

BVI position on the ESAs Second 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

BVI¹ appreciates the opportunity to comment on the second consultation paper related to the risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP.

When explaining the background and rationale, the ESAs point out that not all OTC derivatives contracts will be subject to the clearing obligation or would meet the conditions to be centrally cleared and that the absence of a CCP-clearing provokes the requirement of robust risk mitigation techniques (cf. page 6 of the 2nd Consultation Paper).

Taking also into account that only the “*minimum international standards on margin requirements*” shall be ensured (cf. page 6 of the 2nd Consultation Paper), we get the impression that the Draft-RTS are too restrictive when compared to the requirements for cleared transactions.

EMIR only provides two basic client segregation models. EMIR also does not require the CCP to provide sufficient legal clarity on the applicable segregation model to the market place (e.g. mandatory legal opinions) as a part of the authorization process (cf. Art. 14 et seq. of EMIR). Because of the various segregation models existing in the market it is up to the individual market participant to determine how far he or she is protected in case of the insolvency of a CM or other clients of that CM under the applicable segregation model. Consequently, ESMA (2015/ESMA/880) suggests in case of UCITS that their future legal counterparty risk limits shall not be based only on the two EMIR segregation models but that these limits should be proportionate to the degree of CCP protection offered to the fund, namely: “For example, if the degree of protection is equivalent to individual client segregation, UCITS should not apply any counterparty risk limits to CMs. However, if the protection is lower than an individual client segregation, the UCITS should apply a counterparty risk limit to the CM and the level should not be lower than the one for omnibus client segregation because omnibus client segregation should be considered as the clearing arrangement that provide the lowest level of protection.” (2015/ESMA/880 para 27).

From the perspective of the CM client the (Art. 4 para. 1) EMIR clearing-obligation may lead to the impression of less safety in cleared than in un-cleared OTC trades as, firstly, the known counterparty risk in OTC is replaced depending on the CCP segregation model by the counterparty risk of an unknown number of parties. Secondly, the existing single standard applied to the default of a counterparty laid down in the applicable master agreement governing the OTC transaction is replaced by complex default resolution mechanisms differing from CCP to CCP. Thirdly, the fund client’s level of effective protection in case of insolvency of the CM is less clear and may be ascertained only following a cumbersome and costly, in-depth analysis of the relevant documentation of the applicable CCP segregation model.

¹ BVI represents the interests of the German investment fund and asset management industry. Its 90 members manage assets in excess of EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI’s ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.



With this impression in mind, and reiterating that the required Draft-RTS intends to lay down only “minimum standards” for mitigating risks related to un-cleared OTC derivatives, it is not proportionate to apply even stricter rules to un-cleared OTC derivatives or to require market participants to bear the costs of switching the OTC derivative transaction into the “cleared status” with a perhaps less resilient level of protection.

We would welcome if the ESAs would reduce the requirements in the Draft-RTS proportionate to the risks incurred by market participants.

Specific comments

We would like to make the following detailed comments:

Question 1. Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

We have no comments.

Question 2. Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.

- **Article 1 VM para 5: Collection of VM within one business day from the calculation date**

We do not agree with the proposal to collect VM within one business day from the calculation date in cases where no initial margin is required.

In the securities area the European Commission’s “Harmonisation of Settlement Cycles Working Group” established that t+1 would not work in settlement and recommended t+2. Therefore there is today a maximum settlement period of t+2 for transferable securities which are executed on trading venues, Art. 5 para. 2 Regulation (EU) No. 909/2014.

Usually, highly regulated German investment funds (UCITS/AIFs) execute bilateral OTC-derivative transactions during the business day based on the obligation to obtain the pricing of the contract at least at the end of the execution day. In the case that the pricing of the instrument is only available at the end of the execution day, the calculation of the variation margin amount of the related OTC-derivative exposure can only occur on the following business day.

The implementation of the proposed short timeframe by the management companies is a daring task as various market participants in the collateral fund chain (e.g. custodian, external collateral manager, (external) portfolio manager, counterparties, valuation service provider) need to interact within strict time frames set by cut-offs and in different time zones, in order to reconcile and to agree on the variation amount before either a collection of a cash amount or a collection of non-cash collateral financial instrument is triggered. From an operational perspective, the custodian of the German investment fund is usually responsible for either a payment or posting of non-cash collateral security if a variation margin event is triggered. Therefore, it could happen that the operation of the reconciliation of the payment amounts and the transmission of information to the various custodians processing the payment amount or the posting of the non-cash collateral securities to the counterparties is not feasible



within the proposed short timeframe. The operational process is further complicated if the various market participants are located in different time zones (e.g. UK/US-counterparties) thereby extending the timeframes for the management companies to agree on the variation margin amounts which go clearly beyond the proposed ESA's timelines. Especially, the collecting and posting of non-cash collateral securities to the counterparties by the custodians or the external collateral managers needs more time than the transfer of cash.

Therefore, we propose to **extend the collection of VM to two business days from the calculation date**. Such recommendation should be in line with the regulatory aim of Article 1 VM para 3 as variation margin shall only be collected within 3 business days from the calculation date if the collecting and posting of initial margin is required. Our proposed extension strikes a proper balance between the requirements set by the regulators to exchange variation margin and the needs of the investment fund industry to provide such collateral only as fast as operationally possible. Furthermore, our proposal is operationally compatible with the new existing T2S-settlement cycle T+2 for transferable securities which are executed on trading venues. However, we would like to maintain that based on our members experience the posting of VM within the suggested three business days framework also carries operational risk, certainly in the case of German specialized fund administrators (Master-KVG) which interpose themselves between the custodian and the portfolio manager or advisor of the fund.

Although below the EUR 8 billion threshold (Art. 7 para 1 GEN) no initial margin will be required, the collection of collateral shall not exceed one business day (Art. 1 para. 5 VM). However, ESMA's Guidelines in combination with Art. 1 para. 5 VM may force even small UCITS to consider the exchange of initial margins as they cannot 'rely on the "EUR 8 billion threshold"-exemption.

In this context, we need to explain that in particular UCITS' access to liquidity for the purpose of posting collateral on derivative transactions is currently restricted due to the ESMA Guidelines on ETFs and other UCITS issues². According to these guidelines, the purchase price of a repo contract shall be treated as collateral in itself and may not be reused or reinvested by the fund. Since banks accept only a limited range of non-cash collateral (not included in all UCITS), liquidity demands within UCITS will increase with broader application of EMIR, especially for non-centrally cleared derivatives. The ESMA Guidelines deprive UCITS of repo as an important liquidity source, not the least because short-term credit is limited to 10% of the fund's NAV and usually used for handling fund redemption requests only.

Art. 1 para. 5 VM will require all UCITS to post collateral essentially in form of deposits or cash from repo only. Posting non-cash collateral i.e. the securities held in the fund within this period is difficult as the time that lapses between a margin call and the receipt of non-cash collateral in most cases is more than one business day. Also Art. 2 para. 5 HC will limit the available fund non-cash collateral and the demand for cash should increase correspondingly. We believe that because of these demands fund liquidity will be strained to allow UCITS to comply both with EMIR requirements as well as to be able to cover for large redemption of fund units.

The implicit obligation arising from Art. 1 para. 5 VM for an UCITS to hold more cash for the purpose of posting OTC derivative transaction collateral on T+1 will also reduce the fund performance as it will diminish UCITS' ability to invest in profitable financial instruments. UCITS may respond to the stated liquidity challenges by abstaining either from mitigating existing market risks with OTC derivatives or from investing physically. In cases where UCITS are invested in non-equity instruments the lack of repo

² Cf. para. 42, 43 letter i) and j) of ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937).



generated liquidity may also force UCITS to sell assets in illiquid markets with corresponding prices which may further disadvantage investors.

In this context, it should also be noted that the EU Commission granted pension funds a two-year exemption from central clearing requirements for OTC derivative transactions due to the fact that pension scheme arrangements hold neither significant amounts of cash nor highly liquid assets. Notwithstanding the above mentioned restrictions, UCITS do not benefit from a comparable exemption which in our view amounts to an unequal treatment of market participants.

Therefore, we encourage ESMA to work together with the EU Commission towards a review of the above mentioned provisions in the ESMA guidelines on ETFs and other UCITS Issues and to allow UCITS to reuse cash obtained from repo transactions for providing collateral to OTC derivative trades.

- **Art. 1 para. 3 EIM**

For the reasons provided in our response concerning Art. 1 para. 5 VM, we believe that in Art. 1 para. 3 Sentence 1 EIM the words

“one business day”

should be replaced by

“three business days”.

As explained in our general remarks, we believe that the intended Draft-RTS are way too strict and are likely to mitigate the risks associated with OTC derivatives more than clearing OTC derivatives via a CCP. As the required Draft-RTS are only intended to lay down “minimum standards” for mitigating risks related to uncleared OTC derivatives and Regulation (EU) No. 575/2013 considers Credit Value Adjustments (CVA) for uncleared OTC derivatives but not cleared derivatives, one must question whether Art. 1 para. 3 EIM is proportionate in its current version.

Question 3. Respondent are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models.

- **Maintenance of the option to collateralize via full transfer of title**

The provision in Art. 2 para. 1 (e) LEC in combination with recital 33 suggests a prohibiting of exchange of collateral by full transfer of title. We do not believe that such is intended by the ESAs, especially with respect to variation margin contributions. Clarification is requested.

- **Complexity of initial margin calculations**

The ESAs should consider that Art. 1 para. 5 VM is likely to lead to the effect that many market participants will not be able to abstain from making use of the exemptions related to the thresholds laid down in Art. 6 and 7 GEN (cf. our response to Question 2 regarding Art. 1 para. 5 VM). Against this background we believe that Standardised Model (cf. Art. 1 SMI) reaches a level of complexity making



the implementation difficult and expensive especially for those who can't use the exemptions related to the thresholds laid down in Art. 6 and 7 GEN even when being clearly below those thresholds.

Question 4. Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

- **Article 2 HC Para 5: Haircut policy**

Article 2 HC para 5 requires counterparties (UCITS/AIF) to update and calculate haircuts at least every three months or whenever the volatility of market prices changes materially. Furthermore, procedures shall determine ex ante the levels of volatility that trigger a recalculation of the haircuts. The proposed haircut policy update is disproportionate as the management companies need to put in place complex legal and operational procedures which will clearly increase burden and cost.

First of all, reference is made to para. 45 and 46 of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2014/937) which has been implemented in the Member States regarding UCITS (as well as regarding AIFs in Germany). Insofar, UCITS (and AIF) are already today required to consider haircuts, to measure liquidity of collateral and to consider the results from stress testing the liquidity when determining haircuts. The liquidity stress testing policy shall at least prescribe the design of stress test scenario analysis including calibration, certification & sensitivity analysis; the empirical approach to impact assessment, including back-testing of liquidity risk estimates, the reporting frequency and limit/loss tolerance threshold/s; and the mitigation actions to reduce loss including haircut policy and gap risk protection. Insofar, apply haircuts and measuring liquidity of collateral is not new for UCITS and their managers.

However, requiring UCITS counterparties to calculate haircuts at least once every three months and whenever the volatility of market prices changes materially is way too strict. Because of the above mentioned limits on a UCITS ability to generate cash from repo, UCITS are already today under pressure to provide counterparties with cash on deposit as collateral contributions. In order to reduce the cash demand on them fund managers place a high importance on the fact that the non-cash assets of the UCITS are also acceptable as eligible collateral. Therefore the listing of eligible UCITS collateral in credit support annexes may be up to 20 pages long.

The update provision in Art. 2 para. 5 HC effectively forces the counterparties to engage more often in time consuming negotiations of updates to the existing credit support annexes. The update requirement therefore in itself sets an incentive for counterparties to agree on a short list of eligible collateral only. However, a short listing of eligible collateral may mean restricting many UCITS and AIF from providing a wide range of collateral to their counterparties and to comply with Art. 11 para. 3 EMIR.

Therefore, we propose to update the haircut policy only once a year:

5. Counterparties shall update their data sets and calculate haircuts at least once a year every three months and whenever the volatility of market prices changes materially.

- **Diversification of Collateral**

With respect to Art. 7 para. 4 LEC we would like to refer to the provisions in para. 43 e) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version



ESMA/2014/937) which has been implemented in the Member States regarding UCITS (as well as regarding AIFs in Germany).

Even when it is highly unlikely, that UCITS and their managers (respectively AIFs) will ever be a counterparty belonging to one of the categories listed in Art. 7 para. 3 LEC, it should be added to Art. 7 para. 2 LEC:

“[...] unless stricter provisions requiring the diversification of collateral apply.”

Question 5. Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.

The ESAs should clarify with respect to the provision in Art. 2 para. 2 OPD that the requirement of an “independent legal review” can be achieved by internally verifying legal opinions obtained by associations representing the financial sector or a part of it.

The above would accent the importance of the legal opinions organized by organizations that have published relevant master agreement documentation. Those organizations take a neutral position. Otherwise, a costly incentive is set for not entering into OTC derivatives and markets may become less resilient and robust when market participants limit their efforts to mitigate market risk.

As explained in our general remarks, we believe that the intended Draft-RTS are way too strict and are likely to mitigate the risks associated with OTC derivatives more than clearing OTC derivatives via a CCP. As the required Draft-RTS are only intended to lay down “minimum standards” for mitigating risks related to un-cleared OTC derivatives and Regulation (EU) No. 575/2013 considers Credit Value Adjustments (CVA) to be necessary only for un-cleared OTC derivatives but not cleared derivatives, one must question whether Art. 2 para. 2 OPD is proportionate.

Question 6. Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.

- **Article 1 SEG Para 1 and 3: provision of legally binding arrangements**

We do not agree with the proposal that the collecting counterparty has to put in place legally binding arrangements in order to confirm the segregation of the initial margin from the proprietary assets.

As already mentioned in our July 2014 position, the responsibility imposed on counterparties (e.g. UCITS/AIF) to obtain and apply legal opinions in all relevant jurisdictions in the context of the segregation of initial margins will clearly increase the legal burden and the costs on fund management companies outweighing the benefit of such arrangements. Moreover, the requirement imposed on counterparties to obtain and apply legal opinions is not required by Article 11 para 3 of the EMIR. Therefore, the ESAs should evaluate whether the annual operation and legal costs related to initial margins (accounts, transfers, trustee agreements, legal opinions etc.) are justified in comparison to the bilaterally concluded OTC derivative volume and the aim to mitigate counterparty (credit) risk.



We propose the following wording related to Article 1 SEG Para 1:

1. Collateral collected as initial margin shall be segregated from proprietary assets on the books and records of a third party holder or custodian, ~~or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty, third party holder or custodian.~~

We propose the following wording related to Article 1 SEG Para 3:

3. Where initial margin is collected in cash it shall be segregated individually, ~~unless the collecting counterparty has legally binding arrangements in place to segregate it from proprietary assets.~~

Question 7. Does this approach address the concerns on the use of cash for initial margin?

No. We currently have the following concerns:

- As explained above para. 42 and 43 j) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937) restrict especially UCITS access to a main source of liquidity. For that reason it is unlikely that UCITS (and AIF) will want to make cash collateral contributions when they can provide non-cash collateral.
- If a counterparty provides cash as initial margin and the collecting counterparty has to re-invest for the purpose to protect the collateral poster, it may become liable for any value decreases.
- The intended concept is unclear as it leaves open, whether the re-investment is to be effected for the account of the collateral poster (which may require the collecting counterparty to obtain additional NCA authorization) or for the account of the counterparty having collected the cash collateral contribution, whether the cash collateral contribution will bear interest even if it has been re-invested and who would be entitled to any proceeds resulting from the re-investment.

If the collateral poster wants to avoid being exposed to the default risk of the bank holding the cash, it should invest the cash and should provide the collecting counterparty with the non-cash collateral paid for in cash.

Question 8. Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.

We have no comments.