European Banking Authority (EBA)
European Securities and Markets Authority (ESMA)
European Insurance and Occupational Pensions Authority (EIOPA)

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Re: Consultation Paper on Risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) N° 648/2012

MIROVA thanks the European Supervisory Authorities (ESAs) for giving it the opportunity to respond to the Consultation Paper on Risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) n°648/2012.

Mirova manages EUR 3.6 billion in equities, fixed-income, infrastructure and impact investing assets and EUR 23.6billion in voting and engagement rights24. Mirova is the third largest European manager of open-ended SRI funds and social business funds25. Mirova is wholly-owned subsidiary of Natixis Asset Management.
Natixis Global Asset Management ($838.2 billion AUM26) is a subsidiary of Natixis, the corporate, investment management and financial services arm of Groupe BPCE. The firm ranks as one of the largest asset management companies in the world27 with more than 20 investment managers in the U.S., Europe and Asia.

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MIROVA has actively participated in discussions with the "*Association Française de Gestion*" (AFG) and the European Fund and Asset Management Association (EFAMA) on the Consultative Document, but wishes to express its own views separately.

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<u>General comments:</u>

1) The first risk in an OTC derivative transaction comes from the volatility of the underlying asset that creates price movements sometimes enhanced by leverage in the contract; The second one comes from the counterparty risk failure, which is mitigated by collateral; The third one comes from the quality and the liquidity of collateral; Diversification and haircut rules are the fourth level of risk; ESAs should not focus too heavily on the third and fourth degree of risks.

2) We welcome Recital (5) which clarifies further that all investment funds are considered single entities for the purpose of EMIR regulation and for the application of the IM and the 50 million euros threshold. Indeed, all investment funds (open-ended, closed ended, publicly offered, dedicated to certain investors…) are distinct legal entities and should therefore be considered as such for the purpose of evaluating IM, threshold and exchanging collateral with counterparties when dealing with OTC derivatives.

3) As investment funds and asset managers are very strictly regulated and very closely supervised (through UCITS and AIFM regulation for instance), we consider that a **specific exemption from the obligation to exchange initial margin would be justified for regulated funds** (since their global risk exposure is already regulated).

4) Grandfathering: Deals existing at the time of implementation of a new regulation should be exempted (as mentioned in recital 18) from applying the new rules; their original pricing did not include collateral requirements and the grand fathering clause is necessary; furthermore, any modification of an existing deal that would not result in an increase of exposure should be considered as a **genuine amendment** (as defined in BCBS/IOSCO text) and not a new transaction. Recital 18 (page 21) and Article 1 FP (page 46) should be amended accordingly, especially paragraph 4 which is very confusing.

5) In practice, we fear that market counterparties may force smaller players like asset managers to post Initial Margin even if the aggregate month-end average notional amount of non-centrally cleared derivatives concluded into an investment fund or mandate is below 8 billion euros as of December 1st 2019. This Initial Margin may have a significant cost impact on entities that have smaller balance sheets. As small and medium sizes players are bound to post collateral, they will have to develop or buy new collateral management tools (such tools are quite expensive for participant other than banks). They may face legal costs in order to negotiate and signed appropriate documentation. Consequently, the proposed RTS should clarify that the party above the 8 billion thresholds shall not be entitled to require Initial Margin from the party below the threshold.

6) Some other additional costs may be faced by asset managers, such as collateral financing and segregation of received collateral by the funds from its own assets.

7) With a view to reduce procyclicality and to enhance financial stability, we consider that the basis for eligible collateral should be very large and diversified as much as possible and include many types of assets and specifically funds; according to their quality and their liquidity these assets should be subject to appropriate haircuts and **not percentage limits on concentration** to reduce risk.

8) Keeping in mind that the objective of the regulation is to reduce risk and avoid systemic risk to appear and spread, diversification requirements should only apply to counterparties with a higher level of collateral exchanged; following the idea of the threshold of 50 million that enables smaller counterparties to be exempted from the obligation to exchange collateral when the collateral to be, theoretically, posted does not amount to that threshold (at the level of the group), we consider that a principle should apply for small amounts of collateral effectively exchanged between two counterparties. We are thus definitely in favour of a proportionality regarding the application of the diversification rules and propose for the sake of harmonization throughout Europe to set a threshold : **collateral below 100 million € should be exempted**

from diversification rules.

9) We strongly support the need to have adequate **diversification** requirements in the context of fund investment. Those rules already exist for all UCITS and some "UCITS - Like" funds. **Double layer of constraints should be avoided; thus an alignment should be sought. Collateral diversification rules for funds should continue to be based on the fund net assets as per their current regulation**[1] (whereas the CP's rules propose to base their calculation on the collateral pool).

10) There is no global coherence between EMIR and UCITS rules regarding reuse. Restrictions on the reuse of cash collateral in UCITS guidelines reduce the opportunity to find collateral. The possibility to re-use collateral received can be a major device to leverage a position and should not be granted without restriction; However total prohibition of re-use or rehypothecation in all circumstances is not advisable either, as it increases the run for eligible collateral and hence produces procyclicality and reduced liquidity ; As OTC transactions are conducted between authorized or regulated professionals, **re-use should be allowed in exceptional conditions as defined by IOSCO / BCSS rules**.

11) Models: We fear to be imposed counterparties' internal model. A standard model would be more appropriate. The reference to models developed by banks acting as counterparties of the funds in order to assess the level of variation margin, initial margin and haircut for each type of collateral can only be applicable if the banks give large transparency on their models and the data they use; It is unrealistic and however an asset manager must be in a position to validate the principles and architecture of a model and to challenge the results in order to guarantee proper investor protection.

12) We highlight that it would not be operationally feasible for an asset management company to calculate group consolidated eligibility thresholds on behalf of their clients. In addition a client may sign mandate with several asset management companies. In such circumstance the asset manager is unable to calculate the complete month-end notional amount of non-centrally cleared derivatives. Regarding the threshold referred to in the Recital (3) that is counted per single fund in the case of investment funds should be more precise by stipulating also mandates and sub-funds (page 18 (5)).

13) We **strongly suggest reformulating more clearly the point 3. Of the Final Provisions** (page 46) so as to state that when one of the parties is below the threshold (while the other counterparty may be above the threshold), the agreement in writing is required if parties still wish to implement Initial Margins. Indeed **the principle must be that, by default, there shall be no initial margin applicable if one of the parties is below the threshold** (while the financial counterparty may usually be above the threshold) and if there is, that shall be by way of mutual agreement between the parties. Furthermore, it should be mentioned, for the avoidance of doubt, that the proposed average amount notional is on one counterparty basis and not with all counterparties.

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?

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[1] We urge ESMA to take into consideration its own ruling on the matter that did not came at no cost for our members and that is recent enough so as not to be obsolete.

The aim of the Draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP is to implement robust risk mitigation techniques to bilateral relationships in order to reduce counterparty credit risk and mitigate systemic risk.
The spirit of the technical standards is to avoid unnecessary costs and negative effects without jeopardizing the global objective of risk mitigation and the harmonization of the international regulatory framework.
Nonetheless, the implementation of the RTS will be at cost.

We have identified the below three main types of costs to be supported by market participants:

- Legal and documentation cost, as agreements must be negotiated or amended to take on board new requirements as far as collateral is concerned; legal teams are overbooked with other new developments mainly linked to the implementation of EMIR and AIFM but also the future MIF requirements in terms of distribution and some we may have to solicit external advice which tend to increase the cost of compliance;

- Operational cost exposed in order to establish and then run processes for orderly collateral management; operational costs could be reduced if the suggestions expressed in the answer to the following question were accepted. These costs are related to need of higher operational capabilities (sophisticated collateral management tools, operational staff, daily pricing capability,…) as well as to the development of initial margin models and internal rating-based models (model calibration, back-tests, audit,…);

- Financial costs related to the lower yield realized on the assets; For example, the reduced facility to sell assets transferred as collateral makes the process of arbitrage positions more difficult and might prevent the manager from seizing opportunities;

According to the proposed RTS collected Initial Margin should be segregated from proprietary asset. Consequently both counterparties will have to open separate account from proprietary asset with a consequence of an additional cost.

<u>Eligibility and treatment of collateral</u>

The requirement that the counterparties of OTC transactions have the operational capabilities to collect collateral and manage the collateral in the event of the default of the other counterparty implies that the collateral receiving party will face operational costs such as:

- The daily re-evaluation of collateral;
- The necessary legal arrangement and an effective collateral holding structure;
- An alternative custody account for all asset types in the list of acceptable collateral (in case where the collateral is maintained with the provider) to manage the assets following the default of the provider;
- The access to an active outright sale or repurchase agreement market (in case where the collateral provider defaults);
- Cash accounts in all acceptable currencies with a party other than the collateral provider for depositing cash collateral and crediting the proceeds of repurchase agreements on the collateral;
- The ability to return the unused collateral proceeds to the liquidator;
- The necessary arrangements to ensure that the accepted collateral is freely transferable.
- The development of an approved internal model (thus reducing the reliance on external rating);
- The documentation of detailed procedures in case that the credit quality of the collateral collected no longer meets the requirement of the RTS;
- The ability to identify collateral assets which quality fall below the required level;
- The ability to define a schedule for the replacement of collateral assets already accepted following a downgrade (in order to mitigate the risk of introduction of “cliff effects”);
- The ability to assign haircuts to collateral assets and monitor the value of the haircuts to ensure consistent valuation of the collateral held.

The introduction of proportionality threshold for the application of the concentration limits may help to achieve a good balance between costs and benefits.
In order to fulfil the concentration limit requirements, counterparties will have to support significant operational costs:

- They will have to monitor all collateral flows (including initial and variation margin) on a daily basis to ensure that the amount of collateral collected for each eligible asset class is not above the limit;
- They must have the ability to propose a large range of asset classes as initial and / or variation margin to their counterparties who would have to avoid going over the same limits and may refuse eligible assets as collateral due to that limit;
- The requirement on the concentration limit will increase time delays in collateral exchanges and ultimately risk.

Operational procedures

The RTS requires robust risk management procedures to be in place to ensure the timely exchange of collateral for contracts not centrally cleared. Those risk management procedures relate to:
- The policy and procedures regarding the exchange of collateral
- The escalation process with counterparties
- The reporting of exceptions to senior management
- The operational process for the exchange of collateral
- The storing of all agreements
- The timely settlement of margin calls
- The mitigation of risks arising from collateral assets collected
- The setting of collateral levels
- The verification of the liquidity of the eligible collateral
- The periodic testing of the risk management procedures
- The substitution of collateral.

These requirements will result in significant costs in terms of higher operational burden for market participants. They will have to supports higher costs (collateral management tools, operational staff and front to back proprietary management systems) to be able to meet those requirements.

Segregated Initial Margin from proprietary assets on the books and records of a custodian and for the collecting counterparty to provide the posting counterparty with the option to individually segregate its collateral may also come at significant costs for the collecting counterparty. This will probably be transferred into higher custody fees for the collecting counterparty.

The full ban of the initial margin re-use will prevent market participant from using repurchase agreements to transform securities received as collateral into cash and pursue higher yield investment opportunities. In the same fashion they won't be able to use reverse repurchase agreements to loan the cash received as collateral. This will result in an opportunity cost for market participants.

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.

Particular requirements may be addressed in a more appropriate manner, or still need to be clarified, in order to reduce the costs and avoid any comparative disadvantage for small and medium size players.
Here is a brief summary of our thoughts:
Requirement for initial margin will apply subject to a threshold value of EUR 8 billion for gross notional outstanding of OTC derivatives. In the scenario where a party to OTC transaction is below the threshold, but the other is above will result in a two way payment Initial Margin. The party below the threshold should not support the same rules as its counterparts and should not be forced

to post initial margin. Otherwise, costs may still fall disproportionately on smaller market participants.

The requirement for the implementation of internal initial margin models and the resulting obligation to agree on the outcomes of different models will lead to a sub-optimal situation. We would rather recommend the use of the standardized method or the election of a single initial margin model (market best practice) that would only need to be validated once by a third party and / or the regulator.

One should emphasise that small and medium size players should not suffer from decisions taken by larger players or support substantial costs to mitigate systematic risk inferred by those larger players.

Grand fathering clause: Exchange of collateral requirement as of 1st December 2015 for new contract should be reinforced; it should not only be mentioned under recital 18 but also included in the text of the regulation itself. Furthermore, we consider that a clarification should be added to make sure that **"genuine amendments"** as referred to in the BCBS/IOSCO final report (§ 8.9 and footnote 20, p. 24) made to existing derivative contracts shall not be in the scope of the new regulation. An explicit mention in article 1 FP § 4 shall bring the necessary clarification. As a matter of fact, investment funds often amend existing contracts to reduce their notional amount to adjust their exposure, as a consequence of redemptions. Thus, it is very important for them to keep these existing contracts outside the scope of the regulation.

Reverse the presumption that IM will not be collected: in article 1FP §3, the current wording says that the possibility to exempt transactions between counterparties under the threshold requires a prior formal agreement. **The default rule should be** that, in the absence of a specific agreement between the parties, there is **no IM posted**. Legal services are overworked and this suggestion would simply make things workable.

100 million euros of collateral as Threshold for concentration rules; alignment with UCITS collateral diversification rules: if concentration rules were to apply, they should be coherent with existing requirements. ESMA guidelines require UCITS to spread received collateral in order not to exceed an exposure higher than 20% of the NAV of the fund on one single issuer. The denominator of the ratio is what is important in the fund, i.e. the net asset value or the net capital available in the fund. The proposed regulation refers to the total amount of the collateral when computing the diversification ratio. It is inconsistent to consider that there is a risk on the collateral of small amount that could be mitigated with a diversification rule; it is not workable to ask counterparties to split small amounts of collateral on several issuers for even smaller amounts, uneasy to manage and costly to transfer.

Group consolidated eligibility thresholds: It would be impossible for an asset manager to calculate group consolidated eligibility thresholds on behalf of its client. In addition, the fact that a client may have signed several mandates with several Asset Managers brings additional difficulties in calculating such margin. Which entities will be responsible for calculating and paying the required amount of margin on behalf of the client? The application of two different methods by the parties to evaluate and calculate haircuts may result in discrepancies. It seems that there is no procedure in the RTS to solve those discrepancies. We believe that a ***standardized margin schedule*** may be the preferred approach as a standardized margin schedule used by both parties would lessen the risk of disputes as compared to quantitative portfolio models developed by counterparties.

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?

Not applicable

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?

For both the IRB model (Eligible Collateral and Haircut) and the internal model of Initial Margin calculation small and medium size player will be exposed to non-transparent models of the Banks.

In order to avoid such comparative disadvantage faced by Asset Manager some tools may be proposed:
- To cap the difference between the internal model and the standard model;
- To entrust a third party for the calculation with a commitment to stability of the model;
- The possibility to use specialized models issued by professional provider such as Agencies Rating used for securities ratings;
- To exclude OECD Government Bonds from eligibility rating agencies to avoid the cliff risk criteria;
- As regard to Initial Margin calculation, require Banks to leave the choice for the client and for each transaction between internal model and standard.

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? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?
Eligible Collateral

Before discussing concentration limits it is of prime importance to open the discussion about eligible collateral. We are of the opinion that the list of eligible collateral should be large, diversified and include funds. A large list prevent from the procyclicalilty risk of the collateral. The problem is that a large list of eligible collateral may include assets with a worst quality and liquidity. Quality of the collateral is assessed on the basis of its liquidity and creditworthiness.

Liquidity: the purpose of collateral is to be able to convert it into cash when the counterparty defaults. There is a difference between the price on which the derivative contract was settled and the last level of the variation margin. Liquidity tends to fade or increase very quickly. However, it is a fact that large cap stocks are among the most liquid assets in any circumstances and that government bonds are usually very actively traded as well. But the recent experience has shown that Government Bonds might become totally illiquid overnight. Liquidity should include the possibility to use securities lending and Repo markets to gain it.

Credit quality: Even if we agree that investors should not rely overly on credit rating agencies analysis and that they should develop internal credit assessment capacities, we do not consider that it is fair to introduce a difference when the eligible collateral is determined on an internal rating or an external one provided by a CRA. This causes a particular concern on our part as we will rely on models developed by banks and as such taking into consideration their internal credit estimates. In order to challenge these models we want to be able to take rating published by CRA as reference, especially because the CRAs produce extensive research on credit performance of rated issues over a long period of time.

We consider that the entire field of the investment grade (as defined by CRAs) issues should be considered as eligible. Since they do not show the same level of safety, it is clear that appropriate haircuts have to be provided. We feel that the proposed schedule can be used as a reference.

We do not share the idea to include shares of components of the main indices in the 40% limit that is suggested for convertible, shares and other instruments. First, this proposal is not consistent with the fact that shares are highly liquid and remain one of the few actively traded instruments in periods of stress, probably because of the diversity of types of shareholders. Secondly, this limitation would alter the investment strategy of many funds that are required to invest exclusively or to a very large proportion in shares: hundreds of Structured Funds in France for example have to show a minimum investment of 75% in eligible shares. They might be prevented to use derivative contracts and dramatically reduce the investment universe of their holders. This is particularly true if the 40% ratio were computed on the basis of total collateral and not NAV for funds.

Concentration limits

As regard to concentration limits, we strongly believe that they should not apply below a **threshold of 100 million € in collateral.** Managing concentration limits below 100 million euros would be an operational nightmare, which introduce delays, high complexity and risk in collateral management. We also suggest that the diversification calculation be computed **on the basis of the NAV** for funds (and each sub-fund if any), both UCITS and AIFs (when of course those investment funds individually are above the threshold).

We would like to highlight that as per the "Guidelines on ETFs and other UCITS issues" published by ESMA on the 18th December 2012, a UCITS is bound to invest the cash collateral it receives. Therefore, banning the re-use of cash received as initial margin is in contradiction with other guidelines and rules imposed to UCITS funds.
Cash collateral should be placed on deposits, invested on high quality investment bonds, used for the purpose of reverse repo or invested in short term money market funds. Such investments must be in compliance with additional security constraints. We consider this regime adequately secures transactions and avoid risk in case of default of the receiving party. **Asset managers cannot be subject to a double layer of constraints**. Therefore we kindly ask the regulator to choose between the two set of rules - Guidelines on ETFs and other UCITS issues and the proposed RTS in order apply the diversification of collateral rules.

Q6: How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?

We believe that the prohibition or authorization of re-use should not be determine on a regulatory level but on case by case basis within a bilateral agreement between the parties.

We are of the opinion that BCBS/IOSCO principles have taken a prudent and pragmatic approach when strongly limiting the possibility to re-use or rehypothecate received collateral. We think that there is no reason not to follow these principles. OTC derivatives are traded between professionals. If counterparty agrees that the re-use of collateral will be positive and made for the benefit of its clients, re-use should not be prohibited.

AIFs are currently permitted to re-use collateral (certain disclosure requirements are necessary). These new rules are therefore inconsistent with the rules applying to AIFs and with the way existing AIFs have been structured.
The prohibition of collateral re-use would pose a business problem for some types of funds. If prime brokers are unable to re-use the collateral they receive, access to financing will become more difficult for these funds, and much more expensive.

Another negative effect of this prohibition is that it would deprive the collecting party of a way to generate interests that must be paid to the posting party. How will the collecting party be able to pay interest on collateral that it may not reinvest? In addition and depending of the margin method used, UCITS may be required to post more IM than they may receive from banks. Consequently they would receive less remuneration for such asset transfer.

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