*European Supervisory Agencies (ESAs) - Consultation Paper JC/CP/2014/03 on*

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

**COMMENTS FROM THE BANKING STAKEHOLDER GROUP OF THE EUROPEAN BANKING AUTHORITY**

**July 11, 2014**

## General remarks

The (art. 11(15)) of EMIR delegates powers to the European Commission to adopt certain RTS related to the (i) risk-management procedures, (ii) intragroup exemptions and (iii) criteria to identify impediments for prompt transfer of funds between counterparties. As part of the new structural framework associated to the derivatives markets, the ESAs have been specifically mandated to develop RTS related to the exchange of margins on non-centrally cleared OTC derivatives.

The ESAs, in developing the RTS, have considered the BCBS-IOSCO's framework on margin requirements for non-centrally cleared OTC derivatives that was finalized on September 2013 and that fulfills the G20 agreements (Cannes Summit on November 2011) to develop consistent global standards for margin requirements on these instruments for the purpose of:

i. reducing systemic risk by lowering contagion and spillover effects and limiting the build-up of uncorrelated exposures, and
ii. promoting central clearing by establishing minimum margin requirements that would be comparable to derivatives cleared through CCPs

The proposed BCBS-IOSCO's framework requires a high level of minimum margins to cover counterparty risk on OTC derivatives entered into, on a bilateral basis, by financial firms and systemically important non-financial firms (understood as those with significant non-

hedged positions in derivatives). In addition, the framework proposes minimum standards on the quality of collateral exchanged as margin and mandatory measures to protect collateral posted when the collecting party defaults. The implementation of these requirements would be fundamental in reducing systemic risk and promoting central clearing.

The framework highlights the necessity to implement such requirements on a global scale. The benefits of setting global collateral standards are twofold: it sets a benchmark for all jurisdictions to reduce counterparty risk and improve protection of collateral, and it establishes a level playing field as different jurisdictions implement equivalent standards. The EU is the first among the main jurisdictions to implement such standards, and there is considerable uncertainty on the timing and consistency of implementation in other jurisdictions. Given the importance of consistency in the case of OTC derivatives, mutual recognition mechanisms would be highly desirable.

The RTS has the merit of respecting the BCBS-IOSCO recommendations while at the same time providing a deeper detail on the way to implement the margin standards to accommodate the framework to specific needs in the European financial markets, (e.g. providing exemptions for covered bond issuers and cover pools). However, the implementation of the margin requirements will be complex and additional efforts may still be needed to simplify the European margin framework and facilitate the compliance - of all the different types of participants in the OTC derivative market.

In particular, the RTS focus on reducing systemic risk should concentrate on financial entities where such risk could arise. The RTS requirements would entail complex and demanding operational and management procedures that non-financial entities and small financial players in derivatives markets would not have the capacity to comply with. Extending these requirements to such entities might be disproportionate vis-à-vis the potential benefits that this may generate. The RTS provides some exceptions in this regard for non-financial entities, but they it would be desirable to extend them in some cases to small financial players in derivatives markets.

## Main comments to the proposed minimum margin standards

This section highlights some of the main concerns as to the proposed RTS and offers some additional general considerations, following the structure of the questions for consultation raised by the ESAs.

- **Question 1: Liquidity Drain and Costs for Market Participants**

It is worth noticing that the RTS, as proposed, will require the implementation of **minimum standards that significantly surpass current market practices,** in particular;

a) counterparties on OTC derivatives traded on a bilateral basis will have to exchange collateral, not only to cover the market value (variation margin, which is a current broad market practice) but also to cover, on a gross basis, the potential adverse movement of the market value over a liquidation period (initial margin);
b) collateral exchanged will have to respect minimum credit quality standards, wrong-way risk and concentration limits;
c) collateral collected as initial margin will have to be segregated and not be re-hypothecated, re-used or re-pledged.

The proposed standards will consume liquidity resources for participants in the OTC derivatives market in a regulatory environment that already puts pressure on the liquidity profile of banks (core participants in the derivatives markets) that will have the challenge to comply with the Basel III liquidity framework, such as the Liquidity Coverage Ratio ("LCR").

In addition to the pressure in terms of size of the collateral required, it is important to highlight the fact that such additional stress will be focused on the same type of high quality liquid assets ("HQLA") as the Basel liquidity regulation; this may generate some distortion in the HQLA markets whose systemic effect is not easy to assess.

At this moment, it is hard to estimate the definitive impact, in terms of price, of this new regulation. Even if, in principle, a collateralized transaction should be cheaper than a non-collateralized transaction (i.e.: reduction of counterparty risk), the potential scarcity of collateral could revert this trend and in the worst case scenario could even predominate. Therefore, under this extreme scenario, some small and medium-sized entities could struggle to stay in the market.

In addition, the totality of these requirements (including operational ones) will increase the cost of entering into non-centrally cleared OTC derivatives. Although this will help accomplishing one of the main purposes of the RTS, i.e. promoting central clearing, it will also reduce the availability of risk-management tools accessible for non-financial players to manage or hedge their risks. It will also hinder financial innovation, to the extent that new financial instruments useful for the real economy tend to emerge first on a bilateral basis, until they reach a critical mass that allows standardization and sufficient liquidity to be cleared through a CCP.

Small financial counterparties, whose business model includes the absorption of financial risks from their clients, will be the most affected by the implementation of these minimum margin standards, as they will need to make use of derivative financial instruments to manage their risks but they may not have the capacity to deal with all the complexity these standards impose.

In addition, non-financial companies (except corporates that are treated as financial companies under EMIR, NFC+) are exempt to the mandatory margin requirements (initial and variation margin) when they are the result of hedging activities, but this exception is not extended to financial companies. Consideration should be given to the idea of extending this exemption to the hedging activities of financial companies also below a given threshold in derivatives positions. Furthermore, the exception does not affect non-EU non-financial companies, a restriction that is probably unintended, and should therefore be corrected.

To sum up, small financial counterparties do not individually pose systemic risk, but the application of this framework may disproportionally affect the viability of their business as they may not have the sophistication to (i) manage their risks through standardized (CCP-cleared) derivatives, (ii) use quantitative models to optimize the consumption of collateral, and (iii) adapt their processes to deal with all the requirements on the collateral. For small financial players, the obligation to exchange initial margin may force them out of this business, giving more market share to large financial counterparties and, thus potentially increasing concentration and systemic risk.

- **Question 2: Operational issues**

In addition to the effects on market liquidity, the new margin requirements demand a strengthening of the operational processes that will be costly both on the implementation period and on an on-going basis. Entities will have to develop more sophisticated processes to calculate margins, control the quality of collateral posted and collected, increase protection on collateral collected and be ready to access and manage collateral when counterparties default.

Agreements between counterparties will also have to be expanded to include all new arrangements required by this new framework. The amount of work market participants will have to develop to update contracts with their counterparties is unnecessarily increased, as all the exemptions included in the proposed RTS will have to be agreed in writing in their bilateral arrangements.

The cost of implementing the new minimum margin standards would be less burdensome if the exemptions were directly applicable, having the counterparties only to reflect in their arrangements the cases in which they agree not to make use of them.

- **Question 3: Covered Bonds and Covered Pools considerations**

The treatment in the consultation of derivatives done with CB issuers or CB pools for hedging purposes is broadly appropriate. The solution proposed ensures a high degree of protection to the derivatives counterparty, requiring some specific conditions to the covered bond issuer or cover pool to be exempted from collateral posting.

The requirements proposed are comprehensive and ensure the needed protection for derivative counterparties should the collateral exemption apply. To be more precise, requiring that the derivative contract should not terminate in case of default of the covered bond issuer or the existence of a certain amount of legal overcollateralization in the respective legal frameworks for covered bonds enhances the protection of the derivatives counterparties.

- **Question 4: Quantitative models**

The rates for the standardized tables on the calculation of initial margin and haircuts on collateral proposed by the RTS (same rates as proposed by the BCBS-IOSCO framework) are disproportionally high with respect to the expected outcome of the application of quantitative models (see results of the BCBS-IOSOC QIS). This provides a great advantage to the users of quantitative models. However, these models are difficult to design and handle, which in turn gives a competitive advantage to the larger and more sophisticated market players, which may lead to a concentration of the OTC derivatives market into a small number of large players.

Moreover, the use of models in bilateral agreements requires the agreement of both counterparties on very specific details of the models to be used for each type of derivative. As small differences of parameters or data may lead to material discrepancies in the outcome of the model, a large number of disputes may arise between counterparties.

The RTS does not contemplate approval of the initial margin model by EU competent authorities (as called for by paragraph 3.3 of the BCBS-IOSCO framework document). This introduces a regulatory uncertainty for counterparties relying on the initial margin model,

exposing them to a liquidity risk if their competent authority deems the model not to be appropriate subsequent to its adoption.

- **Question 5: Concentration limits**

Another area where the EU framework deviates from the international standards is on the concentration limits on eligible collateral which is not a feature of the BCBS-IOSCO framework document. This may dissuade non-EU entities from trading uncleared OTC derivatives with EU entities.

While the inclusion of concentration limits in order to reduce the risks generated by counterparties posting non-diversified collateral (and thus generating the risk of a concentrated exposure for their counterparty) is a sound risk management practice, it may generate a series of operational issues and distortions in the liquidity markets. In this sense, considering the composition of the balance sheet of the derivatives' users, small and medium sized financial entities subject to the regulation (not to mention non-financial corporates) will probably have serious problems in generating sufficiently diversified collateral to avoid the concentration limits.

In this regard, we would suggest applying the proportionality principle allowing therefore some exceptions in the concentration limits for small and medium-sized players in this market. To enhance consistency across prudential rules, collateral labeled as Level 1 under LCR legislation may be exempted from this limit as well.

- **Question 6: Rehypothecation**

It is important to note that the concept of rehypothecation is also currently used in the context of the European Commission's proposal for a Securities Financing Transactions Regulation, in the discussion about implementing measures for MiFID2 in ESMA and, at global level, in the context of the 2013 FSB policy recommendations on securities lending and repos. In this respect, it is crucial to ensure consistency and coordination between these parallel political and legislative developments. Rehypothecation generally plays an important role in providing liquidity to markets, which is already under pressure from other regulations such as the LCR and initial margining requirements. Understanding and monitoring the interactions of these rules as they enter into force will remain important for the supervisory community.

The new requirements regarding the segregation of initial margins and the ban on re-use/rehypothecation will require fundamental changes to established collateral management procedures and to the contractual documentation currently in use for margining.

These changes will be extremely challenging and time consumingThe timeline foreseen for the implementation is unrealistic and will only be met with great difficulty (not just by industry, but also by national authorities, given the potentially large volume of model approvals needed, either to approve adjustments to existing models or in view of the need to approve a unified modelling approach which is expected to be developed).

A phase-in period with possibly less formalistic requirements would significantly help reduce these time constraints.

- **Additional considerations: capital consumption**

For banking entities, the derivative netting sets that comply with these minimum margin standards should not generate any additional capital charge. In order to make this happen, this RTS and the CRD IV should be aligned on the way derivative counterparty risk is calculated (margin requirements in the RTS and CCR in the CRD IV) and collateral risk is considered (haircuts on both regulations).

Lack of alignment of this RTS and the CRD IV will make non-centrally cleared OTC derivatives too punitive for banking entities, as they will have to withstand:

- A liquidity drain for exchange of initial margin (segregation and no re-hypothecation);
- A capital charge for the assets they will have to maintain that would be posted to the counterparty;
- An additional capital charge for the derivative netting set when the calculation of the counterparty credit risk under the CRD IV is larger than the minimum margin requirement under this RTS.

- **Additional considerations: other issues**

The need to ensure a level playing field and to not disadvantage the European financial services providers whilst preserving greater financial stability will be critical. In this regard, rules should be homogenous and should apply uniformly across the EU, which implies that

intragroup exemptions should be considered without however giving rise to a heterogeneous treatment among institutions.

In the same vein, regulators should take into account the different regulations implemented in the US and EU in this field. In fact, the difference in the application of these rules in both geographical areas could have unintended consequences for EU market participants, not least by potentially disadvantaging EU banks from doing business with non-EU counterparties as the margin requirements will call for collateral that will be governed by third party laws. In so far as banks from other territories do not have comparable requirements this may create a hurdle for EU banks to compete for business beyond the EU's borders.

Although it is a stated aim to be consistent with international standards, the EMIR margin rules in some areas depart from the BCBS-IOSCO framework. In this regard, the requirement for EU entities that are subject to the EMIR margin rules to collect from all non-EU entities (regardless of status or size, even if these are corporates, central banks or sovereigns) variable margins and initial margins is not consistent with either key principle 2 or 7 of the BCBS-IOSCO framework[1]. This will place EU entities which are active in non-EU jurisdictions at a major competitive disadvantage.

Finally, due to the magnitude of the regulatory draft a phase in period should be considered.

- **Final remarks**

In a nutshell, even if this regulatory proposal aims to enhance the resilience of the markets, regulators should take into account its possible unintended consequences. Accordingly, in designing the new rules one should consider the non-negligible effects on small and medium size players in OTC markets, as well as the need to ensure a level playing field.

[1] Key Principle 2: "All financial firms and systemically important non-financial entities ("covered entities") that engage in non-centrally cleared derivatives must exchange initial and variation margin as appropriate to the counterparty risks posed by such transactions."
Key Principle 7: "Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions."