Position Paper

Draft ESA regulatory technical standards on risk-mitigation techniques for OTC derivatives not cleared by a central counterparty (CCP)

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Key positions:

- Insurance Europe believes that **consistency of rules across jurisdictions and with other regulations** (such as Solvency II) is key to the efficient implementation of EMIR.
- A **delay in the current phase-in schedule should be foreseen**, to ideally allow experience in the central clearing environment to inform implementation in the OTC area.
- The currently foreseen **provisions regarding initial margin and haircuts** focus on aspects and requirements of the banking sector and do not cater for specifics of the insurance business.
- Insurance Europe believes that no differentiation between internal and external credit ratings should be made to define assets' eligibility.
- Insurance Europe advocates for the **elimination of concentration limits applied to government bonds**, in line with other regulations such as Solvency II.
- Contrary to the EMIR intention, a number of currently envisaged provisions would significantly **limit the application of the intra-group exemptions.**
- Insurers continue to have **significant concerns regarding the central clearing environment** and how obligations will impact insurers' investment behaviour, counterparty risk exposure and performance.

General comments:

Insurance Europe welcomes the opportunity to respond to the ESAs consultation on draft regulatory standards on OTC derivatives.

The European insurance industry contributed to and welcomed the global BCBS-IOSCO requirements for OTC derivatives. A number of features of the global BCBS-IOSCO framework are intended to manage the liquidity impact of the margin requirements on financial market participants and Insurance Europe welcomed provisions such as: (i) the introduction of a universal initial margin threshold of €50 million or (ii) the definition of a broad array of eligible collateral to satisfy initial and variation margin requirements, in line with the products that insurance companies are currently invested in.

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The global outcome is, to a very large extent, appropriately reflected in the ESAs' consultation paper. However, a number of areas in the consultation paper raise concerns for insurers from various perspectives, such as:

- Rules which are reflective of the banking business model and activity (eg regarding internal models for initial margin, haircuts or credit risk assessments based on internal models)
- Requirements which generate significant operational and implementation burden and for which there is not a clear benefit in terms of risk reduction or transparency

Insurance Europe welcomed the aim of having in place common global requirements for OTC derivatives and we believe that this should remain a key objective in the implementation phase. Insurance Europe believes that OTC rules should be consistent across jurisdictions and policymakers from jurisdictions around the world should make all efforts to achieve this.

Insurance Europe's response to the consultation is split into three sections:

- In the **first section** a number of areas in the ESAs consultation which can potentially raise concerns for insurers in the **OTC environment** are highlighted
- In the **second section** the insurance industry reiterates a number of concerns related to potential unintended consequences in the **central clearing environment**
- In the **third section other concerns** are raised, which are not explicitly related to the current consultation, but are key to an appropriate implementation of EMIR to insurance companies

Section 1:
Insurance Europe's concerns on a number of areas in the ESAs consultation that need adjustments and/or further reflection

The strengthening of the derivatives framework in an OTC environment should strike a balance between the need to mitigate counterparty risk and the potential economic risks and costs that could derive from the proposed measures.

Excessive requirements for derivatives may result in an excessive cost of hedging financial risks, and therefore discourage hedging operations. Furthermore, any additional costs arising out of the margin requirements will, directly or indirectly, be passed on to policyholders. Therefore, every effort should be made to ensure that costs associated with non-centrally cleared derivatives do not become prohibitively high and eventually harm policyholders.

Under Solvency II insurers will have to hold capital to cover exposures to both OTC and centrally cleared derivatives. So in the case of insurers there will be three types of costs: 1) an indirect cost transferred by banks in the pricing of derivative products 2) a direct cost of capital to be held against derivative transactions and 3) administrative/operational cost to implement/monitor the new requirements.

The following areas have been identified by insurance companies as areas of concern and/or areas where additional clarification and thinking is needed.

- **International consistency of rules is very important for insurance companies that undertake global activities**

The European insurance industry is a global market player[1]. It's often the case that risks on financial markets are managed at a group/holding level in order to increase hedging efficiency and reduce hedging requirements. Companies therefore put in place a group risk management approach to eg collateral eligibility and diversification that is then implemented at the level of each of the relevant group entities. It's therefore important that rules are consistent across jurisdictions (in line with the intention of the BCBS-IOSCO work).

For example, if bilateral margining requirements were different, then group-wide internal OTC collateral guidelines (based on legal requirements) could not be used in a synchronised way; rules would have to be split into separate approaches to cover various jurisdictions. This would lead to significant work in order to separate the respective areas within the group, to operate and monitor them.

While important steps have recently been made regarding equivalence between the EU and other jurisdictions such as Japan, Singapore, Australia, Hong Kong and India, the EU and US regulators hadn't reached an agreement regarding each other's clearing requirements by the end of Q2 2014. Insurance Europe believes that EU-US equivalence is important to avoid fragmentation of cleared OTC derivatives into separate US and EU liquidity pools. Any potential portfolios restructuring due to lack of agreement would be significantly burdensome.

Insurance Europe therefore believes that policymakers from jurisdictions around the world should make all efforts to achieve the BCBS-IOSCO aim for convergence *"Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions"*.

[1] 30% of premiums of top 20 European insurers were written outside Europe in 2012 (source: "L'Argus des Assurances").

- **Insurance Europe believes that the currently envisaged phase-in implementation schedule is extremely ambitious. A delay in the current schedule, for both initial and variation margin, should be foreseen. Such a delay should ideally allow experience in the central clearing environment to inform implementation in the OTC area.**

The new OTC requirements will demand important resources from insurance companies at operational, legal and reporting level. Insurance Europe believes that the currently foreseen start date of December 2015 does not properly respond to the operational challenges that insurers will face.

For example, collateral exchange will require de-facto agreements between the counterparties on (among other things) the daily valuation of derivatives positions. Under EMIR's reporting requirement, this field was explicitly moved from the *Common Data* table (to be reconciled between counterparties) to the *Counterparty Data* table (no reconciliation with the counterparty). Given the high likelihood of disputes, this adds a significant overhead to the EMIR reporting process as well.

The central clearing environment could be used as a good reference for implementing sound and robust processes and procedures in the OTC environment. Rules on non-centrally cleared OTC products should start being phased-in well after rules on central clearing have entered into force to allow for central clearing experience to be reflected in the OTC environment. Given that final rules on central clearing are still outstanding, the beginning of the phase-in period should be pushed well beyond 2015.

In addition, the phase-in schedule is a good example of area where international consistency should be achieved. Especially in the case of globally-active insurers, as indicated above a number of provisions and rules will be defined at group level, in line with the BCBS-IOSCO aim of implementing same rules across jurisdictions.

- **Insurance Europe believes that the minimum transfer amount should be increased from €500 000 to €1m**

Insurance Europe welcomed the introduction of a universal *initial margin* threshold of €50m. However, Insurance Europe believes that the threshold of €500 000 on *total collateral* (ie the mininum transfer amount in Article 2 GEN, paragraph 4) is too low and will create an unnecessary operational burden. A more appropriate threshold would be €1m, which is a level that is commonly used today in bilateral Credit Support Annex (CSA) agreements.

- **The currently foreseen provisions regarding initial margin and haircuts focus on aspects and requirements of the banking sector and do not cater for specifics of the insurance business**

While insurers welcome the possibility to develop internal models for initial margin and haircuts calculation, in practice the use of internal models by insurance companies will be very limited. Even very large insurance companies with significant derivatives exposures have indicated that they do not intend to develop their own internal models for assessing initial margin and haircuts.

The standard schedule, which is the alternative to internal models, is very punitive and is a clear indication of the fact that encouragement of internal models is sought by ESAs. However, in the case where insurers decide to rely on internal models developed by banks, they will still have to assess, according to the consultation, the reliability of internal models. It's not clear how this will be done in practice as this requires a high level of transparency from the banking side.

"Duplicating" margin models may be virtually impossible and it is not just a matter of replicating a computer code (many run on proprietary platforms), but also of maintaining the same data sets. Internal modelling includes historical data backtracked for years and further complex information which cannot be mapped to a "key data package". The more banks an insurer contracts with, the greater the challenge.

In addition, bilaterally agreed methodologies may not be a tenable solution during periods of market stress. During such a period, the efforts required to independently verify calculations and resolve disputes (many of which would likely be due to changes in transparent, unilaterally-determined market parameters used by the calculating party, such as correlations or volatility) would promote neither of the objectives of the final guidelines, and rather likely increase systemic risk due to an accident.

- **Insurance Europe believes that any legislation aimed at encouraging the use of internal rating based (IRB) approaches should take into account the nature, scale and complexity of users of credit ratings. No differentiation between internal and external ratings should be made to define assets' eligibility.**

While the intention to reduce reliance on credit rating agencies (CRAs) is understandable, Insurance Europe believes that incentives to create internal risk assessment models should take into account the specificities of the business that such provisions are targeting. In this case, insurers, as users of derivatives, are in the scope of the draft RTSs and therefore have serious concerns regarding the fact that IRB approaches appear to be favoured by regulators when assessing eligibility of assets for collateral purposes.

More precisely, in the ESAs consultation (*Article 3 LEC – Credit quality assessment*) there is a differentiation being made between eligibility of collateral, eg:

- When assets have a credit rating based on an IRB approach they are eligible to be used as collateral when they have a credit quality step (CQS) of 3 or above (ie probability of default smaller or equal to 1%)
- When assets have a credit rating based on an external provider they are eligible to be used as collateral when they have a CQS of 2 or above (ie probability of default smaller or equal to 0.25%)

The use of an internal ratings is not common outside the banking sector (which is also confirmed by references to CRDIV in the consultation). Insurance companies do not have the resources, nor the expertise to develop internal rating models. Even the very large insurance companies make use of external credit ratings and have in place additional risk management tools based on which risk assessments are made.

Indeed, the objective of the CRA 3 regulation was to reduce reliance on external credit ratings, but *"in line with specific sectorial regulations"*. The recent Omnibus II Directive gives due consideration to the difficulties that insurers might face in developing their own rating models[2].

Insurance companies do not have the special expertise, access to internal information and ability to make use of economies of scale that, for example, Credit Rating Agencies and banks have. This makes it impossible to issue credit ratings and makes it difficult to imagine how such a complex business model could be replicated in an insurance company.

Insurance Europe is also aware of recent discussions in the banking area where, although IRB approaches are allowed, regulators have been focusing recent work on examining the comparability of internal ratings.

Insurance Europe therefore believes that non-users of IRB models should not be penalised in terms of collateral eligibility and therefore no differentiation between and IRB approach and an external credit rating should be made.

[2] *"In order to avoid overreliance on external credit assessment institutions when they use external credit rating assessment in the calculation of technical provisions and the Solvency Capital Requirement, insurance and reinsurance undertakings shall assess the appropriateness of these external credit assessments as part of their risk management by using additional assessments wherever practically possible in order to avoid any automatic dependence on external assessments."*

In the case where an internal credit rating, provided by a banking counterparty would be used, it's not clear how the insurer will have access to such information (eg in some cases credit ratings generated internally could be considered as material non-public information and therefore the banking counterparty would probably not disclose them).

- **Insurance Europe already highlighted in the past that the use of credit ratings as absolute cut-off points for collateral eligibility can lead to cliff-edge effects and pro-cyclical investment behaviour**

In the context of Omnibus II discussions[3], the European insurance industry highlighted that proposals requiring or incentivising insurers to hold bonds that are above a certain credit rating can distort the market price of bonds and can artificially depress investment in bonds with ratings below the threshold. In certain currencies and markets the supply of bonds above the threshold can be very limited and therefore credit quality restrictions can significantly reduce the range of investments available to insurers.

In addition, if such restrictions create immediate and significant action as soon as the threshold is reached (eg the collateral portfolio would need to be rebalanced to re-achieve eligibility), they create pro-cyclical, cliff-edge effects. During an economic downturn, when a higher than normal number of entities are downgraded, the rule risks to turn otherwise stable investors into pro-cyclical forced sellers, thereby reducing the value of distressed bonds even further.

- **The currently envisaged concentration limits are too restrictive and not justified by the risks that they are trying to address. In addition, the benefits of concentration limits do not justify the operational challenges that they generate in practice.**

Insurance Europe believes that the currently envisaged provisions regarding concentration limits are too prescriptive, restrictive and will add significant operational overheads without a clear mitigation of risk. While we are aware of the fact that the BCBS-IOSCO global requirements indicated a need for concentration risk to be addressed[4], we believe that the current proposal raises a number of concerns without a clear balance between challenges and benefits that it creates. We would therefore like to highlight three aspects of concentration limits that need more thinking:

From the explanatory text of the consultation paper (Article 7 LEC), we understand that concentration limits are meant to prevent the risk that a counterparty *"may have to liquidate substantial amounts of single securities or from a single issuer at time of significantly elevated, market uncertainty".* So the scope of concentration limits is to prevent massive losses in the value of collateral in the case where a counterparty would have to liquidate such "substantial" amounts of collateral (following a default).

One of the limits defined in the consultation paper is a 50% limit of sovereign debt (issued by a single issuer) received as collateral. We could imagine a case where a small insurance company would receive from its (only) derivative counterparty collateral in the form of 100% EUR government bonds with a nominal value of, eg, €10m. Assuming that the banking counterparty would default and the insurer would have to liquidate the collateral, it's not obvious how the fact that collateral is composed 100% of the same asset could affect its market value given that the notional value is (only) €10m.

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[3] Discussions around the matching adjustment included at some point a minimum credit quality (BBB and above), namely a 33.3% limitation on the holdings of BBB investments in the matching adjustment portfolio.

[4] *"While haircuts serve a critical risk management function in ensuring that pledged collateral is sufficient to cover margin needs in a time of financial stress, other risk mitigants should also be considered when accepting non-cash collateral. In particular, entities covered by the requirements should ensure that the collateral collected is not overly concentrated in terms of an individual issuer, issuer type and asset type. "*

As emerging from the explanatory text of Article 7 LEC (quoted above), it appears that concentration limits are closely linked to the (lack of) liquidity of collateral and therefore absolute weights, as illustrated in the example above, might not be appropriate to address liquidity risk of collateral. However, given the emerging difficulties in the banking area to find an appropriate approach to measuring liquidity and liquidity risk, more work in this area is needed in the future to find appropriate concentration limits that better reflect the risks that they are meant to address.

From a practical and operational point of view the proposed concentration limits will generate significant operational challenges for insurers:

- Insurers will have to assess whether the weights of assets in the collateral pool are in line with the concentration limits; this test will have to be done on a daily basis, even in cases where, for example, (a) no additional variation margin is required (the value of the derivative is the same), but (b) the weight of assets in the collateral pool would change as a result of market movements.
- Rebalancing of the collateral portfolio would require additional operational costs. The current proposal provides no grace period to fulfil with the diversification obligations so rebalancing would have to be done as soon as a bias would be noticed (eg 50.1% allocation to a certain asset instead of 50% foreseen in the regulation). An appropriate way to address this would be by applying the minimum transfer amount to breaches in allocation.
- Where the collateral portfolio is a small part of total assets, which is likely to be the case for most insurers, achieving the prescribed diversification is impractical and unnecessary.

We therefore believe that concentration limits would cause operational issues with no added value. Instead, RTS should define high level principles allowing for a practical and workable implementation, avoiding prescriptive rules with unnecessary operational burdens and costs. If still a prescriptive approach is desired by ESAs, then we believe that there should be no limits for government bonds (more arguments are provided below).

- **Insurance Europe advocates for the elimination of concentration limits applied to government bonds**

The introduction of limits of government bonds raises a number of concerns for insurance companies, namely:

- Inconsistency with other regulations such as Solvency II

In the Solvency II framework exposure to government risk is excluded from the purpose of capital charges for concentration risk[5]. Therefore defining concentration limits on government bonds included in the collateral portfolio would be inconsistent with the approach taken in Solvency II.

- Limited possibility to pledge and accept government bonds in periods of market stress

While insurers welcomed (and advocated for) a broad pool of eligible collateral, in periods of market stress it might be the case that insurers only want to receive government bonds from their counterparties.

While for insurance companies located in EUR area member states the required diversification of government bonds issued in EUR is at least theoretically achievable (even if not favoured in all cases), insurance companies located in non-EUR area member states would either be forced to accept non-government bond

[5]SCR 5.144 of EIOPA's technical specifications for preparatory phase (April 2014)
A risk factor of 0% should apply for the purposes of the concentration risk module to exposures to EU Member States' central government and central banks denominated and funded in any domestic currency of a EU Member State, or exposures to a multilateral development bank.

assets or accept government bonds denominated in foreign currencies. The latter option would produce additional costs for FX hedging and require a change in the asset management strategy.

- Availability of eligible non-government assets could be a significant challenge in jurisdictions rated with CQS3 (ie BBB) or below

Given that the sovereign rating (most often) acts as a cap on corporate ratings, once a sovereign rating is defined at the level of eg CQS3 (ie BBB), the likelihood of availability of eligible corporate bonds with an eligible credit rating is very limited. It's therefore difficult to imagine how an insurance company could find eligible corporate bonds to place as collateral in conjunction with government bonds.

Therefore in such cases lack of availability of (other) assets would force companies to only accept/pledge government bonds and a cap on government bonds would not make sense.

The BCBS-IOSCO gave government bonds as an example of assets which would, "after accounting for an appropriate haircut, be able to hold their value in a time of financial stress" and which "can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default ". Not applying concentration limits on government bonds would be in line with the BCBS-IOSCO view regarding the quality and behaviour of government bonds in times of financial stress.

European insurers therefore believe that concentration limits placed on government bonds should be avoided. If, however, such a restriction must be in place, the 99% EMIR confidence level for the initial margin model suggests that a risk-free approach to governments is still warranted for governments with a CQS of 3 or better (ie a default probability lower or equal to 1%).

- **Contrary to the EMIR intention, a number of currently envisaged provisions would significantly limit the application of the intra-group exemptions. Insurance Europe believes that a more-principle based approach should be considered to allow for an appropriate application of the intra-group exemption from collateralisation.**

Collateralisation of intra-group derivative transactions is economically inefficient. Insurance companies often manage derivative exposures at group level. For example, equal but opposite FX exposures of insurance subsidiaries can be netted down such that only residual exposure needs to be hedged externally.

The holding company is essentially the only point of access to capital for a subsidiary. Capital within the group is managed in a way to allocate to each subsidiary the capital it needs for its operating business. If the holding posted collateral with a subsidiary it would mean, in a first step, to allocate excess capital to that subsidiary. In a second step, the excess capital would be withdrawn by capital management measures thereby neutralising the collateralisation. Similarly, if the subsidiary posted collateral with the holding it would mean that the subsidiary's capital position is weakened causing the need for additional capitalisation from the holding thereby, again, neutralising the collateralisation effect.

In addition, imposing collateralisation requirements to small entities/subsidiaries who only hedge intra-group would create the wrong incentives. It is not economically feasible to set up a collateral management function in a small subsidiary. Moreover, the subsidiary might decide to leave exposures un-hedged because of the significant operational burden and costs that collateralisation creates.

A number of provisions that would need to be fulfilled by insurance companies managing intra-group derivative transactions were defined in the ESAs draft RTS.

- Provisions referring to insolvency and resolution regimes would create significant limitations in practice due to a wide range of national solvency laws limiting the prompt transfer of funds from a legal perspective.

According to EMIR, exemption from collateralisation of intra-group transactions can be granted if there are no legal impediments to the prompt transfer of own funds or repayment of liabilities. The ESAs consultation goes one step further and defines legal impediments by stating that restrictions "stemming from insolvency, resolution or similar regimes" are an example of legal impediment.

In practice, there are a range of (national) insolvency laws potentially affecting intra-group derivative transactions and the vast majority of rules limit the prompt transfer of funds from a legal or practical perspective. For example, according to (some) insolvency laws, an insolvent person can no longer direct and dispose of its assets after the opening of an insolvency procedure. If this legal circumstance represents a *"legal impediment",* companies would never be eligible for the exemption because they can't guarantee that subsidiaries within the group will never become insolvent.

Therefore, the proposed approach would lead to the consequence that only very few intra-group transactions will benefit from the exemption. Insurance Europe believes that this was not the intention of EMIR and advocates that a broader/more principles-based definition of practical/legal impediments should be provided by ESAs. Restrictions stemming from insolvency, resolution or similar regimes should in general not be included as a criterion for legal/practical impediments to transfer own funds or to repay liabilities.

- Insurance Europe believes that a very strict interpretation of "legal impediments" should be avoided.

The *"absence of impediments to the transfer of own funds or repayment of liabilities"* appears to be inspired from the banking sector (cf. Art. 67 Directive 2006/48/EC and Art. 7, 113 EU Regulation 575/2013, CRR). Insurance Europe understands that, in a banking context, the absence of material impediments to the transfer of own funds or repayment of liabilities is a prerequisite to allow for certain exemptions in the field of banking supervision (eg supervision of certain banking entities on a group-basis only). This approach recognizes the going-concern perspective for supervisory purposes. Insurance Europe understands that the mandate given in Art. 11(15)(d) EMIR to define *"practical and legal impediments to the transfer of own funds and the repayment of liabilities"* should be used to achieve a comparable concept.

Against this background, Insurance Europe believes that the following caveat should be added to Art. 3 IGT para. 1:

Art. 3 IGT – Practical or legal impediment
[…]
For this purpose, restrictions shall be deemed current or anticipated, if concrete restrictive actions or effects materialise or are imminent to materialise.

- **Insurance Europe understands that investment funds should not be included in the calculation of initial margin thresholds for the phase-in approach defined in Article 1 FP**

Insurance Europe understands that the thresholds in Article 1 FP are similar to the thresholds referred to in recital (5) applying at group level, namely *investment funds* and *investor* should be considered distinct entities under the conditions described in recital (5). Confirmation from ESAs on this point would be welcome.

Short answers to questions raised in the consultation

Question 1. *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?*

As indicated in Section 1 of the response, the new requirements would create significant operational burden on companies as all contracts in the OTC environment would have to be re-negotiated. Operational burden will be increased by eg introduction of very prescriptive collateral diversification requirements and, potentially, by non-alignment of rules at international level.

These types of cost can be reduced if the final technical standards define high level principles allowing for a practical and workable implementation, avoiding prescriptive rules with unnecessary operational burden and costs.

More details on Insurance Europe's position can be found in section 1 of the response.

Question 2*. 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.*

A descriptive approach to collateral diversification creates significant operational burden; (especially) in the case of small insurance companies, with limited exposure on derivatives, such requirements have no economic benefits.

More details on Insurance Europe's position can be found in section 1 of the response.

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?*

No answer.

Question 4. *In respect of the use of a counterparty Internal Rating Based 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?*

Insurance Europe believes that any legislation aimed at encouraging development of internal rating based (IRB) models should take into account the nature, scale and complexity of users of credit ratings. No differentiation between IRB and external credit ratings should be made to define assets' eligibility.

More details on Insurance Europe's position can be found in section 1 of the response.

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?

Concentration limits would create operational burden in practice. Insurers with large asset portfolios and derivatives activity already have collateral management rules in place for risk management purposes, while insurers with very limited derivatives activity do not have the need, nor the resources to assess collateral from a concentration point of view. While the introduction of thresholds might look like a suitable solution for addressing concentration risk, the calculation and monitoring of thresholds produces disproportionate additional work and burdens for insurers. Where the value of collateral is limited in absolute terms, the risk of collateral liquidity is inexistent and concentration limits are not needed.

More details on Insurance Europe's position can be found in section 1 of the response.

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?*

No answer.

Section 2:
Concerns regarding the central clearing obligation for insurers

The G-20 OTC derivatives reform (and its European implementation – EMIR) is a good example of regulation that is developed for the right reasons but that fails to take into account the nature and implications of long-term business.

While EMIR recognises that pension funds "typically minimise their allocation to cash in order to maximise the efficiency and the return for their policyholders", it fails to recognise that the same principle is also fully applicable to insurers managing savings and pension products. Because of the way that the exemption was defined in EMIR, its application to insurance companies is very limited and so not many insurers will be able to make use of it.

The insurance business model and the long-term illiquid profile of insurers' liabilities enable them to take a long-term view in their strategic asset allocation and hence to have a limited exposure to cash. At the same time, current practice indicates that central counterparties (CCPs) will only accept cash as collateral for variation margin and there is no indication that they will expand the acceptable collateral to other highly liquid assets, as allowed by EMIR.

Against this background, European insurers managing long-term products risk being forced to either:

1. hold unnecessary amounts of cash (to the detriment of long-term investments)
2. perform forced sales of assets when cash is needed
3. monetise assets via the repo market (if not restricted by national regulations[6])
4. or simply make less use of derivatives, which threatens the provision of long-term insurance products, for some of which derivatives are vital

Unfortunately, alternatives 2 and 3 encourage pro-cyclicality and threaten the significant counter-cyclical role that the insurance industry has traditionally played in periods of market stress. In addition, as experienced in the past, in periods of significant market stress the repo market tends to disappear. Therefore if CCPs continue to accept only cash as variation margin it's important that policymakers consider how to cope with the above mentioned problems.

Looking ahead, the cumulative effect of regulations needs careful attention. For example, the ability to monetise the assets for covering cash needs may be further challenged by regulatory developments in the shadow banking discussions, where the introduction of controls and limits on the use of cash generated via repos is foreseen (FSB-Work Stream 5 in the shadow banking dossier)[7].

In addition to concerns regarding the need to post cash and/or to monetise assets, insurers have increasing concerns regarding risks emerging in the central clearing environment, where significantly high amounts of collateral will be concentrated in very few CCPs. It's not yet clear how, if at all, counterparty risk will be different between CCPs and OTC – whether regulation will, on balance, support the use of CCPs over OTC by insurers. Insurers are also concerns by emerging expectations that banks (acting as clearing members) will ultimately pass all CCP-related losses to end users such as insurers.

There is thus a risk that insurers' allocation to long-term investments products or their use of derivatives will be negatively affected once the central clearing obligation becomes effective. Careful monitoring will therefore be needed to check if unintended consequences are happening and if so how to react to avoid further damage.

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[6] Existing and under development rules in a number of EU jurisdictions are aimed at restricting or limiting the use of repo transactions by insurers (eg Germany, Belgium)in Germany, according to § 7 subsection 2 of the German Insurance Supervisory Act (VAG), repo transactions not linked to insurance business are prohibited).

[7] In Europe the ability to monetise assets for covering collateral needs has already been limited in the context of UCITS funds, where the use of repos for covering derivatives margin needs has been prohibited.

Section 3:
Other concerns

In this section Insurance Europe would like to highlight a number of areas which are not explicitly related to the current consultation, but which are equally important to ensure an appropriate implementation of the derivatives regulation and to avoid unintended consequences on how insurers manage their businesses.

- **There is currently no interaction between EMIR and Solvency II (draft Delegated Acts) with respect to the treatment of derivatives and associated capital charges for counterparty default risk**

EMIR and Solvency II appear to take different approaches regarding exposure to collateral and emerging counterparty default risk. There are 2 main areas where Insurance Europe believes that interaction between Solvency II and EMIR should be envisaged, namely:

1. Capital requirements in the current draft Solvency II rules do not distinguish between centrally-cleared vs OTC derivatives

Solvency II defines capital requirements for covering counterparty risk emerging from derivative transactions. The current charges are however calibrated based on a pre-EMIR OTC environment (without eg compulsory margining and haircuts) and no difference is made between OTC and centrally cleared derivatives[8].

EMIR was designed to incorporate the European Commission objective of reducing counterparty risk via compulsory central clearing[9]. Although it's not yet clear how, in practice, collateral requirements (for insurers to post) will be different between CCPs vs OTC and how, if at all, counterparty risk be different between CCPs and OTC, Solvency II capital requirements should incorporate the important changes that EMIR safety provisions (in term of collateral and haircuts) brings to the derivatives market.

Given the emerging rules of full collateralisation, haircuts and initial margin, the counterparty default risk charge should be set at zero.

2. The collateral adjustment is very punitive and there is no interaction with the EMIR haircut approach

Solvency II defines an adjusted value of collateral that is used to derive the value of the actual exposure. Based on the value of the exposure, a capital charge is calculated. The adjustment of collateral assumes a stress calibrated at 99.5% over 1 year. However, under EMIR the haircut on collateral is calibrated at 99% and at least every 10 days. The assumption under Solvency II that it should be stressed assuming a 1 year holding period seems to overstate the actual risk.

In principle, insurers are "economically" exposed to collateral only in the case of a counterparty default, when the collateral would need to be used to cover the unwinded derivative. While in EMIR, collateral haircuts are calibrated to reflect collateral exposure for maximum 10 days, in Solvency II the assumption is 1 year of collateral exposure. Therefore Solvency II (with its one-year horizon) would need to cater for multiple defaults within one year.

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[8] SCR.6.37. of EIOPA's technical specifications for preparatory phase (April 2014)
For a derivative, the l*oss-given-def*ault *LGD* should be calculated as follows:

$$LGD = \max(90\%(Derivative + RM_{fin}) - F' \cdot Collateral; 0)$$

where the 90% factor is derived by assuming a 10% recovery rate and *Collateral* is the risk-adjusted value of collateral.

[9] *"The Commission also proposes that standard OTC derivative contracts be cleared through central counterparties (CCPs). This will reduce counterparty credit risk."* - extract from EC press release

- **Clarification is needed that insurance derivatives are not in the scope of EMIR**

Insurance derivatives are a means by which reinsurers take over global risks (as an alternative to traditional reinsurance contracts). While traditional reinsurance contracts are linked to the policy owner's proof of loss, insurance derivatives are linked to other payout triggers (eg physical-parametric triggers – earthquake/ storm intensity).

The underlying risk of insurance derivatives is insurance event risk (ie risk of loss from natural catastrophes) which itself is not traded in the capital markets and for which therefore no transparent and continuous market pricing exists. The lack of a traded underlying makes it difficult to build-up synthetic hedge positions from traded financial instruments and thus prevents the creation of a derivative market which is disconnected from the holding of insurance risk. Insurance derivatives are predominantly used for risk management purposes by holders of insurance risk, which makes systemic knock-on effects and hazard for financial stability extremely limited.

Due to their special characteristics and difference to financial derivatives, insurance derivatives should not be classified as derivatives according to EMIR. In order to establish legal certainty, there should be a clarification from the European Commission that insurance derivatives do not fall under the scope of EMIR. The relevance of this issue for the European insurance industry is high, since five of the ten largest reinsurers are located in the European Union.