Please note that the comments expressed herein are solely my personal views

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08 July 2014

- Your Ref: Comment letter on Joint Committee Consultation Paper on 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

Dear Sir.

Thank you very much for giving us the opportunity to comment on your Joint Committee Consultation Paper on 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. I restrict my comments here to margin and collateral issues.

Universal two-way margins

I support that universal two-way margining should apply to non-centrally cleared derivatives. In principle this would meet the requirements of a well-designed margin system, as explicitly recognised by, among others, the Commodity Futures Trading Commission (CFTC):

> Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure.[1]

However, a well-designed margin system should fully ensure the safety and soundness of covered entities, and be appropriate for the risks associated with non-centrally-cleared

[1] See main commentary in Commodity Futures Trading Commission Notice of proposed rulemaking: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 28 April 2011. Available at 76 FR 23733.

derivatives. I would caution against the aggressive use of thresholds as a tool to manage the liquidity impact associated with margin requirements. Such thresholds are arbitrary, reduce market integrity and increase systemic risk.

Model calibration

It is entirely appropriate that approved internal models should determine initial margins prudently. I support the proposal that for the calculation of the initial margins, "the assumed variations in the value of the contracts in the netting set are consistent with a one-tailed 99 percent confidence interval over a margin period of risk of at least 10 days"[2]. The 10-day time horizon reasonably allows for the lower liquidity of non-centrally-cleared derivatives compare with centrally-cleared derivatives.

Concerning your proposal that initial margin models must be calibrated on a historical period of at least three years, including a period of significant "financial stress",[3] I would request further clarification and / or guidance, as it is very subjective and possibly arbitrary to determine what is "financial stress". In my experience, the financial stresses that you experience in practice are rarely the ones anticipated, and I would expect this to be even more of a problem for non-centrally-cleared derivatives compared with centrally-cleared derivatives. Given this, I would additionally recommend that you should include specific wording stating that both the models and methodology, including calibration data and stress data, should be regularly validated by an independent third party.

Eligible collateral for initial and variation margin

I strongly agree that all collateral for initial and variation margin purposes "has to meet additional eligibility criteria such as low credit, market and FX risk".[4] Therefore I agree that cash and high quality government, corporate and covered bonds should be eligible collateral, but I would caution against allowing equities as eligible collateral. Although I accept that diversification of collateral brings certain risk mitigation advantages, equities are too volatile and subject to jump risk, which therefore makes them unsuitable as collateral. Collecting entities would not be assured that their value would be sufficient to meet obligations, particularly during a period of financial stress.

Yours faithfully

C.R.B.

Chris Barnard

[2] See propose Chapter 2 Article 2 Paragraph 1.
[3] See propose Chapter 2 Article 3 Paragraph 2.
[4] See Consultation Paper, page 9.