

## Remarks on Risk Mitigation Techniques

Response to the ESMA/EBA/EIOPA consultation paper on  
Draft regulatory technical standards on risk-mitigation techniques  
for OTC-derivative contracts not cleared by a CCP  
of 14 April 2014

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Thank you for the opportunity to comment on the consultation paper “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”. We hope that our contribution is helpful in developing these draft texts into final ones and are of course more than prepared to provide further detail and explanation on particular items when useful.

As we represent the interests of our members as users/clients of infrastructure service providers in the field of securities, our comments focus on that perspective.

## General comments

We perceive reducing the counterparty risk in non-centrally cleared derivatives as the main objective of the draft regulatory technical standards (RTS). When analysing and assessing the proposal and its components we take into consideration whether they contribute to this objective efficiently and effectively, while also considering:

- their consistency with the BCBS-IOSCO framework: is the translation of the framework into more specific standards in balance (both in time and in content) with the work undertaken in other (major) jurisdictions?
- continued existence of a level playing field between all market participants in the various jurisdictions,
- the functioning of the derivatives markets as such: is their function in the real economy not hampered by onerous or over-structured regulation?

As we will point out in the following paragraphs, the RTS depart from the BCBS-IOSCO framework, in a number of key aspects. Another concern is that the requirements imposed on the markets by the RTS should only become effective in synch with other major markets (e.g. USA and Asia) in order to avoid competitive disadvantages for EU parties and to avoid regulatory arbitrage. The alignment of international rules and regulation is in particular relevant on the third country rules of the several legislations.

While MiFID II/MiFIR in general will drive many contracts to the regulated/organised trading platforms, and EMIR creates a push towards the CCP-cleared environment, the relative importance of the OTC/not centrally cleared segment will probably decrease gradually. This should be taken into account when deciding on the level of detail for the RTS at hand. With only standardised products cleared by CCPs, and tight requirements put on non-centrally-cleared contracts, a range of (illiquid) customer-tailored transactions will become uneconomical to trade. We see a real danger that the costs of measures imposed by the RTS will increase the costs of doing business in these markets for all parties, that end users will find it more difficult to enter into (OTC) derivatives, that one of the effective functions of the financial markets – the transfer of financial risks – will not be covered, and that substantial risks will remain uncovered in the real economy, i.e. outside the financial industry.

## Remarks on individual chapters

### 1. Counterparties’ risk management procedures

#### General feedback

Articles 2 GEN and 1 FP require a formal and explicit agreement between parties in case one or both of them want to make use of exemptions provided by the RTS. This opt-out approach is unnecessarily burdensome and not in line with the BCBS-IOSCO framework.

This approach would require banks to enter into formal opt-out agreements with numerous clients and other counterparties, including counterparties which are not subject to the clearing obligation (and which were always intended to be exempted from the requirements under EMIR). Such an exercise would imply negotiations and written

documentation, and – in case of NFCs – informing and educating. Since many market participants will have contractual relations with more than one counterparty, the market participants will be confronted with many different versions of such arrangements. Especially for smaller and medium sized counterparties, just the costs associated with the necessary legal review of these arrangements will be considerable.

The entire process for opting out would be an operational and financial burden for all parties involved. We do not see the advantages of an opt-out approach compared to an opt-in, and we observe that the BSBC/IOSCO framework is rather based on opt-in. The opt-in may be accompanied by an obligation for FCs to inform their small (and mid-size) non-financial counterparts about their possibilities for opting in in order to achieve the same level of protection as offered by the proposed opt-out approach without invoking the very substantial disadvantages as described above.

*Q1: 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?*

In general, many small and medium-sized entities are not equipped for the necessary calculations and to actually post IM and VM according to the RTS. New procedures would have to be put in place, and additional expertise would have to be brought into the organisation. Furthermore, many of them will not have sufficient collateral available (either cash or financial instruments).

We believe that the new regulations will result in substantial additional costs for derivatives, both as an effect of the mandatory posting of IM/VM itself, and because of the operational costs. As a consequence parties, in particular a very substantial part of NFC-, will decide not to engage into new OTC derivatives at all.

The requirement for EU entities that are subject to the EMIR margin rules to collect from *all* non-EU entities (regardless of status or size, even if these are corporates, central banks or sovereigns) VM and IM (if the EU entity and the non-EU entity are above the IM phase-in threshold):

- places EU entities which are active in non-EU jurisdictions at a major competitive disadvantage compared to non-EU entities;
- deprives the non-EU end users of the services provided by EU entities, implying a negative influence on the functioning of the financial markets both within and outside the EU (less supply, less favourable pricing).

We strongly recommend that non-EU entities which would be exempted if they would have been an EU-entity will also be exempted in the RTS. We believe this would not influence the risk of parties in Europe, since the rationale for the exemption is evenly valid for non-EU as for EU entities.

The impact of the RTS on NFC+, and in particular pension funds, might be severe, because many of such parties do not have cash or bonds freely available on their balance sheet for use as collateral. From a banking side we cannot provide details or quantifications, but in general we anticipate that liquid assets eligible for IM and VM will become scarce to a great extent.

*How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?*

Margin sharing – having margin posted with a third party by both counterparties – or netting of transactions/positions could result in smaller effective margin requirements and in less over-all liquidity need. We realise however, that these possibilities would go beyond the BCBS/IOSCO framework.

*Q2: 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.*

Settling initial margin within the same business day is not feasible. This would require a same procedure as with CCPs, where initial margin is pre-funded. This would be very costly for counterparties, and probably impossible operationally. There is a strong need in the market to have the IM settled on T+1 (transaction date plus one business day, according to market practice).

We agree that the requirements set out in the RTS shall only apply to new contracts. Existing contracts are priced under the assumption that no margin is posted. When margining is introduced in existing contracts, their pricing will have to be renegotiated. This would be costly and complex for all parties engaged, and could also have unpredictable effects on markets. We believe that the RTS should provide guidance as to what would qualify as a “new contract” (as used in Recital 18). In our view an amendment of an existing contract should not trigger the creation of a “new contract”, unless the amendment involves either an increase of the notional amount or an extension of the duration.

With each (counter)party in the market having its own margin model, (mandatory) exchanging of models and their parameters and assumptions will be an extremely complex and time consuming exercise. Although we advocate that models already in use remain acceptable, we strongly recommend that a uniform model be used industry-wide and that the EU stimulates associations (e.g. ISDA) to develop such a model on a reasonable term.

Thoroughly back-testing or calibrating a model is time consuming. Therefore, we propose to back-test the model annually, or more frequently if there are indications that the model is not performing as intended.

The definition of “stressed data” is portfolio – and thereby counterparty – dependent. This requirement may make it impossible for counterparties to agree on a calibration period. We propose to calibrate the model on the most recent 8 years.

## 2. Margin methods

*Feedback is requested on the considerations about Initial margin models*

The development and maintenance of margin models will be cumbersome for a larger number of individual parties. Using the results and agreeing on the model (outcome) with all relevant counterparties will be an even bigger challenge. The consequent large number of arising disputes will contribute negatively to the effectiveness of the measures and to the efficiency of the market. These adverse effects can be avoided by the use of a unified modelling approach between market participants.

We strongly believe that the development of a unified approach (e.g. by ISDA) should be recognised and stimulated by the RTS and the authorities engaged.

The initial margin standardised method (add-on factors) should be aligned completely with article 274 of CRD-IV (regulation EU no. 575/2013) or any replacement of this rule by the Basel Committee's final standard on the standardised approach for measuring counterparty credit risk exposures. In the current draft of the RTS, the maturity bucketing and add-on percentages are not equal to the current standards.

## 3. Eligibility and treatment of collateral

*Q4: 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 appreciate that reliance on ratings by rating agencies is discouraged. However, it is not realistic that banks and other parties develop their own IRB models, apply them to all relevant assets and share all relevant information with counterparties. This would require an army of analysts and lead to higher prices for our counterparties with decreased liquidity if counterparties step out of the market. On longer term counterparties will most likely be necessitated to fall back on external ratings.

We encourage the use of a generic, industry wide model. Regulations/regulators should facilitate such model. Too many models would lead to a very non-transparent market and operational problems. In our opinion it would be good to align the requirements of such a model (e.g. calibration period, recalibration frequency, diversification, and back-test frequency) with the IMM requirements.

*Q5: How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?*

We agree that the use of concentration limits is a useful and even necessary element in the management of collateral (IM and VM). At the other hand, we note that the BCBS-IOSCO framework does not include provisions on concentration limits, and that the proposed text differs from the requirements under the CRR. Apart from the latter inconsistency, which is undesirable by itself, the proposed text should be assessed by its effect in practice. When the freedom of counterparties to use and accept less-diversified collateral and to compensate this with broad haircuts is not recognised, many counterparties will be driven away from these markets for the wrong reasons.

Art. 7 LEC specifies concentration limits with regard to the collateral collected from a single individual counterparty. We believe that these provisions can be improved in two directions:

- by imposing comparable limits on a group level: when counterparties belonging to the same group have posted collateral, diversification of the overall-portfolio (on group level) is much more relevant than diversification of the individual collateral portfolios;
- by applying these limits only on amounts exceeding a particular (absolute) limit; relatively small counterparties engaged in relatively small contracts may not even have an investment portfolio allowing diversification as currently specified. Maintaining the proposed wording would lead to unnecessary costly transactions (SFTs) in order to achieve diversification for margining only.

#### 4. Operational procedures

##### General feedback

The draft RTS do not address the situation where it is legally impossible to establish segregation arrangements in accordance with the RTS. While these impediments will be absent in the majority of EU legislations, we advise that the RTS include a provision for those situations where the obligation to collect margin and the provisions for segregation are in conflict with existing (national) reality.

*Q6: How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?*

The BCBS-IOSCO framework allows the re-use of IM under conditions; in the proposed SFT Regulation “rehypothecation” is not defined unambiguously; the FSB in its “Policy Framework for Securities Lending and Repos” defines “re-hypothecation” more narrowly as “re-use of client assets”.

There are major arguments to restrict the scope of the “re-use” provisions in the RTS to solely collateral consisting of security interest; transfer of title (of collateral) should not be included in the definition. A transfer of title means that the legal ownership is transferred to the transferee. Imposing an obligation to pre-agree contractually the re-use is in contradiction with the transfer of title principle and in contradiction with the principles of the collateral directive, would be in contradiction with the clearing and margining/collateralisation requirements imposed by EMIR and could lead to substantial legal uncertainty for non-centrally cleared derivatives.

CCPs are allowed to re-use collateral under conditions. Prohibiting re-use in the non-centrally-cleared environment would be an impediment for parties in the chain (forcing them to make money “dead”), and would be incompatible with the conventional approach of the banking industry. We believe it could have a major impact on the economy, if this money could not be re-used.

We recommend that - with the consent of the underlying counterparty - IM can be re-used by the CCP (which is currently allowed), but likewise by the Clearing Members (in case of cleared transactions); main reason is to eliminate a concentration of risk on CCP level and to spread this risk on CM level. In case of non-cleared OTC transactions it should be part of the conditions of a transaction whether the IM can be re-used by the receiving party.

## 5. Procedures concerning intra-group derivative contracts

The draft RTS provide an important exemption from the collateral exchange requirements in case the counterparties belong to the same group. Many groups of companies, both financial ones and others, make an intensive use of intra-group transactions, amongst others enabling them to centralise their risk management. With their intra-group transactions entities within the group have mutualised the risks involved. This is recognised in the RTS by creating an exemption for collateral exchange for intra-group contracts under the condition that certain requirements on the risk-management procedures are met and that there are no “practical or legal impediments to the transfer of own funds or repayment of liabilities” (art. 3 IGT). Evidently, such impediments will (almost) always apply when a situation of financial distress (insolvency) exists, and hence restrictions are always *anticipated*. As an effect, application of the proposed text would certainly make the entire intra-group exemption illusory. This cannot be the intention.

We propose that art. 3 IGT sub 1 (third item, erroneously numbered b.) is redrafted in a way that it only refers to *current* restrictions from “insolvency, resolution or similar regimes” instead of *current or anticipated* restrictions.

We consider that transactions that are exempted from the clearing obligation (certain forex derivatives transactions qualifying as intra-group), as well as exempted intra-group transactions should not be taken into account in the calculation of the € 8 billion threshold, as they are perceived as not risky and hence not relevant in this context. The same should apply to the calculation of the phasing-in threshold (€3bn). In determining the timing of when an institution should start exchanging initial margin, institutions should be able to exclude from the aggregate notional size of non-centrally cleared derivatives, those products that are exempted/excluded from exactly those initial margin requirements. Specifically, institutions should be able to subtract the notional value associated with intercompany transactions (as far as they are exempted), physically-settled FX forwards and trades with sovereigns, central banks, multilateral banks, BIS and PSE from the aggregate notional size of non-centrally cleared derivatives.