CORPORATE CREDIT RISK MANAGEMENT

P.O. Box 1800, 1000 BV Amsterdam, The Netherlands

To:
Joint Committee of the European Supervisory Authorities

Date
14 July 2014

Subject
Response to the draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP

Dear Committee,

ING Bank welcomes the opportunity to provide feedback on the draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP as issued by the ESMA, EBA and EIOPA on April 14th, 2014.

ING is a global financial institution of Dutch origin, offering services through its operating companies ING Bank and NN Group. ING Bank has leading market positions in Retail and Commercial Banking in the Benelux. We are also a leading 'direct-first' bank in countries such as Germany / Austria, Spain, Italy, France and Australia and have strong positions in fast-growing economies outside of Europe. With more than 63,000 employees, ING Bank serves over 32 million private, corporate and institutional customers in over 40 countries in Europe, North America and Latin America, Asia and Australia.

In the below, we provide our responses to the specific questions under consultation. Several general comments are captured in the response to question 2. We hope that our contribution is helpful in the process of finalising the regulatory technical standards. Please do not hesitate to contact us with any further queries you may have.

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?

The associated costs to the collateral requirements can roughly be divided in four categories. Firstly, there will be liquidity costs associated with having to post variation margin for the relevant SMEs (depending on the market value of the underlying derivatives) and in unlikely cases even initial margin (depending on the outstanding notional size of the SME). Secondly, investments in the collateral system architecture and additional staff would be required to handle the daily margin call requirements under the draft RTS. Thirdly, banks selling derivatives to SMEs would have to price in the additional liquidity costs associated to the bank. (These may however be off-set by decreased CVA charges). Fourthly, specifically for NFC-'s outside the EEA which are required to exchange margin with EEA banks, there are associated costs for missing the opportunity to get a better price from an EEA bank in the absence of a global level playing field.

As NFC-'s (or equivalent) outside the EEA are required to exchange margin with EEA banks, ING Bank expects they would restrict themselves to hedging their positions with non-EEA banks with whom they are not required to exchange margin to avoid the above-mentioned costs. As NFC-'s in the EEA are not required to exchange variation or initial margin, ING Bank expects they will not voluntarily do so (again because of the associated costs described in the above), potentially leaving positions unhedged or moving towards non-EEA counterparties with whom they are not required to exchange margin. As NFC+'s (inside and outside the EEA) would be required to exchange margin and consequently are exposed to above mentioned costs, they are less stimulated to hedging their open interest rate positions.

ING Bank strongly believes that counterparties outside the EEA that would be considered to be an NFC- within the EEA should not be required to exchange margin. This not only reduces their costs (as in a global level playing field they are expected to get more competitive pricing for the derivatives they want to enter into for hedging purposes), but will be a better reflection of the international standards as set by the BCBS/IOSCO.

ING Bank believes that for NFCs and smaller FCs investments in infrastructure and staff can be better managed if at least 2 years would be allowed between the finalization of the technical standards and the implementation date of margining requirements. This is specifically true for the smaller-sized market participants (like NFCs and smaller FCs), as these may need additional education on the complexity of the rules that will be applicable to them before they are in a position to initiate the required action.

In order to relief SMEs of the burden to set up a daily margin call and settlement process, ING believes that the RTS should support that a party may opt for 'outsourcing' the handling of the margin call process to the other party (i.e. the sole valuation agent) or a third party. Additionally, the sole valuation agent (or the third party) could have the right (via e.g. power of attorney) to withdraw collateral from the clients account up to a certain limit.

Furthermore, we request the supervisory authorities to closely monitor industry initiatives like 'margin sharing' (in which both parties post half of the initial margin to a third party - account). These could substantially reduce the costs for all parties involved, though the example given is not in line with the international standards under 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.

ING Bank firmly considers the administrative procedure that is required to have intercompany transactions not be subject to initial margin requirements to be overly burdensome. Therefore, we would advocate to include a general exemption for intragroup entities to not be required to exchange initial margin, but variation margin only (at least for banks within a single supervisory environment e.g. the Eurozone going forward).

Moreover, the RTS requires a written agreement between parties in case one or both want to make use of exemptions provided by the RTS. This opt-out approach is unnecessarily burdensome and not in line with the BCBS-IOSCO framework. It would require a repapering

exercise with many counterparties and clients which would not be required to post any margin by the BCBS-IOSCO framework. An option to agree on bilateral margining voluntarily (an opt-in approach) would be more workable. In any event we feel the requirement not to apply the margining rules for these transactions should be the base rule. This would avoid any burdensome and costly repapering exercise with counterparties.

Furthermore, ING Bank strongly advocates not having the outstanding notional for intercompany transactions count against the aggregate notional size of non-centrally cleared derivatives that determines the timing of when the initial margin requirement becomes effective as (and in so far) they are exempt from exactly those requirements. Similarly, this should apply to other trades that are exempted from the initial margin requirements, i.e. physically-settled FX Forwards and trades with sovereigns, central banks, multilateral banks, BIS and PSE.

Besides the option for bilaterally agreeing the initial margin model (inputs) to be used, ING Bank is of the opinion that the RTS should promote the usage of industry models. By using the same model across a large group of market participants, the extra reconciliation and dispute management burden regarding the determination of the proper initial margin amount can substantially be reduced.

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 requirement set forth in 1(a) of article 3 would be incompatible with market practice and rating agency requirements for AAA-rated bonds. In our view, the proposal could work if the requirement would be restricted to insolvency related defaults. We therefore propose to insert the wording ‘insolvency related’ before ‘default’.

ING Bank supports the requirement of 1(b) of article 3 provided that this does not allow the current practice in which the claim of the swap counterparty will be subordinated in case of default by the swap counterparty. In our view, it would be appropriate to include a carve-out for the ranking in case of such swap counterparty default.

We support the requirements set out in article 1(c) and 1(d).

We deem the introduction of the requirement to comply with CRR instead of UCITS set forth in article 1(e) to be inappropriate. The requirements of article 52.4 UCITS provide for a strong regulatory legal framework and public supervision as well for high quality of the investments/credit risk involved. It may be that covered bonds are in compliance with 52.4 UCITS, but are backed by assets which are not listed in article 129.7 CRR (e.g. SME). It would be inappropriate to exclude such covered bonds from the preferential treatment. We

would like to emphasize that the swap counterparty for these covered bonds has the same strong position and protection as the swap counterparty for covered bonds that also comply with 129.7 CRR.

We support the requirements set out in Article 1(f).

ING Bank strongly feels that the current practice of one-way collateral posting by the swap counterparty could continue. The swap counterparty is protected by its claim on the cover pool and its at least pari passu ranking with the (normally) AAA-rated bonds. The current draft of article 3 in essence allows to continue this practice. Subject to our comments on this article 3 this would be the preferred approach. Alternative 2 which provides for 2-way collateral in combination with the introduction of an intermediary is undesirable. As said, 2-way collateral posting is not necessary for the enhancement of the position of the swap counterparty, whereas the introduction of a third party would add credit risk to the structure rather than provide for additional comfort for the swap counterparty.

A final remark is that the reasoning for having an exemption of the requirements for swap counterparties in covered bonds is equally valid for swap counterparties in securitizations. We therefore would welcome any initiative by the ESA's to explore the opportunities to extend the scope of this regulation to securitization swap counterparties.

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?

In principle, ING Bank has no strong objections against allowing for internal rating based qualification of collateral, when external rating-based qualification remains an option as well.

However, we do see difficulties in the use of an IRB model with regard to assessing individual securities internally and – as a consequence – we wonder whether the IRB-model will largely be opted for by market counterparties. Firstly, investments should be made in extending the current infrastructure to assess counterparties to the issuers of securities and individual issues. Secondly, the bilateral utilization of an IRB-model may introduce yet another source for disputes between the two entities party to the CSA (on the eligibility and the haircut of the collateral) and thereby a new level of complexity in the daily agreeing of collateral transfers.

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

ING Bank believes that the introduction of concentration limits on individual counterparty level to the extent proposed in the draft RTS will lead to unnecessarily required complexity in infrastructure and administration of collateral. Therefore, we propose to have securities that are eligible under the RTS not be subject to concentration levels on a counterparty level (like cash collateral) but on a firm-wide level. Thereby, the monitoring burden will decrease and the draft RTS would be brought in line with the global BCBS/IOSCO framework (which does not require this limit management on a counterparty level).

Where it concerns collateral issued by entities (i.e. governments, central banks) that are domiciled in the same jurisdiction as where the posting party is domiciled, additional firm-wide measures should be taken as wrong-way risk can be present (i.e. limit setting).

For exposure to governments in general, we consider looking at the sovereign paper taken as collateral for non-centrally cleared derivatives in isolation to be sub-optimal. In this respect, we align ourselves with a comment made in the consultation on the "supervisory framework for measuring and controlling large exposures" of March 2013: ".. the Committee believes that the appropriate treatment of concentrated sovereign exposures' will need to be addressed as part of a broader review of the treatment of sovereign risk within the regulatory framework."

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?

The ability to re-hypothecate / re-use the collateral received is at the heart of the banking business model. Trapping liquidity in segregated accounts is counterproductive towards banks' core function which is to provide credit. Therefore, ING strongly supports to have possibility to re-hypothecate / re-use collateral received as initial margin.

We do, however, recognize certain complications in meeting the conditions as set by the BSBC/IOSCO. Collateral outside of the US typically moves by title transfer, under an English law Credit Support Agreement (under which the initial margin concept is being referred to as the "Independent Amount"). Prohibition on re-hypothecation (as well as the segregation requirement in the proposed RTS) is inconsistent with title transfer and presents a legal re-characterization risk). To ensure fulfilment of all the conditions for the re-use of initial margins under the proposed framework therefore, credit support documentation would necessarily have to take the form of a *security interest* documented under an English law Credit Support Deed. (The New York law CSA already operates in a similar way). This would require a costly

and time-consuming revisit of existing credit support documentation which institutions have in place with their counterparties. Security arrangements can take several weeks if not months to (re)negotiate and the associated costs are high. (There would inevitably need to be an industry consensus around certain forms and structures.) A further complicating factor is the number of jurisdictions that can potentially be involved in any one security arrangement: in such cases it would not always be clear which jurisdiction's rules need to be complied with and what happens if there is a conflict of laws. The consequence of all these factors is that it can be burdensome to try to take cross-border security and the end result can often be less clear-cut than is desirable. In Europe, while the Financial Collateral Directive was intended to simplify and provide more certainty (and a level playing field) in respect of the process of taking financial collateral across the EU, differences in its implementation and interpretation across the EU, as well as a lack of clarity as to the meaning of some of its key terms, means that difficulties are often encountered in practice when attempting to benefit from its provisions.

We remain available should you wish to further discuss.

Yours Sincerely,

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