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Joint Committee of the European Supervisory Authorities

14 July 2014

Re: Joint Committee of the European Supervisory Authorities 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/Madam,

UBS would like to thank the Joint Committee of the European Supervisory Authorities for the opportunity to comment on the 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. Please find attached our response to the consultation.

We would be happy to discuss with you any comments you may have. Please do not hesitate to contact Andrew Bell on +44 20 7568 1385.

Yours sincerely,
UBS AG

Thomas Pohl Managing Director Head of Executive & International Affairs	Andrew Bell Executive Director Public Policy EMEA

UBS AG response to the Joint Committee of the European Supervisory Authorities 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

INTRODUCTION

UBS would like to thank the Joint Committee of the European Supervisory Authorities ("ESAs") for the opportunity to comment on the 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 (the "RTS").

Please find below our general comments as well as responses to the specific questions set out in the paper. Please note that we have addressed questions 1 and 2 of the consultation via comments on the relevant RTS articles. We have not addressed question 3. We have responded directly to questions 4 – 6.

The proposal contains, in our view, three key elements which we consider will create significant costs to the industry and which are likely to disincentivise the use of OTC derivatives for risk management purposes: (i) the requirement for two-way posting of the full amount of initial margin (IM) on a gross basis (ii) mandatory full IM segregation without the possibility to re-hypothecate or re-use the collateral posted and (iii) restrictions on collateral eligibility.

The requirement for two-way posting of the full amount of IM on a gross basis is likely to have a number of considerable impacts: (a) a significant legal impact resulting from the need to renegotiate existing legal contracts (b) an operational impact resulting from parties who currently do not have to post or receive margin having to develop the processes and infrastructure to do so (c) an increase in settlement risk resulting from the significant increase in collateral movements that can be expected under the proposals and (d) a highly significant liquidity impact resulting from the need to collateralise considerably higher margin requirements than are currently required by regulation or existing market practice.

The liquidity impact will be further exacerbated by the proposed mandatory full IM segregation without the possibility to re-hypothecate or re-use the collateral posted as well as by the restrictions on collateral eligibility which will create a situation where significant amounts of high quality collateral is tied up and is not available for other uses. We are concerned that these requirements, coupled with the proposed Basel III/CRD IV/CRR liquidity requirements, will result in very significant liquidity demands being placed on banks which may undermine their ability to lend to the real economy.

We also note that whilst two-way exchange of variation margin (VM) is common market practice today, the conditions under which VM must be exchanged under the RTS will require significant changes to existing market practices and legal documentation. It should therefore not be assumed that implementing the VM requirements will be straightforward.

So whilst we agree that the potential systemic impact of non-cleared OTC derivative counterparty credit risk is likely to be reduced by the RTS, we believe the corresponding increase in liquidity, settlement and operational risk could offset this, with the overall impact on systemic risk being ambiguous.

We recognise however that the RTS is based on the final framework of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) (the "BCBS/IOSCO Framework") and we are supportive of international consistency in the area of margining of non-centrally cleared OTC derivatives. So whilst we do not support the overarching approach in the RTS, we provide comments below on the detailed proposals of the RTS with the intention of supporting the ESAs in developing a robust regime that achieves the objective of reducing counterparty credit risk whilst minimising the introduction of new risks and the potential for the RTS to change the economics of non-cleared OTC derivatives to the extent risks go unhedged and systemic risk increases.

Our key comments on the RTS are as follows:

- The scope of exemptions from the margining requirements should be expanded to cover non-EU counterparties that would be NFC- if established in the EU as well as non-EU sovereigns, central banks and multilateral development banks
- The requirements in the RTS should not be applied to margin that is voluntarily collected over and above the minimum levels required by the RTS or to margin collected from counterparties who are out of scope of the RTS
- The standards applied to IM models should not be overly prescriptive and should provide sufficient flexibility to allow counterparties of varying levels of modelling sophistication to develop their own models
- Eligible collateral for margins should follow the scope agreed by the BCBS/IOSCO Framework and additional constraints should not be imposed in the EU
- The 8% "currency mismatch" haircut for VM and IM should be deleted
- Intragroup transactions involving a third country counterparty should be able to benefit from the intragroup margining exemption in cases where the European Commission is yet to make a determination on the equivalence of the relevant third country provided that the relevant third country counterparty is also taking steps to implement the G20 proposals.

BACKGROUND AND RATIONALE

Objectives of the proposal

On page 6 of the consultation paper, it is stated that "*The overall reduction of systemic risk and the promotion of central clearing are identified as the main benefits of this new international framework*".

We disagree that an objective of margin requirements for non-cleared OTC derivatives should be to promote central clearing. The counterparties subject to margin requirements for non-centrally cleared OTC derivatives are typically the same counterparties that are subject to mandatory clearing requirements. Therefore, in relation to classes of derivatives declared subject to a mandatory clearing obligation, there will be a regulatory requirement to clear and this will not be optional.

In addition, for classes of derivatives not subject to mandatory clearing, capital requirements in Basel III/CRD IV/CRR already address differences in risk presented by centrally cleared versus non-centrally cleared derivatives. In our view, this capital treatment, combined with the multilateral netting benefits of central clearing, incentivises the use of centrally cleared derivatives where viable, even when not mandated.

If, despite these factors, a counterparty still chooses to use non-cleared rather than cleared OTC derivatives, this will typically be based on the need to have a bespoke product to hedge a specific risk where the use of a more standardised cleared derivative would result in material basis risk. So the use of non-cleared OTC derivatives should reduce overall systemic risk and should not be discouraged by overly conservative margin requirements.

CHAPTER 1 - COUNTERPARTIES' RISK MANAGEMENT PROCEDURES REQUIRED FOR COMPLIANCE WITH PARAGRAPH 3 OF ARTICLE 11 OF REGULATION (EU) NO 648/2012

Article 2 GEN – Risk management procedures in specific cases

Treatment of third country entities

Our understanding of Article 2 GEN is that an FC or NFC+ that enters into a derivative contract with an NFC- may agree that no exchange of margin is required but that no potential exemption applies to contracts executed between an FC/NFC+ and a non-EU entity. Furthermore, we understand that the exemption from collecting IM if the total IM to be exchanged is less than EUR 50 million or if one of the parties has less than EUR 8 billion (or higher amounts before 2019) in aggregate notional amount of derivatives would not be available to non-EU entities. We believe this will have a highly detrimental impact on the ability of EU counterparties to engage in non-cleared OTC derivative contracts with non-EU counterparties. This will place EU counterparties at a competitive disadvantage to counterparties operating in jurisdictions that have followed the BCBS/IOSCO Framework and exempted all small, non-systemic derivative users from the margin requirements. It may also impede the ability of non-EU corporates to hedge their risks (thus contributing to global systemic risk) if the availability of willing counterparties to engage in transactions with non-EU corporates does not satisfy demand.

We strongly believe that non-EU counterparties should only be subject to the RTS in cases where they would be classified as an FC or NFC+ under EMIR if established in the EU. This would be consistent with the scope of parties subject to the clearing obligation under EMIR. In our view, this approach would not increase systemic risk given that non-EU counterparties that are only low volume users of OTC derivatives (i.e. they fall below the clearing threshold in Article 10 of EMIR) cannot be considered systemically important users of derivatives.

We also believe that the thresholds in the RTS (the EUR 50m threshold and the EUR 8 billion threshold) should apply equally to EU counterparties and non-EU counterparties as we do not believe there is any risk based justification for a differentiated approach.

Treatment of non-EU sovereigns, central banks and multilateral development banks

Our understanding of the scope of the RTS is that non-EU sovereigns, central banks and multilateral development banks would not be exempt from the margining requirements. We consider this inappropriate and believe they should be exempted from the RTS on the basis that they do not pose systemic or counterparty risk in the same way as private counterparties. We also note that such actors are exempted from the margining requirements under the BCBS/IOSCO Framework where on page 8 of the framework document it is stated that: "*Similarly, the BCBS and IOSCO advocate that margin requirements are not applied in such a way that would require sovereigns, central banks, multilateral development banks (MDBs) or the Bank for International Settlements* *to either collect or post margin. Both of these views are reflected in the exclusion of such transactions from the scope of margin requirements. As a result, a transaction between a covered entity and one of the aforementioned entities is not covered by the requirements set out in this document*".

Application of EUR 50m threshold

Our understanding of Article 2 GEN, paragraph 3 of the RTS is that the EUR 50m threshold is available to FCs only and not to NFC+. We do not consider this appropriate as there is no economic justification for a differentiated approach between FCs and NFC+. Furthermore, the BCBS/IOSCO Framework does not make such a distinction in its application of the 50m threshold. We therefore believe that the EUR 50M threshold should also apply to NFC+.

Counterparty status should remain constant during the life of a transaction

We believe it is important that the status of a counterparty should be determined at the point the transaction is entered into, and should not change during the life of the transaction, given that counterparty status determines whether or not a transaction is within scope of the RTS. It would create significant uncertainty and make it very difficult to price non-cleared OTC derivative contracts if it was possible for the margin requirements in the RTS to be switched on and off during the life of the transaction due to changes in the status of one or more counterparty to the trade.

Interpretation of the requirement to hold capital

Article 2 GEN, paragraph 3 requires a counterparty to hold capital against its exposure to counterparties in cases where the EUR 50 million threshold is applied. We would appreciate clarification of exactly what this requirement means. For example, dealers will typically be subject to the Basel III/CRD IV/CRR capital regime which requires capital to be held against OTC derivative exposures and we would be grateful for confirmation that the RTS is not proposing that any additional capital needs to be held. Also, for counterparties who are not already subject to such existing regulatory capital requirements, we do not consider it appropriate that the RTS would then apply the Basel III/CRD IV/CRR counterparty credit risk framework to such less sophisticated users of OTC derivatives as this would be disproportionate to the risk. If such capital requirements were to be imposed, we also note that it is not clear what the capital calculation methodology would be.

Independent of the above, we are unclear why there would be a requirement for the counterparties "to agree" that no IM will be exchanged in favour of capital, given that in cases where the Basel III/CRD IV/CRR capital regime applied those regulations would already address this point and further documentation would seem redundant.

Article 1 VM – Variation margin

Whilst we support the daily exchange of VM in principle, we believe that in some cases this may be onerous for certain smaller firms. This is because smaller, less sophisticated users of OTC derivatives will typically not have the infrastructure in place to manage daily trade and collateral valuations and the operational means to manage cash payments.

We also note that whilst daily exchange of collateral is useful when underlying positions can be meaningfully re-valued on a daily basis, this may not be realistic in markets which are lacking robust observable price data. There should be some flexibility in the proposals to reflect this.

Also, we highlight that the timeframe for delivery of VM collateral is determined by the standard settlement cycle of the asset used as collateral. For example, if an asset with a settlement cycle of T+2 is posted as VM collateral, the collecting party would not receive the asset until two days after the transfer was initiated. Therefore, we believe the RTS should be amended to make clear that the specified timeframes relate to calls for collateral rather than actual delivery, and that actual delivery of VM will be subject to the standard settlement cycle for the relevant asset.

Article 1 EIM – Initial margin

Article 1 EIM, paragraph 3 of the RTS requires counterparties to collect IM within the business day following the execution of a new derivative contract. We do not believe such a requirement is practical. IM is generally more difficult to calculate than VM due to the complexity of the calculations. Cross border transactions also introduce the additional complexity of different time-zones making compliance with the 1 business day requirement extremely difficult. Therefore, whilst we support prompt delivery of IM, we strongly believe some flexibility should be built in to the timeframe to reflect the above issues and the standard settlement cycles for assets used as collateral. We believe a more appropriate requirement would be for IM to be called within the business day following the execution of a new derivative contract but that IM must be collected "in a timely manner" that would reflect the standard settlement cycle and existing market standards.

Distinction between margin that is required under the RTS and additional margin collected at the discretion of a counterparty

In our view, the RTS should only apply to the minimum levels of VM and IM that are required to be collected under the RTS. Should a counterparty voluntarily choose to require higher levels of margin for its own risk management purposes, or require margin from a counterparty type outside of the scope of the RTS, the requirements of the RTS should not apply to this additional pool of margin. We believe that imposing all the conditions of the RTS on additional margin would disincentivise counterparties from collecting such margin given the cost and operational challenges of applying the RTS. This could have the impact of weakening overall standards of risk management across the market.

Application of the minimum transfer amount

Article 2 GEN 4. (a) requires that the minimum transfer amount (MTA) of EUR 500,000 is based on the aggregate of the amount of VM and IM. We believe that a more appropriate approach would be for the MTA to be calculated separately for VM and IM. This is because VM and IM will be calculated separately and potentially with different frequencies, and will be subject to different reconciliation and netting requirements. Also, if an English law title transfer VM and security interest IM approach were to be adopted, it would be necessary to have separate documentation for those arrangements. It will therefore be very challenging from an operational perspective to calculate the MTA as the aggregate across VM and IM and the requirement to do so could introduce additional operational risk. We recognise that having a separate EUR 500,000 MTA for VM and IM could in theory double the size of the MTA to EUR 1 million, but we still do not consider this to be a systemic level.

Treatment of transactions resulting from portfolio compression

We believe contracts created by portfolio compression should be exempt from the margin requirements. This is on the basis that portfolio compression allows OTC derivative market participants to net down the size and/or number of outstanding contracts amongst them, which lowers the aggregate gross notional value of outstanding contracts, thus reducing operational risk and, in some cases, reduces counterparty credit risk. In our view, requiring OTC derivatives created via portfolio compression to be subject to the RTS would negatively impact the incentives for those participating in the compression exercise which would consequently reduce the volume of contracts subject to compression and the overall risk reduction potential.

CHAPTER 2 - MARGIN METHODS

Article 1 MRM – Initial margin model

Dispute resolution

We consider it essential that there are robust dispute resolution powers in respect of IM exchange. Whilst we believe having upfront dispute resolution procedures should be feasible in cases where both counterparties are using the standardised IM method, we believe it will be very difficult to settle disputes relating to IM calculations where each counterparty to a transaction is using a different margin model.

We highlight that current market practice is for firms to bilaterally agree the terms of any IM requirements. This ensures that both firms value the IM amount in the same manner and avoids any collateral disputes over IM. Moreover, existing dispute resolution procedures are designed to resolve collateral disputes associated with VM only and dealer polls are typically only effective in addressing VM related disputes. Given that the proposal would allow the counterparties to an OTC derivative contract to use two different prudentially approved models for the calculation of IM (or allow one counterparty to use the standardised schedule and the other a modelled approach), we are concerned that the approach may significantly increase the number of collateral disputes. In the case of a dispute, it is unclear how resolution could be achieved as both firms are likely to argue that their calculation methodology is appropriate, particularly if it has been approved by their supervisor.

We believe it is important that the ESAs and national competent authorities support the work of industry in addressing these issues.

Level of model prescription

We highlight that the use of internal models for calculating IM for regulatory purposes is new and that both industry and the regulators face a steep learning curve in this area. We therefore believe the RTS should not be overly prescriptive in terms of the criteria that IM models must satisfy given that good standards of IM models are not currently well understood. Rather, we believe the focus should be for the ESAs and national competent authorities to work closely with industry to understand and get comfortable with the models being proposed. We would then not be opposed to changes being made to the RTS at a later date to address specific issues identified in the initial round of model development and approvals and when best practice is better understood.

In particular, we do not support the requirement in Article 5 MRM – Integrity of the modelling approach, paragraph 1.(h), that IM models shall capture main non-linear dependencies. We believe this will significantly increase the complexity of IM models and will likely also increase the potential for IM disputes as it will be difficult for counterparties to agree on the non-linear dependencies.

We are supportive of the approach to IM modelling set out in the ISDA "Standard Initial Margin Model for Non-Cleared Derivatives" White Paper[1] and believe IM models should satisfy the 9 criteria set out by ISDA, namely: (i) Non-Procyclical (ii) Ease of replication (iii) Transparency (iv) Quickness of Calculation (v) Extensible (vi) Predictability (vii) Reasonable Cost (viii) Governance (ix) Margin Appropriateness.

Distinction between sell-side and buy-side firms

It is important to distinguish between the capabilities of sell-side firms and buy-side firms with regard to their ability to model initial margin requirements. We generally expect that sell-side firms will have greater modelling capabilities than buy-side firms and that the majority of buy-side firms will not be able to develop complex IM models. Whilst the RTS provide for one counterparty to a trade to rely on the model of its counterparty, we believe there are significant validation and governance challenges that would need to be overcome before a counterparty could get comfortable with relying on its counterparty's model.

The use of a third party model may mitigate some of the informational challenges that would undermine effective validation (as third party model providers are more likely to provide detailed information on the operation of the model than a counterparty to a trade that will consider its model proprietary) but a significant level of expertise would still be required to assess the accuracy of the IM calculation and compliance with the requirements of the RTS.

We therefore believe it should be possible for relatively simplistic spreadsheet based models to be used to calculate IM provided it can be demonstrated that such a model meets the minimum confidence interval and risk horizon. This would provide a pragmatic and more risk sensitive alternative for buy-side firms to the use of the standardised IM schedule firms which in our view is very conservative.

Model approval

[1] www2.isda.org/attachment/NjE2Ng==/SIMM%20for%20Non-cleared...

It is not clear to us whether an internal model requires regulatory approval before it can be used to calculate IM under the RTS as in the box on page 29 of the consultation paper it is stated that "*The ESAs will continue to explore the effects of allowing the use of models without prior or post approval and assess the need to introduce conditions to reduce the risk of choosing to apply the model which produces the lowest initial margin calculation*". Our preference would be that there is no formal model approval process but rather that firms should be able, on request, to demonstrate to their competent authority that their model is robust and satisfies the minimum confidence interval and risk horizon standards in the RTS.

Should prior regulatory approval be required, we are concerned that ESMA and the EU competent authorities are likely to be faced with a significant volume of IM model applications for approval within a very short time period (assuming the final RTS are not available until end 2014/start 2015 given that IM exchange will apply to most dealers by 1 December 2015). This has the potential to result in a model approval bottleneck with firms potentially not receiving model approvals decisions until after the IM exchange rules are in force. We are very concerned that this would force the whole market to use the standardised method for IM calculation for an interim period. As we consider the standardised method to be very conservative, we believe the overall liquidity impact of large market counterparties having to use the standardised method would be significant.

We therefore consider it crucial that IM model approvals (if necessary) are prioritised by ESMA and the national competent authorities and that there is a high degree of co-operation and co-ordination between the relevant parties. Given that many dealers already have regulatory approval for counterparty risk models, we believe there is significant merit in permitting such firms to continue to use their existing models and collateral processes for an interim period before approval decisions are taken, with the requirement that they have to demonstrate to the relevant supervisors that the amount of IM they collect meets the minimum confidence interval and risk horizon required by the RTS. In our view this would achieve the objectives being sought by the proposals whilst mitigating against a potentially severe market dislocation if firms are temporarily unable to model their IM requirements.

Article 2 MRM – Confidence interval and risk horizon

Rationale for the exchange of IM

As an overarching comment, we do not believe margin should be calibrated to cover all potential losses without any consideration of the probability of such losses occurring as the counterparty credit risk mitigation benefits of such an approach would in our view be far outweighed by the costs in terms of liquidity. IM is inefficient as it assumes that both parties to a contract must be fully protected against each other's simultaneous default which fails to give credit for the portfolio effects of counterparty credit risk.

We consider that initial margining is a risk mitigation technique used by CCPs which is less relevant for non-cleared trades. CCPs require IM because they typically lack the necessary level of capital to absorb potential losses without recourse to the default fund.

The Basel III/CRD IV/CRR capital requirements result in a significant increase in the amount of regulatory capital that prudentially regulated entities are required to hold. In particular, credit valuation adjustment ("CVA") capital charges and funding valuation adjustments ("FVA") are significant and are very sensitive to counterparty quality and risk mitigants and therefore materially address the risk of rating migration up to default. CCPs however are not subject to such requirements which is why IM is more relevant for CCPs than counterparties subject to regulatory capital requirements. Consequently, we believe a less conservative calibration than 99% over a 10 day horizon should be used to reflect the contribution of risk mitigants available to prudentially regulated entities that are not available to CCPs.

Article 3 MRM – Calibration of the model

We believe the requirement to recalibrate the model every 6 months will be operationally challenging and we are concerned that a short recalibration period will potentially increase the pro-cyclicality of the model as observations from recent periods of market volatility will drive IM requirements. We consider that an annual recalibration requirement would be more appropriate. We also believe the minimum frequency of the backtesting and recalibration requirements should be aligned and therefore propose that the backtesting requirement in Article 5 MRM – Integrity of the modelling approach, paragraph 1. (i), should take place at least every 12 months.

Article 4 MRM – Primary risk factor and underlying classes

Cross-margining

We believe that initial margin models should be allowed to i) account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit and commodities ii) across such asset classes and iii) between cleared and non-cleared instruments. Diversification benefits exist between different asset classes and these should be taken into account within the proposals. The onus should be on firms to demonstrate to their supervisors that their approach is robust.

The move to mandatory clearing will necessarily force the break-up of netting sets by requiring that some classes of derivatives be centrally cleared while others remain subject to bilateral netting agreements. Imposing separate IM requirements to both netting sets would significantly increase the liquidity impact associated with those requirements. To address these issues, arrangements exist to cross-margin centrally cleared and non-centrally cleared derivatives. Under these arrangements, the total IM would be calculated based on the risks of both centrally cleared and non-centrally cleared derivative portfolios. This will more accurately reflect the risk of default on a portfolio basis. We believe such arrangements should be permitted to the extent they are subject to a legally enforceable master netting agreement.

The recognition of cross margining would also be more consistent with the EMIR requirements for centrally cleared derivatives where margining across multiple instruments is permitted subject to haircuts. Whilst we believe there should be full recognition of demonstrable offsets, we believe the haircut approach for cleared OTC trades in EMIR could be used to give material recognition for cross-asset class offsets whilst adding a level of conservatism to address any perceived additional measurement weaknesses when margining across asset classes. As highlighted by the BCBS/IOSCO quantitative impact study, netting benefits for bilateral trades are already materially lower than for centrally cleared trades due to the lack of multilateral netting across counterparties so we don't consider it appropriate to impose further restrictions on bilateral netting that do not reflect economic realities.

Use of risk factors

In order to better account for risk on a portfolio basis, we also believe flexibility should be provided to allow counterparties to categorise derivative contracts according to risk factors rather than asset classes. This would create positive risk management incentives as the risk reducing impact of hedges should be better accounted for. A risk factor classification approach would also address the concern that some derivative contracts may not fit neatly into one of the underlying asset classes set out in Article 4 MRM, 2. (which may result in disputes between counterparties as to the correct asset class for any given contract and may lead to inconsistent approaches across the market).

CHAPTER 3 - ELIGIBILITY AND TREATMENT OF COLLATERAL

Table 2 VA

Table 2 VA paragraph 6 requires that "*Counterparties shall apply a haircut of 8% to the market value of the assets where the collateral currency is different from the settlement currency ('currency mismatch')*". We are concerned that the impact of this will be to incentivise counterparties to post collateral in multiple different currencies corresponding to the currency risk on the underlying assets in order to mitigate the punitive impact of the haircut. This may create significant cross currency settlement risk. We also believe the increase in the number of different cash flows that will result from this change in market practice will increase settlement and operational risk within the market.

We also believe there are several practical concerns with the application of the haircut for both VM and IM as set out below:

First, it may not always be clear what is the relevant "settlement currency" as for example an OTC derivative may have different settlement, reference and termination currencies. We believe the most straightforward way of addressing this issue would be to allow the two counterparties to a trade to agree up-front what should constitute the settlement currency for the purposes of the transaction. It is crucial that guidance is provided as to how the identity of the settlement currency should be determined.

Second, some OTC derivatives involve more than one currency (e.g. currency swaps) and it would be very unclear how to apply the haircut in such a case.

Third, the application of the haircut is very difficult for netting sets containing OTC derivatives denominated in more than two currencies. For example, if a portfolio includes transactions in 3 different currencies and margin is posted in currency X, it is unclear how the currency mismatch between currencies Y and Z will be calculated.

We also note that if margin was siloed into different currency pools as a result of the FX haircut, upon counterparty default, it would still be necessary to close out the contract in a single currency. Therefore, currency risk would not be eliminated whilst a new layer of operational risk would have been introduced.

Our strong preference would therefore be that the currency mismatch haircut is deleted from the RTS. If this is not acceptable to the ESAs, we consider it important that there is a dialogue with industry to consider how these practical issues can be addressed.

Article 1 LEC - Eligible collateral for initial and variation margin

We note that the proposed asset classes that can be considered eligible collateral and the restrictions placed on them (e.g. concentration limits) are more detailed than in the BCBS/IOSCO Framework. We are concerned that this could result in different approaches to collateral eligibility in different jurisdictions and result in an un-level global playing field. We do not believe the EMIR rules should be more restrictive than the global framework. Any specific concerns with the appropriateness of collateral should be addressed by supervisors on a case by case basis. We also note that counterparties are strongly incentivised to take appropriate amounts of collateral based on their assessment of the credit risk of the counterparty for their own risk management and commercial purposes given the potential to incur losses should their counterparty default and the collateral prove inadequate.

Article 2 LEC – Collateral management

Article 2 LEC paragraph 1(d) requires the receiving counterparty to have "*access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions*" as part of their risk management procedures. We do not believe that is a realistic requirement and propose that it should be deleted. The availability of an active and liquid repurchase market in stressed conditions is not within a counterparty's control and, in an extremely stressed market, even typically highly liquid markets can become illiquid. We therefore do not believe that any counterparty would be able to demonstrate that it satisfies this condition.

Article 4 LEC - Credit Risk Assessment by the collateral taker using the Internal Rating Based Approach

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?

We believe it will be extremely challenging for a counterparty to use its counterparty's IRB model to assess the credit risk of collateral. IRB models are proprietary and it's unlikely that a counterparty would be willing to share sufficient information on its model to a third party (particularly where that party is a competitor) for the third party to get comfortable with the operation of the model and to ensure it had robust governance arrangements in place.

Article 5 LEC - Eligibility Criteria for UCITS

We are concerned that the eligibility criteria for UCITS that must be assessed by a counterparty may require access to information that is not publicly available and may be very difficult or impossible to source. We believe all units or shares in UCITS should be considered eligible collateral under the RTS.

Article 6 LEC - Eligibility criteria to avoid wrong way risk and Article 7 LEC - Concentration limits for initial and variation margins

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?

With regard to the application of the wrong way risk criteria and the concentration limits, we note several practical issues with their application. Firstly, it may be very difficult for a counterparty to be aware of which entities are part of the same group. Consistent with our comments in relation to Article 1 FP – Final provisions, we believe this issue can be mitigated to some degree by using the accounting definition of group rather than a regulatory definition (which is likely to be less transparent to the market), but we still foresee significant problems for counterparties to make such determinations.

Secondly, there are restrictions imposed where entities have "close links" as defined as follows under Article 2(16) of EMIR "*Close links means a situation in which two or more natural or legal persons are linked by: (a) participation, by way of direct ownership or control, of 20 % or more of the voting rights or capital of an undertaking; or (b) control or a similar relationship between any natural or legal person and an undertaking or a subsidiary of a subsidiary also being considered a subsidiary of the parent undertaking which is at the head of those undertakings*". We believe it will be very difficult, and in some cases not possible, for a counterparty to make this determination as information regarding which entities have a stake in a counterparty may not be publicly available and will likely be very difficult to source. We therefore believe the close links conditions should be deleted.

In terms of exempting specific securities from concentration limits, we believe the most reasonable candidate would be sovereign debt. However, sovereign debt should not be considered risk free, and the risks posed by different sovereigns may differ significantly in terms of creditworthiness and liquidity, so the argument for an entirely different treatment of sovereign debt relative to other collateral is not clear-cut.

CHAPTER 4 - OPERATIONAL PROCEDURES

Article 1 SEG – Segregation of initial margins

Potential increase in concentration risk

We believe that there are significant credit risks associated with the posting of IM between counterparties where that IM is to be held by the receiving counterparty itself. Whilst we recognise that the RTS propose minimum standards designed to ensure the robustness of segregation, to the extent counterparties cannot get comfortable with the level of protection and segregation provided by their counterparty (likely in cases where such party has no previous experience of segregating collateral (and thus particularly in cases where dealers post margin to buy-side firms) and where local bankruptcy laws are weak), posted IM would almost exclusively have to be held by third-party custodians. We also note that whilst client money rules offer some protection for posted cash collateral, the effectiveness of segregation of cash collateral in an insolvency may be unclear, making it likely that counterparties will require cash collateral to be held by a third party custodian. There are two significant consequences of this: (i) significant cost implications which are likely to disincentivise the use of derivatives for hedging and (ii) a likely increase in concentration risk and systemic risk given that there are only a small number of third-party custodians globally.

If the majority of IM was held with third party custodians, we also do not believe it would be possible for those custodians to accommodate all firms seeking to use their services in a timely fashion as their existing resources would likely be insufficient to accommodate the higher volumes of clients and collateral movements. We also note that the cost per agreement is likely to have a disproportionate impact on the less-sophisticated parties.

Need for harmonisation of bankruptcy laws

The effectiveness of measures to protect posted margin via segregation depends on the local law and insolvency regulation in each jurisdiction. For effective collateral segregation, it is necessary to enhance the harmonization of bankruptcy legislation at a global level. Mandatory posting of IM will increase credit risk for those required to post collateral unless all jurisdictions have laws and regulations to ensure the effective supervision and enforcement of segregation requirements and timely recovery of collateral by non-defaulting parties. Segregation without hypothecation will be very expensive but with no practical benefit if local bankruptcy laws do not provide effective protection.

Protection of asset value versus protection of specific assets

In our view, the requirement to protect collateral in the event of the collateral recipient's bankruptcy should relate to protecting the value of the collateral rather than protecting the specific assets delivered as collateral. We consider this approach to be far more operationally manageable and will therefore reduce operational and legal risk whilst delivering the same economic outcome in terms of return of value to the collateral poster.

Treatment of IM under Basel III and CRD IV

Leverage ratio impact

Cash IM that is collected by banks and required to be segregated with no possibility of rehypothecation would have the impact of grossing up the balance sheet for the purpose of calculating the Basel III/CRD IV leverage ratio. Since the proposal seems to prohibit recycling of the cash into a bank's internal funding process, this is a dollar-for-dollar uplift. It is not permitted to net cash collateral vs negative replacement values (out-of-the money OTC positions) for leverage ratio purposes, so there's no permissible offset. Consequently, we consider that cash IM should be exempted from the leverage ratio calculation, otherwise the mandatory collection and segregation of IM (when the collateral provided is cash) would artificially restrict the maximum size of a bank’s balance sheet and consequently restrict its ability to fund the real economy.

Risk weighted asset impact

Furthermore, if collateral is held tri-party, it is not possible to recognise the pledged assets versus trade exposures. For banks subject to Basel III/CRD IV, this will result in a significant impact on risk weighted assets which is not reflective of the true risk. The requirements of CRD IV and EMIR should be co-ordinated to ensure appropriate recognition of collateral in risk weighted asset calculations.

We also note that it is not clear under Basel III/CRD IV how cash collateral posted to a non-CCP counterparty would be treated for risk weighted asset purposes. It is very important that this is clarified.

We therefore consider it crucial that the interaction between the Basel III/CRD IV/CRR framework and the RTS is reviewed and steps taken to ensure the application of the RTS does not increase a firm's capital requirements (given that regulatory capital is held as a risk mitigant and the purpose of the RTS is to reduce counterparty credit risk so the overall impact should not be to increase capital held against risk).

Immediacy requirement

Paragraph 4. (a) requires that initial margins are immediately available to the collecting entity where the posting counterparty defaults. We believe a requirement for immediate availability of IM is impractical. For example, under the EU Bank Recovery and Resolution Directive, the resolution authorities will have the power to temporarily suspend contractual termination rights. If such bankruptcy stays are not accounted for in the RTS, the impact would be to effectively prohibit any counterparty from entering into any non-cleared OTC transactions with an EU bank. Also, IM held at a third party custodian will typically not be immediately available as the custodian will have to take steps to ensure the legitimacy of the collecting party's claim for IM.

We believe a more appropriate requirement would therefore be for IM to be available to the collecting entity in "a timely manner".

Legal opinions

Paragraph 5 requires counterparties to obtain legal opinions to confirm that a segregation arrangement meets the requirements of Article 1 SEG, paragraphs 3 and 4. As noted above, we do not believe the requirement for IM to be immediately available will typically be fulfilled so it should not be a requirement to have a legal opinion confirming this condition is fulfilled as it is highly unlikely that such an opinion would ever be obtained.

We also note that the requirement to obtain a legal opinion that "t*he posting entity is sufficiently protected where the collecting entity enters bankruptcy or other insolvency proceedings*" is problematic as "sufficiently protected" is not a legal concept and it may be difficult for a law firm to opine on whether this condition is satisfied. Consequently, we believe the scope of the legal opinion should be limited to confirming that IM will not be considered to belong to the proprietary assets of the collecting counterparty in the insolvency of that counterparty.

In order to reduce the documentation burden of the proposals, and to ensure effective arrangements can be put in place in a timely manner so as not to unduly delay the execution of transactions, we would support an approach under which a specific legal opinion was not required for every different segregation arrangement but rather where counterparties could rely on an existing well founded legal basis for the effectiveness of the segregation arrangements used. We also believe that such legal basis view should only be required at the inception of the segregation arrangements, rather than at the inception of each trade, unless the segregation arrangements for the particular trade are different.

To the extent that the ESAs did require a legal opinion to be obtained, we note that the use of industry wide legal opinions is already commonplace in the OTC derivatives market (e.g. in respect of netting arrangements.

Article 1 REU - Treatment of collected initial margin

Question 6. How will market participants be able to ensure the fulfilment of all the conditions for the re-use of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require re-use or re-hypothecation of collateral as an essential component of their business models?

We share the concerns of the ESAs that the BCBS/IOSCO Framework for re-use/re-hypothecation of collateral leads to multiple legal and technical difficulties and in our view it is likely to be of limited value and potentially unworkable in the form proposed. However, as noted previously in our response, mandatory full IM segregation without the possibility to re-hypothecate or re-use the collateral posted will create a situation where significant amounts of high quality collateral is tied up and is not available for other uses. We are concerned that these requirements, coupled with the proposed Basel III/CRD IV/CRR liquidity requirements, will result in very significant liquidity demands being placed on banks.

We therefore consider it appropriate that the RTS does not preclude the potential for re-use or re-hypothecation of collateral. We encourage the ESAs to work with industry with the aim of developing an approach that does not undermine the effectiveness of the protection of posted collateral whilst also providing some flexibility to re-use assets and put them to productive use which we believe will be beneficial to economic growth.

CHAPTER 5 - PROCEDURES CONCERNING INTRAGROUP DERIVATIVE CONTRACTS

Requirement for third country equivalence

We are concerned that the absence of a positive equivalence decision for a given third country from the date of application of the RTS would result in intragroup trades involving an entity from that third country being subject to full exchange of IM and VM. We do not consider this appropriate as derivative transactions between entities within the same consolidation group do not pose systemic risks as they do not create additional counterparty exposure outside of the group and do not increase interconnectedness between third parties. Rather, intragroup trades allow institutions to manage and reduce risks and to increase the scope of netting with individual counterparties by allowing counterparties to transact with a single group entity across a broad range of underlying asset classes. This flexibility would be undermined when imposing IM requirements on intragroup transactions. The amount of collateral tied-up would reduce firms' ability to manage risk on a centralized basis and would increase, rather than decrease, the level of risk within the financial system. Losses incurred by one group entity should be completely offset by gains to the other group entity so the group exposure is flat.

We are particularly concerned that there have been delays to the timetable for the European Commission taking decisions on the equivalence of certain third countries with the provisions of EMIR in accordance with the mechanism to avoid duplicative or conflicting rules as set out in Article 13 of EMIR. Should a decision not have been reached for any given jurisdiction by 1 December 2015, we believe an intragroup transaction involving a counterparty from the third country jurisdiction in question should be still be able to benefit from the intragroup exemption. This should be conditional on the group demonstrating to its national competent authority that it is in full compliance with all of the other non-equivalence related intragroup exemption criteria in EMIR.

We also note that the ESMA technical advice provided to the European Commission on the equivalence of several third countries included the concept of partial or conditional equivalence which requires the application of the higher requirements of the two regimes in cases where standards differ. It is not clear how such conditional equivalence determinations would be treated for the purposes of the intragroup exemption but it is important that it is clarified. We believe it should be possible to benefit from an intragroup exemption where only conditional equivalence has been granted, again subject to complying with the other intragroup exemption criteria in EMIR.

Article 3 IGT – Practical or legal impediment

We are concerned that the list of potential legal impediments is too wide and would undermine the ability of any counterparty to be granted an intragroup exemption. For example, the inclusion of restrictions stemming from insolvency, resolution or similar regimes is highly problematic as all counterparties can potentially become insolvent and insolvency proceedings may result in restrictions in payments.

We also believe that regulatory restrictions stemming from EU legislation should not be considered a legal impediment otherwise EU institutions could be faced with conflicting EU laws.

Article 1 FP – Final provisions

Use of gross notional outstanding

Whilst we support the proposed phase in approach for exchange of IM, we do not support the proposed methodology where the threshold is calculated on the basis of gross notional outstanding. Our concerns are that the approach (i) does not reflect the risk of the contracts and (ii) appears to include hedging contracts.

Re (i), by calculating the threshold on a notional basis, there is no differentiation between the risk of different types of contract. Therefore, contracts that are relatively less risky will contribute equally to threshold as more risky products. This will unfairly disadvantage counterparties that generally trade in liquid and relatively less complex OTC derivatives that can nonetheless not be cleared who may be required to post IM despite not posing a systemic risk.

Re (ii), most counterparties hedge a significant proportion of their derivative positions, so the notional amount of their exposure does not accurately reflect the risk of those positions.

In terms of the transactions that count towards the threshold, we strongly believe non-cleared OTC intragroup derivative transactions should not be included in the calculation. Otherwise, transactions used to manage risk at a group level will artificially result in the threshold being reached very quickly for groups who manage derivative risk centrally, even though these transactions do not represent incremental systemic risk.

Inclusion of FX derivatives in threshold calculation

Article 1 FP - Final provisions paragraph 5 states that all of a group's non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included in the calculation of aggregate month end average notional amount. We do not support this proposal given that there is no IM exchange obligation for physically settled FX derivatives. Requiring physically settled FX trades to be included in the calculation could potentially bring within scope of the IM exchange requirements counterparties that do significant volumes of FX derivatives trades (not subject to the IM requirements) and only small volumes of derivatives that are subject to the IM requirements. We consider this inappropriate as the risk posed by the non-FX derivatives will be very low in such a scenario.

Definition of group

The phase-in thresholds are subject to calculation at group level. It is not specified how to define "group". In our view, it would be appropriate to define a group in accordance with the accounting standards applicable to the parent of the consolidated group of which the relevant counterparty is a part.

We believe this could result in an internationally coherent approach if other jurisdictions adopted the same approach in their implementation of the BCBS/IOSCO Framework. Furthermore, it would make the assessment by a counterparty of the status of its counterparty with regard to the phase-in provisions more straightforward. This is because the scope of a group under relevant accounting laws is likely to be more transparent than the scope of a group under EMIR or other regulation which may not be subject to public disclosure and may not be available to market participants making it very difficult to establish whether a transaction with a given counterparty is subject to the IM requirements during the phase-in period. This could impede the efficiency of the market and lead to inadvertent breaches of the RTS.

We also consider it appropriate that counterparties should be able to self-certify the category they fit into for the purposes of the phase-in of IM exchange. An entity should be able to rely on the representation made by their counterparty unless they have a clear reason for believing the representation to be incorrect. This would be similar to the approach for determining whether an NFC is subject to the clearing obligation under EMIR.