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Northern Trust



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European Supervisory Authorities
c/o European Banking Authority
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Second 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

Dear Sir or Madam:

State Street Corporation, The Bank of New York Mellon Corporation, and The Northern Trust Corporation (the “Custody Banks”) appreciate the opportunity to comment on the second consultation paper issued by the European Supervisory Authorities¹ (“ESAs”) on their 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 (the “draft RTS”).²

Collectively, the Custody Banks hold over \$63 trillion³ in assets under custody and administration (approximately 43% of the over \$147 trillion global custody market)⁴, and expect to be significant providers of custodial accounts for segregation of initial margin for uncleared swaps under the draft RTS.

¹ The European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA)

² <http://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf>

³ As of March 31, 2015, State Street Corporation had \$28.5 trillion in assets under custody and administration; The Bank of New York Mellon Corporation had \$28.5 trillion in assets under custody and administration; and The Northern Trust Corporation had \$6.09 trillion in assets under custody.

⁴ Based on assets under custody of the top 20 global custodians: BNY Mellon, State Street, JP Morgan, BNP Paribas, Northern Trust, Mitsubishi, BBH, Societe Generale, CACEIS, UBS, Six SIS, Royal Bank of Canada, US Bank, Sumitomo, SEB, Santander, Nordea, National Australia Bank.

The Custody Banks are supportive of global efforts to address systemic risks in the OTC derivatives markets, including the ESAs' current initiative to adopt risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP. We are particularly supportive of provisions of the draft RTS which ensure segregation of posted collateral, a function where the Custody Banks play an important role.

Our comments today focus on our ongoing concerns with the treatment of cash collateral under the draft RTS. While we appreciate and support the important change adopted by the ESAs under Article 1 REU (2) of the draft RTS, which permits cash collateral to be reinvested in other eligible collateral upon agreement between the two counterparties to the swap, the draft RTS still needs further clarification to ensure that cash collateral may be posted by counterparties under third-party custodial arrangements. Absent such changes, the Custody Banks are concerned that they may not be able to provide the segregation services envisioned by the ESAs.

Need for cash accounts in third-party custody arrangements

As acknowledged in the final Basel/IOSCO agreement on margin for uncleared derivatives,⁵ “the use of third-party custodians is generally considered to offer the most robust protection” for collateral posted in uncleared derivatives transactions. While not mandated by the ESAs' draft RTS, we expect the use of third-party custodians will be the preferred alternative for protecting collateral posted by counterparties under the final RTS. Unfortunately we are concerned that the draft RTS will make such third-party custody impractical (or impossible), essentially forcing posting counterparties to accept segregation arrangements offered by the collecting counterparty.

Third-party custody arrangements must have the capacity to accept all types of eligible collateral agreed to by the counterparties, both cash and non-cash. In addition, such arrangements must be structured to accommodate other cash flows connected to the posted collateral, such as dividends received, proceeds from repayment of principal from maturing bonds, and proceeds of repurchase agreements. A custody arrangement necessarily must be able to maintain holdings of both securities and cash, even in cases where cash collateral itself may not be present.

While securities are financial assets that are always held off balance sheet in bankruptcy remote custodial accounts, cash is treated differently. Cash is placed on deposit with the custody bank, or reinvested in a suitable asset upon agreement of the counterparties. This treatment of cash is common to all custody arrangements, including mutual funds, pension funds, etc., and is not limited to the swaps margin accounts that are the subject of the draft RTS.

We note that the posting of cash with a collecting counterparty also will result in credit risk to a bank. Industry practice is for collecting counterparties to place cash on deposit with a bank, either a third-party bank or the collecting counterparty itself. Deposits placed with the collecting counterparty, like deposits with custody banks, will result in credit exposure to the bank accepting the deposit. But deposits placed with the collecting counterparty do not have the additional security of a tri-party custody agreement, where the custody bank will only move assets upon proper instructions in circumstances agreed between the counterparties, rather than at the discretion of just one counterparty.

⁵ <http://www.bis.org/publ/bcbs261.pdf>

This treatment of cash is well understood in the financial markets, and users of third-party custody arrangements manage cash accordingly. Such custodians are banks subject to the highest prudential standards, including those for leverage capital, risk-weighted capital, liquidity, large exposures/credit concentration limits, stress testing, living wills, and resolution planning. In addition, institutional investors generally minimize cash left on deposit, both to manage credit exposure to the custody bank and to generate higher yields than is available on custodial deposits. Custody banks have an interest in minimizing such deposits as well, due to the negative impact of such deposits on the bank's leverage ratio and other regulatory limitations.

Concerns with draft RTS and recommendations

As an overall matter, we are concerned that the draft RTS fails to properly accommodate the third-party custody business model, and seems to assume that conditions imposed on segregation by collecting counterparties can be applied without adjustment to third-party custodians. It is important to note that the third-party custodian is not a party to the trade, and has no economic interest in the derivative contract. The custodian's sole purpose is to provide safekeeping of posted collateral. The custodian's actions are dictated solely by the direction of the counterparties subject to the rules prescribed in the custody agreement, and it has no discretion over the collateral. Assets held by the custodian under a tri-party custody agreement, whether cash or securities, are bankruptcy remote from both the posting and collecting counterparties. The ability of the custodian to protect the interests of both counterparties under the contractual custody agreement is one of the key factors in making third-party custody the preferred option for many collateral posters.

The Custody Banks are concerned that the draft RTS does not adequately account for the important difference between cash and non-cash posted to third-party custody arrangements, potentially making such third-party custody impossible.

For the use of third-party custodians to be practical under the ESAs' planned final RTS, the standards must allow the custodial arrangement to include both a bankruptcy-remote securities account and a cash deposit account with the custody bank.

In particular, the Custody Banks urge the ESAs to clarify that cash posted with third-party custodians may be placed on deposit with the custody bank. Since such deposits necessarily result in credit risk to custodians (except when insured under applicable deposit insurance requirements), we also recommend that the ESAs require posting and collecting counterparties to manage such credit risk by, for example, availing themselves of the option under Article 1 REU (2) to reinvest cash collateral in other eligible assets.

Our specific concerns and recommendations on these issues, as well as several suggested technical corrections, follow below.

1) Clarify that cash accounts will hold all cash flows connected to posted collateral

Article 2 LEC (g) of the draft RTS requires risk management procedures of the collecting counterparty to ensure that cash accounts are maintained to accept “collateral collected as initial margin and for crediting the proceeds of repurchase agreements on the collateral.”

As noted above, cash flows connected to posted collateral could result from numerous sources in addition to the two referenced in Article 2 LEC (g), including dividends paid on held securities, payouts of principal on maturity of bonds, or other sources. The cash account in the collateral arrangement must be able to accept cash from any of these sources. As a result, we recommend Article 2 LEG (g) be amended as follows:

*(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 all cash flows related to non-cash collateral.** ~~and for crediting the proceeds of repurchase agreements on the collateral;~~*

2) Require the swaps counterparties to manage credit risk resulting from a bank holding cash collateral

The Custody Banks acknowledge that the credit exposure resulting from placing cash collateral on deposit with a custodian should be managed by swaps counterparties. Generally, the management of such credit risk will be accomplished by reinvestment of cash collateral in other eligible collateral, as is common practice today, and is permitted by the revision of Article 1 REU proposed by the ESAs in the second consultation on the draft RTS, or by other means, such as deposit “sweeps” from the custodian to other banks⁶. We suggest such risk management be addressed in the final RTS, through a new section added to Article 2 LEC, as follows:

(new) Appropriate management of credit exposure resulting from holding of cash collateral on deposit with a third party custodian, including through prompt reinvestment of such cash in other eligible assets, as permitted under Article 1 REU (2), or other means.

3) Clarify that cash maintained by third-party custodians may be placed on deposit

As described above, cash, whether posted margin or operational cash flows, held in third-party custody arrangements is placed on deposit with the custody bank. The draft RTS does not clearly reflect this practice, and fails to distinguish between the treatment of cash held by a collecting counterparty and cash held by a custodian. As a result, we suggest Article 1 SEG (3) be amended as follows:

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

⁶ Note that Article 52 of UCITS IV requires comparable management of cash deposits

collected in cash and maintained by a third party custodian, it shall be placed on deposit with the custodian.

4) Clarify that cash may only be reinvested by the custodian at the direction of the counterparties

New Section 2 of Article 1 REU helpfully permits cash collateral to be reinvested in other eligible assets upon agreement of the counterparties. This provision is consistent with current market practice, and will allow counterparties to minimize their credit risk to the custodian or collecting counterparty.

For a custodian, such reinvestment would involve facilitating the reinvestment of cash on deposit into other eligible securities. A custodian, however, would only do so at the direction of the swap counterparties, and not at its own discretion. We suggest clarification of the directed nature of the custodian's duties, as follows:

2) initial margin posted as cash can be re-invested by the collecting counterparty ~~or custodian~~ (or the custodian, at the direction of the collecting counterparty) only for purposes of protecting the collateral poster, and subject to an agreement between the counterparties. The re-invested collateral shall be treated in accordance with Articles 1 LEC and 1 SEG [segregation and eligibility].

5) Clarify differences between cash and non-cash collateral

As described above, the treatment of cash and non-cash collateral differs considerably under traditional custodial arrangements. In several instances, the draft RTS applies concepts suitable to non-cash collateral (i.e. securities) to all collateral, including cash. We suggest the draft RTS be amended to correct these inappropriate references, as follows:

A) Article 2 LEC (g) –

Section (g) of Article 2 LEC requires collateral to be transferable without regulatory, legal, or third-party constraints. This concept is entirely appropriate for securities collateral, but not consistent with cash placed on deposit, where the collateral holder is a general unsecured creditor of the bank. As mentioned above, the presence of such credit risk has led the Custody Banks to recommend a specific provision in the RTS requiring counterparties to manage such risk. The requirement of Section (g), though, should be limited solely to securities collateral, as follows:

(g) All securities collateral should 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.

B) Article 1 SEG (1) –

Similarly, Section (1) of Article 1 SEG would require all collateral to be held in a manner which protects the collateral from default or insolvency of the custodian. As described above, cash held in third-party custody arrangements necessarily creates credit exposure to the custodian. Such exposures should be managed by the counterparties, but cash (either margin or operational) cannot be accepted by the custodian if no such credit exposure is permitted. Article 1 SEG (1) should be amended to read:

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

Conclusion

Once again, the Custody Banks appreciate the opportunity to comment on the draft RTS. We strongly support the mandatory segregation of margin with independent custodians, but are concerned the draft RTS still needs further clarification to ensure that cash collateral may be posted by counterparties under third-party custodial arrangements. As a result, we strongly urge the ESAs to clarify the treatment of cash margin, as described above.

Please do not hesitate to contact the undersigned with any questions:

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Respectfully submitted,



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