Responses on ESMA, EBA and EIOPA Joint discussion paper

Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (JC/DP/2012/1)

April 2012
Insight Investment is responsible for €200bn of assets under management on behalf of predominantly European pension funds and other long-term savings institutions. Our business is largely focused on providing asset and liability risk management for these clients. As such, we make extensive use of interest rate, inflation, credit and equity OTC derivatives to execute these risk management strategies.

Insight Investment welcomes the opportunity to provide our views and are pleased to submit our response to the “Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (JC/DP/2012/1)”

We have provided our high level thoughts on this paper to question 1 below and then have answered in more detail the rest of the questions bringing out the same themes.

Q1. What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

Pension funds make extensive use of financial derivatives to protect and manage their solvency through asset and liability risk management overlay programmes. It is critical that any regulation takes into consideration:

- Impact on liquidity: it is important to ensure any path to creating ‘better’ and more prudent risk management takes into consideration the liquidity constraints this will inadvertently create for pension funds and other market participants. Impact of regulation should be well thought through to ensure that the by-products of these rules do not at some point create a liquidity crisis in the future.
- Impact on cost: whilst a certain amount of cost increase may be justifiable to put in place robust risk management, costs should be borne proportionately to the risks that end-users bring to the system. A significant increase in costs could either prevent or discourage prudent risk management and we don’t believe this is an outcome that authorities are aiming for.
- Ensures robust operational structure and collateral efficiency: any regulation should not only reduce risk but should also be robust from a practical and operational perspective. Collateral efficiency is an important consideration for pension funds to ensure that their assets are invested in an optimal fashion to ensure they can best meet their obligation to future pensioners.

Our high level thoughts on this paper are as follows:

Initial Margin approach

- **We believe the amount of IM posted should take into account the credit quality of the counterparty.** A high quality counterparty should post less IM for the same transaction exposure as compared to a lower credit quality counterparty. This reflects the lower probability of default and therefore a lower expected loss related to an exposure with a counterparty of higher credit quality.

- **We believe the actual size of IM should be calculated by market participants, adopting a principles based approach that accurately takes into account counterparty credit quality, position risk, and full portfolio netting.**

- **We support two-way IM in principle, but we do not think it makes sense in all instances.** Requiring two-way segregated IM between dealer banks could create four or more sets of IM to be posted for each transaction that an end-user originates with a dealer bank (because a dealer banks are likely to enter into back-to-back transactions hedging with other dealer banks, as further described below in question 2). This could:
  - increase costs associated with trading non-cleared OTC derivatives to be prohibitively high such that it could lead to the non-cleared OTC derivatives markets becoming functionally unviable
  - create a substantial liquidity drain on the financial system, especially in stressed market conditions, which could add to, rather than reduce, financial stability.

- **We believe that market participants, or at least inter-dealer transactions between dealer banks who are subject to stringent capital requirements (e.g. CRD IV or equivalent) should have the option to choose between either a two-way segregated IM approach or one-way IM approach.** For a one-way IM approach to work appropriately we believe the IM should flow from the counterparty with higher expected loss to counterparty with lower expected loss (taking into
consideration counterparty credit quality, position risk and accurate portfolio netting). This would allow dealer banks who are subject to stringent capital requirement to opt out of the two-way IM approach avoiding the issue of having four or more sets of IM for the same transaction originated by the end-user. We think this is critical to ensure that the IM requirements do not constrain the effective functioning of non-cleared OTC derivatives markets.

Further to this we would not be averse to this one-way IM being zero or close to zero if it appropriately takes into account counterparty credit quality, position risk, and portfolio netting.

If the suggested above approach is adopted by regulators (where market participants can choose to post two-way or one-way IM), we would most likely opt to post two-way IM for transactions between our pension fund clients and dealer banks to ensure robust and prudent risk management.

- **We would support the eligibility of collateral for initial margin to meet a set of criteria based approach established by the ESAs.** Unlike collateral that may be acceptable as initial margins to CCPs, we feel that initial margins for bilateral transactions could be broader and could include other bonds also (such as corporate bonds), with appropriate haircuts. As a minimum, cash and high quality sovereigns, with appropriate haircuts, should be acceptable as collateral for IM. However a broader set of high quality collateral may be required to mitigate the resultant liquidity drain on the system during times of market stress.

**Variation Margin approach**

- We support the exchange of variation margin (“VM”) being transferred to cover mark to market exposures on a portfolio of positions with a counterparty. We already transfer variation margin on a daily basis, above a de minimus minimum transfer amount, on all client OTC derivatives transactions as part of our normal course of business.

- **We would support the collateral for variation margin to meet the criteria as set out in EMIR Article 43 of “highly liquid collateral with minimal credit and market risk”; and should include cash and high quality sovereign bonds (with appropriate haircuts).** We consider it essential that VM should not be limited to cash only. High quality sovereign bonds with appropriate haircuts also provide good protection for credit risk and meet the Article 43 definition of collateral eligibility.

**Categorisation of counterparties**

- If regulators determine that option 2 IM approach should be adopted, where there is one-way IM with the direction dictated by the category of counterparty as opposed to being determined by counterparty credit quality (which we do not support), it is important to ensure that the definition of PRFC includes all pension entities captured by Level 1 EMIR. It would not make sense to have any pension entities recognised by Level 1 EMIR falling outside the PRFC definition (and therefore classified as NPRFCs) because that would require pension entities to post one-way IM to dealer banks. Pension funds, being asset rich, and employing generally conservative investment strategies are generally considered by the market to be of higher credit quality than dealer banks. It would not, therefore, be prudent risk management for pension entities (higher credit quality counterparties) to be posting one-way IM to dealer banks (lower credit quality counterparties) as required under option 2 IM approach.

- **Therefore any counterparty categorisation of pension entities in Level 2 should follow the categorisations set out in Level 1 of EMIR.** In particular, any pension entities that have been provided the temporary transition period for clearing should be treated as part of the same category for the treatment of bilateral collateralisation.

- Whilst institutions for occupational retirement provisions are included in definition of PRFC, the following, also part of the definition of ‘pension scheme arrangements’ or entities included in the pensions temporary transition period in EMIR (Article 71(-)) are currently not included in the same category. We believe the definition of PRFC should be worded accordingly to be consistent with Level 1 EMIR to include the following:
  - The entities underlined in the below definition of Article 2 (7a)(a) within Level 1 EMIR, we believe, are currently not captured under the PRFC definition.
"institutions for occupational retirement provision as defined in Article 6(a) of Directive 2003/41/EC, including any authorised entity responsible for managing such an institution and acting on its behalf as referred to in Article 2(1) of that Directive as well as any legal entity set up for the purpose of investment of such institutions, acting solely and exclusively in their interest"

- The definitions used in EMIR to refer to pension entities (i.e. Article 2 (7a)(a) and wording from Article 71(-1) above) need to be included in the same categorisation.

Other points

- The timing of when the EMIR rules shall come into effect should not be before the finalisation of Level 2 rules to ensure the smooth functioning of the markets. Based on our understanding, we believe, that there is a risk that non-cleared trades may be captured by the bilateral collateralisation requirements before the Level 2 technical standards are finalised. This is based on our understanding that ‘entry into force’ of EMIR could occur before when Level 2 technical standards are expected to be finalised. The bilateral collateralisation rules set for non-cleared trades under Level 2 will have significant pricing impact on OTC derivative markets and as such it is critical that at the time of trading market participants are clear as to what the margin requirements are for these non-cleared trades. Any uncertainty (which we understand to currently exist between ‘entry into force’ of EMIR and when the Level 2 rules are finalised) shall impact the liquidity and the stability of the OTC derivative markets. We believe this will be counterproductive and is not in line with the G20 objectives.

We ask the ESAs (perhaps working with the European Commission) to consider any timing mismatch that may exist and to propose a timeline that brings the two in line with each other.

- Risk can be prudently risk managed using the exchange of collateral and as such we would support the suggestion to not create a new capital regime for that purpose.

Q2. What are your views regarding option 1 (general initial margin requirement)?

Whilst we would support two-way IM in principle, it would not make sense in all instances. We believe that market participants should have the flexibility, at least in some instances, to choose between two-way IM and one-way IM. However we believe that one-way IM would only work appropriately if IM flows from counterparty with higher expected loss to the counterparty with lower expected loss - taking into consideration counterparty credit quality, position risk and full portfolio netting etc.

If the suggested above approach is adopted by regulators (where market participants can choose to post two-way or one-way IM), we would most likely opt to post two-way IM for transactions between our pension fund clients and dealer banks to ensure robust and prudent risk management. However the key to this approach is that it would also allow dealer banks subject to stringent capital requirements (e.g. CRD IV or equivalent) to opt out of two-way IM approach. We think this opt out for dealer banks is necessary to ensure the smooth functioning of the market as described below.

If every leg of a non-cleared OTC derivative trade required two-way IM, then there would be multiples of IMs being posted for each transaction that an end-user originates. This is because the dealer bank that the end-user trades with is likely to enter into back-to-back trades with other dealer banks to hedge their exposures.

By way of example, assume a client trades with Bank A (original transaction), and Bank A hedges with Bank B (back-to-back transaction). Then two-way IM with segregation would require that the client and Bank A each post IM for the original transaction, and then Bank A and Bank B each post IM for the back-to-back transaction. This would result in four sets of IMs being posted, once by the client and Bank B, and
twice by Bank A – all as a result of one transaction being originated by the end-user. This is illustrated below.

Clearly if Bank B also further conducts back-to-back transactions to hedge its exposures then another two sets of IM would be required, and so on. Hence one transaction originated by an end-user could potentially require four or more sets of IMs to be posted.

The additional cost resulting from the many postings of IM is likely to be significant and would be passed on by the executing dealer bank onto the end-user. In practice the significant increase in costs in relation to multiples of IM is likely to lead to non-cleared OTC derivatives markets being highly inefficient and effectively becoming unviable to use. This is likely to prevent the legitimate use of OTC derivatives for the purposes of hedging. Not all OTC derivatives will be cleared, at least initially, but these derivatives nevertheless play an important role in helping end-users risk manage their exposure and it would be counterproductive if the legitimate use of these instruments was effectively precluded by regulation.

Pension funds are, subject to requirement to prudently manage risk. However, the tools available for doing so shall be significantly limited as a result of the impact described above. This could significantly increase the risk for pension beneficiaries and the sponsor corporates responsible for the employee pension schemes. Pensioners retirement income is therefore likely to be reduced and the funding costs for sponsor corporates associated with the pension schemes are also likely to be increased. Overall, this is likely to introduce greater volatility into the financial solvency of pension schemes, and hence the security of pension benefits and the financial performance of corporates are likely to be compromised. It would therefore have a negative impact on the overall economy.

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Whilst IM is an important tool for risk management (and increasingly prevalent in the OTC derivatives market as a replacement for having downgrade based triggers in credit support annex), it is not the only tool. Furthermore, IM is only a robust tool for risk management if it is adopted in the right way. A robust IM framework could include one-way IM as long as it flows from counterparty with higher expected loss to counterparty with lower expected loss (taking into consideration counterparty credit quality, position risk and full portfolio netting etc.).

Other approaches used for protecting against counterparty default includes capital and prudent risk management (e.g. counterparty selection, counterparty due diligence, counterparty limits, posting and collecting variation margins for mark-to-market moves, timely collateral valuation, robust dispute resolution mechanisms and other measures). These non IM approaches to managing counterparty credit risk are equally robust and their impact should not be underestimated.

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.
It is likely that the cost of posting IM shall be high for end-users as they are likely to not only pay for the funding costs / opportunity costs of posting collateral as IM themselves; but they are also likely to be passed on any funding costs that dealer banks would face in posting collateral as IM from the dealer banks. Furthermore cost increase from any back-to-back hedging transaction that dealer banks shall execute (as described in question 2 earlier) is also likely to be passed on to the end-user, adding potentially significant costs to end-users or pension schemes.

The ESAs need to consider the impacts of this carefully to ensure that the costs related to non-cleared OTC derivative trades do not become so prohibitively high that it leads to certain markets from being completely inefficient and effectively becoming unviable to use. This would reduce the tools available for market participants wishing to engage in prudent risk management.

More details on cost to pension schemes

The below diagram illustrates what we believe would be a reasonable asset allocation shift for pension schemes in a post-EMIR landscape assuming that pension schemes do not cut back on prudent risk management, and therefore carry on using derivatives for the legitimate use of managing interest rate and inflation risk related to its liabilities. As shown below, we expect that, as a result of EMIR and the increased need for high quality liquid collateral to be available as margin for OTC derivatives (for both cleared and non-cleared trades), the allocation to government bonds and cash is likely to increase. Although the actual proportional increase shall depend on the nature of the final clearing solution that is developed for solving the ‘pension issue’ - for which we thank the authorities for providing a temporary exemption period from clearing to develop such a solution – the final solution, nevertheless is likely to require a greater allocation from return-seeking assets into cash and high quality government bonds.

If we ignore the use of any collateral transformation facilities that pension schemes may apply to change this asset allocation (because this shall inadvertently introduce other counterparty risks to pensions schemes which would effectively go against the intention of EMIR), we estimate the opportunity cost of reallocating from higher return seeking assets into higher credit quality and liquid instruments to be c.1.5% per annum on returns of pension schemes. Please note that this is an estimate only and is based on reasonable assumptions available to us today.

Note further that this does not take into consideration the impact of four or more sets of IM that may be required for each transaction a pension fund end-user originates (as described in question 2 earlier). We believe that if such an IM approach is adopted it is more likely to lead to pension schemes compromising on the high prudent risk management standards that they have adopted to date and instead are likely to ‘run the risk’ within the scheme.
Q5. What are your views regarding option 2?

We think one-way posting of IM with the direction being prescribed by regulators based on the category of counterparty has significant limitations. One-way posting of IM would only be appropriate if the direction of IM takes into account the credit quality of counterparty. IM should flow from counterparty with higher expected loss to counterparty with lower expected loss, taking into consideration counterparty credit quality, position risk, and full portfolio netting.

The determination of credit quality should be counterparty specific and not something that can be generalised based on the broad category of counterparty. It can be dangerous to set the direction of IM flow based on the category of counterparty, such as a requirement for IM to flow from NPRFC to PRFCs. The recent financial crisis, and in particular, the collapse of Lehman Brothers in 2008 illustrates that PRFC firms are capable of failing. An option 2 framework in that scenario would not have provided NPRFCs with any protection for the collapse of Lehman Brothers.

A one-way margin approach would only be appropriate if it was accurately capturing the credit quality of counterparties and one that was flexible enough to be able to react to changes to counterparty quality.

Whilst we think regulators could set overall principles to help firms analyse credit quality of firms, and hence the direction (in a one-way IM framework), the ultimate determination would need to be made by counterparties to be fully risk sensitive to market conditions.

If however regulators adopt a one-way IM approach with the direction of IM flow stipulated by the category of counterparty as opposed to by counterparty credit quality (which we do not support), it is important to ensure that the definition of PRFC includes all pension entities captured by Level 1 EMIR as further set out in more detail under question 1, “categories of counterparties” section.

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

We do not comment on this.

Q7. What is the current practice in this respect, e.g.
- If a threshold is currently in place, for which contracts and counterparties, is it used?
- Which criteria are currently the bases for the calculation of the threshold?

Current practice for IM is such that IM is usually not exchanged between higher credit quality counterparties. But where there are concerns of credit quality then one-way IM is posted from the lower credit quality counterparty to higher credit quality counterparty.

Pension funds, being asset rich, and employing generally conservative investment strategies are considered to be of higher credit quality than dealer banks. As a reflection of this, we do have some arrangements with our counterparty dealer banks where there is one-way margin posting from the dealer banks to pension funds.

Q8. For which types of counterparties should a threshold be applicable?

We do not comment on this.

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

We do not comment on this.

Q10. How – in your opinion - would a threshold change transactions and business models?

We do not comment on this.
Q11. Are there any further options that the ESAs should consider?

We support a robust risk management framework for non-cleared OTC derivatives trades. However we believe that there are limitations to the IM options set out in this paper (as already set out earlier).

The ESAs may therefore wish to consider an alternative approach setting out robust principles for market participants to bilaterally collateralise their non-cleared trades without being overly prescriptive. The specifics should be agreed between the market participants, subject to meeting some robust criteria. This would allow market participants to set the size of IM based on a fully risk sensitive approach and taking into account counterparty credit quality, position risk and full portfolio netting.

We feel that regulation should offer market participants the choice to choose between one-way or two-way IM, at least in some instances (as already described in question 2 earlier). This would prevent any unnecessary requirement of duplicating IMs on back-to-back trades which could make costs associated to non-cleared OTC trades prohibitively high.

We understand the public policy desire to incentivise centralised clearing. We think that policy objective shall be achieved by the combination of stringent bilateral collateralisation framework as described above and tougher capital requirement on dealer banks for non-cleared OTC derivatives. Whilst the delivery of tougher capital rules for non-cleared OTC derivatives have been focused on modifying bank capital rules, we note that this will have the effect desired by regulators of impacting the entire market for non-cleared OTC derivatives given that most of these trades are transacted with dealer banks.

Q12. Are there any particular areas where regulatory arbitrage is of concern?

One area where EMIR is inconsistent and hence regulatory arbitrage may be of concern is described further here.

Whilst EMIR currently captures pension funds as a financial counterparty which shall be subject to the mandatory clearing obligation (once the temporary exemption expires) and the bilateral collateralisation requirements in the meantime, non-financials are provided an exemption from both clearing and bilateral collateralisation for commercial hedges and for non-hedges that fall within the clearing threshold. This could provide an inappropriate economic incentive for non-financials to retain pension liabilities on their balance sheets given that the use of OTC derivatives for the purpose of hedging shall be permitted without the requirement to clear or bilaterally collateralise. This could disadvantage non-financials that prudently manage these liabilities by transferring the pension fund assets into a separate stand-alone entity (such as a pension fund), because these entities would not be able to take advantage of the non-financial exemption, even when used for hedging purposes.

We believe the difference in treatment of the use of OTC derivatives used to manage pension liabilities as described above unfairly disadvantages those non-financials that adopt a more prudent approach to risk management of pension liabilities.

Q13. What impacts on markets, transactions and business models do you expect from the proposals?

Cost of trading OTC derivatives is likely to increase for end-users which can discourage the legitimate use of OTC derivatives for hedging.

End-users, including pension schemes, are likely to pay the following costs when trading non-cleared OTC derivatives:

- Opportunity cost of locking up investment capital into a set of relatively low return eligible collateral that is allowed for posting as IM (as opposed to investing in higher return seeking assets such as equities as an example), or funding cost associated with sourcing the collateral that will need to be posted as IM.
- Funding costs that dealer banks are likely to incur for posting IM on their side of the transaction is likely to be also passed onto end-users, including pension schemes.
- Any further cost associated with IM requirements on any back-to-back hedging transactions that dealer banks shall execute (as described in question 2 earlier) is also likely to be passed on to the end-user, adding potentially significant costs to end-users or pension schemes.
Cost associated to default fund contributions that banks will be required to post to CCPs is also indirectly likely to be passed to the end-user, including pension schemes.

Any increased capital or credit valuation adjustment ("CVA") charge that dealer banks will have to post as part of their regulatory capital requirement is also likely to be passed on to end-users, including pension schemes.

We think if the right model is not adopted by regulators, then there is a danger of the following broader market impacts:

- A ‘squeeze’ on high quality collateral given the significant increase in demand for this from margin requirements for both non-cleared OTC derivatives as well as cleared OTC derivatives.
- Less prudent risk management by firms who may decide to ‘run the risk’ rather than hedging using non-cleared OTC derivatives which could lead to greater financial instability.
- Less prudent risk management of employee pension scheme liabilities. This could significantly increase the risk for pension beneficiaries and the sponsor corporates responsible for the employee pension schemes. Pensioners retirement income is therefore likely to be reduced and the funding costs for sponsor corporates associated with the pension schemes are also likely to be increased. Overall, this is likely to introduce greater volatility into the financial solvency of pension schemes, and hence the security of pension benefits and the financial performance of corporates are likely to be compromised. It would therefore have a negative impact on the overall economy.

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

We generally support daily exchange of collateral as variation margin. There should be a de minimus minimum transfer amount below which daily collateralisation does not need to occur to ensure that collateral does not need to be exchanged for very small and insignificant moves in mark-to-market.

Q15. What would be the cost implications of a daily exchange of collateral?

We already have daily collateralisation in place subject to appropriate minimum transfer amounts.

Q16. Do you think that the “Mark-to-market method” and/or the “Standardised Method” as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

Being non-banks we are not experts on banking capital methodologies hence can not take a strong position on the above methodologies in the limited time that is provided however we have the following reservations about using these models. The mark-to-market model is not fully risk sensitive, does not capture position risk accurately, and does not fully take into account netting.

We believe that the ESAs should put in place a transparent and principles based approach for counterparties to calculate IM that is fully risk sensitive and accurately taking into account the credit quality of counterparty, position risk, and full economic portfolio netting. Our preference would be for the ESAs not to set prescriptive standards on the actual number or detailed calculation of IM because there is a danger that any approach can not be fully risk sensitive (and therefore unable to accurately capture credit quality of counterparty, position risk, and full economic portfolio netting) if it is overly prescriptive.

However if ESAs do require a prescriptive approach then we believe that any market participants willing to invest resources into building risk sensitive models should be allowed to develop appropriate models that can be, if necessary, approved by competent authorities. We understand that currently competent authorities approve risk sensitive models developed by banks under capital framework and will approve models insurers develop under Solvency II. We feel that other market participants should also be allowed the opportunity to build and approve models with the competent authorities if they wish to do so. If a prescriptive model is required, we would support a value at risk methodology, similar to those currently adopted by some CCPs.
Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?

We repeat our answer from question 16 above:

We believe that the ESAs should put in place a transparent and principles based approach for counterparties to calculate IM that is fully risk sensitive and accurately taking into account the credit quality of counterparty, position risk, and full economic portfolio netting. Our preference would be for the ESAs not to set prescriptive standards on the actual number or detailed calculation of IM because there is a danger that any approach can not be fully risk sensitive (and therefore unable to accurately capture credit quality of counterparty, position risk, and full economic portfolio netting) if it is overly prescriptive.

However if ESAs do require a prescriptive approach then we believe that any market participants willing to invest resources into building risk sensitive models should be allowed to develop appropriate models that can be, if necessary, approved by competent authorities. We understand that currently competent authorities approve risk sensitive models developed by banks under capital framework and will approve models insurers develop under Solvency II. We feel that other market participants should also be allowed the opportunity to build and approve models with the competent authorities if they wish to do so.

If a prescriptive model is required, we would support a value at risk methodology, similar to those currently adopted by some CCPs.

Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

We revaluate IM based on event-driven scenarios such as the deterioration in counterparty credit quality.

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

No. We believe all market counterparties should be allowed to develop risk sensitive models if they wish to invest the resources. Any prescriptive approach without the development of internal models would not be fully risk sensitive.

Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?

Being non-banks we can not take a strong position on banking methodologies in the limited time that is provided here.

Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?

We do not comment here.

Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?

We do not comment here.

Q23. To what extent would the mark-to-market method or the standardised method change market practices?

Being non-banks we are not experts on banking capital methodologies hence can not take a strong position on the impact of the above methodologies in the limited time that is provided.

However to the extent that the models are not fully risk sensitive, do not take accurately into account position risk, portfolio netting, or credit quality of the counterparty appropriately; this would go against current market practice where there is posting of IM for non-cleared trades.
Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.

Yes we do expect practical problems if there are discrepancies. For this reason it is important to have strong collateral dispute mechanisms in place as required by EMIR already.

There may need to be some practical ways to resolve disputes of IM discrepancies. Some suggestions below:

- Polling other market participants
- Having an independent third party calculation agent

Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?

Conflicts of interest, in particular during times of stress, can make this unworkable. We would always want the ability, if we choose, to calculate IM on the trading activity that we undertake on behalf of our clients, without relying on the counterparty to calculate this for our clients.

Q26. Do you see other options for treating such differences?

Repeating answer to question 24 earlier:

There may need to be some practical ways to resolve disputes of IM discrepancies. Some suggestions below:

- Polling other market participants
- Having an independent third party calculation agent

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

We think segregation should be offered to all market participants but not be a requirement. This is in line with our view as further described in question 2 that market participants, at least in some instances, should have the flexibility to choose between two-way IM (which would require segregation for it to work properly) or one-way IM (where segregation is not necessarily required). The details of the agreement should be for market participants to agree on without being prescribed in regulation.

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

Any cash in a segregated model should sit in an account that is ring fenced and over which the beneficiary has a secured interest. However we do not think that regulation should overly stipulate restrictions because market participants need to have the flexibility to make trade-off versus impact/costs and also take into account any local law restriction when agreeing on the appropriate structure with their counterparts.

Q29. What are the practical problems with Tri-Party transactions?

We do not comment on this.

Q30. What are current practices regarding the re-use of received collateral?

 Whilst we do not currently re-hypothecate collateral received from our counterparties, counterparties that we post collateral to do have the flexibility to re-hypothecate our collateral. Re-hypothecation is common practice in the market and one that we would support.
Q31. What will be the impact if re-use of collateral was no longer possible?
Greater increase to costs, which may make using non-cleared OTC derivatives unviable.

Q32. What are, in your view, the advantages and disadvantages of the two options?
Collateral for Variation Margin:
We would support collateral for VM following option 1 approach, but including at a minimum cash and high quality sovereign bonds (with appropriate haircuts).

Collateral for Initial Margin:
Given the large amount of collateral that is likely to be required to be posted as IM for cleared trades as well as non-cleared trades, it may make sense to broaden the set of collateral from option 1 to be acceptable as IM for non-cleared trades. If only a narrow set of collateral is allowed then the regulatory requirements may cause a ‘squeeze’ on this narrow set of eligible collateral. Therefore it may make sense to include collateral that fall into both options 1 and 2 (and potentially any other collateral that is high quality and deemed to be appropriate). We do not however think that bank guarantees would be appropriate instruments to post as collateral.

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?
Our pension fund clients would typically not post non-financial assets to meet margin calls.

Q34. What consequences would changing the range of eligible collateral have for market practices?
Indiscriminately widening the range of eligible collateral for VM would likely impact the choice of mark-to-market valuation curves thereby introducing differences in valuation based on the underlying collateral that is posted. However we do not think that this would be an issue for a range restricted to cash and high quality sovereign bonds (with appropriate haircuts), where the market convention is to use the same market valuation curves for these (given the high quality/security nature of cash and high quality sovereign bonds).

However for IM it would make sense to have a broader set of collateral (with appropriate haircuts) as already described in question 34.

Q35. What other criteria and factors could be used to determine eligible collateral?
We would support a similar principle as set out in EMIR of “highly liquid collateral with minimal credit and market risk” in Article 43 for eligibility of VM.
For IM, we think there could be a similar set of principles which allows for a broader range of collateral.

Q36. What is the current practice regarding the frequency of collateral valuation?
Our practice currently is, and would continue to be, to value client collateral positions on a daily basis. However the collateral valuation frequency may need to reflect the type of underlying collateral that is posted.

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?
We do not comment on this.

Q38. What are the cost implications of a more frequent valuation of collateral?
We do not comment on this.
Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

We could support bilateral agreement of appropriate haircuts reflecting the term, liquidity and credit quality of each type of collateral. However, we would not be averse to the agreement of industry standard minima for each category and term of collateral.

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

No, this would introduce a conflict of interest for transactions between PRFCs and NPRFCs. There should be a level playing field between different market participants.

Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?

Processes and systems to ensure the following is monitored and integrated into the risk management operations of the firm:
- daily position and collateral valuation
- robust dispute resolution process
- daily monitoring of compliance with the terms of Credit Support Annex (CSA)
- daily monitoring of counterparty credit risk

Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?

Difficult to quantify, but we believe it is important to have robust operational processes in place and as such would be willing to develop appropriate operational processes that we believe makes sense. We further believe that we already have the robust infrastructure largely in place today.

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?

We do not comment on this.

Q44. How would setting a cap impact markets, transactions and business models?

In practice we would support the concept of a cap. In the markets that we operate, we would not expect this to have a material adverse impact.