HSBC

[Submitted via electronic submission]
The European Securities and Markets Authority
The European Banking Authority
The European Insurance and the Occupational Pensions Authority

14 July 2014

Ladies and Gentlemen,

Consultation Paper ("CP") on draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP ("draft RTS") under Article 11(15) of Regulation (EU) No 648/2012 published by the European Securities and Markets Authority ("ESMA"), the European Banking Authority ("EBA"), the European Insurance and the Occupational Pensions Authority ("EIOPA", and together with ESMA and EBA, the European Supervisory Authorities, the "ESAs") on 14 April 2014

HSBC welcomes the opportunity to respond to the CP on the draft RTS. HSBC has also contributed to and supports the industry submissions by the International Swaps and Derivatives Association ("ISDA"), the Association for Financial Markets in Europe ("AFME"), the UK Covered Bond Council ("UKCBC") and the European Banking Federation ("EBF") responses. This letter comprises our supplemental comments to those submissions.

HSBC is one of the world's largest banking and financial services organisations with assets of USD2,671 billion at 31 December 2013. Headquartered in London, HSBC serves customers worldwide from around 6,600 offices in 80 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

HSBC supports the introduction of globally harmonised infrastructural and prudential measures which could improve systematic stability and provide a framework in which growth is possible. HSBC agrees too, as recital (3) observes, that risk mitigation is not only limited to margin, but that exposures arising from counterparty risk which are not margined will be well capitalised under the new Capital Requirements Regulation ("CRR"). Therefore, HSBC believes that it will be more important for systemic risk mitigation purposes that counterparties should be able to reach agreement on the margin needed, rather than requiring each firm to demand what it computes to be the technically exact margin for every OTC derivative exposure.

The draft RTS appears to have the effect of adjusting some elements of the Basel Committee on Banking Supervision international standard ("Basel") for European Union ("EU") application. Though we recognise that Basel is a minimum standard, this approach creates uncertainty as to the intended regulatory prioritisation when EU entities transact with entities outside of the EU. For example, although there are some exemptions for EU end users and ultimately in the EU there is an EUR8bn threshold in respect of initial margin ("IM"), variation margin ("VM") appears to be required for counterparties and products even in cases where clearing is not required. Further, even the smallest of corporate entities outside the EU appear to be subject to VM and possibly IM too, whereas the Basel text explicitly carves out transactions with non-financial entities that are not systemically important. As another example, the collateral haircutting requirements are far more detailed and onerous than the Basel text which is likely to make collateral negotiations with those outside the EU more complex. HSBC urges the ESAs to align their counterparty, product scope and collateral specifications with those contained in the Basel paper and to coordinate closely with other regulators to ensure consistency.

As has been acknowledged in the CP, there are a number of uncertainties as to how the operational aspects will be implemented in practice and within the timing constraints, given the December 2015 compliance commencement date. HSBC does not believe the provisions of the draft RTS alleviate these concerns. In particular, there are still uncertainties surrounding the potential volume of documents that may need to be amended or renegotiated for VM, but if HSBC understands the current draft correctly, HSBC could potentially have to amend in excess of 20,000 documents with its counterparties, in part because new agreements appear to be required where non-financial counterparties below the clearing threshold (“NFC-”) do not wish to exchange IM or VM.

HSBC has a more thoroughgoing concern that there is no clarity as to the practicalities of custodian or depositary interoperability and processing of initial margin (IM). These matters are not readily soluble by requiring firms to put appropriate procedures in place, because the underlying depositary infrastructure is not in the control of those firms. Because of these practical uncertainties over external dependencies and internal readiness, HSBC supports the industry request for delay in implementation for 2 years after the text is finalised. If this is not possible, to avoid material market disruption, we would urge the ESAs to work with the European Commission to ensure that suitable transitional provisions are built into the final RTS. There could perhaps be National Competent Authority (“NCA”) discretion to determine that no breach of regulation has occurred if viable market-wide operational arrangements are not established by the relevant start date, or if non EU jurisdictions set different commencement dates.

HSBC has set out its responses to the ESA’s questions in the Annex attached hereto.

Yours faithfully,

Nazir Badat
Chief Operating Officer, Global Markets

Annex – HSBC responses to ESA questions
Please see below HSBC's responses to the specific ESA Questions and associated matters:

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?

From HSBC's perspective, it seems unlikely that small and medium-sized ("SME") stand-alone entities in the EU which decide to hedge frequently would reach the EUR 8bn notional trigger for IM. **However, to ensure regulatory uniformity all such entities globally should be exempted from these provisions not only those in the EU.**

The expense for SMEs is likely to arise from the net increase in cost to the banks on provision of IM for the banks' hedges less any reduced cost of capital from those hedges. This cost of provision of IM is in part a function of the variability of the senior debt financing spread for the relevant bank and the marginal capital requirements are likely to be similarly subject to market fluctuations. But firms have a choice whether or not to charge for these gaps and their potential variation. So the quantification of cost impact is likely to be highly subjective. As the regulation requires either higher capital or provision of margin, ESAs may find that it is not possible to reduce costs to SMEs as well, because market participants bear additional hedge side costs and the new capital costs of the unmargined derivatives.

It is quite likely that EU based subsidiaries of larger corporate entities, whether or not headquartered in the EU, may be required to post margin because of the group based assessment. HSBC questions whether it is reasonable, for the purposes of risk mitigation under EMIR, that distinct subsidiaries (which are separate legal entities and are separately sustained) should contribute to and inherit this requirement from the parent group status. Such an approach may provide an incentive for companies to undertake risk management with non-EU banks or just to retain financial risk. The concerns here include the potential for withdrawal of operations by non-EU corporates where they cannot offset their risk at a reasonable price; or the retention of material financial risk in the EU corporate sector; and, loss of revenue to EU banks should the companies choose to trade with non EU entities instead to avoid the operational and liquidity demands from margin. **HSBC believes that it would reasonable for the RTS to permit the assessments against thresholds to be determined entity by entity, rather than at group level, where the entities are separately capitalised.**

The current drafting appears to require margin calls from EU firms when transacting with any non-EU non-financial or financial counterparty (without regard for thresholds). As a result, EU firms would be likely to be discouraged from providing cost-effective solutions to help smaller corporate entities outside the EU reduce their financial risks. This would be true even if the hedges happened to be intended precisely to reduce their risks arising from trading into the EU. Further, for the SMEs, the burden of documentation and process to ensure compliance with EU requirements is onerous, and in most jurisdictions would be materially more burdensome than if conducted solely domestically. As a result, the cost implications of arranging for the relevant documentation to be entered into are likely to be high and disproportionate. In HSBC's view, if a company would be exempt from the regulation were it domiciled in the EU, it ought to be exempt if it is not domiciled in the EU. Such an approach would enable EU firms to price in a comparable way to local firms. **HSBC recommends the rewriting of the text explicitly to recognise companies' statuses as if they were based in the EU.**

Another, perhaps unintended consequence of the current provisions could be that an entity outside the EU, but within an EU group of companies, trading with a counterparty outside the

EU, might be required to give or receive margin subject to the draft RTS, rather than the transaction either being exempted, as should be the case for sub-threshold counterparties, or subject to domestic regulatory arrangements for financial style counterparties. This appears to be the case even for jurisdictions which are recognised as equivalent under EMIR.

The term "Competent Authority" does not appear to be defined in each context within the draft RTS, particularly in relation to corporate entities.

Imposing IM along with restrictive VM requirements may force entities, and in particular non-bank entities, to seek liquidity from banks to fund margin payments. This would contribute to the adverse liquidity effects of the measure, and create operational complexity while transforming rather than reducing risk to the banking system. **The regulations should be disapplied to any company which is, or would be were it to be incorporated in the EU, an NFC-.**

For entities based in non-netting jurisdictions or jurisdictions where collateral is not enforceable the proposed measures would increase risk in the system. Essentially VM, and more arguably IM, are treated as separate exposures and offset is not permitted legally or from a capital perspective. The position is not always completely homogenous. For example, in some jurisdictions it is possible to have specific standalone enforceable collateral even though generally netting is not permissible. The position is not completely static either, with netting becoming legally viable with counterparties in different sectors, and sometimes for the jurisdiction as a whole. At the moment Saudi Arabia, United Arab Emirates and Russia are amongst these countries where there is uncertainty, but with whose companies EU firms have active and ongoing OTC derivatives business. **HSBC believes that reliance on the existing capital rules is the optimal regulatory approach to risk mitigation in such cases, rather than requiring margin exchange. This is because the capital rules capitalise the potential risk, rather than increasing the risk in the system.**

HSBC believes that any systemic benefit achieved by exchange of IM by sites (branches or subsidiaries) with modest transaction volumes is likely to be outweighed by the costs of such exchange. It could reduce the operational burden significantly if groups deemed to be over the threshold could be permitted to exempt sites and subsidiaries which are themselves materially under the lowest threshold from these requirements.

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.

Yes, there are such operational concerns in addition to concerns around implementation and timing. It is not only the appropriateness of approach though - entire areas of operation and operational interaction appear not to have been addressed.

Documentation

This letter has already suggested that NFC- equivalent non-EU counterparties ought not to be subject to VM requirements. However, if this requirement is retained in the RTS, HSBC and its counterparties would be required to renegotiate thousands of collateral agreements in advance of trading after the start of December 2015. Further, as many such clients would not have the liquidity to meet future margin calls, they may require special financing arrangements in order to fund the calls. They will also need to establish processes to receive the funds and place them back as margin.

In respect of financial counterparties ("FC"), which are covered by the VM requirements in most instances, the revised documentation process could be slightly less onerous if covered by the protocol approach suggested by ISDA. However, in HSBC's experience with many counterparties in relation to past protocols, it can take a number of months for FCs to perform relevant legal diligence and to gain management approval to adhere to such protocols. In the meantime, trading would have to cease. HSBC also notes that, protocols are not always applicable to certain master agreements (such as the German Ramenvertrag) or bespoke collateral arrangements and, in those situations, separate negotiation is likely to be required with those counterparties.

Even where protocols are capable of being applied, if the counterparty does not adhere, there would be a need to negotiate a new agreement, which would be a manually intensive and time consuming process involving positive action and cooperation from the counterparty. The counterparty would also have to establish internal processes both for giving or pledging assets, and recognising assets pledged to it, and releasing assets. These are made more onerous when assets are given as collateral in systems in which the recipient has no pre-existing accounts.

Threshold Application

HSBC welcomes the concept of a Threshold Amount for IM to reduce systematic liquidity strain. **We believe the Threshold Amount determination should apply at the level of the legal agreement which would usually be at the contracting party level only.** Though the application of Threshold for IM is optional, it will have an effect on pricing and on the operational processes that are likely to be necessary in the early stages of application.

As the option to apply a Threshold Amount has financial value (or expense) if used by different subsidiaries, it would actually be required to be applied for pricing equivalence, but it is not obvious how the ESAs would like this to work in situations where a fiduciary duty is owed by the holding company to a number of different entities within a group. Each could reasonably demand to apply the threshold for transactions with their entity, for example, this would apply to publically listed companies within a financial group.

HSBC does not believe that it is reasonable to limit the threshold to the consolidated group level. Such an approach penalises particularly groups which have subsidiary banks which are separately capitalised for risk mitigation purposes and function on an arms-length basis from other entities in the group, over those which have a more operational branch structure. As both counterparties would have to agree the Thresholds, where this spanned different entities in the different groups this would be another area requiring negotiation.

Legal Opinions

The ISDA response highlights some of the practical constraints on the number, nature and timing of legal opinions being required. HSBC shares these concerns.

Notional Limit Determination

Without public attestation or separate and continuing bilateral representation, firms cannot have certainty as to the total notional outstanding in derivatives from any other company or group of companies (where relevant). **The ESAs might consider, as an alternative means of achieving the policy objective, holding a list for all derivatives counterparties which exceed each of the successive thresholds or allow a longer lead time from the announcement of IM eligible counterparty groups and the application of the regulations.**

It would be helpful if the final RTS confirmed the comments made by ESAs at the public hearing, to the effect that, where a counterparty exceeds a threshold, only new transactions from that date need necessarily to be subject to the IM process. As this is not likely to be practicable immediately after triggering a threshold, perhaps a reasonable time for compliance with this requirement (for example, 4 months), ought to be permitted to ensure that the new counterparty has appropriate documentation, is fully integrated in the operational process and would have had sufficient time to undertake preparatory testing.

Process for IM collection and release

Under some EU country laws (Belgian law, for example) total title transfer is required to perfect a pledge. As a result, though the economic interest is retained by the pledgor, the pledgee can use the pledged assets as they please (unless controlled and agreed under ancillary arrangements). Indeed this is the normal practice under so-called tri-party collateral agreements within Euroclear. A legal question then arises as to whether the imposition of ancillary restrictions on the use of pledged assets prevent the construction that transfer requirements for perfection have been met. The processes for pledging under the proposed IM arrangements are therefore to some extent breaking new ground. The legal position has also not been tried on what might be described as an industrial scale before. This interplay between national laws, new simultaneous bi-party IM pledging documentation and possible operational options HSBC believes is likely to make it difficult to achieve legal certainty over the arrangements in a timely way. It may be prudent for the ESAs to introduce milestones post-RTS publication so the ESAs can assess readiness. **The ESAs should ensure that they are apprised of the new operational risks being introduced under these regulations.**

The timeframes for agreeing trade populations, derivative valuations, and future exposures is extremely short for the process to be anything other than fully automated. HSBC is concerned that the timeframe for creation and delivery of such systems after the RTS is published and other international regulations are drafted and published is likely to be too short for a vendor solution to be created, tested and implemented. Standalone automated processes within each firm would present more connectivity issues including time to ensure connections exist between counterparties and the risks of breakages in links between counterparties. **ESAs can reduce this impact by publishing RTS as soon as possible, perhaps indicating a preference for common market systems in the text. A simple process should be made available whereby on proof that material operational risk would result from compliance, the relevant NCA could agree that capital requirements would be deemed sufficient risk mitigation for a limited period.**

It is likely that counterparties will need to pledge or give lien over assets held in a range of depositaries. The processes for interoperation between the depositaries are not well established. HSBC is therefore concerned that the processes for granting IM and releasing IM will not be sufficiently well established to ensure that the operation poses no additional credit, legal or other risk on failure of the counterparty. HSBC understands the ESA approach is to require firms' procedures to be sufficiently comprehensive to ensure compliance, but this is not likely to be possible where the underlying external operational structures are not established.

Model approval

The use of initial margin models is economically important. Companies which are only able to offer standardised approach computation are unlikely to find trading counterparties at the same market price as those with models. The capacity and competence of the NCAs to respond to, or not reject notifications, of initial margin models will be critical for firms. However, the draft RTS is unclear as to what the competent authority is approving, if anything. If NCA approval or acquiescence is required this may lead to an uneven playing field within the EU. **HSBC recommends that ESAs clarify that the notification of models to the National Competent Authority is for information only.**

Financial institutions in the EU are already covered by capital requirements for any shortfalls of margin under CRR. With such cover, the need for precision of estimation and requirement for margin itself is relatively slight. The final RTS in isolation should not dictate the total risk or capital or funding, but is just one component in these calculations. The overall requirements are computed using existing more precisely computed, regulatory approved and often modelled capital figures. **In HSBC's view, this should mean that the RTS does not need to be prescriptive about the degree of testing and validation applied to the models.**

Model details
It is important that there should be some convergence of model outcomes and therefore presumably of models themselves in order that reasonable levels of agreement on valuation and future risk are reached in a timely way. It is also important for the industry to understand how the ESAs intend choices to be made when the results of models used by a firm and their counterparty disagrees. **The ESAs could specify, for example that model approach could be agreed between the parties, that the receiving party model always prevails, or the posting party, or that there could be an agreed tolerance between these and the higher or lower should be pledged.** It is not sufficient to determine that if there is failure to agree, the standardised computation is to be applied as this will change the price of the business reinforcing market fragmentation.

The model requirement to use at least 25% of stressed data is confusingly worded. The period for the financial stress is unclear, and bank and counterparty modelled IM requirements are unlikely to agree when using different periods. **HSBC believes that setting fixed stressed periods or ESA support for industry wide harmonised period would help to reduce the mismatches.**

Historical data is required to be at least three years, but this phrasing can lead to issues, if one party chooses to use 20 years and another 4 years, dramatic differences would be observed. Two counterparties may use the same model but have different results when using different data periods.

A separate risk factor for each equity or commodity that is significant may have unforeseen issues, because, for example, an equity deemed insignificant for one netting set may be significant for another.

Allocation to the appropriate asset class based upon primary risk factor has an element of subjectivity. The classification of hybrids is unclear and may be treated differently by the counterparties.

Although this is aligned to Basel, the initial margin model is based upon siloed risk, and no offset is allowed between asset classes. This differs from the real risk. Particularly on close out, offsetting will exist at least to some extent, so IM will be far higher than necessary. **HSBC suggests that ESAs should consider allowing offsetting across risk factors.**

For the annual validation of the model by "suitably qualified and independent parties", if this is intended to refers to third parties, in HSBC's view this is unnecessarily onerous. **ESAs should clarify that this refers to internal processes and not third parties.**

Collateral
Any restrictions on permitted collateral should be strictly limited to permit substitution which is in turn a key element of reducing potential adverse market liquidity impact.

The standardised add-on factors are aligned with Basel proposals but in HSBC's view the factors are too high; and appear to be inconsistent and high compared with the standardised approach for measuring counterparty credit risk ("SA-CCR") when scaled for appropriate margin period of risk. **HSBC suggests that the scaling proposed in SA-CCR (paragraph 164) should be applied with no maturity dependency.**

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 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?

Covered bond pools still seem to be subject to variation margin requirements and this will prevent them functioning, particularly in the instance that their sponsor fails. We strongly support the intention to grant exemptions to covered bond issuers. We agree with the more detailed considerations in the UKCBC response in this regard.

HSBC agrees with observations and proposals made by AFME in its response regarding exposures between banks and securitisation vehicles and believes that they are adequately covered by firms' capital requirements under CRR.

As a possible alternative approach which achieves the same result, similarly to the covered bond approach, that EMIR recital (24) requires due account to be taken of impediments faced by cover pools in providing collateral. The text later references preferential claims by counterparties on its assets as providing equivalent protection. Given this approach, which is also reflected in the draft RTS recital (7), this intent appears in GEN 3 to have been expanded upon in respect of covered bond issuers only. However, securitisation vehicles are often effectively just cover pools, which equally have no capacity to provide collateral, they provide seniority or equivalence to derivative counterparties and have even less capacity for recourse outside the pool than do covered bond issuers. HSBC believes it would it be appropriate to read through that an exemption may similarly be intended to apply to securitisation vehicles. **If this alternative approach is in line with the ESA understanding and intent, it would be helpful if it could be stated explicitly in the text for the sake of clarity that other entities (than solely covered bond issuers) for which the only resource is pools of cover are similarly exempt.**

If, on the other hand, the ESAs were not of the same mind, HSBC suggests that securitisation vehicles should be exempted from the requirements to provide VM or IM for the same reasons as covered bond issuers (though we observe that in some such vehicles based in the EU may be classified as NFC- and so be exempt in any case). As well as the practicalities of generating the cash or securities for VM (or IM), we are concerned that there would be likely to be further shrinkage and impediment to the securitisation market in the EU if exposures to securitisation vehicles were not to be exempted, because of difficulties securing ratings.

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?

HSBC supports the detailed responses from the industry and notes that:

EU Competent Authorities are presently taking quite differing views on what constitutes sufficiency of modelling data. With the Prudential Regulation Authority, for example, suggesting that for sovereigns, public sector entities and financial sector entities IRBA (Internal

Ratings Based Advanced) models are likely to be rejected. This would be likely to lead to quite different haircuts between counterparties.

The collateral has to be credit quality assessed each day, but it is unclear which internal model would be used in this assessment. The ESAs could clarify the precedence for such validation.

Should a margin giver's model determine that it is over-collateralising, this could result in an additional capital requirement inferring that systemic risk is actually being created. **HSBC suggests that the ESAs should introduce a prudent systematic requirement that capital regulation haircut collateral should not be required to be posted in excess of the Exposure at Default ("EaD").** The risk of the collateral posted changing in value is already capitalised on the posting firms' balance sheet. If applied symmetrically, the system collateralisation would remain sufficient. For collateral received, the collateral receipt would be haircut in any case in the computation of collateral offset against EaD, so the system remains protected and the issue of excess posting or asymmetry need not arise.

HSBC believes that the approach to collateral haircutting is over-engineered and, depending on the meaning of settlement currency, would create risk (as determined by regulatory measures) in the system. Less prescription from the ESAs would be useful and would not materially impact stability.

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?

In addition to the practical constraints highlighted in the industry responses, as the threshold is reduced the concentration constraints become less pertinent, because the scale of likely exposure reduces. **HSBC suggests that the ESAs could reasonably set a level of initial margin, perhaps EUR100m, below which concentration restrictions do not apply between two entities.**

In recital (9) and Article 2 LEC (1)(d) there appears to be a link between liquidity with re-financing (repo). However the priority of the non-defaulting entity is to realise the value of the collateral and not to procure liquidity through refinancing, because on failure the retained assets otherwise could be detrimental to the non-defaulting party capital ratio and leverage. HSBC believes that these elements of the RTS should be amended to remove reference to repo.

Pension Funds may hold large concentrated pools of high quality government bonds and may be unwilling to diversify to the extent required by the concentration rules. Own sponsored pension schemes appear not to be exempted. These may not be treated as part of the groups which sponsors them, but significant circularity is generated should IM be required to be posted. **HSBC suggests that exposures to group sponsored pension schemes should be exempted**.

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?

HSBC notes that the BCBS-IOSCO paper permits single rehypothecation which appears to be aimed at financial intermediaries with limited inventory and also intended to reduce somewhat the liquidity impact on the markets of such margin. Rehypothecation may also somewhat defray the potential expense of IM, but this expense should not be a determining consideration for the ESAs over the reduction of operational risk.

HSBC is concerned at the potential for market fragmentation which could arise where counterparties reasonably choose each other based on the relative cost efficiency, and their costs are lowest where IM rehypothecation is permitted, so the market could become fragmented on regional lines. This is problematic, not so much because of the direct end user transaction, but because of the cost of the various market transactions used to hedge the portfolio in which the end user risk is managed.

HSBC believes that the ESAs should discuss their proposed approach with the wider Basel committee to better understand the cross border impact of failing to allow for rehypothecation.