board and operate around 70% more CSAs in order to collateralise around 2% more MTM. The phase-in of VM requirements agreed by BCBS-IOSCO, while welcome, will not fully address the challenges these clients will face. This is because smaller clients lack required operational processes, IT systems, human



resources and the expertise to support VM exchange. Consequently, there is a risk that in order to capture 100% of MTM exposure instead of focusing on systemically significant exposures, many counterparties may be not be able to access hedging services or they may choose not to hedge due to the fact that the legal and operational cost of daily VM obligations outweighs the risks of not hedging or they simply do not have the operational capability to post and receive collateral.

Intra-group exemptions and equivalence determinations

There have been considerable delays in finalising the equivalence assessments under Article 13(2) of EMIR even in relation to the initial group of non-EU countries on which the European Securities and Markets Authority (ESMA) has already delivered technical advice to the European Commission (EC). In line with the changes the EC have proposed making to the draft RTS on interest rate derivatives clearing, a transitional period should be foreseen in the margin requirements RTS during which EU counterparties can receive exemptions for transactions with group entities in a third country for which formal EC equivalence assessments have yet to be concluded. Absent such a safe-guard there is a risk that the draft RTS' final endorsement by the EC may be slowed down, which would negate the benefits of the extended implementation period.

II. CONSULTATION QUESTIONS

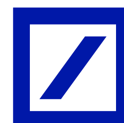
Question 1. Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

Some of the respondents to the first Consultation Paper commented that the treatment of non-financial counterparties domiciled outside the Union could be seen as inconsistent with the principles of the Basel Committee and IOSCO. The ESAs, recognising the fact that the risk profile of exposures to non-financial counterparties should be treated in the same way as they were domiciled in the Union are therefore consulting on this new draft.

We welcome the amendment to treat non-systemically important third country corporates similarly to EU NFCs-.

The new proposal in the updated draft RTS for a margin posting and collection requirement is also welcome with respect to jurisdictions with equivalent margin rules in place for uncleared derivatives, such as the US, as it should help facilitate a positive substituted compliance determination by reducing the structural differences between the EU and US rules on collecting and posting. However, with respect to non-netting jurisdictions (e.g. many emerging markets), such a requirement could introduce risk for EU counterparties as they will now need to post collateral, both VM and IM if appropriate, to counterparties in jurisdictions where the "legal enforceability of the netting and segregation agreements" may be at risk. The draft RTS attempts to address this risk by stating that "alternative arrangements such as posting collateral to international custodians" must be applied in order make the requirement workable. This is not a straightforward solution however.

Although a suitable custodian may protect posted assets, such an arrangement will require complex multi-jurisdictional legal analyses, and will also introduce the additional cost associated with the segregation of IM. With respect to netting, posting to an international custodian will not immunize a counterparty from the risk of a local jurisdiction cherry-picking transactions in an insolvency proceeding. In such a case, the amount of collateral posted may not match the close-out amount determined after cherry-picking. This will therefore result in



considerably increased credit risk. As transacting in non-netting jurisdictions also incurs a capital cost, the effect would be to force EU counterparties to post collateral without receiving any corresponding Risk Weighted Asset benefit. An exemption from the posting requirement for non-netting friendly jurisdictions should therefore be considered.

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.

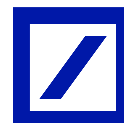
Some respondents to the first public consultation noticed that the requirement to complete the collection of margins margin within the following business day ('T+1') of the first Consultation Paper may be unfeasible because it was not considering some of the operational delays that, in certain circumstances, are unavoidable. In particular this refers to time zone differences and margin calls reconciliations. However, as the daily exchange of margins is considered a core component of the entire framework, the current proposal remain similar to the one in the first consultation paper identifying very limited circumstances where the exchange of variation margin can occur less frequently than on a daily basis.

The current VM timing proposals are most likely unachievable for many counterparties covered by the draft RTS when the settlement period for the delivery of collateral and time needed to reconcile margin calculations are considered. Where counterparties (and their respective custodians, if applicable) are located outside the EU in different time zones, the difficulty in meeting the requirement will be compounded.

The rules should focus on requiring that margin is calculated on time and on ensuring documentation is in place requiring margin delivery within the prescribed time rather than on obliging the collector to have received margin by the specific margin delivery time. As a practical solution, the RTS could be framed in a way where more systemically important counterparties (those captured by the IM phase-in) are required to comply with whatever current best practice is in terms of calculation and delivery times of collateral while counterparties only subject to VM requirements (many of whom will be new to posting VM) should be able to deliver up to t+3 given the challenges outlined above. The calculation date that begins the three day period should be the earliest the two counterparties can have a common calculation while a 'business day' should be defined from the perspective of the collector. Even where the above flexibility is provided counterparties should still have the right to call for margin at t+1 or the same day (depending on type of client and operational constraints).It should also be made explicitly clear in the RTS that the posting party is responsible where they fail to meet margin delivery requirements.

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.

Respondents to the first Consultation Paper commented that the requirement to assign every single trade to a specific asset class instead of calculating all the sensitivities to the relevant risk factors had two major drawbacks. First, the approach would have been more restrictive than the wording in the BCBS-IOSCO framework and, second, that this would have implied a substantial increase of the IM requirements. On the top of that, operational processes would need to change. In order to avoid unintended consequences and with the intention to preserve the overall principle of limiting the offset between well-defined asset classes, the ESAs are consulting on a new draft of the RTS that allows more flexibility in the modelling phase which at the same time uphold the principle in the BCBS-IOSCO



framework.

The draft RTS appears to require that if a model does not comply with any of the requirements then counterparties have to switch to the standardized method (SM). This could have disproportionate effects even where the overall risk management objective is still satisfied but where challenges arise around minor details.

Where the IM model ceases to comply with the requirements, transitional arrangements should be available in the first instance before the use of the SM is required in order to allow counterparties to engage in dialogue with their supervisors and determine what action to take. This is important as the SM would result in a significant increase in the calculated margin and could result in 'cliff effects' and potential market disruption.

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 accordance with the Basel Committee and IOSCO principles, collateral should be diversified "in terms of an individual issuer, issuer type and asset type". Recognising that some participants might have constraints in posting collateral different from government debt securities (most often issued by the government of the country where the entity is domiciled), the ESAs are of the opinion that, for this particular asset class, the diversification requirements should only be applied to systemically important institutions.

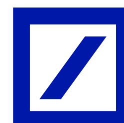
In order to comply with Article 6 LEC (1) it should be stated explicitly in the RTS that receiving counterparties can rely on representations from a posting counterparty that the securities they are posting are not from entities to which they have close links. This is necessary as it would be very difficult for a counterparty to carry out the necessary level of diligence and ensure ongoing monitoring of their counterparty's group structure. Further, while Article 291 of the Capital Requirements Regulation (CRR) defines general and specific wrong way risk (WWR), it does not provide sufficient clarity on the definition of significant WWR. Moreover, whilst the draft RTS states that the EMIR definition of 'group' applies (preamble 16), it is still not sufficiently clear what constitutes a 'group' absent the RTS stating that 'groups' shall be determined in accordance with IFRS/GAAP/similar accounting principles.

Under Article 4 LEC the use of internal rating models in determining collateral eligibility may have an unintended market impact of releasing non-public information to the market further to the requirement to communicate to the other counterparty the credit quality step (CQS) associated to the securities that are posted as collateral. The internal IRBA approved rating models of banks will be based on a combination of public and non public information, and the use of these models to indicate collateral eligibility may result in the collateral taker releasing non public information to the counterparty, particularly where a request for collateral substitution is required due to a change in CQS.

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

Respondents to the Consultation Paper noted that having a written agreement with all the counterparties including also those that would not be subject to the margin requirements could result in a excessive operational burden with limited risk-reduction benefits.

As proper trading documentation is deemed necessary but there is no intention to create unnecessary burden on the market participants, this consultation paper includes a more



general requirement covering all the aspects related to trading documentation.

Article 2 OPD requires an independent legal review of netting procedures and Article 1 SEG (5) requires independent legal review of segregation arrangements. The final RTS should explicitly state that "independent" can mean an internal review provided there is sufficient independence or that satisfaction of the netting opinion requirements under an entity's regulatory regime will be sufficient to satisfy the Article 2 OPD (2) requirement.

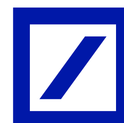
Per the requirements under Article 2 OPD (1) confirmation would also be welcome that confirmations for types of trades which might be made via SWIFT are sufficient for documentation purposes.

Question 6. Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.
The ESAs recognize that obtaining a legal opinion on the effectiveness of the segregation for each of the different agreements would result in an excessively cumbersome process. It should be however recognized that need for the counterparty to comply with the fundamental due diligence principle of producing an internal assessment of the reliability of the agreements and their enforceability.

The draft RTS requires "robust risk management procedures shall be in place" including with respect to payment and close-out netting. In addition, the draft RTS requires a counterparty to perform an independent legal review at least on an annual basis to "verify the legal enforceability of the bilateral netting arrangements". Thus, as explained in response to Q1, the collateral requirements in regards to non-netting jurisdictions remain problematic. The RTS 'Executive Summary' section implies two-way exchange of margin is required even in non-netting jurisdictions, so long as suitable alternative arrangements are in place. However, the parties cannot contract into an enforceable netting arrangement where one does not exist under the insolvency laws of the relevant jurisdiction. Collateral should not have to be posted bilaterally on a gross basis as this would exacerbate risks faced by EU counterparties. Certainly, the policy approach should not have the effect of blocking the access of European counterparties to many non-EU and emerging markets and ceding such markets to local/international banks.

The requirement to perform an independent legal review at least on an annual basis would be excessively burdensome, particularly for jurisdictions not covered by industry opinions. Instead of an annual review, such review could be conducted every three years absent some material change in legislation – this would be in line with legal review updates pursuant to CRR netting.

Question 7. Does this approach address the concerns on the use of cash for initial margin?
Respondents noticed that the difficulties in segregating cash according to the requirement on this Regulation could have resulted in a de-facto ban of cash as eligible collateral for IM. In order to avoid unwanted effects of the segregation requirements, the obligation concerning the re-use of collateral should exclude cash to the extent that the collected margin is reinvested to protect the liability that the counterparty collecting the collateral has towards the posting party. Securities obtained from the (re)investment of cash collateral should be segregated and not re-used in line with the treatment of IM. This would appear to solve the issue that may inadvertently have resulted in a de facto ban of cash as initial



margin, which was not the intention of the ESAs.

Article 1 SEG requires that IM is protected from the default or insolvency of a third party holder or custodian. Given the difficulty of segregating cash, Article 1 REU states that IM posted as cash can be reinvested to satisfy the segregation requirement. These provisions should be amended as, firstly, addressing custodian risk is not within scope of the BCBS-IOSCO framework and secondly, the reinvestment requirment amounts to a de-facto ban on the posting of cash as IM, which is clearly contrary to the ESA's stated objective to avoid such an unintended consequence.

Cash is one of the most liquid and high quality assets so any restriction which has the effect of limiting its use as collateral is clearly contrary to the overarching objective of reducing counterparty credit risk. Cash IM must be permitted to be posted without requiring reinvestment.

We strongly support ISDA's response and proposals in relation to this specific consultation question.

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

This Article aims to clarify the proposal of the First Consultation Paper concerning the identification of a reference currency for the calculation of the FX haircut under the standardized approach. As cash for VM is considered the pure settlement of a claim, this should not be subject to any haircut. Furthermore, VM and IM should be considered separately when identifying the reference currency for this purpose: the transfer currency is the most natural choice for the VM, the termination currency the most natural for IM. Where "transfer currency" and "termination currency" do not appear in a bilateral agreement, the FX haircut should apply to the entire collected collateral.

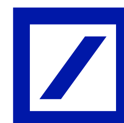
The final RTS should explicitly confirm that the FX haircut is only to be applied to non-cash. Cash is the most fungible of all collateral and thus should be exempt in its entirety from any FX haircut. It should also state that FX risk for cash or collateral VM may be included in the IM calculation instead of calculating an FX haircut.

Given the absence of a definition of "termination currency" and "transfer currency", counterparties should be able to define the transfer and termination currency in their agreement since European counterparties will most likely want to deliver cash and securities in a European currency while the US counterparty they are facing would prefer to deliver US securities or cash. This would allow counterparties to designate a termination currency for each party that can match the collateral they are expecting to post in.

As drafted the FX haircut would be additive to the asset class haircut, i.e. if the collateral is an equity then the collateral value is haircut by 23% (15+8). This is disproportionate and should rather be applied independently to the reduced value of the asset after asset class haircuts have been applied.

III. Clarifications

- Article 4 GEN (2): This requirement refers to the minimum transfer amount. The drafting has the potential unintentional consequence of meaning that where counterparties



decide to collect house margin over the regulatory minimum, they cannot have a minimum transfer amount. It should be clarified to state that "the amount due shall be calculated as a minimum of the sum of…"

- Art 6 GEN(3) / Art 7 GEN (3) / Preamble (12): This relates to the EUR 50m IM amount threshold (Art 6) and EUR 8bn IM notional amount (Art 7) threshold as applied to investment funds. The draft RTS clarifies these should be considered distinct entities and treated separately for the purposes of such thresholds unless such funds are 'collateralised, guaranteed or supported' by other investment funds or the investment advisor. A representation from posting fund counterparties stating that they are not 'collateralised, guaranteed or supported' by other funds / its investment advisors should be sufficient to satisfy the requirement.

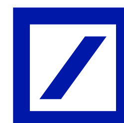
- Art 1 GEN (4): The proposed definition of initial margin herein should refer to the last collection of 'variation' margin for consistency.

- Article 1 VM (1): This is prescriptive about the amount of VM to be collected. This could inadvertently prohibit counterparties collecting in excess of the regulatory required amount, e.g. over-collateralising on VM. To avoid such an unintended consequence the second sentence should read *"The minimum amount of variation margin..."*

- Article 2 MRM (2)(a) states that the margin period of risk (MPOR) shall be set by reference to the period between the last collection of margin and the default of the counterparty. It is unclear which type of default should be referred to. A bankruptcy can happen on any day, so if this is meant then the period of risk will always be zero (because of the potential to be declared bankrupt immediately after the collection). Alternatively the default might refer to a failure to pay. If this is the case then there could be multiple permutations of what is meant. They could refer either to failure to pay on regular transaction payments, or VM payments which happen as often as daily, or to either of those two possibilities in addition to the expiry of a grace period, or it could be later again if time is allowed for any dispute mechanism to be followed and satisfied. These considerations refer to only two types of default; there are others which may raise their own questions. More precision is required in the final RTS to know what period to measure.

- Article 4 MRM: We welcome the amendments which aim to state that the IM model may calculate sensitivities to the relevant risks rather than assigning each derivative contract to an asset class. The draft RTS should be clarified such that this objective is made explicitly clear.

- Article 3 LEC: The summary in the draft RTS refers to minimum CQS being set at 2, but article 3(3) sets minimum levels at 3 for both internal and external ratings (whereas the previous draft of the RTS set the internal rating minimum level at 3 and external at 2). Regarding assets referred to in article 3 (2), i.e. securitisation, these are now intrinsically required to use minimum level of 3 (previously 2), however, article 3(4) refers to assets referred to in paragraph 2 (i.e. securitisation) should have a minimum level of 4, although the bracketed reference does not refer to securitization, but sovereign debt in non-local currency. Indeed sovereign debt issued in non-local currency are also specifically referenced in paragraph 1, which would imply that these assets would require a minimum level of 3. Clarification is required on the correct reference levels for all asset classes.



- Article 1 OPD (1)(g) requires procedures for re-appropriation of collateral in the event of default of the counterparty having collected it. However we believe the ESAs mean to refer to re-appropriation of unused collateral, i.e. only the excess left after the termination values are worked out.

- Article 2 OPD (5): The reference to "other counterparty" should be changed to "collecting party".

- Article 1 FP (6)(a): This should refer to ‘paragraph’ rather than ‘Article’ 3(a).

- Table 2 VA: This has changed the last haircut reference to refer to asset category (o) (securitisations) from (m) (financial institution bonds). The previous interpretation was securitisations issued by financial institutions. Clarity is needed on whether the new interpretation should be all securitisations and not limited to those issued by financial institutions.

- Annex II - Standard haircuts to the market value of collateral: It would be helpful if the final RTS clarified the difference between long-term and short-term debt.