Deutsche Bank

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Consultation on the procedures for excluding transactions with non-financial counterparties (NFCs) established in a third country from the own funds requirement for credit valuation adjustment (CVA) risk.

Dear Mr. Farkas,

Thank you for providing us with the opportunity to comment on the draft RTS on procedures for the exclusion of transactions with non-EU non-financial counterparties (NFC) from the CVA own funds requirement. We appreciate that the EBA has drafted these standards to clarify the process by which banks can prudently determine the status of NFCs, when calculating the capital requirements for CVA.

Consistency with EMIR practice
We support the EBA in their interpretation of the Capital Requirements Regulation (CRR) so that NFCs that qualify as NFC+ should attract CVA capital requirements, whereas those NFCs which qualify as NFC- should not.

Banks have already developed practices (based on EMIR regulations and guidance from ESMA) for determining the NFC status of their clients. Given that the CRR text explicitly references EMIR, the determination of NFC status under CRR should be consistent with EMIR requirements and practice. Under EMIR, banks currently classify counterparties as NFC- as part of Know Your Customer (KYC)/ Client Onboarding. Any changes to this status would only occur upon new information causing a change in a NFCs status. In the majority of cases, NFCs are unlikely to be moving across the EMIR clearing thresholds on a regular basis. The EBA should not deviate from this in the context of CRR as this would be overly burdensome for corporates operationally, whilst not resulting in any meaningful improvement to banks' risk management. Additionally this would also result in a higher burden of proof for non-EU corporates vs. EU corporates.

Additional suggestions for determining the status of an NFC
Where a client is not based in the EU, the process of determining NFC status can prove more challenging, as many non-EU clients have to try to understand the EU law to provide accurate NFC representations. As a consequence, the following suggestions to determine the status of NFC's in third countries should be taken into consideration by the EBA when finalising this RTS. This would provide a more efficient and prudent way of determining the status of an NFC in third countries, without unduly burdening the NFCs.

- **Utilise EMIR NFC Representation Protocol:** The International Swaps and Derivatives Association (ISDA) maintains a list of corporates that have signed the NFC Representation Protocol[1]. Banks use the ISDA database to check the status of the NFC, eliminating the need to seek bilateral

[1] https://www2.isda.org/functional-areas/protocol-management/protocol/11

representations from each NFC. From the NFCs perspective this approach is efficient and effective, since they only have to report their status to one source, rather than to every bank they trade with.

- **Taking local law into account:** In jurisdictions where local law clearly states that corporates are only permitted to enter into OTC derivatives transactions for hedging purposes and these are in line with EMIR definitions, these NFCs should be automatically recognised as NFC-. This should be a one-time exercise and no representation should be required from the NFC.

- **Confirmation of hedging purpose:** Where clients are willing to confirm in writing that they do not engage in speculative derivatives trading and only use OTC derivative transactions for hedging purposes in line with EMIR definitions, banks should be able to classify them as NFC- without any calculations. This should be a one-time exercise, with the requirement for the NFC- to update its status only if it starts to engage in speculative derivatives trading.

- **Materiality:** Where clients are willing to confirm in writing that their overall derivatives exposure is below the EMIR thresholds, banks should be able to assume they are NFC- without needing to undertake any calculations.

If the EBA and ESMA both agree that there is still a need for a more frequent confirmation of NFC- status, we would recommend an alternative where the status of a NFC would be determined and fixed for one year, after which it is reviewed again when a new trade is made.

In the Annex to this letter, we provide detailed comments on the consultation. Please do not hesitate to contact us if you have questions or wish to discuss these comments further.

Yours Sincerely,

Daniel Trinder
Global Head of Regulatory Policy

<u>Annex I EBA Questions</u>

Question 1: What are stakeholders' views on the interpretation proposed?

We agree with the interpretations of the EBA that:

a) Only uncleared OTC derivative contracts with a NFC that continuously qualifies as NFC+ would attract a CVA risk charge; and
b) Contracts with an NFC which qualifies as NFC- should not receive a CVA risk charge.

Under EMIR, transactions with NFC+ will be subject to clearing requirements. We appreciate that the EBA is cooperating with ESMA on the development of the RTS to specify the procedures for excluding transactions with NFCs established in a third country from a CVA risk charge. Given the overlap between the two regulations, we believe it would be appropriate to have a consistent approach to determining and monitoring the status of third country NFCs.

When looking at EMIR, ESMA has published Q&A's[2] providing guidance to banks regarding the determination of status of NFCs. The ESMA guidance states that NFCs should determine their own status against the clearing threshold. It is then up to the banks to obtain representations from these NFCs to be able to apply the correct (NFC- or NFC+) status to those counterparties.

Where banks are not able to obtain such representations, EMIR rules demand a conservative approach. The EMIR Q&A's clearly state that in the absence of the counterparty supplying the classification, the bank should assume that they are an NFC+.

Article 2 of the proposed EBA RTS suggests that EU banks should "ensure and document" that NFCs calculate their positions in OTC derivatives as prescribed under EMIR and do not exceed the clearing thresholds. This goes beyond ESMA's EMIR guidance with respect to third country NFCs, which states:

"The EU counterparty is not expected to conduct verifications of the representations received from the third country entity detailing their status and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect."

Furthermore, under EMIR, banks currently classify counterparties as NFC- as part of KYC / Client Onboarding. Any changes to this status would only be made upon new information being provided by the NFC. In most cases, this approach is prudent as NFCs are unlikely to move across the EMIR clearing thresholds frequently. We would recommend that the EBA does not deviate from this practice in the context of CRR as this would be overly burdensome for corporates from an operational perspective, whilst not resulting in any meaningful improvement to banks' risk management.

In order to ensure regulatory consistency, the EBA proposal for the process of determining the status of a third country should not diverge from this existing ESMA guidance, taking our suggestions to question 2 into account.

Question 2: What are stakeholders' views on the burden this might create for NFCs established in a third country? What could be a credible alternative treatment?

A number of larger third country NFCs who engage in significant OTC derivatives trading are already calculating their derivatives exposure under EMIR regarding their trading activities with EU banks. These counterparties should be able to continue to do so as required for CRR. However, smaller counterparties, which are less likely to engage in speculative derivatives trading, and therefore would not qualify as NFC+, may find it comparatively more difficult to run these computations. The proposed options by the EBA would become too burdensome for NFCs and banks and may result in

[2] ESMA Q&A on the procedure for assessing the status of a NFC: OTC Question 4 and OTC question 13.

misclassification of NFCs as NFC+, due to the inability of NFCs to provide representations regarding their status. This would have the unintended consequence of increasing hedging costs for NFC-.

A more simplified approach should be adopted for NFCs that do not or cannot engage in speculative OTC derivatives trading (e.g. due to their corporate policies or local laws which restrict corporates from trading derivatives other than for hedging purposes). Under Article 10(3) EMIR, the notional amounts of hedging transactions do not count towards the clearing threshold. It is therefore impossible for such corporates to be NFC+ and requiring them to provide representations on a trade-by-trade or periodic basis would not result in any meaningful improvements to banks' risk management.

Additional suggestions to make a prudent determination of a NFC's status

While the procedures for reviewing the status of NFCs are necessary from a prudent risk management perspective for the calculation of the CVA capital requirement, that determination of NFC status under CRR should be consistent with EMIR requirements and practice. Regarding the determination of NFCs in third countries, where the requisite information is available publicly, EU banks should be able to rely on this information, and no additional representation should be required from the NFC.

- *Utilise EMIR NFC Representation Protocol:* ISDA maintains a list of corporates who have signed the NFC Representation Protocol. Currently a number of larger NFCs (formed inside and outside the EU) already provide information on their status to EU banks through participation in this protocol. Banks use the ISDA database to check the status of the NFC, eliminating the need to seek bilateral representations from each NFC. From the NFCs perspective this approach is efficient and effective, since they have to report their status to one source, rather than to every bank they trade with.

For smaller corporates, or those that do not engage in speculative OTC derivatives trading, requiring representations on a trade-by-trade or periodic basis (even to a single source) could be disproportionately burdensome. For such corporates, we would recommend the following approach:

- *Taking local law into account:* In jurisdictions where local law clearly states that corporates are only permitted to enter into OTC derivatives transactions for hedging purposes and these are in line with EMIR definitions, these NFCs should be automatically recognised as NFC-. This should be a one-time exercise and no representation should be required from the NFC.

- *Confirmation of hedging purpose:* Where clients are willing to confirm in writing that they do not engage in any speculative derivatives trading and only use OTC derivative transactions for hedging purposes in line with EMIR definitions, banks should be able to assume they are NFC- without any calculations. This should be a one-time exercise, unless local laws change, with the requirement for the NFC- to update its status only if it starts to engage in speculative derivatives trading.

- *Materiality:* Where clients are willing to confirm in writing that their overall derivatives exposure is below the EMIR thresholds, banks should be able to assume they are NFC- without any calculations.

Question 3: **What are stakeholders' views on the relevance of the inclusion of a minimum frequency? What is stakeholders' preferred option?**

We would recommend alignment with EMIR to ensure regulatory consistency regarding frequency. However, if the EBA and ESMA both agree on the need for a more frequent confirmation of NFC- status, we would propose to apply the following framework:

- The NFC- status to be confirmed at inception of the trade with a new counterparty;
- This status is then valid for 1 year for all trades within this period;
- After the validity period, the NFC- status would need reconfirming at the time of inception of the next new trade;
- Any subsequent status updates would be valid for a one year period;
- To the extent an NFC+ becomes an NFC- they can update this status outside of the reconfirmation period to avoid waiting for when they do the next trade.