German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

On ESAs' Second Consultation Paper on the 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

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A. Structure of our response/terminology

Our key observations and concerns are summarised in **Section B.I**. Our responses to the questions classified as mandatory in the response section for the Consultation have already been directly entered in the relevant fields – we have nevertheless included them in this document in **Section B.II** for the sake of completeness.

Section B.III contains some further comments on individual provisions of the draft RTS and the Annexes.

Terms used hereinafter which are defined in EMIR shall have the meaning ascribed to them under EMIR. One exception is the term "counterparty/ies" which – for the purposes of our comments – is intended to mean any party to a transaction, regardless of its status under EMIR (thus covering financial counterparties, non-financial counterparties (subject or not subject to the clearing obligation), third country counterparties equivalent to financial or non-financial counterparties and parties which do not qualify as non-financial counterparties, i.e. because they are not an undertaking).

B. Comments

I. Introduction and summary of key observations and concerns

The German banking industry welcomes the opportunity to comment on the Consultation Paper of European Supervisory Authorities (Consultation Paper) on draft regulatory standards (draft RTS) on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of regulation (EU) No 648/2012 (EMIR) with draft regulatory technical standards (draft RTS).

We continue to support the central objective of the draft RTS, namely to extend the use of margining as means of risk mitigation, including mandatory margining in certain circumstances for certain types of counterparties. This ultimately reflects the developments in the derivative markets over the past few years: The reciprocal collateralisation, usually on the basis of standard collateral annexes to the various master agreements for derivative transactions,[1] has already become more and more prevalent in the market.

We also fully agree with the approach to base the future regime for margining requirements under EMIR on the international minimum standards for margining requirements in respect of non-centrally cleared derivative transactions as defined by the BCBS-IOSCO Framework for margin requirements for non-centrally cleared derivatives (BCBS-IOSCO Framework): In view of the international nature of the markets it will be of paramount importance to have margining regimes in the various jurisdictions which are as closely aligned as possible in order to ensure safe and functioning financial markets and to prevent diverging or even conflicting regimes. In addition, only consistent and non-conflicting margining regimes prevent competitive disadvantages and regulatory arbitrage. Of course, in this context, close coordination between regulatory authorities with a view to a consistent implementation of the standards will be as important as the regulatory rules implemented.

[1] For example, the Credit Support Annex (CSA) to the ISDA Master Agreements or the Collateral Addendum (Besicherungsanhang) to the German Master Agreement for Financial Derivative Transactions (Deutscher Rahmenvertrag für Finanztermingeschäfte).

We further very much welcome that the draft RTS follow the revised general timeline proposed by the amended BCBS-IOSCO Framework for a gradual introduction of margining requirements beginning from 1 September 2016.

Having said this, it needs to be pointed out that despite the revision of the implementation timeline the introduction of mandatory margining requirements will be extremely challenging for all market participants for a number of reasons.

II. Responses to questions marked as mandatory

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

- **Clarification of the personal scope of the obligations in relation to third-country counterparties – Articles 2 and 3 GEN**

Under Articles 2 and 3 GEN of the revised proposal for the draft RTS the obligation to exchange variation and initial margin will exist in relation to third-country counterparties

- only where these third-country counterparties are equivalent to financial counterparties (FC) or non-financial counterparties above the clearing threshold (NFC+) established in the EU and
- in the same manner as in relation to FC and NFC+ established in the EU; that is subject to the same exemptions, thresholds and phase-in timeline.

Consequently, an FC or NFC+ would not be obligated to exchange variation and initial margin with any third-country counterparty which would neither be qualified as FC nor NFC+ had it been established in the EU; for example with a counterparty equivalent to a non-financial counterparty below the clearing threshold (NFC-) or a counterparty which does not even qualify as non-financial counterparty (NFC) because it is not an undertaking (non-undertaking).

We very much welcome this clarification of the personal scope of application of the obligation in relation to third country counterparties. We share the assessment that this limitation of the scope of the margin requirements helps to ensure a greater international consistency and therefore prevents regulatory arbitrage as well as severe competitive disadvantages for European market participants.

- **Alternative processes to post collateral – Recital 8**

Recital 8 of the draft RTS addresses the issue of the legal enforceability of the collateral arrangements not being sufficiently certain under the legal framework of a particular jurisdiction. According to this recital, the addressees of the obligations would be obligated to identify alternative processes to post collateral under these circumstances. The recital itself mentions the possibility to rely on third parties situated in another "safe" jurisdiction. In the public hearing, the possibility to elect the application of the laws of other jurisdictions was mentioned as a further example. In addition, it was explained that more specific provisions had not been included intentionally in order to give the market participants some flexibility to implement alternative processes.

We welcome this approach and indeed believe that market participants will need some discretion in order to address any unforeseeable legal challenges which they may face when trying to implement collateralisation arrangements in various jurisdictions, in particular third country jurisdictions. However, this necessary room for discretion is currently addressed only in the form of a recital and is not reflected in any way in the regulatory provisions as such. To ensure that market participants indeed retain some flexibility in devising alternative approaches it would be helpful if the possibility were also explicitly addressed in the material provisions themselves.

Moreover, it should further be clarified that the examples for alternative approaches mentioned in Recital 8 and the public hearing (reliance on third parties and election of the laws of another jurisdiction) are not to be understood as limiting the scope of options available. This is because under certain circumstances the election of the laws of a certain jurisdiction and the involvement of third parties residing in jurisdictions which support the margin requirements alone will not be sufficient so that further discretion will be required to deviate from the requirements to exchange and segregate collateral.

Such further discretion to deviate from reciprocal collateralisation and segregation will specifically be required in relation to transactions with counterparties based in jurisdictions where effective segregation of collateral cannot be ensured and netting agreements are not (or not sufficiently) legally protected or recognised under applicable insolvency law. Here, the involvement of third party custodians situated in a netting and segregation supporting jurisdiction and/or the election of the laws and courts of such jurisdiction lone may not sufficiently safeguard the effectiveness of netting and segregation agreements in the case of an insolvency and an exchange of collateral may actually increase the risk exposure of the posting party rather than reducing it.

In such circumstances, alternative approaches should be permissible which go beyond the involvement of third parties and election of the laws and courts of supportive jurisdictions. Such further alternative approaches should include (without intending to limit the choice of other, effective alternatives):

- Reliance on third party guarantees securing the obligations of the relevant counterparty

- The introduction of a threshold amount for uncollateralised transactions for specific circumstances/jurisdictions/markets

- The introduction of exemptions from margin requirements for specific situations, such as transactions with counterparties from emerging markets

As to the specific challenges which may be caused by conflicting or not fully recognised or aligned margin requirements in cross-jurisdictional transactions, see immediately below.

In this connection we have the following additional comments and suggestions:

In the penultimate sentence of Recital 8, the word "and" should be inserted between "bilateral agreements" and "of the effectiveness of". Furthermore, we feel that the expression "guaranteed" in the last line of the Recital 8 may have unintended legal connotations. We therefore suggest the following alternative wording: *"....where those requirements can be met"*.

- **Treatment of cross-border transactions until recognition of equivalency – Articles 2 and 3 GEN**

There is currently no provision addressing the specific challenges arising in the situation that the third country counterparty may be subject to margin requirements under its regulatory framework which are similar, but not fully compatible, with the EMIR requirements and have not yet been deemed equivalent in accordance with Article 13(2) EMIR (and, conversely, have not yet been deemed equivalent by the regulatory authorities of the other jurisdiction). It may be impossible for the European counterparty to comply with both requirements as they are likely to be conflicting to some extent. Under these specific circumstances, it should – at least where both parties are subject to similar requirements based on the BCBS-IOSCO Framework – be permissible to apply the obligations unilaterally, that is to deviate from the general requirement to exchange collateral so that only one counterparty is required to collect collateral, consequently obligating only the other party to post collateral in accordance with the EMIR margin requirements.

- **Definitions/clarifications - Articles 1 and 2 GEN**

We note that Article 2 GEN uses the term "non-financial entity" in this context (distinguishing between third country-counterparties which are "financial entities" or "non-financial entities" equivalent to NFC+ on the one hand and "non-financial entities" which are not equivalent to NFC+). The term "financial entity" presumably is intended to capture entities which are equivalent to FCs as defined under EMIR (and "covered entities" under the BCBS-IOSCO Framework). However, the term is currently undefined, which may lead to uncertainties. It could therefore be considered to either include a clarification (perhaps in a recital) that this is meant to capture covered entities within the meaning of the BCBS-IOSCO Framework by incorporating a definition of "financial entity" and/or "third country financial entity" as well as "third country non-financial entity".

Although this can be construed from the context and the underlying objectives of EMIR, it should also be considered to include a clarification to the effect that the requirements also need not be applied in relation to counterparties which do not even qualify as NFC (such as non-undertakings or counterparties falling within the scope of Article 1(4) and (5) EMIR or equivalent thereto).

- **Procedural character of the obligations (no formal opt-out agreements) – Article 1 GEN and Articles 2 to 4 GEN**

We further welcome the fact that the revised draft RTS now underline the procedural character of the obligations, and, as one consequence thereof, no longer require the entering into formal agreements with each counterparty, even those not qualifying as FC or NFC+ (and equivalent third country counterparties), in order to be able to rely on existing exemptions from collecting and exchanging variation and initial margin. Rather, the addressees of the obligations (FC and NFC+) will be able to discharge their regulatory obligations by introducing internal procedures under which, for example, collateral arrangements are put into place in relation to those counterparties which have been identified as being FC or NFC+ and equivalent third-country counterparties, and in relation to other types of counterparties only on a discretionary basis and only to the extent and in the form this is deemed appropriate in view of the internal risk assessment. This approach to describe the obligations primarily as procedural without detailed formal requirements ensures that it will not be necessary to approach every single market participant with the sole purpose of formally agreeing on an opt-out from collateralisation (and the connected contractual documentation). This significantly reduces the burdens for the addressees

of the obligations as well as for the numerous market participants which are not intended to be captured by the margin requirements, and will help the market participants to concentrate their efforts on the – despite the extended implementation timeline – still extremely challenging task of developing the required new collateral documentation and the negotiation and agreement of these documents and the specific terms in relation to all counterparties falling within the personal scope within the prescribed time limits.

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

- **Definition of variation margin – Article 1(5) GEN**

The definition of variation margin (VM) refers to "outstanding contracts" and does not mention the fact that the positions may be covered by a netting agreement and thus combined to a single net position. Although this follows from context and the fact that netting agreements are expressly addressed in other provisions, it may be considered to clarify this in the definition as well.

- **T+1 requirement for IM – Article 1(3) EIM**

Currently, the settlement of margin calls by way of full title transfer and without having to observe the many of the additional requirements which are to be introduced with these RTS (such as a group-wide MTA and concentration limits) which will add considerable complexities to the collateral management, can generally only be accomplished within two to three days.

A shorter settlement period can currently only be observed in relation to cash collateral, such shorter period, however, regularly exceeding the T+1 timeline as prescribed and calculated in the current draft RTS.

Against this background, it will be next to impossible to observe the proposed T+1 time limit for the exchange of IM. For one, as a consequence of the segregation obligation, the exchange of IM will in the future have to be implemented by pledging securities (or similarly formal means), which alone adds additional processes and requires compliance with additional formal requirements. In many cases this will also involve a central securities depositary and thus observance of their specific requirements, standards and settlement cycles.

Moreover, the calculation of the margins can only be initiated after the necessary information has been gathered from different sources, which information would then first need to be processed and consolidated.

What makes the proposed T+1 requirement even more unrealistic is that this time limit is apparently intended to begin with the occurrence of the event triggering the margin call (thereby effectively constituting a T+0 time) without leaving time for taking into account the many operational steps which will need to be taken in order to allow for the calculation of the margins following such event and the additional complexities to be introduced with these RTS, such as the calculation of the MTA on group level and concentration limits, which will make the process of calculating and determining the margins to be exchanged even more time consuming.

We therefore strongly urge the ESAs to extend the timeline to up to three working days (T+3). The relevant time limit to be calculated as of the business day following the trigger event (the calculation date) in order to allow for the processing the information required for the calculation of the margin calls. In this connection, it will also be necessary to address the issue of differing time zones and business day concepts by clarifying that in such a case the later of the two times will be applicable between the parties.

We, of course, fully recognise that a time lag in the exchange of initial margin needs to be avoided to the extent possible. However, unrealistic time lines will necessarily only introduce new operational risks.

Finally, it should further be clarified that any breaches of the time limits, where these are not caused by the party in question (that is where the causes are outside of its sphere of influence, e.g. caused by the central securities depositary and their delivery periods etc.), do not constitute a breach of regulatory requirements by such party.

- **T+1 requirement for VM where no IM is required (Article 1(5) VM)**

The above mentioned concerns regarding the T+1 time limit for the collection of IM also apply correspondingly to the proposed T+1 time limit for the exchange of VM where no IM is required (Article 1(5) VM). This strict time limit also needs to be extended in order to avoid unintended consequences: Even under current practices and without any of the additional complexities which will be introduced with the RTS, it is a matter of fact that it takes more than one business day (counting from the margin call) to procure the settlement of a margin call (again disregarding the time it takes to determine the margin amounts in question) if non-cash collateral is to be posted, prominent examples being Japanese or Spanish government bonds. Even cash collateral regularly requires settlement periods which are longer than T+1. Therefore, it will be extremely challenging, if not impossible to meet the T+1 timeline for the exchange of VM even where the parties switch to cash collateral for all transactions and impossible to meet where securities are involved. We therefore strongly believe that the time limit under Article 1(5) VM should also be significantly extended. In addition, it will again be necessary to address the issue of differing time zones and business day concepts by clarifying that in such a case the later of the two times will be applicable between the parties.

- **VM amount – Article 1(1) VM**

The last sentence of Article 1(1) VM can be read to imply that the VM can only be the precise amount calculated in accordance with the provision. This would preclude the collection of any additional margin exceeding that calculation. Such a restrictive reading cannot be intended. This should be clarified by inserting the word "minimum" between "the" and "amount".

- **Application of the MTA when calculating VM and IM – Article 4(2) and (3) GEN**

Recital 10 addresses the possibility that counterparties split the minimum transfer amount (MTA) in two separate amounts for VM and IM, respectively (the total of which not exceeding the prescribed maximum of EUR 500,000). The provisions setting out the manner in which the amounts due are to be calculated when applying the MTA can, however, be read to preclude a direct application of such a split MTA on the level of the VM and IM amounts since they appear to foresee an application of the MTA only after calculation of the IM and VM amounts calculated in accordance with Article 4(2)(a) and (b) GEN. It should therefore be clarified that in the case of a split MTA, these can be applied already directly on IM and VM level, that is, when calculating the IM and VM amounts in accordance with Article 4(2) (a) and (b) GEN.

- **Application of group IM threshold – Article 6 GEN**

The provisions regarding the application of the threshold on group level do not clearly set out that this threshold is to be applied in relation to the own group and not the group of the counterparty, that is, each group is responsible for monitoring its overall exposure to a specific counterparty and have procedures in place in order to ascertain that the own group members observe the group threshold when entering into transactions with this specific counterparty. This could be clarified in a recital to avoid confusion.

In Recital 14 of the draft RTS we note that the threshold of EUR 8 billion for gross notional outstanding amounts does not refer to the group level. As this is inconsistent with other references in the Consultation Paper (for example in Article 6(1) GEN), we suggest to include such a reference to the group in Recital 14.

Furthermore, we appreciate the intention of the draft RTS to limit the operational burden of exchanging initial margin by allowing for a EUR 50 million threshold. However, we would like to emphasize that the application of the threshold on group level on the other side poses significant operational challenges which may in some cases mean that the option not to collect IM will be theoretical only since it will practically not be possible to apply the threshold within a group. We therefore suggest to introduce the option to choose an alternative approach to the application of the EUR 50 million threshold on group level, such as permitting the application of low, fixed thresholds on entity level (i.e. EUR 5 million per entity).

- **Communication of credit quality steps under IRB approach – Article 4(3) LEC**

Under Article 4(3) LEC the requirement to communicate to the other counterparty the credit quality step may have an unintended impact on the markets as such information can entail the release of sensitive information to the market. This is because approved internal IRBA rating models are based on a combination of public and non-public information. The relevant requirement thus should be reconsidered or amended to the effect that it does not entail the requirement to disclose sensitive/non-public information.

- **Calculation of notional amounts months to be observed – Article 7 GEN, Article 1 FP.**

The various provisions concerning the calculation of notional amounts refer to different months to be observed: Article 7(1) GEN (p. 53 of the consultation paper) for example refers to the months June, July and August of the previous year. Article 1(4) FP refers to March, April and May. From an operational perspective it would be helpful if these time periods would be aligned (that is, the same periods would have to be observed for calculation purposes).

- **Collateral Management/unused collateral – Article 2(1)(e) LEC, Article 1(1)(g) OPD**

Article 1(1)(g) OPD requires procedures for the timely re-appropriation of collateral in the event of default of the counterparty having collected it. However, we believe that this is intended to refer to re-appropriation of **unused** collateral, that is, only the excess left after close-out netting and application/realisation of the collateral in this connection. It would be helpful to clarify this.

- **Collateral Management/credit quality – Article 4(1) and (2) LEC**

Article 4(1) LEC refers to the credit quality of the collateral; Article 4(2) LEC, however, refers to the credit quality of the issuer. In order to avoid confusion, it appears to be more appropriate to refer to the credit quality of the collateral in both instances.

- **Applicable criteria concerning legal impediment to the prompt transfer of own funds and repayment of liabilities - Article 3 IGT**

Although we realise this is only indirectly connected to Question 2, we would nevertheless like to take the opportunity to address the issue of the provisions concerning the impediments to prompt transfers of funds, as they have a direct impact if and to what extent the margin requirements apply within a group. Due to the intended parallelism of Article 113(6) and (7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation, CRR) – 0% risk weight for exposures within a group and, thus, also no need to impose bilateral margin requirements for exposures within a group – we propose to include an express provision in Article 3 IGT to the effect that impediments within the meaning of Article 3 IGT can been deemed to be absent if and as long an approval has been granted by the competent authorities for the purposes of Article 113(6) or (7) of Regulation (EU) No 575/2013, respectively.

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

No comment.

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

Rather than any percentage based on concentration limits we suggest a risk based approach whereby the limits would only apply if margin exceeds certain thresholds. These thresholds could be calibrated as follows:

- Only apply the single issuer concentration limit where the margin requirement (IM+VM) is in excess of EUR 10 million

- Only apply the single asset class limit where the margin requirement (IM+VM) is in excess of EUR 50 million

- Only apply the government bond limit where the margin requirement (IM+VM) is in excess of EUR 1 billion

We further suggest including an express clarification – in order to comply with Article 6(1) LEC – receiving counterparties can rely on representations from a posting counterparty that the securities they are posting are not from entities to which they have close links. This is necessary as it would be very difficult if not impossible for a counterparty to make the necessary determinations and carry out an ongoing monitoring of their counterparty's group structure.

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

- **Written trading documentation – Article 2(1) OPD**

The term "trading documentation" is open to interpretation. We assume that this is intended to cover the contractual documentation setting out the general legal basis for the transactions to be concluded, namely the general framework for the margin requirements (including supplemental agreement) as well any netting agreement, but does not include the trade confirmation with the commercial details and sometimes further specific terms governing the specific transactions. This would reflect the established market practice of relying on standardised contractual agreements which address the general framework and key provisions (such as netting provisions and collateral annexes) and the use of trade confirmations to determine further details. The general framework (master agreement and collateral annex) is generally entered into in advance or on the conclusion of a transaction whereas the trade confirmations, by their nature, are issued subsequently following the agreement on the specific terms (which agreement can occur many forms, including by telephone). Consequently, a clear distinction has to be drawn between the general contractual framework which has to be in place in advance of or at the time of the conclusion of the transaction on the one hand and the trade confirmation which may cover additional terms but may only be formally documented following the agreement on a transaction on the other hand.

In this context we would like to make the following observations and suggestions:

- The use of the word "any" in Article 2(1)(a) OPD can be understood to mean that the relevant contractual documentation need to include provisions which cover every possible payment obligation which may arise under or in relation to a transaction and/or contractual relationship. Such an understanding would be incorrect since contractual documentation intents or is able to specify or cover all possible payments obligations which emanate or may emanate from a contractual relationship. In addition, this understanding would conflict with the above described situation that certain transaction specific terms, including payments, may be agreed and documented in the trade confirmation, and thus not already in advance of a transaction. The contractual documentation will only be able to cover the general or material terms and the general basis for the rights and obligations but not any and all rights and obligations. The term "any" should therefore be deleted. The above applies correspondingly to the use of the term "any" in Article 2(1)(e) OPD.

- The use of the term "written" in this context can be understood to preclude electronic messages and means of recording/documenting which. It should therefore either be deleted or replaced by a term with a broader meaning covering any form which ensures an adequate recording/documentation, including electronic records.

- **Independent legal review requirement – Article 2(2) OPD**

We note that Article 2(2) OPD sets out a requirement to annually perform an "independent legal review" regarding the (continued) legal enforceability of the netting agreements used.

We very much welcome the fact that the revised draft no longer sets out a requirement to obtain formal legal opinions. We further welcome the clarification made in the public hearing that the term "independent" is to be interpreted in accordance with the EBA response to Question No. 2013_23 in the

Single Rulebook Q&A process; thus including provision of qualified internal legal advice, i.e. from the legal department of the relevant counterparty.

The changes and clarifications made provide for the necessary degree of flexibility regarding the manner in which a legal review process can be implemented as part of and under the existing risk management systems and procedures of a counterparty.

For example, we assume that the independent legal review requirement can been deemed to have been met, where a counterparty has procedures in place which provide for a monitoring / regular assessment whether there have been any material changes in the relevant laws which may adversely affect the enforceability and validity of the contractual arrangements used, and where such material changes then trigger further steps which may include, for example, the obtaining of further legal advice and/or opinions.

In this context we reiterate the concerns already voiced in our comments on the first consultation paper over any requirement which can be understood to result in the need for a rigid annual review cycles (in particular annual update cycles for legal opinions). A rigid timeframe is not necessary and may actually be counterproductive. The focus should rather lie on effective procedures which ensure that potential material adverse changes in the legal situation are being noticed and adequately addressed. A formal legal assessment (and/or legal opinion update) should and can always only be one element of such procedures and should, as such, not be subject to a rigid timeframe.

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

- **Relation between segregation requirements and collateral management requirements – Article 1 SEG and Article 2 LEC**

Article 2 LEC appears to address some aspects which are also covered by the segregation requirements. One example is the requirement under Article 2(1)(c) LEC regarding insolvency or bankruptcy remoteness of initial margin maintained with the collateral provider. It is not entirely clear how these obligations covering similar or connected questions are to interact or which requirements prevail in the case of conflict. In particular all requirements addressing insolvency/bankruptcy remoteness need to be coordinated to avoid discrepancies or uncertainties. To this end, these should only be covered by one single provision.

- **Independent legal review requirement – Article 1(5) SEG**

The concerns already raised above in our response to Question 5 regarding the legal review requirement apply correspondingly.

In addition, we further refer to our concerns raised under Question 1 regarding the impact of legal uncertainty over the protection of netting agreements in a certain jurisdiction and the need to a greater degree of flexibility to permit alternative approaches such as exemptions from the reciprocity requirements and/or exemptions for certain jurisdictions. In any event it needs to be avoided that an addressee of the obligations is required to post collateral to counterparty in jurisdiction where the enforceability of netting and segregation is in doubt.

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

In particular taking into account the explanations made at the public hearing, we understand that cash collateral paid into an account will generally not qualify as being sufficiently segregated because the secured party generally only obtains a security interest in relation the claim for repayment against the bank – whether this is the secured party or a third party. In either case the repayment claim would be subject to a certain insolvency risk of the bank.

In order to nevertheless give counterparties the opportunity to rely on cash to post IM, Article 1 SEG does not prohibit the use of cash, but would, in conjunction with Article 1(2) REU, require that the cash is invested in securities which could then be segregated.

Although this of course indeed allows reliance on cash as collateral for IM purposes (albeit in a roundabout way) it has to be noted that this indirect manner of using cash to invest in "segregatable" securities will be operationally complex and time consuming so that the T+1 requirement which is already challenging under normal circumstances will be even more difficult to meet (see our comments on Question 2 above).

Furthermore, it should also be noted that reliance on cash for IM purposes is expected to be the exception because of the many disincentives and disadvantages. It is unlikely to be considered other than in very exceptional circumstances, i.e. where a counterparty is not able to procure securities which it could use as IM. However, in such exceptional circumstances, such as a market disruption, it will – in all likelihood – be equally difficult for the recipient of the cash to invest the cash in securities. In addition, more flexibility will be required in order to allow for the receipt of distributions and/or interest on collateral.

Against this background, it might be considered to provide for an exemption from the segregation requirements in respect of any distributions and/or interest on collateral as well as cash placed with a third party for a limited period of time in certain exceptional circumstances such as a market disruption. Such an exemption would be consistent with the BCBS-IOSCO Framework.

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

- **8% Haircut – Article 1 VM, Article 1 EIM/Annex II**

It is not entirely clear whether the 8% haircut addressed in Annex II (item 6) is only to be applied in relation to IM or also VM. This needs to be clarified both in the Annex as well as the substantive provisions.

In addition it needs to be explicitly confirmed that the haircut is only to be applied to non-cash (as it was clarified in the public hearing and which also follows from Recital). Such limitation of the haircut to non-cash collateral would correctly reflect the fact that cash is the most fungible of all collateral and thus should be exempt in its entirety from any FX haircut (currency mismatches should and will be accounted for when IM is calculated). Again, this should be clarified in the substantive provisions.

In this connection, since neither "termination currency" nor "transfer currency" are defined and the latter not being a concept generally used in the ISDA documentation we would assume that counterparties will

be able to determine the transfer and termination currency by agreement. Alternatively, it could be considered to only refer to the "termination currency".

III. Comments on individual provisions of the draft RTS

- Recital 8: In the penultimate sentence of Recital 8, the word "and" should be inserted between "bilateral agreements" and "of the effectiveness of". Furthermore, the term "guaranteed" in the last line of the Recital 8 may have unintended legal connotations. We therefore suggest the following alternative wording: "....where those requirements can be met".

- Article 1 CCP (currently placed between Article 4 GEN and Article 5 GEN) should be moved elsewhere because of its highly specific content and lack of direct connection to the previous and following provision. .

- Article 1(2) VM and Article 1(4) EIM contain references to sections 3 and 4 which should be replaced by references to section 6.

- Article 1(5) VM incorrectly refers to Section 1, Chapter 1 and fails to make a reference to Article 1(3) FP.

- Article 1(3)(a)-(e) FP should read either "that is above" or merely "above".

- Article 1(4) and (5) FP need to make reference to "paragraph 3" as opposed to "paragraph 1".

- Article 1(6)(a) FP incorrectly refers to "Paragraph 3(a)" instead of "Article 3(a)".

- Annex IV Article 1(3)(c) SMI should be set as a separate paragraph; the same applies to Article 1(3)(d)-(f) SMI.

- The definition of NGR provided for in Annex IV Article 1(3)(c) SMI would not be operational in the event of negative market values in a netting set resulting in gross replacement cost of zero and a NGR's denominator of the same value. Consequently, the NGR should be set to 100% if the gross replacement cost equals zero.

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