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Combined IRSG/OPSG Response on draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of EMIR Regulation (EU) No 648/2012

1 Introduction and Executive Summary

With this paper, the Occupational Pensions Stakeholder Group (OPSG) and the Insurance and Reinsurance Stakeholder Group (IRSG) wish to address issues and concerns related to the implementation of the European Market Infrastructure Regulation (EMIR). EMIR may potentially have a severe negative impact on IORPs[1] and insurers, as well as the banks who serve as swap counterparties to both the IORPs and insurers. Both stakeholder groups believe that the practical implications of EMIR implementation will be opposite to the main goal of what EMIR tries to achieve. This paper aims to highlight the position of both OPSG and IRSG with regard to EMIR.

In summary

1. The OPSG and IRSG both agree with the overall principles of EMIR, which is to increase transparency and decrease systemic risks.
2. The OPSG and IRSG both believe that both IORPs and insurers face similar problems with the implementation of EMIR, in terms of increased costs and the negative impact on returns to IORPs and insured beneficiaries and policyholders.
3. The OPSG and IRSG both agree that EMIR is likely to increase costs, which is the price of improved transparency and decreased systemic risk. However, EIOPA should try to minimise excessive or avoidable increases in costs, and develop workable implementation solutions.
4. The OPSG and IRSG both recommend that EIOPA delays the implementation of mandatory posting of collateral for both IORPs and insurers until well beyond the current IORP exemption expiration of August 2015. The OPSG believes that the social goals of IORPs and the exemption granted to IORPs merits special consideration by EIOPA. The IRSG notes that the business model of insurers is relatively low-risk, so any extension of the exemption for posting of initial margin and variation margin should also apply to insurers.
5. The OPSG and IRSG note that EMIR possibly will only shift the system risks from IORPs and insurers to Clearing Members (CM), which often will have a higher default risk. Shifting these risks to CMs will not lower these risks per se. The concentration risks of Central Counterparties (CCP) is even bigger than that of CMs, so even though their default probability is most likely smaller, the impact of their default will be more severe. A CCP default will lead to replacement risk, i.e. having to set up the derivative positions all over again at high costs (and possibly in non-willing markets), which exposes IORPs and insurers to open positions and high costs.
6. The OPSG and IRSG differ in certain respects. The OPSG suggests that IORPs should be given access to ECB liquidity and CPPs rather than going through bank intermediaries. IRSG members do not ask for ECB and CCPs access since they believe that this access would force the insurers to be characterised as globally systemic financial institutions, which would result in significantly increased levels of regulation.
7. In terms of specific comments, the OPSG notes that the current three year exemption period to IORPs from mandatory clearing ending in August 2015 has barely

[1] IORP stands for Institutions for Occupational Retirement Provision.

been effective. The intended effect, the creation of a fit for purpose clearing environment for IORPs, is not observed in the markets yet. Neither are alternative measures which would mitigate the impact of central clearing on IORPs introduced. The OPSG would like the exemption period at least for the margining requirements to be prolonged until an acceptable solution for IORPs has been found especially for the following items: fully segregated accounts, a solution for cash variation margin, and the guaranteed return of specific collateral posted. An increased willingness and capacity of CCPs to find solutions together with IORPs would speed up the process[2].

8. In terms of specific comments, IRSG insurer concerns are: a) insurance derivatives be specifically out of scope b) a solution for a likely lack of exchange of internal models for initial margin be developed c) collateral concentration limits be made materially more flexible and in particular eliminated in the case of EU government bonds, d) the implementation of mandatory posting of variation margin be extended beyond December 2015, and e) intergroup exemptions be expanded. In addition, IRSG bank concerns are a) securitisation swaps should be specifically exempted from EMIR and b) that limited rehypothecation be permitted.

2 OPSG and IRSG Joint Objectives and Endorsement of the overall objectives of EMIR

Regulators and policymakers aim to regulate the OTC derivatives market to increase transparency and decrease systemic risk (see box 'Objective of EMIR'). In order to make derivative markets safer, counterparty risk and operational risk should be decreased. Over the past years, both the EU and the US have adopted comprehensive legislation to regulate the derivatives market. EMIR and the Dodd-Frank Act (DFA), which was enacted in the US, will have a significant impact on IORPs' and insurers' operations. It is very important to take into account the general objective of EMIR as this reflects the concerns and standpoint of the legislator.

It is important to state that, in principle, the OPSG and IRSG are positive about EMIR. Both agree that increased transparency, increased financial stability and better functioning financial markets are important goals to strive for. More broadly, the OPSG and IRSG do believe that it is important to emphasise that some of the technical comments provided by each of OPSG and IRSG below are different. It is important to emphasise that EMIR will have a negative impact on economic results for all of the various people it affects – their members, policyholders, beneficiaries, owners and clients.

Objective of EMIR

"Over-the-counter derivatives ('OTC derivative contracts') lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This Regulation lays down

[2] A minority of the OPSG prefers a time limit of 2 years for the additional exemption.

conditions for mitigating those risks and improving the transparency of derivative contracts."
Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (4 July 2012)

3 OPSG Perspectives

The OPSG would like to propose several possible solutions that could mitigate the negative impact of EMIR on IORPs. This is done by elaborating on the legal background, looking into the current market circumstances and the architectural possibilities to facilitate the future participation of IORPs in central clearing.

3.1 IORPs use OTC derivative contracts for risk management purposes

The OPSG does wish to grasp the effects on the EU pension sector, given the recognition of the position of IORPs under EMIR (see below box 'EMIR recognises…'). IORPs use (OTC) derivatives to manage their risks in their balance sheet and liabilities by hedging – among others – their interest rate, inflation, longevity and currency risks. Indeed, the IORP Directive requires IORPs to be managed on a prudential basis[3] and specifically only allows IORPs to use derivatives for containing risks instead of taking risks and managing the IORP in a more efficient and effective way[4]. Currently, only collateral in the form of variation margin is exchanged with counterparties in order to mitigate the counterparty risk following from a value change of a derivative contract.

3.2 IORPs present very low counterparty risk

IORPs are long-term investors which are conservatively managed, highly creditworthy and with very low or nonexistent leverage. As explained above, IORPs engage in long dated derivative instruments to hedge their long-term liabilities limiting like this their investment risk. In addition, and contrary to other financial institutions, IORPs are not leveraged at all or are to a very limited extent and exclusively for liquidity purposes and on a temporary basis[5]. Moreover, regulations both at EU and national level set out an extensive set of rules regarding their solvency and liability coverage ratios of the IORPs. For these reasons, amongst others, IORPs are highly creditworthy, and the theoretical bankruptcy risk of an IORP is very limited. The IORP would however be able to further mitigate such risk by, for instance, the funding and/or backing from its sponsor company and other available tools such as pension protection funds and benefit reduction mechanisms.

EMIR recognises the potential adverse effects of EMIR on IORPs
"(…) technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners. During a transitional

[3] Article 18 (1) (b) of the IORP Directive (2003/41/EC) imposes the obligation to invest in assets to ensure the "security" of the portfolio. Article 18 (1) (f) requires IORPs to have a diversified portfolio.
[4] Article 18 (1)(d) of the IORP Directive (2003/41/EC) explicitly establishes that "investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management
[5] Article 18 (2) of the IORP Directive (2003/41/EC) prohibits IORPS from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.

period, OTC derivative contracts entered into with a view to decreasing investment risks directly relating to the financial solvency of pension scheme arrangements should be subject not only to the reporting obligation, but also to bilateral collateralisation requirements."
Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (4 July 2012)

3.3 Unintended consequence of EMIR could be increased risks for IORPs

The implementation of EMIR could lead to substantially higher execution costs for IORPs. The main reasons are the fees to counterparties, higher costs in execution and managing the IORP (also administration and communication) and loss of return on (cash) collateral, which will yield less than other assets as well as the negative impact on the liquidity management of the IORP as a whole (i.e. the need to hold more cash than economically needed, including a reduced ability to match assets and liabilities). It could also disincentivise market risk management of liabilities and balance sheets because of these higher costs, thereby increasing the risk in balance sheets, liabilities and underfunding. It may also lead to higher liquidity risk and a liquidity squeeze since more high quality liquid assets will be needed as collateral for derivatives transactions. This could negatively impact long term assets allocation (i.e. LTI) due to the switch to more liquid assets in order to comply with EMIR requirements. It is also important to note that not all OTC derivatives will be suitable for central clearing. Indeed, some IORPs need to hedge their risks/investments through customized transactions that currently CCPs are not able to offer.

3.4 Recognition of special position of IORPs translated via exemption from the clearing obligation of OTC derivatives

EMIR granted a 3 year exemption period starting August 2012 to IORPs from mandatory clearing to provide CCPs enough time to find an alternative for cash variation margin which is currently the only way to fulfil the variation margin obligation. IORPs are fully invested which means that in principle no cash pool is available to post as variation margin. Cash variation margin would make IORPs highly dependent on the repo market or other forms of collateral formation. It is uncertain whether these markets are still accessible and liquid in times of stress when liquidity is needed most. Nowadays banks use the repo market for funding, but Basel III and shadow banking regulations are likely to restrict the future use of the repo market. This makes it doubtful banks will provide liquidity to the repo market under all circumstances. Therefore, one of the only possible mitigations to IORP (over)reliance on the repo market would be for IORPs to have access to ECB funding. An extension of the exemption would thus be needed and justified, if there is no solution to avoid the undesired consequences for IORPs after this 3 year exemption period.

3.5 Consider special features for IORPs when adopting risk-mitigation techniques for non-centrally cleared OTC derivatives

EMIR Level I text has satisfactorily recognised the particular features of IORPs when granting them a temporary exemption from the clearing obligation for OTC derivatives. Such recognition should be extended to the risk-mitigation requirements for OTC derivatives not cleared through a CCP. This would be fully compatible with the EU objective of implementing internationally agreed minimum standards, while taking into

account the specificities of European financial markets[6] reflected in EMIR. IORPs would ideally not be subject to initial margin requirements, since it is contrary to the current business practice in which the low risk profile of IORPs is adequately reflected. IORPs should also be offered the possibility to provide a wide range of assets as collateral due to their limited access to cash collateral (see above) and in order to ensure that there is sufficiently available collateral to all market participants. Moreover, concentration limits for collateral should not apply to certain instruments widely used by IORPs, such as corporate and government bonds, for which liquidity is lower in distressed market conditions. Furthermore, IORPs should not be forced to rely exclusively on external credit ratings for the assessments of the credit quality of collateral, nor should they be penalised for using them. Proper regulation of the credit rating agencies would be more efficient and cost-effective way to monitor the adequacy of rating models. Finally, posted collateral should be held by a third party custodian in segregated accounts and not be rehypothecated or reused in order to ensure an adequate protection of the IORPs in case of a defaulting counterparty.

3.6 Is current implementation acceptable for IORPs?

As becomes clear from the reasoning provided above, this means that the temporary exemption for IORPs from EMIR applies to derivatives which are used to decrease risks. But the following questions remain essential:

1. Does the market propose fit for purpose clearing solutions that meet the needs of IORPs?
2. Are other measures possible to mitigate the negative impact on IORPs?

3.7 General concerns of the OPSG

Before going into details on the impact of the EMIR regulation on IORPs, the connection to other European legislation, especially the IORP Directive needs to be taken into account in this respect. The OPSG realises that some of its concerns are beyond the control of EIOPA and the other ESAs.

The OPSG strongly encourages the European Commission, together with EIOPA, EBA and ESMA to find solutions for the following issues:

<u>1. The European Commission should prevent the negative spill-over of regulations</u>. Both IORP and EMIR aim to lower financial risk, thereby causing double safety nets, which in the case of IORPs has the adverse effect of creating little additional safety at the expense of higher costs and the creation of severe liquidity risk for IORPs.

<u>2. The European Commission should solve the issue of conflicting regulation</u>. The new and future IORP Directive will most likely lead to additional risk management, while EMIR will be penalising the use of derivatives for risk management in the form of higher costs and extra requirements. There is an inherent tension between these two objectives.

<u>3. European Commission, ESMA, EBA and EIOPA should recognise the position of IORPs and the adverse effect of EMIR on IORPs</u> and EMIR has a

[6] This is explicitly previewed on page 4 of the 2014 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.

possible negative impact on (future) pensioners in the form of lower, less secure benefits and/or higher contributions due to high initial margin requirement which do not reflect the low default risk of IORPs that pose low counterparty credit risk).

3.8 Market experiences of IORPs in preparation to EMIR

Some IORPs have started negotiations with clearing brokers in order to gain experience and further insight in how the clearing landscape evolves. Based on first experiences in the market from different pension participants, the low risk characteristics of IORPs are not taken into consideration. IORPs are treated like, for instance, highly leveraged hedge funds. In addition, IORPs are being penalised by the margining policies of CCPs and Clearing Member (CM). First of all, CCPs continue to exclusively accept cash as collateral for variation margin, which was the basis for granting an exemption for the clearing obligation to IORPs. Moreover, CMs want to have the right to claim for 1.5-2 times the initial margin requirement of a CCP within short notice and at their sole discretion. Also, a CCP can ask for a multiplier due to large directional derivative position. This leads to excessive demands for collateral by clearing brokers in total disregard of the low-risk character of IORPs as well as the natural directional directive position. The required liquidity buffer for an IORP to be able to meet all obligations even in times of stress will be smaller due to the fact that part of it will already be posted as initial margin. This will mean that the liquidity buffer will need to be raised which leads to lower investment returns: IORPs have to sell assets to create cash, which will lower the return of the IORP since cash has a lower expected return than other assets.

3.9 Exemption has real value but has not started running yet

The European Commission and ESMA should link the three year exemption period for IORPs to the start date of mandatory clearing (expected to end 2014 at the earliest); the exemption period already started but has no function yet. A further extension of the exemption is necessary when undesired consequences for IORPs are still not addressed, thus until all issues with cash variation margin are solved. It is only after a full three-year initial exemption from an enforced clearing obligation, that the adverse effects on IORPs should be evaluated, the efforts and possible solutions identified by CCPs assessed, and for the European Commission to decide to further extend the exemption.

The OPSG would like the exemption period at least for the margining requirements to be prolonged until an acceptable solution for IORPs has been found especially for the following items: fully segregated accounts, a solution for cash variation margin, and the guaranteed return of specific collateral posted. An increased willingness and capacity of CCPs to find solutions together with IORPs would speed up the process.

3.10 Possible measures to mitigate impact of EMIR on IORPs

Apart from market solutions to be negotiated between CCPs, CMs and end users other measures could be helpful in mitigating the impact on IORPs and recognising the low risk characteristics of providers of pension scheme arrangements. The OPSG would like to propose several possible ways to mitigate the impact on IORPs.

Providing direct access to the ECB as a lender of last resort would enable IORPs to fully mitigate liquidity risk. Under article 85 paragraph 1 point (a), (d) and (e) it is stated that the Commission shall assess:

1. The need for any measure to facilitate the access of CCPs to central bank liquidity facilities
2. The efficiency of margining requirements to limit procyclicality and the need to define additional intervention capacity in this area
3. The evolution of CCPs' policies on collateral margining and securing requirements and their adaptation to the specific activities and risk profiles of their clients

Direct access to CCPs. For sizeable IORPs which would be recognised having a low risk profile, direct clearing at CCP level should be made possible. Currently, highly creditable IORPs have to access the balance sheets of lower rated commercial banks for clearing, which imposes extra risks. In economic terms it makes no sense that a leveraged and low rated bank is guaranteeing a high creditworthy IORP towards a CCP. This guarantee in combination with the use of the CM's balance sheet makes the current clearing infrastructure unnecessary expensive.

Direct access to CCPs would mean that the legislation would provide for a two-tier system of clearing membership, in which it would be possible for IORPs to become clearing members, however without the requirement of bidding on portfolios of transactions of defaulting clearing members. This would also help to solve the dependency of an IORP on commercial banks for central clearing and addresses the objectives of FSB with respect to shadow banking issues.

The development of Indirect Client Clearing. This could be one of the possible ways in which the regulator can ensure that smaller parties will also be able to get and maintain access to CCPs, at reasonable costs. However, indirect client clearing is not yet adequately developed, as there are still important legal, security, and operational challenges that would need to be addressed.

Fully segregated accounts. CCPs should develop and provide fully physically segregated clearing arrangements which protect IORPs' assets, as they are part of their investment portfolio, from the default risk that arises from sharing the account with other members. No tested solutions are yet available. In particular, CCPs exclusively offering segregation based on the Legally Separate, Operationally Commingled ("LSOC") model, such as those CCPs based in the US, do not provide the structural protections given by individually segregated accounts and could eventually lead to the abuse or negligent collection of collateral by clearing members. It should be noted that Article 39 of EMIR stipulates the legal obligation for CCPs and clearing members to offer clients the possibility to choose between omnibus client segregation and individual segregation.

Solution for cash variation margin. The possibility for posting non cash variation margin should be made possible in legal and regulatory terms, which up to now is not the case.

Guaranteed return of specific collateral posted. The CMs claim not or barely to be able to guarantee to return the same collateral (same ISIN) to the client that the client had delivered to them. For IORPs, CCPs should redeliver the same collateral as posted.

3.11 OPSG Conclusions

The EMIR legislation was adopted in August 2012. Not all obligations and rules introduced by EMIR have entered into force yet. There are still issues on the table and the impact on IORPs is one of these. EMIR granted a 3 year exemption period to IORPs from mandatory clearing, but this has barely been effective. The intended effect, i.e. the creation of a fit for purpose clearing environment for IORPs, has not been observed in the markets yet. Neither have the markets seen the introduction of alternative measures which would mitigate the impact of central clearing on IORPs.

Given the procyclical effects of the EMIR margining requirements together with the punitive margining policies of CCPs and CMs on IORPs' liquidity profiles, IORPs should be given access to the ECB. Alternatively, CCPs should be encouraged to recognise the low risk characteristics of IORPs in their margining policies in order to avoid the creation of unnecessary risk and costs for the pension sector. The OPSG is convinced that EMIR allows the ESAs and the European Commission to implement a risk-based approach in imposing margin requirements on different kinds of counterparties. The OPSG wants the exemption period for IORPs to be prolonged until acceptable solutions for IORPs have been found. More willingness and capacity of CCPs to find solutions together with IORPs would speed up the process.

4 IRSG Perspectives

4.1 IRSG Insurance Perspectives

European insurers benefit from the IORP exemption to a limited extent, namely in the case where insurance companies manage occupational retirement provision businesses (which in addition comply with certain conditions defined by EMIR, such as ring-fencing). Except for this limited application of the exemption, European insurers managing long-term savings and pensions products are not exempt from the clearing obligation under EMIR, which risks creating negative consequences on insurers' asset allocation. Insurers' main concerns are in the areas addressed below.

4.2 General concerns about EMIR and central clearing

While EMIR recognises that IORPs "typically minimise their allocation to cash in order to maximise the efficiency and the return for their policyholders", it fails to recognise that the same principle is also fully applicable to insurers managing savings and pension products. Because of the way that the exemption was defined in EMIR, its application to insurance companies is very limited and so not many insurers will be able to make use of it.

The insurance business model and the long-term illiquid profile of insurers' liabilities enable them to take a long-term view in their strategic asset allocation and hence to have a limited exposure to cash. At the same time, current practice indicates that central

counterparties (CCPs) will only accept cash as collateral and there is no indication that they will expand the acceptable collateral to other highly liquid assets, as allowed by EMIR. Against this background, European insurers managing long-term products risk being forced to either:

1. hold unnecessary amounts of cash (to the detriment of long-term investments),
2. perform forced sales of assets when cash is needed
3. monetise assets via the repo market
4. …or simply make less use of derivatives, which threatens the provision of long-term insurance products, for some of which derivatives are vital

Unfortunately, alternatives 2 and 3 encourage pro-cyclicality and threaten the significant counter-cyclical role that the insurance industry has traditionally played in periods of market stress. Looking ahead, the cumulative effect of regulation needs careful attention. For example, the ability to monetise the assets for covering cash needs may be further challenged by regulatory developments in the shadow banking discussions, where the introduction of controls and limits on the use of cash generated via repos is foreseen (FSB-Work Stream 5 in the shadow banking dossier). In Europe the ability to monetise assets for covering collateral needs has already been limited in the context of UCITS funds, where the use of repos for covering derivatives margin needs has been prohibited.

4.3 General concerns about forthcoming requirements in the OTC environment

The strengthening of the derivatives framework in an OTC environment should strike a balance between the need to mitigate counterparty risk and the potential economic risks and costs that could derive from the proposed measures. Excessive requirements for derivatives may result in an excessive cost of hedging financial risks, and therefore discourage hedging operations. Furthermore, any additional costs arising out of the margin requirements will, directly or indirectly, be passed on to policyholders. Therefore, every effort should be made to ensure that costs associated with non-centrally cleared derivatives do not become prohibitively high and eventually harm policyholders.

Under Solvency II insurers will have to hold capital to cover exposures to both OTC and centrally cleared derivatives. So in the case of insurers there will be two types of costs: 1) an indirect cost transferred by banks in the pricing of derivative and 2) a direct cost of capital to be held against derivative transactions. The insurance industry welcomed a number of provisions in the BCBS-IOSCO global work on margin requirements, in particular: 1) the introduction of a threshold and a trigger for initial margin and 2) the definition of a broad array of eligible collateral, which are both in line with insurers' derivatives management and business model. The global BCBS-IOSCO requirements are, to a very large extent, appropriately reflected in the ESAs' consultation paper. However, a number of areas in the consultation paper raise concerns for insurers from various perspectives, such as:

- Rules which are reflective of the banking business model and activity (e.g. regarding internal models for initial margin, haircuts or credit risk assessment)

- Requirements which generate significant operational and implementation burden and for which there is not a clear benefit in terms of risk reduction/transparency

4.4 Other concerns

In addition to concerns purely related to derivatives management in the central clearing and the OTC environment, insurers also have concerns regarding:

- Existence of restrictions placed on assets backing liabilities in a number of European jurisdictions.
  Insurers are aware that potential restrictions on insurance companies exist in some European jurisdictions, where assets backing policyholders' liabilities cannot be pledged as collateral for margining purposes. In such cases, insurers would therefore need to hold additional assets to pledge as collateral. Insurers consider it important that EIOPA and the European Commission encourage the elimination of any such restrictions.
- Insurance derivatives, for which clarification would be needed that they are not in the scope of EMIR. Insurance derivatives are a means by which reinsurers take over global risks (as an alternative to traditional reinsurance contracts). While traditional reinsurance contracts are linked to the policy owner's proof of loss, insurance derivatives are linked to other payout triggers (eg physical-parametric triggers – earthquake/ storm intensity). The underlying of insurance derivatives is insurance event risk (e.g. risk of loss from natural catastrophes) which itself is not traded in the capital markets and for which therefore no transparent and continuous market pricing exists. This lack of traded underlying makes it difficult to build-up synthetic hedge positions from traded financial instruments and thus prevents the creation of a derivative market which is disconnected from the holding of insurance risk. As insurance derivatives are used predominantly for risk management purposes by holders of insurance risk, their systemic knock-on effects and hazard for financial stability are minor. Due to their special characteristics and difference to financial derivatives insurance derivatives should not be classified as derivatives according to EMIR.

EIOPA should aim to advise the European Commission on this topic and, in order to establish legal certainty, there should be a clarification from the European Commission that insurance derivatives do not fall under the scope of EMIR. The relevance of this issue for the European insurance industry is high, since five of the ten largest reinsurers are located in the European Union.

4.5 Detailed comments regarding the ESAs' consultation on OTC derivatives

The following areas have been identified by insurance companies as areas of concern and/or areas where additional clarification and thinking is needed from the ESAs:

Phase-in implementation of requirements (regarding variation margin)

- The current phase-in proposals with a starting date of December 2015 do not properly respond to the operational challenges that insurers will face: the new requirements will demand important resources from insurance companies at operational, legal, reporting levels

- Given prior experience with the EMIR reporting, the current deadline for introducing variation margin exchanges from December 2015 is very aggressive
- Collateral exchange requires de-facto agreement between the counterparties on the daily valuation of derivatives positions. Under EMIR's reporting requirement, this field was explicitly moved from the Common Data table (to be reconciled between counterparties) to the Counterparty Data table (no reconciliation with the counterparty). Given the high likelihood of disputes, this adds a significant overhead to the EMIR reporting process as well.
- The time is not enough to set up neither the operational processes required nor the information exchange with counterparties.
- Given that final rules on central clearing are still outstanding and likely to remain unclear for some time, the beginning of the phase-in period should be pushed well beyond 2015. Rules on non-centrally cleared OTC products should start being phased-in well after (eg 24 months) rules on central clearing have entered into force to allow for central clearing experience to be reflected in the OTC environment. This would allow the development of sound and robust processes.

Use of internal models for initial margin (IM) and haircuts

- The requirements focus on aspects and requirements of the banking sector and do not cater specificities of insurance business model
- While insurers welcome the possibility to develop internal models for IM/haircuts calculation, in practice the use of IM models by insurance companies will be very limited
- The standard schedule, which is the alternative to internal models, is very punitive and is a clear indication of the fact that encouragement of internal models is sought by ESAs
- In the case where insurers will rely on internal models developed by banks, they will still have to assess, according to the consultation, the reliability of this model. It's not clear how this will be done in practice as this should theoretically require a high level of transparency from the banking side

Provisions around the use of credit ratings

- The use of an internal model for credit risk assessment is not common outside the banking sector (which is also confirmed by references to the CRDIV in the consultation). The IRSG should make a clear remark in this area and highlight that insurers do not have the resources, nor the expertise to develop internal rating models. Insurers (even the very large ones) make use of external credit ratings and have in place additional risk management tools based on which risk assessments are made.
- In the ESAs consultation (*Article 3 LEC – Credit quality assessment*) there is a differentiation being made between eligibility of collateral:
- When assets have a credit risk assessment based on an internal model they are eligible to be used as collateral when they have a credit quality step (CQS) of 3 or above
- When assets have a credit risk assessment based on an external provider they are eligible to be used as collateral when they have a CQS of 2 or above

- Therefore financial market participants, such as insurance companies using externally provided credit risk assessments, are penalized
- In the case where an internal model, provided by the banking counterparty would be used, it's not clear how the insurer will have access to information as this could be considered as material non-public information and therefore the banking counterparty would probably not disclose it

Provisions regarding concentration limits

- Provisions regarding concentration limits are too prescriptive and restrictive and add significant operational overhead
- In particular, the IRSG advocates for the elimination of concentration limits applied to EU government bonds
- Where the collateral portfolio is small as part of overall assets (which is likely to be the case for many insurers) achieving the prescribed diversification is impractical and unnecessary
- Concentration limits would cause operational issues with no added value
- RTS should define high level principles allowing for a practical and workable implementation, avoiding prescriptive rules with direct operational burdens / costs

Intra-group exemptions

- A number of provisions that would need to be fulfilled by insurance companies managing intra-group derivative transactions were defined in the consultation
- According to EMIR, exemption from collateralization of intra-group transactions can be granted if (among other things) there are no legal impediments to the prompt transfer of own funds or repayment of liabilities.
- The draft RTS provide in Art. 3 para.1 IGT – Practical or legal impediment – as follows:

  "A legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No. 648/2012 shall be deemed to exist where under the laws applicable to counterparties, or under the contractual relationship between the counterparties, or between a counterparty and a third party, there are any current or anticipated restrictions including (a) currency and exchange controls, (b) regulatory restrictions, (c) restrictions stemming from insolvency, resolution or similar regimes, (d) current or potential limitation on the ability of a counterparty to promptly transfer own funds or repay liabilities when due between the counterparties."
- The reference to laws of general applicability in lit.c and d, such as insolvency rules, may lead to the consequence that only very few transactions, if any, will benefit from the exemption, because these legal concepts exist in all jurisdictions. It is therefore appropriate to take only those legal restrictions into account, which have a concrete impact. This could be achieved by adding the following sentence to Art. 3 para.1 IGT: "For this purpose, restrictions shall be deemed current or anticipated, if concrete restrictive actions or effects materialize or are imminent to materialize."

  This approach would be consistent with comparable situations in the field of bank regulation, where the criterion "absence of material impediments to the transfer of own funds or repayment of liabilities" is a prerequisite for supervisory exemptions , e.g. supervision of certain banking entities on a group-basis only (cf. Art. 67 Directive 2006/48/EC and Art. 7, 113 EU Regulation 575/2013, CRR).

Interaction between EMIR and Solvency II (Delegated Acts) should be considered

- Solvency II defines capital requirements for covering derivatives' counterparty risk; there is however no difference being made between OTC and centrally cleared derivatives, although EMIR recognises that risk in central clearing environment is lower than risk in OTC environment
- Solvency II also defines an adjusted value of collateral that is used in derivatives trading; the adjustment works similar to a collateral haircut; there is however no interaction between the 2 approaches and there is therefore a risk of double counting

4.6 IRSG Bank Perspectives

Concentration Limits

In terms of concentration limits, most banks are happy to accept securities from IORPS and insurers, and all parties will need to figure out how to manage any concentration limits. However, it is important to note that at least from a bank standpoint, securities do not fund at the same rate as cash. Therefore, at some point the present value of swaps collateralized with securities is not the same as the present value of swaps collateralized with cash, which may one day impact swap pricing and valuation. For variation margin, the economics may suggest it may be much better for parties to convert securities to cash and post this as variation margin, rather than retain the flexibility to post securities and absorb the present value change that this may imply. For initial margin the analysis is different, and securities may make more sense, mainly because of the non-rehypothecation and segregation rules around cash, which means it earns a negligible return.

Uses of Internal Models vs Standardised Margin Levels

Swap counterparties are permitted to use internal models to value margin requirements. In terms of verification of each counterparties' model output, for a variety of reasons it seems likely that there will never be any mutual disclosure of proprietary models between banks, IORPs and insurers. In terms of alternatives, the global swaps market is faced between (a) everybody using their own proprietary black box models without any effective right to dispute the resulting valuations or margin calls (which may not work in practice at all), (b) using the standard initial lookup tables from WGMR (which is very expensive and may make swaps uneconomic), or (c) developing some type of common standard initial margin model, i.e. SIMM.

Impact on Non-EU Entities

Essentially all non-EU entities would have to post margin under the draft RTS. Banks propose that a non-EU entity should be exempt from the margin requirements if: (i) it would not be an FC or NFC+ if established in the EU; (ii) it is below the EUR 50 million or 8 billion threshold; or (iii) it is a sovereign or a central bank. This proposal is consistent with the BCBS-IOSCO paper issued in 2013.

Collateral Requirements

The eligibility requirements, concentration limits, credit quality assessments and limits on wrong way risk are too rigid and detailed. Generally, they should be replaced with more flexible criteria that can be reviewed on an ongoing basis by regulators. Specific

examples include imposing a 50% concentration limit on sovereign debt as collateral (this is excessive because many markets rely heavily on sovereign debt as collateral), and also specifying that collateral issuers will be viewed as part of one group if they share "close links" (which can mean as little as 20% shared ownership) for purposes of the concentration or wrong way risks. Determining who has "close links" will be extremely difficult in practice. Collateral concentration limits should be eliminated, at least, in the case of EU government bonds and bonds from other selected jurisdictions.

Intragroup Exemptions

First, the draft RTS should include a general intragroup exemption for IM. If intragroup transactions do not meet the relevant conditions under the draft RTS, then the relevant risks would be sufficiently addressed if the affiliates post VM. Second, the rules should have a transitional exemption for cross-border intragroup trades while the Commission is making equivalence determinations. Third, "practical and legal impediment" should be defined as a material, affirmative prohibition on payments because a broader definition, such as the one currently proposed, would apply to virtually any intragroup transaction.

Rehypothecation

Broadly, banks do not agree with the approach taken by IOSCO/Basel in their 2013 paper on rehypothecation. Although banks understand the reasons for an outright ban, banks do not agree with an outright ban. Rehypothecation is an important liquidity tool, and when properly managed and controlled can offer benefits to the financial system. Banks recommend that EU officials work to develop a better EU approach, which is one that serves the protection of clients and encourages the safe clearing of derivatives. The key points on the calculation, segregation and use of initial margin with respect to rehypothecation are:

- In the calculation of initial margin, cross margining should be permitted. Specifically, if there is a position that offsets the uncleared derivatives exposure (the position may be from a cleared derivative or from another type of transaction altogether) then it should be possible to consider that in the calculation of the initial margin.
- Segregation of initial margin should be optional – it’s for the benefit of both counterparties if segregation is an option (that the client can opt for) rather than the introduction of mandated segregation. The rehypothecation provisions would then only apply if the client opted for segregation. This the regime currently in place in the US.
- There should not be a full or effective ban on rehypothecation. Rehypothecation is very important for generating client financing. The ESAs should take a pragmatic approach to the provisions as they are currently unworkable.
- In any event, for all of the above, there should be global consistency in the application of the BCBS-IOSCO provisions. If the US takes a pragmatic approach and Europe does not, there will be an unlevel playing field. If Europe waits for the US to implement the rehypothecation provisions and then follows with its implementation, a more practical and globally consistent approach may be achieved.

Exemption of Securitisation Swaps

Central banks and policy makers are calling for a revival of Europe’s securitisation market. The European Commission’s March 2014 Communication on Long-Term

Financing of the European Economy explicitly noted the ability of securitisation to "unlock capital resources, increasing the ability of banks to expand their lending and finance economic growth." The regulatory treatment of securitisation in Europe is complex and under review. However, while there have been significant positive changes, there is a risk that the final rules do not allow the market to flourish. Representatives of key sectors of the economy – including the car industry, small- and medium-sized enterprises (SMEs) and mortgage lenders – fear that new regulation will reduce their access to capital and raise the cost of financing. The current proposals for the treatment of Securitisation Swaps under EMIR risk having that negative effect.

The key issue of concern for securitisation Swaps is the lack of any special provisions exempting a securitisation issuer (the Issuer) and the swap counterparty from the requirement to post collateral, similar to those which apply for covered bonds swaps under Article 3 GEN. Similarly to IORPs, securitisation special purpose vehicles (SPVs) use (OTC) derivatives to manage the risks in their balance sheet and liabilities, by hedging. Most European securitisations utilise some forms of interest rate, currency or basis swaps to smooth cash flows for investors and to mitigate certain risks within the securitisation structures. The draft RTS does not contain any special provisions in relation to Securitisation Swaps. If a securitisation issuer is a NFC+ (or a third country entity), then unless the exemptions in Article 2 GEN are applicable, both the Issuer and the swap counterparty will be required to post margin. This is a problem because SPVs, because of how they are structured, are fully invested and (like IORPs) do not have free cash or other assets available (or access to such cash or other assets). This could, in certain circumstances, prevent a securitisation from taking place because in order to achieve the high credit ratings required (typically, AAA), all interest, basis and currency risks of the securitisation issuer must be hedged. This could create a severe hindrance to the recovery of the European securitisation market.

In addition, imposing such additional collateral burdens is unnecessary because of the structural protections – both for the securitisation Issuer and for its swap counterparty - which are already a feature of Securitisation Swaps. Securitisation swaps already contain several risk mitigation features.

- Firstly, to protect the securitisation Issuer from the counterparty credit risk of the swap counterparty the swap counterparty is required to have a specified minimum credit rating and to post collateral, replace itself or procure that its obligations are guaranteed by a suitably-rated third party in the event of any downgrade of the swap counterparty.
- Secondly, to protect the swap counterparty from the counterparty credit risk of the Issuer, the swap counterparty becomes a secured creditor of the Issuer and ranks at least pari passu with or senior to the senior noteholders (typically AAA). The swap counterparty also benefits from a mechanism providing for the return of any collateral (net of the mark-to-market) it has provided to the securitisation Issuer (see above) following a termination of the swap.

Accordingly, the risks on which EMIR focuses are already addressed in securitisation structures. These risks are very similar to those which apply to swaps entered into in

connection with covered bond transactions. Yet securitisation swaps do not benefit from a similar exemption. This creates an "unlevel playing field" for securitisations compared with covered bonds, even though both are important funding tools for the real economy. We therefore call for a more flexible interpretation of the primary text as we believe there is scope within the EMIR framework to provide for special rules for posting collateral in relation to securitisation swaps, without undermining the underlying objective of EMIR.

There are also other concerns which affect securitisation swaps. These are (a) that all Issuers established outside the EU would be required to post collateral (even where they would be classified as NFC-) as if they were established in the EU, (b) the impact of the phase-in of the initial margin requirements, (c) the impact of the RTS on existing transactions, (d) the requirements for initial margin to be segregated, and (e) the requirement for express agreement between the parties to disapply various requirements in the RTS.

Foreign Exchange Swaps

Banks as foreign exchange dealers broadly agree with the ESA consultation paper's recommendation to follow the IOSCO/Basel recommendations regarding foreign exchange (FX). The RTS acknowledges that a specific treatment of certain products may be appropriate. This includes, for instance, physically-settled FX swaps, which may not be subject to initial margin requirements". Also, "accordingly the BCBS and IOSCO agree that standards apply for variation margin to be exchanged on physically settled FX forwards and swaps in a manner consistent with the final policy framework set out in this document and that those variation margin standards are implemented either by way of supervisory guidance or national regulation.

In terms of initial margin, the banks recommend that physically-settled FX forwards and swaps should be exempted from any regime which requires the exchange, collection or posting, of initial margin between transacting parties on a mandatory basis. Further, the market for such products should not be split based on tenor for the purpose of applying any such requirement. In terms of variation margin, the replacement cost risk associated with physically-settled FX forwards and swaps is appropriately mitigated today. Variation margin requirement for these products should be required as a result of supervisory guidance or national regulation.

Conflicts of Law

To certain law firm market participants, it is not clear whether there is any conflict of insurance law whether, in the event of the insolvency of an insurer there is a conflict between the rights of derivative collateral holders and the rights of insurance policyholders. A confirmation by EIOPA that there is no conflict of law is requested.