European
Banking
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Ref.: EBF_008115

Brussels, 14 July 2014

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

## General Comments

The European Banking Federation (EBF) welcomes the opportunity 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).

Consistency on a global level is crucial in the application of the margin regime in order to guarantee a level playing field between all market participants involved in the OTC derivatives space, across jurisdictions. In that respect, we would like to point out that the scope of instruments covered under EMIR is wider than under the Dodd-Frank Act. Financial instruments such as equity options or derivatives on equity indices are neither considered "swaps" nor "security based swaps" in the US and consequently are not subject to margin requirements, contrary to the rules in Europe. This creates a major competitive disadvantage for European banks.

The EBF fully 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. It is important that the EMIR margin rules for uncleared OTC derivatives are consistent with the BCBS-IOSCO framework in all material respects. Page 6 of the consultation paper states "To avoid regulatory arbitrage and to ensure harmonised implementation at both the EU level and globally, it is crucial to be consistent with international standards". However, in a number of key respects, the EMIR margin rules depart from the BCBS-IOSCO framework:

- 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) VM and IM (if the EU entity and the non-EU entity are above the IM phase-in threshold) is not consistent with either key principle 2 or 7 of the BCBS-IOSCO framework. This places EU entities which are active in non-EU jurisdictions at a major competitive disadvantage as counterparties will chose to transact with non EU banks instead that are not required to collect margin from small corporates. This discriminatory treatment is justified on the basis that level 1 did not explicitly accord non EU corporates the same treatment as EU NFCs-. This is an unnecessarily restrictive interpretation of EMIR.

- The requirement for an FC/ NFC+ to obtain a positive agreement from an NFC-/exempt counterparty not to apply the margin requirements (positive election requirement): key principle 2 of the BCBS-IOSCO framework clearly states that a transaction between a covered entity and

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a non-systemically important non-financial entity or a sovereign/ central bank/ MDB or the BIS is not covered by the requirements of the framework.

• Article 1 FP (3) uses the term "counterparties". This is defined as in Article 1 DEF as FCs and NFC+s i.e. EU entities.

• There is uncertainty over the personal scope of the provisions providing for exceptions/exemptions in connection with counterparties, which do not qualify as non-financial counterparties ("non-undertakings") – Article 1 DEF in conjunction with Article 2 GEN and Article 1 FP (3).

• While the RTS does not contemplate approval of the initial margin model by EU competent authorities, counterparties will be required to notify the competent authority and be prepared to supply relevant documentation if required. If the models cease to comply with the requirements, the use of the standardised approach is required. We propose that a transitional period should first be granted as the use of the Standardised Method will lead to a significant increase in the margin calculation which potentially exposes model users to a liquidity risk. This transitional period (e.g. 3 months) would give model users the opportunity to discuss any challenges that have arisen with their models with their regulators and make the necessary changes before the use of the Standardised Method is required.

• The ban on rehypothecation of IM is inconsistent with the IOSCO principles and out of step with established industry practice. We urge ESAs to follow the flexibility provided in global rules and ensure a level playing field for European companies. In addition, we suggest that cash may be reinvested in a very restricted range of products, which would be in line with the approach retained in the ESMA guidelines for UCITS.

• Concentration limits on eligible collateral is not a feature of the BCBS-IOSCO framework document. In particular in the case of limits on debt securities issued by sovereigns (government bonds) these are impractical and may also be counterproductive. Concentration limits are also counterproductive in the context of certain equity derivatives transactions where the most protective collateral is the underlying equity.

• Participants will need two years from the adoption of final rules to implement the margin requirements and the requirement to post VM should be phased-in. It is essential that there is a phase-in of VM requirements. If the RTS is not finalised until Q1 2015 then there may be as little as 6 months until the mandatory compliance date on 01 December 2015. This is too short considering the legal, operational and documentation changes that will be required.

The EBF continues to support the central objective of the draft RTS to extend the use of margining as means of risk mitigation. However the introduction of mandatory margining requirements will be extremely challenging for all market participants for a number of reasons.

The new rules will (in particular as they are currently designed to require a formal opt-out by contractual agreement - even in the case of counterparties which are exempt from mandatory margining, see below), affect all market participants, many of which have – up to now – no or little experience with the margining of bilateral transactions, and in particular, variation and initial margining.

The new requirements regarding the segregation of initial margins and the ban on re-use/rehypothecation will require fundamental changes to established collateral management

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procedures and to the contractual documentation currently in use for margining. These changes will be extremely challenging and time consuming - it is to be expected that the timeline foreseen for the implementation is unrealistic and will be met only with great difficulty (less formalistic requirements, see immediately below, would significantly reduce these time constraints). Whilst not currently proposed in the RTS, national regulatory authorities would have difficulty committing to such a timeline should they ever have to approve the potentially large volume of models, 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.

The draft RTS diverge from the BCBS-IOSCO key principles by prohibiting the re-use of IM, which BCBC-IOSCO considers acceptable in certain circumstances. It is important to note that if other jurisdictions – the US in particular – allow the re-use of IM, it will create a distortion of competition and will seriously harm the derivative operations of European banks and impair their ability to service their customers. A bank that can re-use IM, will have a clear competitive advantage as to pricing over those who can't. Any misalignment between EU and US interpretation of IM re-use will create distortion of competition.

In this context, the EBF is of the opinion that the ESAs should include in the draft RTS clause to review the RTS within one year from the date of application. This would 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.

Several partially overlapping regulatory initiatives and rules have led to an increased demand for collateral. These rules touch upon the amount of collateral that needs to be posted, list eligible collateral in greater detail and set out requirements for two-way margining. High quality collateral is a key part of minimising systemic risks. However, a proper balance needs to be found to ensure that the scarcity of collateral does not prevent new market entries or become too much a burden for the smaller and medium-sized companies in the future.

If the ESAs persist with the approach to require positive agreements to benefit from exemptions (positive election requirement), this will not only result in unreasonable burdens for corporate counterparties and other counterparties which are intended to be exempted from the margin requirements but there is a real risk that the OTC derivatives market for corporates will be disrupted at the beginning of the implementation period on 01 December 2015. The experience of the introduction of EMIR trade reporting as well as the risk mitigation techniques has demonstrated that, despite the best efforts of banks to inform their NFC- clients of the requirements, NFC- clients have tended to react late to the requirements and what they imply.

**Response to the Consultation Paper:**

**Chapter 1 - Counterparties' Risk Management Procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012**

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| Article 1 DEF – Definitions<br>Article 1 GEN – General counterparties' risk management procedures<br>Article 2 GEN – Risk management procedures in specific cases<br>Article 3 GEN – Treatment of derivatives associated to covered bonds programmes for hedging purposes<br>Article 1 VM – Variation margin |

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| Article 1 EIM – Initial margins |
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Both Article 2 GEN (addressing the exceptions from mandatory margining requirements or possibility to agree on thresholds) and Article 1 FP require a formal/written opt-out by way of contractual agreement in order to allow counterparties to benefit from exemptions (positive election requirement). This approach is unnecessary cumbersome and formalistic and would impose unreasonable burdens on market participants, in particular, on counterparties which are not subject to the clearing obligation (and which were always intended to be exempted from the requirements under Article 11 (3) EMIR).

This approach would require banks to confront all customers engaged in derivative transactions (regardless of their status under EMIR) with a demand to enter into such a formal opt-out agreement. The process to negotiate and enter into opt-out agreements with each customer will be extremely time consuming, bind resources to a very considerable degree and, of course, be very costly for both sides: The possibility to achieve this via “equivalent permanent electronic means” will only help to reduce the burdens for a limited circle of market participants. The majority of the counterparties, in particular non-financial counterparties, will not have access to technical platforms supporting such a process. Likewise, the protocol-system used by ISDA for certain types of changes to contractual arrangements cannot be applied in all situations and in relation to all counterparties. It is also not available for other – widely used – types of contractual documentation. Consequently, any requirement demanding a contractual agreement will require negotiating and entering into written agreements.

Since many market participants will have contractual relations with more than one counterparty, the market participants will be confronted with many different versions of such arrangements. Especially for smaller and medium sized counterparties, just the costs associated with the necessary legal review of these arrangements and the operational challenges to negotiate terms which ensure a consistent application of margining techniques in relation to all their counterparties will be considerable.

A contractual agreement to opt out is also not necessary to ensure that counterparties can assess whether their counterparties are eligible for any of the exemptions:

- To the extent these exemptions are dependent on the status (or classification) of the counterparty as financial counterparty (FC), non-financial counterparty above the clearing threshold (NFC+) or non-financial counterparty below the clearing threshold (NFC-), equivalent third country counterparty or counterparty not qualifying as FC/NFC (“non-undertakings”), counterparties will be able to rely on the classifications already made in connection with the implementation of the risk mitigation techniques prescribed by Delegated Regulation 149/2013. In the case of ISDA master agreements this was done on the basis of the EMIR NFC Representation Protocol. In case of other master agreements, the relevant documents/annexes implementing the risk mitigation techniques into the master agreements included similar provisions on the classification of a counterparty. These classifications can be used to determine whether a counterparty qualifies for an exemption based on its status (as in the case of the exemptions addressed in Article 2 GEN (4) (b) and (c).

- To the extent exemptions are not based on the status but trade volume, the relevant information can be obtained more effectively and with less formality through an obligation to inform the other party accordingly and/or confirmations/representations from the relevant counterparty.

The commentary to key principle 2 in the BCBS-IOSCO framework indicates that “the requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party. As a result a transaction between a covered entity and one of the aforementioned entities is not covered by the requirements set out in this document”. On the basis of this commentary, Article 2 GEN should simply state that Article 1 GEN does not require FCs and NFC+s to collect VM or IM in relation to transactions entered into with NFC-s or exempt entities.

There is currently no provision addressing counterparties which are neither financial, nor non-financial counterparties because they do not qualify as undertakings. Examples for such non-undertakings are private individuals or municipalities, where these do not carry out economic activities in the market (as addressed in the EMIR FAQ of the Commission under item II.14 and 15).

The EUR 50 million threshold set out in Article 2 GEN (3) is to be calculated between counterparties at a group level. The introduction of a possibility to exclude group entities, which are financial counterparties, e.g. life insurance companies, pension funds or asset managers, would make the calculation of the threshold less complicated. In addition, it should be considered to treat subsidiaries or groups of subsidiaries within a group (sub-groups) as independent groups for the purposes of the margin requirements where these are treated as separate for the purposes of recovery and resolution measures.

As an example, it is highly relevant to measure counterparty risks across multiple trading entities within a banking group as there is often a clear economic relationship between them and thus their counterparty risk. It is, however, less clear that such an economic relationship exists between the counterparty risk of the trading arm(s) of a banking group and any consolidated insurance, pension fund or asset management undertakings belonging to such group.

Operationally, it can furthermore be difficult to consolidate the information needed to measure group wide exposures. Specifically, it is not evident that e.g. the insurance arm of a banking group would share IT systems with the trading operation(s) of the bank - it will therefore become a manual task to consolidate the exposure against counterparties at group level.

We generally favour the proposed principle that the requirements set out in the RTS shall only apply to new contracts. It should however be noted that operational and risk management challenges may occur in the future when firms must manage both “old” and “new” portfolios of derivatives transactions.

Covered bond issuers may have several independent cover pools, therefore we would suggest adding “or” in article 3 GEN, so it reads: “Counterparties risk management procedures may include the agreement in writing or through other equivalent permanent electronic means that initial and variation margins are not posted by covered bond issuers and/or cover pools if all the following conditions are met”.

The clearing and other risk management procedures in EMIR and in the EU delegated legislation issued under EMIR (such as the draft RTS) only applies to derivatives transactions which involve two or more counterparties. Hence, the rules do not apply with respect to derivatives transactions entered into within the same legal entity (see ESMA's response to TR Question 14 in the EMIR Q&A published by ESMA on 23 June 2014). If, in accordance with national legislation and upon prior approval by its competent authority, a bank issues covered bonds on its own balance sheet and internally hedges the risks relating to such covered bond issues, all such hedging arrangements are made within the same legal entity. It would be both desirable and advantageous to clarify that the RTS does not apply to such internal hedging transactions.

**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?**

Both Article 2 GEN (addressing the exceptions from mandatory margining requirements or possibility to agree on thresholds) and Article 1 FP (3) (with the provisions on the phase-in and the threshold based exemption from the initial margin requirement) require a formal/written opt-out by way of contractual agreement in order to allow counterparties to benefit from exceptions (positive election requirement). This approach is unnecessary cumbersome and formalistic and would impose unreasonable burdens on market participants, in particular, on counterparties which are not subject to the clearing obligation, a great many of which will be small and medium sized corporates (which were always intended to be exempted from the requirements under Article 11 (3) EMIR). Credit institutions would be required to confront all customers engaged in derivative transactions with a demand to enter into such a formal opt-out agreement. As many customers will have relations with more than one bank, they will have to deal with different versions of such arrangements. The process to negotiate and enter into opt-out agreements with each customer will be extremely time consuming, bind resources to a very considerable degree and, of course, be very costly for both sides. In order to simplify the operational challenges for all market participants but in particular for smaller and medium sized counterparties, the exemptions should therefore be designed as directly applicable exemptions (not requiring an opt-out) paired with duty on counterparties to inform the other counterparties of their status or relevant factors (and any subsequent changes) as well as a requirement to obtain the relevant declarations/representations from counterparties.

There will be additional administrative 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 even for small FCs end-users. 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. The increase in administrative and operational costs is a factor that may stop small / medium sized entities hedging their interest rate risk, thereby leaving more rather than less risk in the system. These costs are hard to quantify but the requirements will result in higher operational and funding costs. Promotion of standardised third party solutions may reduce the operational burden/IT development costs.

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The need for various agreements for the purpose of not exchanging initial and variation margin will pose a significant operational burden. This will be particularly significant with respect to the relationship to small and medium sized entities.

Equity funds will have to reach for collateral transformation services (which represents costs) to meet their margining requirements, to the extent that they do not have eligible collateral assets in their portfolio or cash available.

The obligation to collect margin from both EU and third country entities may have negative effects. From both a business and regulatory sense we question why parties not governed by EMIR should effectively be required to post IM (and also be forced to disclose the information required to determine which category they fall in or whether thresholds have been breached), thereby giving EMIR an extraterritorial reach. It is difficult to see why any third country counterparty should be willing to post IM and divulge this information when it is not subject to similar regulatory obligations in their home jurisdiction. Rather, it is more likely that these counterparties will simply choose not to trade with EU entities, leading to further market fragmentation.

Additionally, small non-EU funds may be required to collect as well as post margin under the RTS as they will be deemed an FC by virtue of their manager being authorised under AIFMD. Many of these small entities with not have the legal or operational capacity to be able to do this and thus would be detrimental to their operations if this was mandated.

In the first instance it would be reasonable to only require IM to be exchanged between two parties that both are required to post IM under EMIR (namely, only FC, NFC- and NFC+ or excluding any non-EU entity). On the cross-border/extraterritorial issues we 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 entity to post margin (which in all likelihood would mean that the EU entity would have to post IM in return), when there is not the equivalent regime in the country of the non-EU entity, requiring the same.

The EBF encourages the ESAs to allow for the recognition of equivalent margin rules in other jurisdictions (as contemplated by the commentary to principle 7 indicate of the BCBS-IOSCO framework). This is important for EU banks who are registered swap dealers under Title VII Dodd-Frank Act and therefore will be subject to both the EU rules and US rules implementing the BCBS-IOSCO framework.

**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 (positive election requirement). This will pose a significant operational burden, in particular with respect to the relationship to small and medium sized entities (see also response to Question 1 on the effects of this positive election requirement on small and medium sized companies).

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 election 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 benefit of phasing-in would be watered down as long as it does not reduce the documentation burden. The exemptions should therefore be structured a direct exemptions not requiring an opt-out (positive election). If contractual agreements are deemed to be necessary, this could be achieved by an obligation on all counterparties which are or become subject to the margin requirements to put in place the appropriate documentation (that is as of the time they become subject thereto).

It is not clear whether formal documentation is required where the transactions were entered into with exempted entities under Article 2 GEN 4 (b) and (c) i.e. NFC- of article 10 EMIR and sovereigns/supranational entities of Article 1 (4)/(5) EMIR. Indeed, the introductory section refers to writing or equivalent means only with respect to FC and NFC+, while such agreement is stated to be made with respect to "following" including (b) and (c). If so, the entities intended to be exempted would still be affected through the corresponding documentation requirement in order to benefit from the exemption.

It is not clear whether a written form is also required to be repeated each time the parties do not reach the phase-in thresholds in Article 1 FP (3) (i.e. are not subject to IM). Re-documenting all derivatives relationships with all (including exempted) counterparties seems disproportionate to the goal of fostering financial stability. In other words, we believe that where an exemption is available for practical exchange of collateral, it shall be consistently available for documentary requirements.

It is not clear what constitutes "other equivalent permanent electronic means" as alternative to writing and how this can ease the operational burden. As already mentioned above, the relevant agreements would involve negotiations and thus do not lend themselves to electronic standards (not a binary decision). In addition a significant portion of the affected counterparties will not have access to such electronic means and protocol system such as the one established for ISDA master agreements (see response to Question 1 on the limits of the use of protocol systems).

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.

The haircut on collateral for FX mismatch will result in more collateral movements and operational risks. They way exposure is calculated in CM systems will also be affected with requirements on developments as a result.

It would be helpful, if the definition of "currency mismatch" (on page 50 in the Consultation Paper) were clarified. We do not understand what is meant by settlement currency. It could, for example, mean the currency in which non-collateral payments are made in respect of a transaction, but this would not be meaningful for cross currency swaps or other transactions with payments in multiple currencies. Alternatively, it could mean any currency in which settlements may be made for the transaction, but this would then include the collateral payments themselves. Or it could have other meanings, including the base currency, but this may seldom be used for payments except for termination determinations. The haircut of 8% ought to be lower for currency pairs with low volatility, e.g. when one currency is pegged to another.

The RTS should make it clear that:

1. Netting across asset classes for the purposes of calculating VM is permitted. Article 1 GEN (3)(b) refers to collection of VM on a net basis, but this is not carried through to Article 1 VM.

2. Uncleared OTC derivatives between members of the same group should not be included in the calculation of the IM phase-in threshold. This is consistent with the application of the EUR50m IM threshold between consolidated groups. If not, there is a double-counting effect for back-to-back transactions to transfer market risk to the group member who holds the market making book and/or who contracts with external parties. This may cause a group to exceed an IM phase-in threshold when such back-to-back trading does not really represent incremental systemic risk.

The EBF considers that the setting up of the following two registers would facilitate the application of the margin rules by EU entities:

1. A public register of NFC+s. As each non-financial counterparty who exceeds the clearing threshold is required to notify ESMA and its competent authority under article 10(1) of EMIR, ESMA is in a position to maintain and publish a public register of each EU entity that is an NFC+.

2. A public register of EU FCs and NFC+s who are a member of a group whose aggregate month-end average notional amount of uncleared OTC derivatives exceeds the prevailing IM phase-in threshold. This could be combined with a requirement for such EU FCs and NFC+s to notify ESMA and their competent authorities by the 30 September following the applicable calculation period if their group exceeds or has ceased to exceed the applicable IM threshold for the next following annual period. This is consistent with paragraph 8.10 of the BCBS-IOSCO framework document.

This would help market participants to accurately apply the IM and VM requirements and reduce the reliance on representations from its counterparty to establish if and to what extent it must apply the margin rules to new transactions with that counterparty.

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.

The EBF supports the introduction of more clarity around the definition of Minimum Transfer Amount (MTA). The MTA should be defined as per the current market practise as the minimum (threshold) amount that has to be settled between counterparties on any business day. By referring to "collateral amount" it is not clear whether the definition refers to the cumulative full value or the collateral amount to be exchanged on that day.

The provision on the MTA in Article 2 GEN (4) (a) and (6) demands that the amount is calculated as the total amount of all initial margins and variation margins to be posted, that is without differentiating between variation and initial margin. The function and understanding of this MTA differs significantly from current practice. The operational introduction of this new MTA concept will be extremely challenging since it would require the implementation of new and very complex allocation and monitoring systems. In addition, the proposed new MTA concept could defeat the purpose of the MTA: Once the total amount is breached, even very minor differences (which occur regularly) would trigger margin calls needing to be processed (effective zero threshold), resulting in unnecessary and, considering the very limited risks involved, unreasonable additional operational burdens. Electronic processing can reduce these effects only to a limited extent and, is in any event, not an option in relation to those counterparties, which have no access to such electronic processing (in particular smaller and medium sized counterparties). In this context it should be taken into account that the risk exposure of credit institutions would, in any way, be addressed by existing the capital requirements under the CRR.

The described negative effects could be minimised by introducing two separate total MTAs, on for variation margins and another for initial margins, and an additional operative de-minimis threshold for any margin call (e.g. to the amount of 50,000 €).

We further propose to delete the last half sentence of Chapter 1, Article 2 GEN, paragraph 3 (p.23 of the draft RTS) which sets out the requirement to "hold capital" where no initial margin is to be exchanged ("and that they will hold capital against their exposure to their counterparties". Such a requirement to hold capital requirements is unnecessary and may cause misunderstandings: FCs are, of course, already subject to (regulatory) capital requirements under the CRR. These, however, do not and are not intended to apply to NFC. Such requirements can also not be imposed by contractual agreement, not least because it would be impossible to determine whether the other counterparty complies with such an obligation.

We would welcome a clarification that no threshold other than Minimum Transfer Amount with respect to Variation Margin is authorised. Indeed, the second paragraph on the page 8 referring to a "minimum exchange threshold" of EUR 500,000 may lead to confusion and be interpreted as another threshold on the top of the Minimum Transfer Amount (where "margin requirement exceeds EUR 500,000"). Regardless, it is industry's view is that the MTA should be applicable to IM and VM independently. By making it applicable to the consolidated figure of IM and VM, it would not only be operationally complex and intensive but inconsistent with current market practice.

**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.

The exemption should be extended to securitisation swaps for securitisations based on the same asset classes on the basis that such swaps effectively work in the same way as covered bond swaps. The requirement for securitisation vehicles to post initial and/or variation margin on swaps that they transact to hedge the cash flows on the underlying assets they hold against the principal and interest on the notes they issue will have a material adverse effect on the effectiveness of such transactions or structures as a funding tool. If a securitisation is required to post initial and/or variation margin, this will also have adverse implications for the asset encumbrance ratio of the originator bank as a result of asset pools having to be larger to generate adequate cashflows and/or the use of issuance proceeds, to fund initial and/or variation margin. This is detrimental to the position of unsecured bank creditors. We believe that adequate protection against counterparty credit risk is provided to swap counterparties through security on the assets that the vehicle holds and the over-collateralisation features embedded within such transactions and structures.

For this reason, we encourage the ESAs to consider exempting securitisation vehicles from the scope of the EMIR margin rules in order to ensure that this important funding tool for banks to support real economy remains effective.

Regarding Article 3 GEN (1)(a), it would be preferable that this requirement was removed in its entirety. It is not clear why it has been included and effectively precludes the covered bond issuer being the basis swap provider to the covered bond vehicle (to the extent that the application of the RTS is not precluded because the hedging transactions are entered into within the same legal entity). Should this requirement be retained, it is important that it is limited to insolvency related defaults only. As presently drafted no event of default (e.g. payment default) relating to the issuer would be permitted. Such a requirement would be incompatible with market practice and reach beyond the requirements applied by the rating agencies for AAA compliant covered bond related derivatives. The purpose of this restriction should be to avoid that the derivative is terminated as a result of the issuer's insolvency, not to prevent the counterparty from terminating upon other limited non-insolvency related defaults. Therefore, we propose a change to add the words "insolvency related" before "default" in paragraph (a) of Article 3 GEN.

In addition, GEN 3 (1)(b) should be qualified with "except in the case of the default or insolvency of the derivative counterparty" to allow for flip clauses required by rating agencies as a condition to their ratings of covered bonds.

The regulation of covered bond programs and hedging related to them is quite strict and limiting at the moment. In our opinion, this level is adequate and even tighter regulation wouldn't benefit the investors or the hedging counterparties. The underlying cover pool assets already cover the interest of the hedging counterparties to the same extent as the cover pool assets cover the interest of the covered bond holders and tighter regulation would only add administrative burden without notable benefits. A requirement to post collateral in respect of the derivatives which are also covered by the cover pool assets would result in a situation where the hedging counterparties would have a stronger protection than the investors. This would not be consistent with the investor's protection point of view.

Regarding Article 3 GEN (1)(f), we believe it should be sufficient to have a de facto 2% over collateralisation and not a necessity to have a legal requirement in each jurisdiction.

## Chapter 2 - Margin methods

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| Article 1 SMI – Standardised Method<br>Article 1 MRM – Initial margin models<br>Article 2 MRM – Confidence interval and risk horizon<br>Article 3 MRM – Calibration of the model<br>Article 4 MRM – Primary risk factor and underlying classes<br>Article 5 MRM – Integrity of the modelling approach<br>Article 6 MRM – Qualitative requirements |

The calculation and agreement of initial margin could be a challenge and lead to more disputes. Even if the same model is used, counterparties in general may use different market price, underlying values in the portfolio (i.e. variation margin), etc. In addition, the IM is not symmetrical because some contracts only result in PFE for one of the counterparties.

In practice, the choice of internal model methodologies will also differ across counterparties and lead to an escalation in the number of disputes. On the other hand, the margin level produced by standardised models is broadly still too high and reduces the usability of such models when compared to internal models

We firmly advocate the development and use of a unified margin model between market participants, e.g. ISDA's SIMM. We firmly believe that this is the best way to ensure a transparent as well as efficient margin process, in particular in regards to the dispute resolution procedures.

In connection to this, we do not believe that the "practical and legal issues", referring to Article 1 MRM - Initial margin models, in relation to a unified modelling approach, should stop efforts to try to agree a coordinated European and even global model approval process. Even though certain details may differ in the various countries, it is our view that a unified industry model and a coordinated approval process would, all things considered, be far preferable to alternative approaches, e.g. where each counterparty uses its own models.

We are of the opinion that the use of an Internal Margin Model (IMM) must remain possible even where a unified margin model exists. Even if a unified margin model were to be approved, a 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, we suggest that the counterparties to a contract agree by convention whose model will be used or rely on a calculation agent agreed in advance.

We ask the ESAs to clarify point 1 of Article 5 MRM, integrity of the modelling approach, which states that the IM model is required to capture "main non-linear dependencies". If this means that it would not be permissible to only use first-order sensitivities, then in our view the consequence would be an (industry standard or other) model that would be much harder to set-up and operate. In particular, potential comparability issues between counterparties on second order sensitivities will become problematic.

There are other elements of MRM that are vague and require clarity from the ESAs. For example:

• Article 3 MRM (2): guidance is required on what indicates a "period of significant financial stress".

• Article 3 MRM (8): the RTS does not state the maximum period within which posting of IM resulting from a re-calibration must be completed. In addition, the RTS does not give the same grace period to the posting of IM as a result of the counterparties having to move from the initial margin model basis to the standardised basis (as required by MRM 1(4)) – this may result in a liquidity cliff event if counterparties must move from the model to the standard schedule overnight.

• Article 5 MRM (1): "material exposures", "significant for the netting set"

We would suggest an alternate approach to assigning a derivative contract to an underlying class based on its primary risk factor. Instead, we suggest that the IM model calculates all risk factors (interest rate, equity, etc.) for all trades and aggregates VaR (type) numbers for these risk factors. This way, there would be no offsetting of risk between asset classes due to spurious historical correlations. In addition, this approach would ensure that, for example, the interest rate risk is still calculated and included for trades that where equity maybe the primary risk factor.

We believe that the requirement to use the most recent data for the IM modelling will actually result in pro-cyclicality. We would suggest further thought be given as to how to standardise the process and governance around the updating of data, to avoid such unintended consequences.

In general, the ways to define internal models are unclear. If the use of an internal model is agreed on, many questions are still left unanswered. How will it be followed in practise? Should there be an ex ante approval and calibration thereafter? Margin calculations may even with the same model lead to different end results. Following this, one of the counterparties may be required to post more margin than expected with the internal model. Finally, is it intended that a party has several different internal models, one for each counterparty or type of counterparty?

## Chapter 3 - Eligibility and treatment of collateral

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| Article 1 LEC – Eligible collateral for initial and variation margin<br>Article 2 LEC – Collateral Management<br>Article 3 LEC – Credit Quality Assessment<br>Article 4 LEC – Credit Risk Assessment by the collateral taker using the Internal Rating Based Approach<br>Article 5 LEC – Eligibility Criteria for UCITS<br>Article 6 LEC – Eligibility criteria to avoid wrong way risk<br>Article 7 LEC – Concentration limits for initial and variation margins<br>Article 1 HC – Calculation of the adjusted value of collateral<br>Article 2 HC – Own estimates of the adjusted value of collateral |

Concerning Article 2 LEC (b), the EBF would welcome some further clarity regarding what these legal arrangements would entail.

As a result of the rule proposed in Article 2 LEC (e), where cash collateral is posted to a 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.

With regard to article 6 LEC we believe that it would be sufficient to have only a requirement that the securities are not subject to any significant wrong way risk (Article 1 LEC (c)) e.g. securities issued by the posting counterparty may not be subject to any wrong way risk if the securities are guaranteed by a third party guarantor. Also, securities issued by entities which are part of the same group may be ring fenced and therefore not pose any significant wrong way risk.

**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?**

At this stage it is not clear whether the proposed rules on the use of IRB models are suitable for practical purposes, in particular if it realistic for the parties to share sufficient information about the IRB model to be used.

The counterparty providing the model will of course need to provide appropriate information on the model to the counterparties to be confident in accessing sufficient information.

Ultimately, we believe that the best approach will be the application of a unified margin model as this will greatly reduce the complexities and operational problems since all counterparties relying on this unified model will have a common understanding of the information required for this model and the manner in which it is to be implemented. We support the use of internal models for determining collateral haircuts. However, these haircut estimates should not be run separately from the IM model themselves. To not take into account any correlations between the unsecured exposure, collateral or exchange rates, is likely to lead to more disputes than if they were otherwise taken into account.

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Also, we believe that the standard schedule proposed would be overly penal in a number of cases, e.g. Danish Flex bonds are given a minimum 12% haircut for >5y issues, which could be harmful to the both issuers of and investors in these bonds.

**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?**

We understand that Article 7 LEC, concentration limits for initial and variation margins, imposes an upper limit on how much collateral (received) in relation to a single issuer, or entities that are part of the same group or those with close links, shall not exceed 50 % of the collateral collected from any single counterparty.

The proposed concentration limits will require fundamental changes to existing collateral management systems and procedures as they differ significantly from current practice. This will result in substantial operational costs. This is further exacerbated by the fact that the proposed requirements differ from and conflict with similar requirements under the CRR. 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 the basic 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.

In particular the requirement to apply the concentration limits in relation to each individual counterparty increases the complexity and thus the operational challenges unnecessarily. Such counterparty-based concentration limits will also be challenging for the relevant counterparties, in particular small and medium-sized counterparties.

The purpose of concentration limits is served just as effectively but with significantly less complexity by permitting the collateralised counterparty to apply these in relation to all counterparties, that is in relation to its total exposure. This would not only reduce the operational complexity for the collateralised party. It would also prevent that collateralising counterparties are effectively denied access to the market simply because they are unable to diversify the collateral they have at their disposal.

Moreover, in some cases the concentration limits may actually be counterproductive as they might force counterparties to replace collateral of a very high grade by collateral of a lesser

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grade simply because the concentration limits have been breached. This may apply in particular to debt securities issued by sovereigns. In the context of equity derivatives customarily secured by collateral in the form of the underlying equity, forcing market participants to diversify collateral and to substitute it with uncorrelated collateral would result in a discrepancy between exposure and collateral which would increase the risks of collateral takers. This would also prove inefficient for collateral providers holding the underlying equity who will be deprived of other sources of liquidity in order to meet the diversification requirement. For the same reasons, collateral in the form of underlying equity should also be exempted from the requirement of the inclusion in main indexes.

If a decision is made to introduce concentration limits then they 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 practise most of the collateral sent is in form of cash, therefore we do not think that it is appropriate to introduce concentration limits at the current time. 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 the concentration limits in relation to highly rated government bonds and covered bonds should at the least be significantly increased because the operational costs will out weight the liquidation issues under stressed scenarios. Counterparties should also be able to bilaterally agree concentration limits in relation to some minimum requirements.

To reiterate the above, in practise most collateral is sent in the form of cash. It would therefore seem inappropriate to introduce more concentration limits.

## Chapter 4 - Operational procedures

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| Article 1 OPE – Operational process for the exchange of collateral<br>Article 1 SEG – Segregation of initial margins<br>Article 1 REU – Treatment of collected initial margins |

Article 1 SEG (4) (a) requires that segregation arrangements ensure that collateral posted as initial margin is “immediately” available to the secured party upon an event of default. However, the realisation of collateral always follows certain processes and thus requires a certain time and can therefore never be achieved instantly. Against this background the term “immediately” should either be replaced by the more appropriate “in a timely manner”. In this context it is also critical that EU member states implement the Bank Recovery and Resolution

Directive 1 in a way that does not compromise the ability to enforce IM collateral arrangements per Article 2 LEC (1) (g) and Article 1 SEG (1).

Concerning Article 1 SEG (5), the requirement for every counterparty to obtain a legal opinion in all relevant jurisdictions on whether the segregation arrangement meets the requirements set out in Article 1 SEG (3) and (4) at the inception of the transaction and on a regular basis thereafter and at least annually is extremely cumbersome and unworkable.

As currently drafted, the obligation is considerably more rigid and formalistic than similar obligations concerning the need to assess and monitor legal risks under the CRR, or, in fact the corresponding obligations regarding segregation in the case of CCP clearing under Article 39 EMIR.

The provision can be understood to require a new legal opinion for each transaction. This would be impossible to implement and is presumably not intended. It should therefore be clarified that counterparties are required to make a legal assessment regarding the effectiveness of a segregation arrangement prior to entering into such arrangement based on the most recent legal opinion (allowing for the possibility to rely on existing opinions in respect of standard arrangements).

The rigid timeframe for updates of legal opinions should be replaced by more flexible approach. For example, counterparties could instead be required to regularly review whether existing legal opinions can still be relied upon (that is, whether there have been any material changes in the law indicating a need to update the opinion).

If, however, in contrast to all existing legal opinion requirements under the CRR, a rigid timeframe for updates is considered to be necessary, the relevant timeframe should at least be expanded to permit counterparties to coordinate timing of the opinions on segregation arrangements with other existing opinion requirements (it is likely that opinions on segregation arrangements interact with or will be based on opinions obtained for the purposes of the CRR) and also in order to avoid the situation that updates become due although it is already foreseeable that legal changes are upcoming. An expansion of the timeframe to up to two years would already alleviate many of the operational problems. In this context it should again be taken into account that the legal structures and areas of the law which would be analysed in the legal opinions on segregation arrangements are well-known, well established and are rarely subject to fundamental/material changes affecting their effectiveness and are usually standard structures used for collateralisation in general.

The draft RTS do currently not address the question of the consequences in the event that it is not legally possible to establish segregation arrangements meeting the standards of the draft RTS under the laws of a certain jurisdiction (or where changes in the law render it ineffective).

The vast majority of jurisdictions will of course have a legal framework for collateralisation that will permit effective segregation arrangements. However, in the exceptional cases where this may not be the case, the current draft RTS fail to provide any guidance on the consequences.

[1] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

In particular, as currently drafted, the obligation to collect initial margin would still continue to exist.

One possible manner to address this issue would be to provide for an exception from margining requirements (variation and initial margin) in respect of transactions with counterparties from specific jurisdictions, where a counterparty subject to the margining requirements under the draft RTS demonstrates that the legal situation in the relevant jurisdictions does not support legally effective segregation arrangements or margining in general as prescribed by the draft RTS.

In order to ensure consistency, assets posted as collateral that are bankruptcy remote in the event that the counterpart becomes insolvent, should result in an exposure value of zero in the same way it is when collateral is posted to a CCP. If not given the same treatment, then the received and posted IM will net out against each other, without the IM giving a proportionate reduction in capital. It is not currently clear from the CRR/CRD IV text that this IM/capital off-set is possible, as this text appears only to refer to CCPs. Assuming this is the case, then an update to the CRR/CRD IV text is needed to include other counterparties than just CCPs. As a technical matter this (update) in itself could be problematic as we understand CRR/CRD IV will not be “open” for amendments before the start of 2017, while bilateral IM requirement would be live before the end of 2015.

**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?**

In European law-making, one should always ensure that the capability of European companies to create growth is not harmed with more stringent requirements. 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. In that respect, we would like to point out that the scope of instruments covered under EMIR is wider than under the Dodd-Frank Act. Financial instruments such as equity options or derivatives on equity indices are neither considered “swaps” nor “security based swaps” in the US and consequently are not subject to margin requirements, contrary to the rules in Europe. This creates a major competitive disadvantage for European banks.

The requirements set out in BCBS-IOSCO are well suited to ensure high level protection of the original collateral. Some requirements for rehypothecation of collateral are also provided for in other European regulations.

We suggest that cash may be reinvested (instead of not re-used at all) in a very restricted range of products, which would be in line with the approach retained in the ESMA guidelines for UCITS.

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## Chapter 5 - Procedures concerning intragroup derivative contracts



Article 3 IGT (1) (a) and (b) mention "regulatory restrictions" and "insolvency, resolution or similar regimes" as one of the legal impediments to the prompt transfer of own funds which would prevent reliance on the intragroup exemption. However, many regulatory regimes and all insolvency, resolution or similar other regimes, by their nature, contain provisions which can affect the ability of the regulated or insolvent party or the party under resolution to effect payments or transfer assets. Thus, unless Article 1 IGT (1) (b) is intended to mean that such impediment is only deemed to exist upon initiation of such proceedings but not before, the relevant requirement would effectively invalidate the effects of the exemption for intragroup transactions. This cannot be the intention: The intragroup exemption is essential to minimise the adverse effects of and challenges posed by the application of mandatory margining to transactions between members of the same group. If it would factually not possible to rely on this exemption, the negative consequences for groups would be very considerable.

In addition to the above, the provisions fail to set out any standards how to distinguish between effects of regulatory restrictions or effects of an insolvency, resolution or similar event which are not yet an impediment and those which are.

We consider that transactions that are exempted from the clearing obligation (certain forex derivatives transactions qualifying as intra-group) should not be taken into account in the calculation of the 8 billion threshold.

The fact that the largest banks globally (G-SIBs) and in some cases on a national level (L-SIBs) now has robust recovery and resolutions plans should also alleviate some concerns regarding intra-group exposures.

These issues aside, in our view there is simply not the same contagion/systemic risk with intra-group exposures as there can be with exposures to external counterparties. This is important when keeping in mind the overall aim of this initiative is to address systemic risks in the OTC derivatives market.

We therefore question if moving to a "defaulter pays" model for intra-group exposures is (on balance and overall) really any better than the current techniques for mitigating such risk. An IM requirement on intra-group exposure puts additional strain on groups to hold and manage even more collateral. Not forgetting the need to hold (potentially) larger buffers for other purposes like the LCR. Also, if the cost is too high then firms will stop doing transactions that may be beneficial to them on a group level. We believe these issues (as examples) with IM for intra-group outweigh any perceived benefit.

Further, in the case of intra-group exposures the financial health of the "counterparty" is extremely well known, whereas in the case of external counterparties there may be more limited information. In addition, it is easier to follow the development of an internal entity, i.e. any deterioration, and therefore there is the ability to respond faster to change. The sometimes criticism of capital is that it is less responsive to changes in the counterparty risk than margin, but this should be less of a concern for intra-group exposures.

In addition, and more importantly, groups have the ability to manage the risk profile both in terms of size and types of risks for the entities within the group. The same cannot be said of external counterparties.