11 July 2014

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FBF RESPONSE TO JOINT ESA CONSULTATION PAPER ON DRAFT RTS ON RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP (EMIR)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 500 commercial, cooperative and mutual banks. They employ 400,000 people in France and around the world, and serve 48 million customers.

The FBF welcomes the initiative to comment on the joint ESA Consultation Paper on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP (JC/CP/2014/03), in order to address the issues regarding margin requirements for non-centrally cleared derivatives on a global basis, and foster harmonization and coordination across jurisdictions. We appreciate the opportunity to respond to this Consultative Document.

GENERAL COMMENTS

The FBF agrees with the approach to base the future regime for margining requirements under EMIR as on the international minimum standards for margining requirements in respect of non-centrally cleared derivative transactions as defined by the BCBS-IOSCO framework.

First of all, the FBF would like to stress that OTC derivatives (where French banks are among the major players in the world) are vital to the real economy. Indeed, OTC derivatives allow economic actors to optimize their capital and to secure their investments. We share a common objective of making these markets more secure and efficient without unduly penalizing an efficient way to properly reallocate risk within the economy.

We remind that under current OTC derivatives markets reform, the scope of un-clearable derivatives is not stabilized yet and relies on the capability of CCPs to develop adequate solutions for clearing.

In this context, the FBF favours the principle of appropriate margining for un-cleared derivatives in order to reduce systemic risk and to foster financial stability. At the same time, we believe that both the regulators and the industry need to have a clear view of the scope of clearable derivatives by CCPs first, in order to properly calibrate and implement these measures without posing huge operational risks to the system.

French banks, for their part, anticipated the introduction of variation margins that are effective measures of reducing systemic risk.

According to the letter sent in July 2014 by the FBF to Michel BARNIER, Commissioner at the European Commission, which clarifies the French banks' main positions regarding this consultation paper, we take the opportunity to stress the need for global consistency in the application of the margin regimes.

This will be crucial in order to guarantee **a level playing field** between all markets participants involved in the OTC derivatives space, across jurisdictions.

In this context, harmonization is needed in 3 areas:

(i) Scope of instruments:

The FBF note that the scope of instruments covered by EMIR is wider than for instance in the US: instruments such as equity options and derivatives on equity indices are neither considered "swaps" nor "security based swaps" under the '*Dodd-Frank Act'* and hence are not subject to the margin requirements set out by BCBS/ IOSCO, contrary to the situation in Europe. Consequently EU firms will be rejected from the US market if they have to collect IM on these instruments while US banks don't. In addition, we have no indication that these products will be covered by equivalent margin rules in Asia.

International consistency is needed to avoid what could be a major disruption of competition for banks submitted to EMIR and their clients. Therefore, we think that **it would be appropriate for the ESAs to explore a way to phase the collateral requirements to equity and index options** taking into account this international inconsistency and the fact that no CCP will provide clearing services for these products at short term.

(ii) Entities covered:

There is a material risk of conflicting regulation where (i) the non-EU counterparty is not subject to IM regulation in its home jurisdiction; or (ii) the IM exemptions are not the same in EU and non-EU jurisdictions. As a result an EU bank will have to collect margins where its non-EU counterparty may not be subject to margin rules as per its local regulation. This would create a major competitive distortion. In line with BCBS-IOSCO principle 7, EU institutions should be allowed to comply with the margin requirements of a host country's margin regime where such regime is deemed consistent with BCBS-IOSCO principles.

Therefore, **we would urge the ESAs to coordinate with foreign authorities** notably to make sure that what it is considered as systemic corporate in Europe (NFC+ - submitted to the IM/VM requirements) is consistent with the other jurisdictions.

(iii) Re-use:

Re-use of IM is currently banned in the draft RTS proposal, while BCBS/ IOSCO guidelines allow for a certain degree of re-use. Also I this area, a harmonized approach across jurisdictions will be of utmost importance in order for EU banks to maintain their client franchise in non-EU markets.

Consistency around the globe is key to allow fair market **competition**, consistent **pricing**, counterparty **choice** and to **avoid regional liquidity pools** that would remain closed to EU counterparties on the back of conflicting rules.

The FBF is of the opinion that **the ESAs should integrate in the draft RTS to be proposed to the European Commission a review clause of one year** which would usefully give enough flexibility to modify European rules on re-use in accordance with what the other major jurisdictions will decide in that matter in the coming months.

RESPONSE TO THE CONSULTATION PAPER

Q1: What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions?

Is it possible to quantify these costs?

How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

Indeed, there will be additional costs due to a significant increase of agreements to be established with counterparties trading OTC derivative contracts and necessity to allocate resources to operate margin transfers on daily basis. This may have impact on liquidity and use of capital.

As a result, small end-users will have to rethink the way they use derivatives, including for hedging. Refraining from hedging risks would be an unintended consequence and contrary to the objective of financial stability. These costs are hard to quantify but the requirements will result in higher operational and funding costs.

The obligation for FCs and NFC+s to collect margin from all their counterparties, both EU and third country entities, may have negative effects and is widely questioned. From both a business and regulatory sense we question why parties not governed by EMIR would want to post IM or make the needed representation of their thresholds and classification under EMIR? It would seem more likely that these counterparties, for example corporates, simply will choose not to trade with EU entities, leading to further market fragmentation and impact on the EU economy.

On the extraterritorial issues, the FBF would suggest regulatory bodies work towards consistency and alignment on their respective third country rules, in terms of threshold, timing, entities covered, exemptions, etc. It should be of great concern if an EU entity requires a non-EU to post margin, when there is not the equivalent regime in the country of the non-EU entity, requiring the same.

Q2: Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner?

If yes, please provide the rationale for the concerns and potential solutions.

A need for a vast number of various agreements, for the purpose of not exchanging initial and variation margin, is required. This will pose a significant operational burden, in particular with respect to the relationship to small and medium sized entities.

The explanatory notes suggest that the exemptions were introduced to ease the operational burden and insure proportionate implementation of margining requirements. We welcome and agree with such considerations.

However, the requirement of a positive agreement (whether in writing or other equivalent electronic means) in order to benefit from exemptions seems in contradiction with such objective. Indeed, it will create administrative burden even for exempted counterparties, products, implementation phases.

The operation burden of collateral substitution due to concentration limits of collateral must be addressed more appropriately. This requirement will result in increased settlement risks and new functionality requirements in Collateral Management systems.

As far as collection of margins is concerned, the RTS foresee that this is done within one business day following the transaction date. However, standard settlement regimes applicable to securities are generally between 1 and 3 days.

Hence, counterparties posting securities as collateral could be in breach of the RTS if collection of collateral is not consistent with securities settlement delays. Next to that, we would like to know to what point in time on the term “collection” itself refers to: it is not clear if this is the point of calculation, claiming or actually receiving collateral.

As a result of the rule proposed in Art 2 LEC - (e), where cash collateral is posted to counterparty, the counterparty should deposit this cash with an entity distinct from the collateral provider.

This approach highly differs from existing market practices and would make much more complex current cash holdings.

The collateral receiver would have to open a high number of cash accounts to comply with this rule without really reducing the counterparty risk attached to the cash collateral. This approach only results from transferring counterparty risk from one place to another without real added protection. Other options that could be considered may be:

(i) application of this rule only above a certain threshold in order to avoid multiplication of cash account openings ;

(ii) where the collateral taker is a bank, other regulations adopted to strengthen the resilience of banking institutions are sufficient to ensure a high level of protection for cash collateral

We consider that transactions that are exempted from the clearing obligation (certain forex derivatives and transactions qualifying as intra-group) should not be taken into account in the calculation of the 8 billion thresholds as these are considered not to pose any systemic risk.

We do not support the proposed 8% haircut on Forex mismatches, as contrary to the envisaged outcome, we think this would create extra counterparty risk and lead to under collateralisation of 1 of the counterparties, even to procyclicality.

Q3: Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately?

Is the market-based solution as outlined in the cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?

The Proposal adequately addresses the risks and concerns of derivatives in cover pools and should not be tightened further.

Q4: In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

The FBF support the use of internal models for determining collateral haircuts.

The use of an Internal Margin Model (IMM) must remain possible, even if the industry is currently working on propositions for a Unique Margin Model.

Even if a Unique Margin Model were to be approved, counterparty still must be able to choose for an Internal Margin Model, derived from its existing approved models used for the Value at Risk (VaR) for market risk or the Expected Positive Exposure (EPE) for counterparty risk.

In order to avoid any disputes arising from the use of internal models, thr FBF suggest that the counterparties to a contract agree by convention whose model will be used or rely on ISDA calculation agent clauses.

As such we strongly support the IMM RTS as currently drafted that allow for a model to be either developed by one of the two parties or jointly by the two parties, or to be provided by a third party agent.

According to the fact that the counterparty providing the model will have to provide appropriate information on the model to the counterparties to be confident in accessing sufficient information.

Q5: How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)?

Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated?

What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction?

Concentration limits should be defined in such a way that it only defines limits to ensure that the value of and ability to liquidate the collateral is secured in the event of a counterparty default. We think that all concentration limits should be set in both absolute and relative terms, i.e. first when the absolute value of the collateral exceed a threshold, the relative limit will be applied so that only the largest of collateral positions (where concentration to a single name may in a material way impact the value of and ability to liquidate the collateral in event of a default) are required to be diversified.

The absolute limits could be calibrated to the estimated credit quality of the collateral. In practice the most of the collateral send is in form of cash. Therefore we don't think it is appropriate to introduce more concentration limits at all. It is as well not proportionate to introduce complex concentration limit mechanisms to address the small proportion of securities used as collateral today.

In addition, we also suggest that high rated government bonds should be excluded from any concentration limits, because the operational costs will out weight the liquidation issues under stressed scenarios. Counterparties should also be able to bilateral agree concentration limits in relation to some minimum requirements.

To reiterate the above, in practice most collateral is sent in the form of cash. It would therefore seem inappropriate to introduce more concentration limits. Government Bonds above a certain rating should be exempt from concentration limits.

The proposed concentration limits will results in substantial operational costs. We see no real benefit in imposing restrictions on small amounts of exchanged collateral (as proposed in Article 7 LEC) as this will impose significant (and potentially harmful) operational burden for many counterparties. As an example this this could be especially problematic for certain entities e.g. SPVs that only hold certain types of assets and thereby are unable to meet these rules.

The same applies to insurers, pension funds and other types of investment funds, which have to comply with strict investment rules and as such may not have a portfolio that allows sufficient diversification in securities offered as collateral. Moreover, we think that the risks inherent to the concentration of positions (directionality, volatility, liquidity) cannot be adequately captured by basid diversification guidelines as suggested in the RTS. These risks should be measured dynamically by internal haircut models. As a consequence, collateral posted that is already subject to a haircut model should not be subject to concentration rules.

Q6: How will market participants be able to ensure the fulfilment of all the conditions for the re-use of initial margins as required in the BCBS-IOSCO framework?

Can the respondents identify which companies in the EU would require re-use or re-hypothecation of collateral as an essential component of their business models?

Re-use initial margins (IM) are prohibited in the current project. FBF, with a goal of transparency and protection against potential systemic risk, defends the impossibility for initial margins to be segregated and reused at the same time. Both operations should not be duplicated or consecutive.

However, in other countries, the United States in particular, reuse of initial margin is authorized and is, as such, generate distortions of competition vis-à-vis the European entities. A level playing field between different markets is crucial especially in derivatives markets which are global in nature. Therefore we urge ESAs to follow the flexibility provided in global rules and ensure a level playing field for European companies.

Even though we understand that this ban is linked to the obligation to segregate initial margins, we would like to stress that this total ban on re-use of collaterals will generate considerable liquidity problems. As re-use of collateral is allowed for transactions cleared with CCPs, we would advocate for the same kind of rules to apply for non-centrally cleared transactions provided that it is limited to certain type of instruments (e.g. money market funds).

Re-use initial margins are indeed an undeniable competitive advantage which will overburden the competition ensuring consistency of sound and transparent market.