EIOPA-IRSG-15-15

IRSG Response to JC 2nd Consultation Paper on Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

Executive Summary

The EIOPA Insurance and Reinsurance Stakeholder Group (IRSG) strongly supports the goals of strengthening systemic resiliency in the non-centrally cleared derivatives market by establishing risk mitigation techniques and margin requirements in accordance with the requirements of Regulation (EU) No 648/2012 ("EMIR"). In order to assist with the implementation of these requirements, we set out below our responses to the questions raised by ESAs and raise other issues. Where appropriate, we suggest specific changes to the text of the Draft RTS.

General Remarks

IRSG welcomes some of the changes that have been introduced in the updated draft of this RTS, such as the alignment of provisions related to the use of external credit ratings vs use of credit ratings based on internal models (Art. 3 LEC). This gives recognition to the fact that market participants, such as insurance companies, for whom the development of credit ratings models is not

part of their core business model, are not penalised for making use of external credit ratings instead.

However, IRSG would like to reiterate its concerns related to the practical implementation of EMIR. EMIR may potentially have a severe negative impact on insurers as in practice it appears that central clearing counterparties (CCPs) accept only cash as collateral. This risks forcing insurers to either hold higher than optimal amounts of cash, perform forced sales of assets when cash is needed or monetise assets via the repo market to cover collateral needs. All these options are not ideal and risk incentivising insurers to take a pro-cyclical behaviour in periods of market stress when, like most other market players and in constrast to their traditional role, insurers will be looking for liquidity. From this perspective the stakeholder group believes that the practical implications of EMIR will be opposite to the main goal of what EMIR tries to achieve, namely to decrease systemic risk. The IRSG also reiterates its concerns on the treatment of insurance derivatives. Insurance derivatives represent an alternative to traditional reinsurance contracts and are usually linked to other payout triggers than the policyholder's loss (e.g. weather statistics). 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.

The following issues are particularly important:

Timing: The proposed timing for collection of collateral is too short.

Model: The use of risk sensitivities should be a clear option (as an alternative to assigning derivatives to asset classes) for the initial margin model.

Compliance: Cash should be eligible as initial margin if protected from insolvency of the collecting party.

Haircut: The Draft RTS should be clearer in stating that the 8% currency mismatch haircut does not apply to cash initial margin or cash variation margin.

Cross-Border: The Draft RTS needs to accommodate trades with non-netting jurisdictions and to recognize the equivalency of the margin requirements of other jurisdictions.

In terms of securitisation swaps, securitisation swaps should be treated in a similar way to swaps connected with covered bond transactions for the purposes of the Draft RTS. Accordingly, the Issuer should not be required to post initial or variation margin to the Swap Counterparty. Where a securitisation contains certain structural features which provide for effective risk mitigation, the circumstances in which the Swap Counterparty is required to post collateral, and the amount of collateral which the Swap Counterparty is required to post, should be modified.

Answers

Q1: Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

We welcome the change in the treatment of Non-EU NFCs.

Q2: Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.

As a general comment in relation to the delivery of initial and variation margin, IRSG agrees with the recognition that, to maintain international consistency, specific treatment of certain FX products may be appropriate and supports the treatment of FX contracts under the proposed risk management procedures.

Collecting Cash Variation Margin (VM)

The phrase "settling exposures in cash" in Art. 1 VM (2)(a) should be replaced with the phrase "exchanging cash in amounts sufficient to extinguish exposures". The current language is not a correct general description of VM transfers for OTC derivatives because the transfer of cash VM does not necessarily settle current exposure. This change should also be reflected in Recital 11 (p.19).

Timing

We are concerned that the Consultation Paper does not allow enough time for collection of Initial Margin (IM). The Consultation Paper provides that VM will be collected within 3 business days of collection but only if IM is collected and there is an adjustment to the margin period of risk. (pp. 31 – 32, (3) – (6)) The Consultation Paper also provides that IM will be collected within one business day of the execution of a new OTC derivatives contract.

A period of at least 3 business days is needed between trade date (adjusted for time zones) and collection of IM and VM. The Draft RTS needs to allow sufficient time for time zone issues and for the call and collection of collateral.

Time Zone Issues: Many market participants enter into swaps marked to market in multiple regions. An example would be an entity trading AUD IRS, JPY IRS, EUR IRS and USD IRS, or cross-currency swaps. The products will be marked in their respective time zones, for example Sydney close, Tokyo close, London close and NY close. The variation margin call will be the netted amount of the change in value of all of the contracts, and so can only be calculated once the last time zone of the trading books in the entity have closed (which would be NY in the example above). The calculation will then be available to the operations team of each of the market participants on the business day after

trade date. For the margin call to be agreed between two market participants, both operations teams must have performed the calculation.

For example, consider an Australian financial counterparty (with risk below the IM threshold) with a EUR trade versus a European financial firm. Based on Monday's closing value, the European participant will issue a margin call to the Australian firm on Tuesday at say 8am CET. However, the Australian firm will be outside office hours for Tuesday and only able to agree the call on Wednesday a.m. Sydney time. Although this example focuses on a specific cross-border trade, as explained above financial firms are generally "cross-time-zone" by virtue of products traded and it would be difficult to segregate trades subject to potential time-zone issues from those not.

Call: The call requires the calculation and reconciliation of collateral, both of which will require time, especially for market participants managing a global book of transaction. For IM, data reconciliation prior to calculation of the margin call would facilitate the process and reduce the likelihood of dispute on the basis of differences in portfolio.

Collection: The Consultation Paper envisions a range of collateral types, which, as set out in Art. 1 LEC (p. 38), includes debt securities issued by Member States and non-Member States governments, central banks, regional governments and PSEs, and equities included in a main index. The settlement cycles of these assets vary between same day (for example, cash) and T+2 (equities – [tbc]). If a market participant envisions using non-cash collateral, it must ensure sufficient unencumbered collateral is available in anticipation of a margin call. Additionally, the settlement location of the collateral may be different to the jurisdictions and office hours of the market participant meeting the margin call.

Q3: Respondent are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models.

A. Use of Risk Sensitivities or Classification into Asset Classes

Suggested Language:

In Art. 4 MRM (1), (p. 35), third sentence: "Initial margin models may account for diversification, hedging and risk offsets within (a) the risk sensitivities related to the ~~same underlying~~ asset class referred to in paragraph 2 ~~and not across such asset classes~~; or (b) the asset classes referred to in paragraph 2 but not across such asset classes."

In Art 4 MRM (3), (p. 36): "The total initial margin requirements for a netting set shall be the sum of initial margin requirements calculated either (a) for each risk sensitivity for ~~the~~ OTC derivative contracts or (b) for the OTC derivatives assigned to each underlying asset class within the netting set."

Explanation:

These changes are needed to clarify that the IM model may either calculate sensitivities to the relevant risks or assign each derivative contract to an asset class. The Explanatory Note at p. 35 explains that assigning each derivative to an asset class, instead of calculating sensitivities, could have the drawbacks of being more restrictive than the BCBS-IOSCO framework, substantially increasing IM, and requiring changes in operational processes. Nonetheless, some parties may wish to assign each derivative to an asset class, as originally proposed by the ESAs, and the option to do so has been retained in the proposed language.

B. Implementation period following recalibration of 90 Days subject to extension

Suggested Language:

Art. 3 MRM (8) (p. 34):

Counterparties shall establish procedures for adjusting margin requirements in response to changing market conditions. These procedures may allow each counterparty to post the additional initial margin resulting from the recalibration of the model over a period that ranges between one and ~~thirty~~ ninety business days (or longer in times of financial stress, subject to regulatory review.)

Explanation:

The longer time period for additional IM is needed to allow market participants to fund additional demands for IM. These amounts are potentially very significant, especially at time times of financial stress in the markets. A 30 day limit could have procyclical effects by increasing stress on market participants during times of financial disruption. In addition, following recalibration, market participants will need to adjust their infrastructure by, for example, updating the data used as input for the models. It is therefore critical that parties have at least 90 days to respond to recalibrations and that the 90 day period may be extended at times of financial stress. Moreover, the timing of any increase in IM in periods of financial stress should be subject to the discretion of regulators, acting on a coordinated global basis, who may determine that a phasing-in of an IM increase is more prudent.

C. Allow use of correlation between unsecured exposure and collateral:

Suggested language:

Art. 5 MRM (2) (p. 36): Currently: "Counterparties shall estimate the initial margin to be collected without taking into account any correlations between the unsecured exposure and the collateral."

Explanation:

This could have adverse consequences: for example, for a euro swap collateralized by euro for which IM is calculated in USD, this section will not recognize the correlation of 1.

D. Quarterly back-testing

Suggested Language:

Art. 5 MRM (4) (p. 37): … The performance of the model shall be monitored on a continuous basis; this analysis shall include a comparison between the risk measures generated by the model and realized risk measures ('back-testing') as prescribed by the relevant regulator every three months.

Explanation:

The requirements for quarterly back-testing by an entity should be determined by the applicable regulator as part of its overall supervisory responsibilities. This regulator is best placed to determine what type of back-testing is appropriate for a specific entity.

F. Recalibration Triggers

Suggested Language:

Art. 6 MRM (6) (p. 37): "Counterparties' procedures shall describe ~~clearly identify~~ what results of the back-testing shall result in remediation ~~trigger a recalibration~~ of the model.

Explanation:

The procedures need to be flexible to cover the wide range of possible results from back-testing. Recalibration should be required only when the model does not adequately cover the relevant risks.

G. Explanatory Note, p. 33 and Recital (6)

The text suggests there is no counterparty credit risk if the counterparty has bought an option and paid for it upfront. But the text states that the counterparty should collect VM, which in practice will mean the immediate return of the premium as collateral (as the exposure value equals the premium). The option seller now has counterparty risk again – if the value of the option decreases (through changes in either spot or volatility), then the option seller has counterparty credit exposure because of the variation margin.
It is not correct that a sold option position (in the presence of VM) has no counterparty credit risk. It has counterparty credit risk in the same way as all other derivatives. Once VM is exchanged, the net value of the option plus the VM is approximately zero. And this value can go up though market movement, which creates counterparty credit exposure.

H. The model should incorporate interest rate risk factors corresponding to all foreign currencies.

Suggested Language:

Art. 5 MRM (3)(b) (p. 36): " … the model shall incorporate interest rate risk factors corresponding to the individual ~~foreign~~ currencies in which the OTC derivative contracts are denominated …

Explanation:

It is not clear what is meant by "foreign currencies" in this context and the model should address interest rate risk factors for all currencies.

Q4. Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

IRSG welcomes the relaxation of concentration limits for government debt. The IRSG believes that the new proposal is appropriate and in the spirit of the BCBS-IOSCO global requirements and therefore urges the ESAs not to revert to a more restrictive approach on the use of government debt as collateral.

A. Collateral threshold of EUR 1 billion is to be calculated on a bilateral, non-consolidated basis

Suggested Language:

Art. 7 LEC (2) (p. 43) should be: "The risk management procedures shall provide that the collateral collected from an individual counterparty in excess of EUR 1 billion shall meet the conditions in paragraph 4 where each of the counterparties belong to one of the categories listed in paragraph 3."

Art. 7, LEC (3)(c) (p. 44) should be "… counterparties, for which the total amount of initial margin to be collected by the counterparty itself (and not ~~or~~ from counterparties belonging to its group) from an individual counterparty exceeds EUR 1 billion."

Explanation:

These changes clarify that the EUR 1 billion threshold is calculated on a bilateral, non-consolidated basis. A netting set for purposes of the RTS is a "group of transactions between an institution and a single counterparty …"[1] and therefore the EUR 1 billion should be determined based solely on OTC derivatives between two individual counterparties.

B. De minimis: no concentration limits for counterparties posting less than EUR 100 million

Concentration limits should not apply to parties that have less than a specified amount of margin. As the first Consultation Paper (14 April 2014) pointed out (p. 38), if concentration limits apply to small amounts of margin, the posting party would need to diversify into multiple smaller lots which could pose significant operational burdens relative to the size of the collateral and exposure. In addition, the liquidity considerations that concentration limits are designed to mitigate are not applicable to small portfolios because the liquidation of small amounts of margin should not have a significant impact on the market. For these reasons, IRSG suggests that the concentration limits would not apply to a counterparty that has collected less than EUR 100 million from any individual counterparty.

[1] Article 272(4) of Regulation (EU) 575/2013, which provides the definition of "netting set" for the Draft RTS under Art. 8 GEN, (2)(e) (p. 30).

Q5. No response.

Q6. Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.

IRSG welcomes a delay in the phase-in schedule from December 2015 to September 2016. This was very much needed for implementation and operational purposes and is in general welcome. However, the IRSG had argued in the past that the application date of OTC rules should come in after application of central clearing requirements, to allow for at least a 24 months experience in the central clearing environment to be used in the OTC case – this is still not the case as there is no clear alignment between OTC and central clearing requirements.

Suggested Language:

Article 1 SEG (p. 48)

1. Collateral collected as initial margin shall be segregated from proprietary assets of the collecting counterparty on the books and records of a third party holder or custodian, or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty, third party holder or custodian. Such requirements to segregate the collateral from the proprietary assets of the collecting counterparty are satisfied where the collateral is held in an account in the name of the posting counterparty and is secured in favour of the collecting counterparty. The arrangements will also protect collateral other than cash from the default or insolvency of the~~,~~ third party holder or custodian.

2. Where the collateral is held by the collecting party or by a third party holder or custodian on behalf of the collecting party, t~~T~~he collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties ('individual segregation').

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

4. The segregation arrangements shall ensure that the initial margins are available to the posting counterparty in a timely manner in case the other counterparty defaults.

5. A counterparty shall perform an independent legal review ~~at least on an annual basis~~ in order to verify that the segregation arrangements meet the requirements referred to in paragraph~~s~~ 3 ~~and 4~~ and always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

Art. 2 LEC (1)(d) (p. 39):

(d) cash accounts in all the acceptable currencies are maintained with a party other than the collateral provider for depositing cash collateral collected as initial margin and for crediting the proceeds of repurchase agreements on the collateral (and such cash accounts may include accounts maintained by a custodian in the name of the posting party);

Art. 2 LEC (1)(g) (p. 40):

(g) the collateral shall be transferable without any regulatory or legal constraints or third party claims, including those of the liquidator of the collecting counterparty or third party custodian (other than liens for fees and expenses incurred in providing the custodial accounts);

Explanation:

A. Cash should be eligible as IM if protected from insolvency of collecting party

Article 1 SEG (1) requires that IM is protected from the default or insolvency of the third party holder or custodian. It is not possible to achieve this in respect of cash as the return of the cash is inherently linked to the solvency of the third party holder or custodian acting as banker.

As proposed, the Draft RTS requirement that cash be protected from the default or insolvency of the third party holder has the effect of prohibiting cash from being posted as eligible IM. We note that cash is the first asset listed in key principle 4 of the BCBS IOSCO framework for margin requirements for non-centrally cleared derivatives (the "BCBS IOSCO framework") and the background discussion describes cash as one of the most liquid top-quality assets. Cash provides vital liquidity if securities are not available for posting. Cash can also be quickly and easily transferred to remedy collateral deficits or as a substitute for other assets that the posting party needs returned.

The margining requirements are designed to remove counterparty credit risk (rather than custodial risk) in line with the G-20 mandate. Key principle 5 of the BCBS IOSCO framework requires that IM should be held in such a way as to protect the posting party from the collecting party's bankruptcy and vice versa. Protecting the posting party from the default of the collecting party may be achieved by segregating cash IM from the proprietary assets of the collecting party. Neither the G-20 mandate nor the BCBS IOSCO framework envisage protecting margin from custodian related risk even though the BCBS IOSCO framework specifically envisages the use of third party custodians as a method to protect IM. Consequently this should not be introduced as a requirement now, particularly if it has the effect of limiting the ability to post cash as IM.

Possible custodian credit risk mitigants

If the ESAs are of the view that custodian default risk in respect of cash must be mitigated, the RTS could instead impose one or more of any of the following:

(a) a requirement that cash held at a custodian is treated like a government bond issued by the home country of the custodian (for purposes of the haircut and concentration requirements);

(b) a credit quality assessment requirement on the custodian;

(c) a requirement that cash IM above a threshold is split between more than one custodian to reduce the impact of the insolvency of a custodian; or

(d) a requirement that the custodian is not an affiliate of the collecting party (which would have synergies with the US requirements).

B. Types of IM Arrangements and suggested clarifications to Article 1 SEG (2) and (3) and Art 2 LEC (1)(d)

Explanation:

IRSG notes that two IM structures could be considered, which are: (a) the 'direct' model (described below) and (b) holding the IM in a custody account in the name of the posting party and securing the contents of such account in favour of the collecting party (referred to below as the 'alternative model').

Under the direct model, the IM is held in the name of the collecting party. The IM is usually held in an account at a third party holder or custodian acting on behalf of the collecting party (although in respect of securities this is not necessary for compliance with the Draft RTS). However, we expect that in many (or even the majority of) cases, the IM will not be provided under the direct model. Instead the IM will be provided under the alternative model.

Under the alternative model, the IM securities will remain with the posting party and legal title will never pass to the collecting party prior to foreclosure. The IM cash will also be held in an account in the name of the posting party that is charged in favour of the collecting party (subject to the proposed requirement that cash IM must be re-invested to remove custodian risk if that requirement is retained).

Article 1 SEG and Article 2 LEC (1)(d) of the Draft RTS appear to have been drafted primarily with the 'direct' model in mind. We suggest the changes proposed above so that these provisions also address the 'alternative model'.

Q7. Does this approach address the concerns on the use of cash for initial margin?

In the area of intra-group transactions the IRSG continues to believe that it is necessary for the RTSs to include a specific definition of "current or foreseen restrictions" which could read as: "Restrictions shall be deemed current or foreseen if concrete restrictive actions or effects materialize or are imminent to materialize". The element of materialization is important to allow for an appropriate reflection of the EMIR intention, including recognition of the fact that collateralisation rules for intra-group transactions may limit the efficiency of the transaction from a risk-management perspective.

Q8. Respondents are invited to comment on the requirements of this section [standard haircut to market value of collateral] concerning treatment of FX mismatch between collateral and OTC derivatives.

As was mentioned in the response to Question 2, IRSG agrees with the recognition that specific treatment of certain FX products may be appropriate and supports the treatment of FX contracts under the proposed risk management procedures.