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European Securities and Markets Authority

European Banking Authority

European Insurance and Occupational Pensions Authority

Joint Committee of the European Supervisory Authorities

Submitted online

Dear Sirs

Consultation Paper - Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

1. INTRODUCTION

We welcome the opportunity to give comment on the draft regulatory technical standards published jointly by the ESAs detailing the requirements for exchange of collateral under Article 11(3) (the "Draft RTS"). We are aware of responses being prepared by various stakeholders in relation to certain aspects of the Draft RTS including the treatment of securitisation vehicles, and as a result our comment is focused on the following:

1.1 The effect on non-EU repackaging vehicles used in repackaging transactions;

1.2 The effect of concentration limits on equity financing transactions using put and call options;

1.3 The provisions of the Draft RTS relating to segregation and re-use of margin, and associated legal opinions;

1.4 The absence of grandfathering provisions and the limited applicability of materiality thresholds.

2. REPACKAGING VEHICLES AND THEIR USE OF DERIVATIVES

Repackaging vehicles are similar in some respects to securitisation vehicles in that they are backed by pools of assets (either cash-generating or synthetic), but they do not issue tranched liabilities. A sponsoring bank will create an off-balance-sheet SPV which buys a range of financial assets from a range of vendors (generally banks or investment firms), and issues bonds into the capital markets. Repackagings usually involve programme issuance - one vehicle may own many portfolios of assets which support a particular bond issuance, and each issuance will be ring-fenced contractually by security over the particular pool, and sometimes by statute. Assets and liabilities are perfectly matched - there is no excess spread and no profit going to an equity interest.

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Repackaging vehicles are used as an alternative to issuance of structured products from a bank's own balance sheet, thereby reducing investors' exposure to a bank's own credit risk. They also significantly broaden the market for bond issuance for corporate and sovereign borrowers

A repackaging vehicle will generally use OTC derivatives in one of two ways - firstly to transform the rate or currency of the cashflows on the underlying assets to match that of the bond liabilities (which we will call a "cashflow hedge"), and secondly, where the underlying itself is an OTC derivative and the assets are provided as collateral by way of a security interest (which we will call an "embedded derivative"). With cashflow hedges, as assets and liabilities of the vehicle are matched, the only assets available in the vehicle are those secured in favour of the bondholders and secured creditors such as the swap counterparty - there is no ability to provide variation margin under a cashflow hedge on an ongoing basis, and provision of initial margin would be costly enough to mean the transaction is not economically viable. Embedded derivatives include a credit default swap where payment on the bond liabilities of the vehicle depend on payments under the CDS, and bond assets are taken as collateral. Alternatively, the underlying derivative may be a total return swap. In the case of embedded derivatives, the transaction may or may not involve the posting of collateral under a credit support annex, but as transactions are bespoke there is no real standard provision for exchange of margin - whether margin is exchanged or not, or posted in one direction, will depend upon the type of assets, the profile of the notes and any rating requirement. Standardised requirements for exchange of only certain categories of financial assets are too prescriptive to allow repackaging vehicles, which are not systemically important financial entities, the freedom to continue to use bespoke derivative structures to meet the economic requirements of their investors.

Furthermore, whether or not there is exchange of collateral, repackaging vehicles collateralise their liabilities already by granting a security interest over their assets in favour of their swap counterparty (in the case of cashflow hedges)

Cashflow hedges to a repackaging vehicle will be generally be provided by the sponsoring bank. However, the vehicle will not usually be consolidated and will not form part of the sponsoring bank's "group" for the purpose of the definition of that term in EMIR - thus the intra-group exemptions contained in Article 11 of EMIR would not be available.

3. DIFFICULTIES FOR NON-EU VEHICLES

Under the Draft RTS, "Counterparties" must collect initial and variation margin for non-cleared derivatives transactions unless an opt-out is available. "Counterparties" is defined as (i) Financial Counterparties ("FCs") as defined in EMIR and (ii) Non-Financial Counterparties over the clearing thresholds referred to in Article 10 of EMIR ("NFC+s"). Subject to various opt-out provisions (discussed below), such Counterparties must collect margin from all entities they face in non-cleared OTC derivative trades, whether the facing entity is in the EU or not, and whether the entity is above the clearing threshold or not.

Repackaging vehicles are frequently located in non-EU jurisdictions and many existing repackaging programmes include Cayman issuers (i) for cost reasons, and (ii) because investors in non-EU jurisdictions such as the U.S are often more comfortable with established structures which use non-EU issuers. Although certain opt-outs from the collection requirement are available, these are of limited assistance for repackaging vehicles.

3.1 Initial Margin Thresholds and availability of "opt-out"

(a) The first opt-out (Article 1FP paragraph 3 of the draft RTS) is available if one of the parties belongs to a group (as defined in EMIR) whose gross aggregate notional amount of non-centrally-cleared derivatives is below a certain threshold (the "Initial

Margin Threshold"). In this case, the two counterparties may agree in writing that initial margin will not be collected.

However, there are several difficulties with this - firstly, the opt-out does not apply to variation margin, and repackaging SPVs will remain unable to deliver variation margin as all available cash and eligible investments will be secured as support for the vehicle's liabilities to noteholders and other transaction counterparties. However the swap counterparty will be a senior secured creditor of the vehicle ranking above noteholders (unless the swap counterparty itself is in default, when it will rank below the noteholders), and so will be heavily over-collateralised already.

(b) Secondly, unlike the EMIR clearing thresholds, the Initial Margin Threshold is calculated with reference to all members of the group, including financial counterparties, and there is no exclusion for transactions which are entered into for hedging purposes. This means that there is a realistic possibility of the threshold not being sufficiently high to allow the opt-out for cashflow hedges by repackaging vehicles.

(c) Thirdly, and perhaps most importantly for repackaging transactions - this opt-out provision does not appear clearly to allow for counterparties to agree not to exchange initial margin where one of the parties is a non-EU entity, as the definition of "counterparties" as used in Article 1FP refers only to financial counterparties and non-financial counterparties as defined in EMIR, which are both confined to EU entities. However, the intention of the ESAs in relation to the ability to opt-out from the requirement to collect initial margin appears to be that non-EU entities *should* be included in the scope of the opt-out. On page 7 of the "Background and Rationale" section of the Draft RTS, the ESAs state:

"The RTS impose an obligation on EU entities to collect margin in accordance with the prescribed procedures, regardless of whether they are facing EU or non-EU entities. EU entities would have to collect margin from all third-country entities, unless explicitly exempted by the EMIR or under the EUR 8 billion threshold, even from those that would be classified as non-financial entities below the threshold if they were established in the EU" (our emphasis).

If "counterparties" as used in Article 1FP paragraph 3 is used in its defined sense, then the italicised words above seem to contradict Article 1FP if they refer (as would be the natural reading) to the third country entity rather than to the collecting EU entity. However this natural reading also requires that the reference to "the threshold" in the last phrase of the sentence is to the clearing thresholds in Article 10 of EMIR, and not to the EUR 8 billion Initial Margin Threshold.

Thus the intention behind the quoted section is far from clear, and on a strict interpretation of "counterparties" in Article 1FP itself, it would be the case that FCs and NFC+s entering trades with non-EU entities cannot agree not to exchange initial margin (as well as being unable to agree not to exchange variation margin). However, despite being a defined term, the term "counterparties" appears to be used loosely in the Draft RTS, sometimes appearing to include only financial and non-financial counterparties as defined in EMIR, and sometimes appearing to mean the parties to a derivative transaction whether a "counterparty" as defined or not. We would ask that the types of entity intended to be allowed the opt-out in Article 1FP is clarified in the final RTS. If non-EU entities cannot opt out of the exchange of initial margin, then repackaging vehicles will be unable to comply as the cost of doing so would make the transaction not economically viable.

3.2 Availability of "opt-out" below the clearing thresholds

Under the second potential opt-out from the requirements for exchange of collateral, in Article 2GEN 4(b), Counterparties can agree with Non-Financial Counterparties below the EMIR clearing thresholds ("NFC-"s) not to exchange both initial and variation margin. Again, as the definition of "Non-Financial Counterparty" in EMIR refers to entities established within the EU, this opt-out appears not to be available where the repackaging vehicle is established in a third country. The same arguments for an opt-out for non-EU NFC-s apply as those above in relation to the opt-out below the Initial Margin Threshold.

Hence there is no ability for a repackaging vehicle outside the EU to agree with its swap counterparty not to exchange variation margin, and even if (despite the drafting of Article 1FP) it is intended that there is an ability for non-EU entities to agree not to exchange initial margin, such ability will be subject to the vehicle not breaching the Initial Margin Threshold either individually or as part of a "group" as defined in EMIR. For our arguments as to why such treatment of non-EU vehicles is not necessary or appropriate see section 6 below.

The other opt-out provisions included in Article 2GEN of the Draft RTS (relating to FX swaps, the exchange of principal in currency swaps, trades with certain public entities, and trades subject to CCP margin requirements) are limited and do not provide alternative methods of relief to repackaging vehicles.

Nor do the minimum margin transfer amounts assist as the vehicle will have no additional assets to post as margin should the thresholds be triggered (however see our discussion in section 8below with respect to the application of minimum transfer thresholds for non-EU entities).

4. EQUITY FINANCE TRANSACTIONS

Strategic investors in listed equities frequently seek to use derivatives to hedge their exposure to downside equity price risk or to raise finance using shares as collateral. For example, an investor holds 5% of the shares in a publicly listed company and wishes to hedge against downside equity price risk. If it is a long term investor, it may also wish to raise cash funding using the value of the shares as collateral, but without relinquishing beneficial ownership and control of the voting rights attached to the shares.

This investor can hedge its exposure to downside price risk by purchasing a put option from a bank (an FC) under which the investor has the right to sell the shares to the FC at a pre-agreed put strike price (usually set below the current market price). In order to reduce the cost of this option it may also grant a call option to the FC set at a call strike price higher than the current market price. The effect of this is that the investor protects itself against downside risk of the share price falling below the put strike price in return for giving up the upside benefit if the share price rises above the call strike price. This could be a purely cash-settled transaction, giving the investor financial protection against a fall in price without having to sell the shares. It may also be the case that the FC provides financing to the investor secured on the shares and the embedded value of the put option. It would be common for the FC in this structure to take security over the shares in order to collateralise the FC's exposure under the call option. However, the FC will only have an exposure under the call option if the share price goes up above the call strike price, in which scenario the value of the collateral, in the form of security over the same shares as are referenced to the call option, will also go up thus matching the FC's exposure. As a result, the collateral perfectly matches the exposure, and there is no need for a concentration limit as there is no concentration risk even though 100% of the collateral consists of shares.

In addition, the parties would frequently agree for the FC as secured party to re-hypothecate the pledged shares. Re-hypothecation here provides two benefits; (i) the FC is able to hedge its exposure under the put option by selling shares into the market; (ii) the FC may also raise liquidity

by selling the shares into the market, enabling it to provide funding to the investor secured on the shares.

This type of transaction has the following benefits for the investor: (i) it allows a long term equity investor in a company to hedge and manage its exposure to equity price risk in the shares whilst maintaining beneficial ownership and voting control over the shares; (ii) it allows equity investors means to raise term financing against a shareholding without having to dispose of the shareholding outright; (iii) re-hypothecation rights allow an efficient means to hedge exposure under the transaction and increase liquidity in the market for the shares.

5. DIFFICULTIES FOR EQUITY FINANCE TRANSACTIONS

The draft RTS would make the above equity finance structure unviable for the following reasons:

(i) the concentration limits in Article 7 LEC prevent the FC holding more than 10% of the initial margin in the form of shares in the same issuer. This would therefore prohibit the above structure as 100% of the initial margin is in the form of shares in the same issuer, despite there being no actual concentration risk as explained above. Indeed if the FC is forced to diversify the pool of collateral constituting the initial margin, this would actually worsen the FC's collateral protection because the collateral pool would no longer match the FC's exposure under the call option. It would also mean that the investor would not be able to use the shares as collateral and would have to find (and finance) other forms of collateral;

(ii) the proposed ban on re-hypothecation would mean that the FC would need to hedge its exposure under the put option by borrowing shares in the market. This would incur greater costs and also reduce liquidity in the market for the shares by using up the market's stock lending capacity;

(iii) due to the lack of definition of what constitutes collateral being segregated from proprietary assets and "immediately available" to the FC and as to what constitutes the posting party being "sufficiently protected" against the insolvency of the FC as required by Article 1SEG, it would be difficult to obtain a legal opinion on these issues; which is required under Article 1SEG (5).

(iv) the equity investor will often be a non-EU entity and as such is neither an FC or an NFC for the purpose of EMIR. The same comments apply here as are made in 3.1 and 3.2 above .

6. APPLICATION TO NON-EU NON-FINANCIAL COUNTERPARTIES NOT REQUIRED BY LEVEL ONE EMIR TEXT OR BCBS

In our view, the application of the requirements for exchange of collateral with non-EU counterparties below the clearing threshold is not required by the level one EMIR text. Article 11(3) of EMIR does not expressly provide for OTC derivative contracts between an FC or an NFC+ and a non-EU entity to be subject to prescriptive margin arrangements, unlike Article 4(1) which makes express provision for clearing of trades between FCs/NFC+s and non-EU equivalents. Instead, it leaves the level and type of collateral required to be exchanged in any case under Article 11(3) to the ESAs to determine in the RTS to be made under Article 11(15). Furthermore, Article 11(4) allows FCs (such as swap providers for repackaging vehicles) to hold capital covering the risk not covered by exchange of collateral (which they are required to do under the CRR). In our view, the ESAs are free to make provision in the RTS allowing FCs and NFC+s exactly the same ability to agree with non-EU entities below the clearing thresholds to opt out of the margin exchange requirements as is given to EU NFC-s .

In addition, the Draft RTS are expressed to be intended to be consistent with international standards and to have considered the standards published jointly by the Basel Committee and IOSCO in September 2013 (the "BCBS standards"). In the BCBS Standards, the BCBS stated that:

"The BCBS and IOSCO believe that the margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempted from central clearing mandates under most national regimes."

This would appear to support the view that there is no intention at global level to include OTC derivatives entered into by non-systemically important non-financial entities in the margin requirements, and that there is a clear intention to exempt those entities for whom the clearing obligation does not apply - this would exempt OTC derivatives entered by non-EU entities which would be classed as NFC-s were they incorporated in the EU.

As structured finance vehicles such as repackagings are not systemically important entities, and fully collateralise the swap counterparty through grant of security over the underlying assets held by the vehicle, we believe that they are within the types of entity that BCBS and IOSCO would consider to be suitable for exclusion from the requirements to exchange collateral under their non-cleared OTC derivative contracts.

7. PROPOSED SOLUTIONS TO THE ISSUES ABOVE

We are of the view that (as explained above), the text of Article 11(3) of EMIR does not require the ESAs to impose a mandatory requirement for exchange of collateral in transactions conducted with non-EU entities.

As such, we would propose that the final RTS allow non-EU entities which would be NFC-s if they were established in the EU to agree not to exchange margin with their swap counterparties. This mirrors the clearing requirement under EMIR and is consistent with both the text of Article 11(3) and the intention stated in the BCBS Standards.

This would i) enable repackaging programmes which use non-EU vehicles to continue to enter OTC derivative transactions in the best interests of their bond investors, and ii) allow other non-EU entities without access to balance sheets large enough to pay compulsory margin calls, to agree with their counterparty the level of margin, if any, to be posted in respect of their OTC derivative transactions.

Secondly, we would propose creating a specific exemption from the requirement to exchange margin for OTC derivative transactions entered by structured finance vehicles. We are aware of, and support, the submission made by the Association for Financial Markets in Europe proposing an additional opt-out allowing securitisation vehicles to agree not to post margin to their derivative counterparty.

As repackaging transactions do not tranche credit risk however, they are not "securitisations" for the purpose of CRR, and would not fall within an exemption based on that definition. However, they would fall within an exemption based on the definition of "securitisation" under EC Regulation 24/2009 of the European Central Bank, which is as follows:

'securitisation' means a transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation, and:

(a) in case of transfer of credit risk, the transfer is achieved by:

— the economic transfer of the assets being securitised to an entity separate from the originator created for or serving the purpose of the securitisation. This is accomplished by the transfer of ownership of the securitised assets from the originator or through sub-participation, or

— the use of credit derivatives, guarantees or any similar mechanism;

and

(b) where such securities, securitisation fund units, debt instruments and/or financial derivatives are issued, they do not represent the originator's payment obligations;"

Thirdly, (and as an alternative to the previous solution), the one-way opt out should be permitted for a wider group of purpose vehicle issuers of asset-backed securities, along the same lines as the current draft proposals for swaps entered by covered bond vehicles, allowing collection of margin from the swap counterparty but no obligation on the vehicle to post collateral. However, the nature of a covered bond issuer differs from a repackaging vehicle, and certain of the criteria would need amendment:

- a cashflow hedge in a repackaging does give the swap counterparty the ability to terminate the swap on default by the vehicle.
- Termination payments under the swap will rank prior to the claims of the noteholders, (unless the swap counterparty is in default, in which case any termination payment due to the swap counterparty will rank below the claims of the noteholders).
- There will be no derivatives unrelated to the repackaging in the netting set
- The other requirements of the opt-out for covered bonds are not applicable to repackagings as they derive from national legislation governing the treatment of covered bonds for the purpose of eligibility for preferential regulatory treatment.

Additional conditions for the one-way opt out to apply could be imposed, such as that the swap counterparty must benefit from security over the asset-pool, and that it ranks senior to the secured noteholders unless it is itself in default. We would be pleased to assist in the drafting of any provision aimed at relaxing the requirements in the case of bespoke respackaging vehicles which do not meet the definition of securitisation in CRR.

Fourthly we would suggest that the concentration limits in Article 7 LEC should not apply where the composition of the collateral is correlated to the relevant exposure being collateralised. We would also suggest that an outright ban on re-hypothecation is disproportionate, prevents sensible re-use of the collateral within the economics of the transaction and should be reconsidered in conjunction with appropriate protections for the posting party.

8. MATERIALITY THRESHOLDS/MINIMUM TRANSFER AMOUNTS

For non-EU entities, similar comments apply as in sections 3.1(c) and 6 above as to whether it is intended that the provisions of Article 2GEN(3) and 4(a) are available where OTC derivatives are entered between FCs/NFCs and non-EU entities. The wording appears to restrict the operation of these materiality thresholds to transactions between EU entities. We are not aware of any rationale for restricting the use of these provisions to EU entities.

Furthermore, the opt-out in Article 2GEN 4(a) applies when the total collateral amount based on all derivatives between the two parties is under EUR 500,000. It is not clear whether collateral to be provided in respect of cleared derivatives is included in this figure (cleared transactions are explicitly excluded in Article 2GEN (3)). Clarification of this would be helpful.

9. SEGREGATION AND BAN ON RE-HYPOTHECATION

We are aware that a number of industry bodies have made submissions with respect to the requirement to segregate initial margin under Article 1 SEG of the Draft RTS and do not propose to repeat those arguments here except to say that we support the view that segregation of margin and a ban on re-hypothecation is unnecessarily restrictive and more onerous than other global initiatives.

We do, however, suggest that Article 1 SEG clarifies what is meant by "segregation" and "legally effective arrangements". In particular, we would suggest that guidance is provided as to whether segregation of the assets by way of identification in the books of the collecting counterparty is sufficient if, for example, such assets are subject to a preferential client asset or custody asset regime upon the insolvency of the collecting counterparty or whether tri-party security arrangements will be required in order to satisfy this requirement. By way of example, Article 1 SEG(2) of the Draft RTS requires the collecting counterparty to offer individual segregation from assets of other "posting counterparties", which would only appear to be applicable where collateral is posted directly to a custody account held with the collecting counterparty as custodian or is held with a third party custodian but in an account in the name of the collecting counterparty (which implies title transfer). Please see also our comments below on the netting and collateral enforceability requirements.

10. NETTING AND COLLATERAL ENFORCEABILITY REQUIREMENTS

The Draft RTS contains requirements: (i) to confirm the enforceability of netting agreements constituting the netting sets that IM calculations reference under Article 6 MRM (2) (the "Netting Enforceability Requirements") and (ii) to confirm certain matters regarding the segregation arrangements applicable to initial margin posting under Article 1 SEG (5) (the "Collateral Enforceability Requirements").

With respect to both the both the Netting Enforceability Requirements and the Collateral Enforceability Requirements:

(a) we suggest that the final RTS clarify which type of counterparties are subject to such requirements. We note that Article 11(3) applies directly only to FCs and NFC+s. However, even applying the requirement to certain kinds of FC and to NFC+s could have additional compliance costs. For example, those entities that are not subject to similar requirements under the CRR will need to develop processes for reviewing and confirming the enforceability of the arrangements and/or commission opinions. In addition, such entities may not necessarily be members of market associations that provide standard netting and collateral opinions to their members.

(b) we note that the requirement to verify the enforceability of netting and segregation of collateral arrangements at least annually is less flexible than the current standard applicable to credit institutions and investment firms under the CRR and represents a change to what we believe is the prevailing practice (both for industry and bespoke opinions), which allows a certain level of flexibility to parties to determine whether or not there have been material changes in the legal regimes in the relevant jurisdictions that merit obtaining updated opinion coverage.

With respect to the Collateral Enforceability Requirements, the current formulation requiring confirmation that the collateral be on the one hand "immediately available" to the collecting entity on default of the posting party whilst on the other hand the posting entity is "sufficiently protected" on the insolvency of the collecting entity would be difficult to opine on as these concepts are not clearly defined. In addition, the requirement to look at the protections afforded to the posting

entity on an insolvency of the collecting entity would go beyond the current scope of many industry opinions, which focus on the enforceability of the collateral arrangements on a default of the posting entity. Given that security arrangements with respect to collateral will, generally speaking, require bespoke enforceability opinions, the Collateral Enforceability Requirements as currently formulated could significantly increase compliance costs for those counterparties that are required to obtain them. We would, therefore, suggest that the Collateral Enforceability Requirements be reformulated to refer to confirmation of the enforceability of the collateral arrangements in a similar manner to Articles 194 and 207 of the CRR.

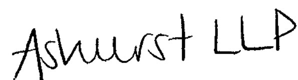
11. GRANDFATHERING

The Draft RTS do not include express grandfathering provisions for existing derivative contracts. Instead, the accompanying commentary from the ESAs states that only "new contracts at the time of entry into force" of the RTSs will be caught when the rules start to apply, but that market participants should endeavour to apply the principles to the widest set of non-cleared derivatives possible. Whilst the statement is of some comfort, it is far from clear and it may not form part of the final version of the RTS. Furthermore, the requirement in Article 11(3) of EMIR itself is that the rules apply to trades entered by FCs from 16th August 2012. This leaves OTC derivative market participants without clear guidance as to what action should be taken in respect of transactions entered prior to the coming into force of the rules (which clearly cannot be the case without final RTS in force and must be treated as postponed in the light of recital 93 which states that any obligation imposed by EMIR takes effect only once the relevant RTS comes into effect)[1]. We would ask that a clear provision be included in the final RTS that the rules only apply to derivative contracts entered into after the date the final RTS come into force.

12. CONTACT DETAILS AND NEXT STEPS

We would be very happy to assist the ESAs with any questions they may have relating to the above, and to input into any revision of the Draft RTS. If you would like us to assist further please contact James Coiley (james.coiley@ashurst.com), Jonathan Haines (jonathan.haines@ashurst.com), Anne Tanney (anne.tanney@ashurst.com) or Kerion Ball (kerion.ball@ashurst.com).

Yours faithfully



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[1] Cf. also the letter from Patrick Pearson, head of unit, DG MARKT, European Commission to ISDA, 28 August 2012, stating "The precise level and exact type of collateral to be exchanged will be specified by the Regulatory Technical Standards to be adopted by the Commission under Article 11(15). As long as those standards are not yet in place, counterparties have the freedom to apply their own rules."