Standard Chartered

European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ

14 July 2014

Dear Sir or Madam,

Re: 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

Standard Chartered Bank fully supports the G20 commitments on derivatives market reform. We agree with the objectives behind the requirement to margin non-cleared derivatives in order to increase systemic resiliency and incentivise central clearing. However, we have some concerns about the European Supervisory Authorities' ("ESA") draft technical standards ("RTS"), which we address in our comments below. These relate to the policy framework as a whole and to specific aspects of implementation.

For a bank like Standard Chartered, operating across some 70 markets globally, clarity on the extraterritorial application of any legislation is a pre-requisite to being able to implement it in a practicable way. As a result, most of the issues we raise in our response are about how the draft RTS are intended to work cross-border, with counterparties outside Europe.

Our overriding concern is about scope. As currently drafted, the RTS require European financial counterparties ("FCs") and non-financial counterparties above the clearing threshold ("NFC+s") to collect initial and variation margin from all non-EU NFCs, regardless of whether they are above or below the clearing threshold. The same asymmetrical treatment of EU and non-EU entities is adopted for trades with most non-EU central banks and sovereigns, and other public sector bodies.

This approach is inconsistent with the Basel Committee on Banking Supervision ("BCBS") and International Organisation of Securities Commissions ("IOSCO") Final standards on margin requirements for non-centrally cleared derivatives, and with what we believe are the policy aims of the European Markets Infrastructure Regulation ("EMIR"). There is a global consensus that small non-financial firms and central banks and sovereigns do not pose systemic risk and should therefore be exempted from the requirement to margin. Many of them would not be in a position to do so anyway – most corporate derivative end users in particular do not have the operational capabilities or the financial resources and flexibility required to manage the liquidity requirements.

Unless changed, the RTS would have a detrimental impact on all EU firms in scope that have a non-EU client base. In particular, as many EU banks operate in third country jurisdictions through their branch network, they would be put at a significant competitive disadvantage compared to non-EU banks: rather than create the operational and liquidity risk of calculating and posting margin, their local non-financial counterparties would most likely either choose to trade with non-EU firms or, if that is not possible, leave their risks unhedged. If end users reduce or stop their use of derivatives for hedging real economy risks, there will be an overall increase in risk in the global economy – precisely the opposite of what the rules are meant to achieve.

We would therefore urge the ESAs to align the scope of the final standards with the policy framework agreed by BCBS IOSCO. Article 11 should be subject to a purposive interpretation, and the scope of entities caught should mirror that of Article 4 on clearing.

Our additional concern on cross-border application is that the RTS give no guidance on how EU firms can collect margin from counterparties in jurisdictions where there is no legal certainty on enforceability of collateral arrangements. There are some emerging markets jurisdictions – most notably China and the Middle East – where this is currently the case, and where EU banks currently use other methods of risk mitigation. If margin now has to be collected, despite the lack of assurance that the collateral can be kept in case of counterparty default, the risk to the bank in question and to the system as a whole is likely to increase. Alternatively, if the ultimate sanction is to stop trading with counterparties from those jurisdictions, EU firms will effectively be shut out of some emerging markets.

Finally, we would stress the importance of global consistency not only on the scope and detail of the rules but also on timing. While we understand that there remains a commitment to the BCBS IOSCO agreed start date of 1 December 2015, the FSB Seventh Progress Report on Implementation of derivatives reform[i] confirms that the EU and the US are the only jurisdictions that have taken regulatory steps in this area so far.

Staggered implementation will be problematic. Derivatives markets are global - they operate cross-border. Firms will experience practical difficulties in trying to collect margin from counterparties who are themselves not subject to margin rules. Even a short time lag between different jurisdictions will create an unlevel playing field and risk of regulatory arbitrage. For counterparties outside Europe, the ability to delay margining even for a few years would be enough of an incentive to move business away from EU entities. Many will be reluctant to engage without first having clarity on their own requirements.

We would therefore urge the European regulators to continue to continue to work with the Working Group on Margining Requirements ("WGMR"), set up by BCBS IOSCO, to ensure that the timetable for implementation is realistic, and aligned as much as possible across different jurisdictions.

If you have any questions or wish to discuss further, please do not hesitate to contact us.

Yours faithfully,

Keith Macdonald

Chief Operating Officer, Financial Markets

Question 1: What costs will the proposed collateral requirements create for small or medium sized entities, particularly 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?

We are not convinced that the costs of requiring EU firms to collect margin from a range of non-EU counterparties have been properly reflected in the ESAs' impact analysis. The asymmetrical treatment of non-EU NFC-s and central banks/sovereigns compared to their EU equivalents is likely to have a significant impact on both the EU firms and the markets in which they operate. It is also inconsistent with the BCBS IOSCO standards, which explicitly state 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 the central clearing mandate under most national regimes"[ii].

Impact on non-financial entities below the clearing threshold

Based on our extensive experience in over 70 markets, we are certain that many of our non-financial clients will have neither the ability nor the appetite to post margin. Outside financial institutions, exchanging any kind of margin is not a standard practice. This is not surprising - for corporates using derivatives for hedging purposes, managing the risk of those transactions is a core part of the service provided by their banks. Emerging markets-focused banks like Standard Chartered have built business models around their strength to understand and manage various types of risks related to dealing with clients in these markets. Credit lines are extended without any obligation for the parties to exchange collateral - a practice entirely consistent with the credit intermediation function of a bank.

Most non-financial entities – wherever they are based - do not have the operational, administrative, legal or system capabilities to calculate and exchange margin. More fundamentally, they do not have access to pools of collateral or readily available liquidity: they do not take money from depositors or have access to central banks, so they are not in a position to raise funds quickly.

Sourcing collateral and acquiring capabilities to margin (or outsourcing them) mean significant costs. This is money that corporates would otherwise be spending on the real business of what they do, such as product development or research – ultimately those things that policy-makers rightly believe are good for the economy. Above all, the obligation for these entities to manage margining would create liquidity risk, which these firms would have to manage by reducing investment in the rest of their business, thereby creating a drag on the real economy.

There is no reason why they would choose to incur higher costs if they can continue transacting on existing terms with other banks not subject to these or similar rules. Alternatively, if they cannot get the same service elsewhere - either because there are no local banks that can provide it, or because those banks also have to collect margin under their local regulation - they may choose to leave their risks unhedged, in full or in part. This would result in an increased risk to the real economy.

As stated in the executive summary, the RTS would have a detrimental impact on all EU firms in scope that have a non-EU client base. Many EU banks operate in third country jurisdictions through their branch network, so they would be put at a significant competitive disadvantage compared to non-EU banks.

However, it is not only the EU banks and their clients that will be impacted. Many EU non-financial firms will also be affected, as they frequently have investments in non-EU entities that would be subject to margin requirements. Some may also have a non-European NFC-s in their group. The response to the ESAs' consultation by the UK Association of Corporate Treasurers[iii] points out the consequences for the latter.

In the infrastructure sector, for example, large EU manufacturing non-financial entities often establish joint ventures with utility operators in emerging markets. Those utilities need long-term hedges for both interest rate risk on their long term debt and for foreign exchange hedges on the purchase of heavy industrial equipment. Typically, these investments and contracts lead to a direct trade with the EU and the EU sponsor. A project utility of this kind would have relatively fixed cash flows and little scope to create surplus liquidity for margin requirements, even if it were able to forecast the requirements easily. Reserving liquidity for margin would have a direct impact on such an entity's levels of leverage and therefore the amount of equity needed to be invested. This will, in turn, affect the potential for the project to generate economic growth and trade with the EU partners, and it would also conflict with the stated aims of both OECD and G20 to encourage institutional long term investment financing.

In cases such as these, the relatively less well-developed local banking system will sometimes be unable to service those entities' financing and hedging requirements, especially for hedging long-dated contracts. The EU banks play a key role in partnering with the EU project sponsors - a role which local banks are unlikely to have the full capacity or risk appetite to service. Without the ability to hedge risks, some of the projects would never materialise as they would to too risky and too expensive.

The introduction of thresholds, in particular the Eur 8bn threshold below which initial margin ("IM") does not need to be exchanged, only solves a small part of the problem. While it may serve to reduce the universe of clients from whom initial margin would have to be collected, those caught are still using derivatives for hedging purposes and are arguably no better positioned to margin than any other corporate.

For those that remain below the threshold, the requirement to post variation margin ("VM") will be a sufficient deterrent from trading with EU entities. Daily variation margining may be common between financial counterparties, as the ESAs' cost benefit analysis points out, but for non-financials, not only is it relatively rare but it would pose many of the same practical difficulties as those described above.

The inclusion of foreign exchange ("FX") in the scope of VM (which was left to the discretion of national competent authorities in the BCBS IOSCO standards) exacerbates the problem. It is precisely these products that are most used by non-financial firms in emerging markets, and for obvious reasons: there is a real need for FX hedging in all markets which use USD for trade and investment but have a different local currency. (A survey by ISDA[iv] shows that some 76% of derivative turnover in Asia is FX OTC derivatives, with interest rate derivatives a distant second with 18%). This is why we have in our responses to BCBS IOSCO consultations argued that FX products should be explicitly excluded from the scope of both IM and the VM. Regulators could risk replacing a small, second order risk – the credit risk associated with the FX transaction – with a much larger first order risk that clients stop hedging their FX exposures altogether.

Global consistency

More generally, the impact of the EU rules on derivatives markets globally will depend in part on if and how other jurisdictions choose to implement the BCBS IOSCO standards. It is difficult to talk about global consistency without knowing the detail, but a unilateral move by the EU authorities to change entity scope is likely to be unhelpful under any scenario.

If other regulators follow the global standards faithfully, EU firms operating outside Europe will be at a competitive disadvantage to their peers. This will be felt across their entire client franchise and not just their derivatives business. Conversely, if each jurisdiction follows the EU model and affords a preferential treatment to its own corporates only, the global derivatives market is likely to fragment further along national or regional lines, to the detriment of cross-border trade and investment. If we end up with a combination of both, as seems plausible, at the very least there is a real risk of regulatory arbitrage.

We would urge the EU regulators to revise the RTS in light of their commitment to international agreements, and permit EU entities subject to the margin rules to exclude non-EU NFC-s from the requirement to post either initial or variation margin. As the UK Association of Corporate Treasurers pointed out in their response the BCBS IOSCO consultation on margin standards, meeting the needs of non-financial firms is the reason why derivatives markets exist in the first place. It would be perverse if these non-systemic firms, which form the backbone of the real economy, end up being the collateral damage of rules designed to deal with large financial institutions. It would also be unjustifiable for Europe to treat its own firms differently from those in other jurisdictions.

EMIR Level 1 drafting

We understand the reason cited by ESAs for the different treatment of non-EU counterparties are restrictions under EMIR Level 1 which require margin to be collected for all uncleared OTC derivatives, with no geographical or entity limitations. We also understand that the obligation to collect margin is not imposed on EU NFC-s, which is how they can be taken out of scope via Article 2 GEN in the RTS, and that the scope of exempt central banks under EMIR is currently limited to EU, US and Japan only.

However, EMIR Level 1 drafting seems far from clear. For example, it could be argued that Article 11 provisions apply only to transactions undertaken between EU FCs and NFC+s - and that is in fact how the ESAs themselves initially interpreted them. The Discussion Paper[v] on margin published in 2012 states: “Although the mandate for draft RTS analysed in this discussion paper does not leave room for outlining a third country regime to the exchange of collateral, it is essential that transactions between EU counterparties and non-EU counterparties are also subject to margin requirements.”

It could also be argued that if margin has to be collected for all OTC derivatives, without any limitations, FCs and NFC+s would already need to be compliant with Article 11, whereas the Commission has already clarified in their FAQs that this is not the case, and that existing collateralisation procedures are sufficient while the RTS are being developed.

In our view, the provisions in Level 1 Article 11 offer more flexibility than the narrow interpretation put forward in the draft RTS allows. In particular, it is evident from the mandate given in EMIR Level 1 under Article 11(15)(a) for ESAs to specify the level and type of collateral, and from the RTS drafting on IM thresholds and minimum transfer amounts (“MTA”), that EMIR contemplates that some trades will not be margined at all – in other words, collateral does not have to be collected in all cases. EMIR Article 11(4) supports this interpretation, as it allows FCs to hold capital to manage the risk not covered by the exchange of collateral under Article 11(3).

Recital 24 and Article 11 should be read in the context of the broader policy objectives of the G20 derivatives reform as a whole, and the EU legislation which implements it. The overall aim for both is to reduce systemic risk and promote central clearing. There is a consensus that NFC-s do not pose any systemic risk – their derivatives trading is used to hedge against commercial risks directly related to their commercial or treasury financing activities, and not for speculative purposes. They were therefore not subject to many of the detailed regulatory requirements that followed.

There also seem to be no good micro-prudential reasons for a different treatment of non-EU corporates: the risk posed by these entities is arguably no different from that posed by their EU equivalents, and banks already hold capital against derivative exposures to them. Excluding them from scope would not compromise the objective of sound risk management.

It is on this basis that EMIR draws the entity scope for the mandatory clearing provisions. It is also how the Capital Requirements Regulation deals with the CVA exemptions and how the Markets in Financial Instruments Regulation formulates the mandatory trading obligation for derivatives. In all cases, non-systemic financial institutions are afforded a more proportionate treatment, and there is no difference between EU and non-EU entities.

To make a distinction based on geography for margin rules alone would violate the spirit of not only the global agreements but also of what has already been agreed across a whole body of European legislation. The purposive interpretation of EMIR would therefore exclude all NFC-s - irrespective of where they are established - from the requirement to post margin to EU firms.

The RTS Article 2 GEN should therefore be redrafted to state that margin only has to be collected from non-EU entities that would be FCs or NFC+s if they were established in the EU, with the same thresholds available to all. This would align the scope of Article 11 with that of Article 4 on mandatory clearing, which we believe was the policy intention behind EMIR. It would also address concerns raised by BCBS IOSCO – they state that: "Ensuring consistency between entities that are subject to the central clearing obligation for standardised derivatives and those entities that are subject to margin requirements for non-centrally-cleared derivatives is desirable because any inconsistency may create various market distortions (e.g. by creating preferred counterparties) and could permit regulatory arbitrage."[vi]

The argument that the EMIR level 1 text does not use the same language when talking about non-EU entities for mandatory clearing in Article 4 and for margining in Article 11 – and that as a result the intent behind how they should treated must somehow be different – seems misleading. There appears to be no good policy reason why EMIR would impose a higher standard for margining – in fact, it could be argued that the drafting used in Article 11 is less specific than that used in Article 4 precisely in order to allow for more entities to be excluded from the requirements.

Equivalence

We would caution against using Article 13 provisions on equivalence to deal with the cross-border application of the RTS. This is in part because of the difficulties experienced in the context of Article 25 decisions, the lack of progress in jurisdictions other than US and EU, and because the European Commission is unlikely to be able to assess more than a small number of jurisdictions in the short to medium term. It is, in any case, not clear how Article 13 applies if the EU counterparty itself is only subject to one set of rules. Most importantly, equivalence will not work because of the inherent uncertainty of the process: even a small mismatch in timing could result in a permanent loss of clients.

Question 2: Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If so, please provide the rationale for the concerns and potential solutions.

There are several areas of concern that are not addressed in the draft RTS and which would need to be clarified before firms can start the implementation process. Many of these are covered in detail in the International Swaps and Derivatives Association's ("ISDA") response but we would like to draw ESAs' attention in particular to the issues of legal nature, related to the mechanics of how margin has to be collected from counterparties in jurisdictions where the local legislative regime does not support netting or collateral enforceability and, as a subset of the latter, segregation opinions.

Collateral enforcement

ISDA currently has collateral enforceability opinions in relation to 51 countries. However, there are some jurisdictions which do not support close-out netting or collateral enforceability. (If a jurisdiction does not support netting, its insolvency and other laws typically do not support enforceability under the ISDA credit support documentation.) These include China and the Middle Eastern countries such as UAE, Qatar and Saudi Arabia.

We appreciate that the regulatory requirement is on the EU firms to collect margin, rather than to post it. However, this does not mean that the jurisdiction of the counterparty can be disregarded, either as a matter of regulation or of commercial reality. While it is market practice that many collateral arrangements under standard ISDA documentation are governed by English or New York law over collateral assets held or located in western jurisdictions (e.g. England, New York, Belgium), the jurisdiction of the posting counterparty remains relevant.

This is for two reasons. First, even if collateral is taken in Europe, absent a 'clean' opinion or legal certainty covering the posting counterparty's jurisdiction, there remains a risk that collateral will not be immediately available (as the draft RTS require), or that it can be clawed back. In other words, if a counterparty defaults, we may not be able to liquidate their collateral quickly if enforcement stays are imposed under the local law (speed of liquidation being one of main reasons for collecting margin in the first place). Alternatively, we may be prevented from retaining the collateral posted to us at all, because an insolvency official or other third party may be able to enforce a claim to it.

It would not be reasonable to expect firms to simply 'take' collateral from these jurisdictions in the face of uncertainty about their rights to it. This is why the existing prudential regulatory requirements for the recognition of financial collateral state that there needs to be legal certainty on enforceability of agreements, including in relation to the posting counterparty's jurisdiction. It is also worth noting that the European Financial Collateral Directive was an attempt to deal with some of the problems inherent in cross-border enforcement of collateral. As there is no equivalent legislation in many jurisdictions outside the EU, these issues remain unresolved.

Second, it is unlikely that all counterparties will be willing to accept asymmetrical margin arrangements. For any margin we collect, we may also have to post. Although the posting leg of the transaction will not be subject to the regulatory requirements as prescribed by the RTS, and although collateral may in fact be kept with a third party custodian, we will nevertheless be posting margin to counterparties from jurisdictions where there is a risk it may not be protected. This would increase our risk exposure – and arguably systemic risk too – which is the opposite of what the margin rules are aiming to achieve.

The draft RTS are silent on the consequences of not being able to obtain 'clean' opinions or legal certainty. It is not clear whether trading would have to cease in circumstances described above. Article 1 SEG requires that margin is immediately available to the collecting entity, and that satisfactory legal opinions must be obtained on whether the segregation arrangements meet the prescribed requirements. Neither of these conditions will be met in the case of non-EU jurisdictions described above.

If a policy decision is taken that banks have to margin all trades and can no longer choose to take credit risk and hold capital instead, European firms may effectively be shut out of some emerging market jurisdictions – including China and the Middle East. We would therefore urge ESAs to consider alternative ways of dealing this issue. We believe that the only realistic solution is to introduce a full exemption, or a transitional period of some kind, and for supervisors to continue to closely monitor firms' exposures. Any transitional should not be subject to fixed end dates, as the change of local law is not within the counterparties' control.

Local legislators should also be encouraged, via international bodies, to change their legal regimes to support the exchange of collateral.

VM phase-in

We suggested in our response to the second BCBS IOSCO consultation that a phase-in period should be permitted for variation margin. The exchange of variation margin is by no means universal practice and it would, for some counterparties, require a significant shift in current practice. This could be particularly acute in emerging market jurisdictions.

We would therefore support the proposal put forward in the ISDA response that VM should be phased in, and we would urge regulators to re-consider their approach to timing in the context of the Working Group on Margining Requirements ("WGMR") set up by BCBS IOSCO.

Intra-group

EMIR defines intra-group trades in Article 3 and, in cases of group entities outside Europe, that definition is in part founded on jurisdictional equivalence. No country has so far been deemed equivalent by the European Commission. Without clarity on which of their group entities are likely to be covered by the definition, firms will find it difficult to plan for implementation. Even if the Commission publishes its initial round of determinations this year, this is likely to be limited to a small number of jurisdictions initially. It seems unlikely that the list will grow in the short to medium term - not only because of the slow progress of implementation globally (even among WGMR jurisdictions), but also because of the limited resources available at the European Commission to undertake the assessments.

We would propose that the final standards either exempt intra-group transactions in their entirety, irrespective of whether the equivalence test of Article 3 is met, or allow for a longer transitional in cases where the other group entity is from a non-EU jurisdiction.

In any case, the examples of restrictions in the legal impediment definitions in Article 3 IGT are too restrictive. Most countries have restrictions on the movement of capital when a business is in insolvency. However, while such restrictions may be in place, the transfer of own funds or repayment of liabilities would still be possible up to the point of insolvency. In addition, the existence of currency and exchange controls may not in themselves prevent the repayment of loans. The language as stated in examples (a) to (d) would effectively seem to disallow any intra-group entity that is a regulated entity or is subject to international accounting rules from applying the exemption, which seems at odds with the spirit of the exemption. Intra-group entities are considered to be safer due to the consistent risk management framework that is required to be applied across the group, which ensures greater security against a group entity becoming insolvent compared to a third party. All entities must still operate within the legal framework of the country in which they are incorporated.

Initial margin thresholds

The final RTS should clarify that intra-group trades are not be included in the gross notional thresholds used for IM phase-in. As the threshold is determined on a group-wide basis, and such trades would be ignored when determining the consolidated position of the group, there seems to be no reason to include them.

Physically settled FX forwards and swaps should also be excluded from the calculations. EMIR Level 1 recognises that the risk posed by these products is different to that of other OTC derivatives, and the draft RTS permit FX forwards and swaps to be taken out of scope for initial margin. It would seem odd if those products were then counted towards the initial margin notional calculations – the same logic should apply throughout.

FX haircuts

The FX haircut should not apply to VM. This is because, unlike securities, cash in most currencies can be liquidated quickly. For securities denominated in a different currency, the haircut on the security would cover the possible loss of value during the foreclosure process.

Question 3: 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?

n/a

Question 4: 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?

Although we appreciate the ESAs' attempt to simplify the process and move away from over-reliance on external ratings, we are not convinced that the proposal to allow the use of a counterparty's IRB model is workable in practice.

IRB models are proprietary and therefore unlikely to be shared in the level of detail that would likely be required by counterparties. More importantly, any discrepancy between internal ratings could risk regulatory arbitrage: firms may choose to accept a counterparty's rating only if it is advantageous to them, and dispute it if it is not. The process would therefore face many of the same issues inherent in the proposal to use proprietary IM models, and it is precisely this potential for disagreements and disputes that led the industry to start developing the Standard Industry Initial Margin ("SIMM") via ISDA.

If the aim is to reduce reliance on external ratings, it may be better to consider setting up or endorsing an independent body to aggregate ratings and produce an industry average. This would preclude the need to share proprietary data with counterparties and would be based on models approved by supervisors. (Similar initiatives already exist – for example, PECDC (http://www.pecdc.org/) has been created by member banks to collect data to assist with the measurement of Loss Given Default and Exposure at Default.)

Question 5: 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 do not agree with the proposed concentration limits. Problems that would arise as a result of a requirement to diversify collateral go far beyond operational difficulties. This is especially – though not exclusively – the case when it comes to collecting margin from counterparties in emerging markets, where markets do not allow efficient mobilisation of collateral or where the sovereign issuer is the only realistic source of non-cash collateral.

In our view, the RTS definitions of collateral eligibility and the mandatory haircuts requirements already deal with the issues the ESAs are trying to address via concentration limits. BCBS IOSCO standards say that assets collected as collateral must be highly liquid and, after accounting for an appropriate haircut, be able to hold their value in times of financial stress so they can be liquidated in a reasonable amount of time. The draft RTS provisions similarly state that, without concentration limits, a counterparty may have to liquidate substantial amounts of single securities or from a single issuer at time of market uncertainty, which may impair the ability of counterparties to close their exposure.

In other words, both the eligibility criteria/haircuts and concentration limits are an attempt to deal with the issue of liquidation in times of market stress. While we appreciate the policy objective behind this, it is not clear why both should be needed. Collateral haircuts are sufficient – and, unlike the prescriptive concentration limits, they were agreed by BCBS IOSCO so should be implemented consistently. Firms are already strongly incentivised to protect themselves against counterparty default, and collateral management will form a part of their risk management process.

At the open hearing in June, ESAs explained that the reason for the inclusion of concentration limits in the RTS was to reduce the reliance on sovereign debt and address the EU banks/sovereigns loop. In practice, in many emerging markets there is insufficient liquid collateral available from any other issuer. Corporate bond and repo markets will be either non-existent or not very well developed, so a requirement to diversify would be prohibitively expensive.

Nevertheless, if ESAs wish to impose limits, some securities should be exempted. Ideally, exemptions should mirror the local central bank collateral eligibility regimes, but at the very least include all securities issued by governments and central banks. In addition, and as the RTS allude to, smaller counterparties should be excluded from the requirement to diversify.

Question 6: 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 limited use of rehypothecation as proposed in the final BCBS IOSCO standards did not seem workable in practice. One-time rehypothecation would be overly complex to operationalise and control, especially across global markets and timezones - it would be too expensive for the limited benefits it would provide. We were therefore not surprised that the ESAs chose not to allow any rehypothecation at all in the European rules.

However, as with all the other proposals where the EU rules diverge from the BCBS IOSCO standards, there remains a risk that other jurisdictions do not restrict rehypothecation in the same way. This should be closely monitored by the WGMR and by the European regulators in order to avoid creating an unlevel playing field.

More generally, we have from the outset maintained that rehypothecation should not be prohibited in principle. As the ESAs will be aware from discussions in the context of the BCBS IOSCO consultation, the inability to reuse collateral will have an impact on the price of services provided to clients. The choice of asset treatment should be left to clients, with additional disclosure of risks and closer regulatory scrutiny if warranted.

A ban on rehypothecation, combined with a higher demand for high quality liquid assets as a result of both regulatory and commercial pressures, will also have an effect on liquidity more generally. This may require a policy intervention in the future, so we would urge regulators to monitor the market developments closely.

i http://www.financialstabilityboard.org/publications/r_140408.pdf

ii http://www.bis.org/publ/bcbs261.pdf

iii http://www.treasurers.org/node/10270

iv http://www2.isda.org/attachment/NTYxOQ==/Celent%20ISDA%20Asian%20OTC%20Derivatives%20Markets%20FINAL.pdf

v http://www.esma.europa.eu/system/files/jc_dp_2012_01.pdf

vi http://www.bis.org/publ/bcbs242.pdf