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BVI position 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

BVI[1] welcomes the opportunity to comment on the draft technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP.

BVI supports the aim by the G20 to regulate the derivative markets infrastructure and to require risk mitigation techniques for OTC derivatives not cleared by a CCP.

We support the ESA`s proposal that collateral requirements for initial margin should be applied only to key OTC derivative market participants with significant exposure to other counterparties above a minimum threshold of up to EUR 50 million. This will reduce the burden on smaller financial counterparties (including UCITS/AIF), while still achieving a sizable reduction in systemic risk. In this context, we fully share the view that the calculation for the minimum threshold of the initial margin for each investment fund (EUR 50 million) should be calculated on the basis of a single fund. This is consistent with European investment fund law (UCITS/AIF directives) according to which each investment fund managed by an investment fund management company is considered as a distinct entity.

Furthermore, we welcome the proposal that initial margins should not be collected with respect to physically settled foreign exchange forwards and physically settled foreign exchange swaps.

In order to reduce the costs of collateral requirements without compromising the objective of sound risk management, we are of the opinion that the ESAs should take into account existing European/national fund regulation law (UCITS and AIFM directives) which aims to mitigate counterparty (credit) risk arising out of bilaterally concluded OTC derivative contracts.

German investment fund management companies already apply concentration limits on collected collateral according to paragraph 43 (e) of the ESMA Guidelines on ETFs and other UCITS issues. We propose that UCITS and other regulated investment funds (AIF) should use the ESMA guidelines on concentration limits instead of being obliged to implement similar but not equal provisions laid down in the regulatory technical standards (RTS).

We would like to make the following specific comments:

Question 1. What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members currently handle assets of EUR 2.2 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. (BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.

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The implementation of the EMIR obligations either for OTC derivatives cleared by a CCP or the provisions for non-centrally cleared OTC transactions drafted in this regulation will increase the cost of trading, clearing and reporting for derivative contracts in the investment fund industry.

The implementation of the provisions for non-centrally cleared derivatives by the investment fund management companies involves various market participants (e.g. custodians, external collateral managers, counterparties, valuation service providers etc.) for which new legal and operational frameworks need to be implemented. The development of new legal and operational frameworks between the investment fund management companies and the market participants is complex and will therefore increase the overall cost along the entire value chain for non-centrally cleared OTC derivatives (e.g. trading, execution, exchange of collateral, legal documentation etc.).

Furthermore, the responsibility imposed on the financial counterparties to obtain and apply legal opinions in all relevant jurisdictions in the context of the segregation of initial margins will clearly increase the burden and the costs for investment fund management companies outweighing the benefits of such legal arrangements (please see also our comments to question 2). It is however difficult to quantify the costs of implementation of the proposed collateral requirements in more detail.

As a consequence, the costs for the proposed collateral requirements will reduce the performance of investment funds and will be borne by the institutional and retail investors, leading to a reduction in pension savings.

In order to reduce the costs for the envisaged collateral requirements without compromising the objective of sound risk management, we are of the opinion that the ESAs should carefully take into account existing European/national fund regulation which already aims to mitigate counterparty (credit) risk for bilateral concluded OTC derivatives. One alternative solution could be to apply for UCITS the cover rule below the threshold for initial margin instead of holding own capital by the investment fund management companies (please see also our answer to question 2).

In this context, we would like to mention that UCITS and other regulated investment funds are already subject to a tighter regulation than other market participants related to counterparty risk.

UCITS and other regulated investment funds have to comply with the following obligations relating to risk mitigation:

- The total counterparty exposure related to derivatives, security lending transactions and repurchase agreements is not allowed to exceed 10% of the investment funds value (Article 52 para 1 of Directive 2009/65/EC).

- The above mentioned exposure as well as any exposure arising from securities issued by the counterparty (e.g. bonds) and the default risk related to bank accounts maintained at the counterparty shall not exceed 20% of the investment funds total value (Article 52 para 2 of Directive 2009/65/EC).

UCITS and other regulated investment funds need to comply with further obligations regarding the restriction of the counterparty exposure (e.g. maximum leverage, cover rule (Article 51 para 3 of Directive 2009/65/EC), concentration limits regarding collateral).

All of the above mentioned risk mitigation measures already reduce and limit the risk of losses resulting from the default of a counterparty of an investment fund.

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If so, please provide the rationale for the concerns and potential solutions.

- **Usage of initial margin for regulated investment funds (UCITS/AIF): Recital 5 in conjunction with Article 2 para 3 GEN**

We strongly support the proposal made by the ESAs that the collateral requirements for initial margin should only be applied to key OTC derivative market participants with significant exposure to other counterparties above a minimum threshold of up to EUR 50 million. This will reduce the burden on smaller financial counterparties (e.g. UCITS/AIF), while still achieving the principle objective of a sizable reduction in systemic risk.

We fully share the view by the ESAs that in the context of the calculation for the minimum threshold of the initial margin at group level each investment fund (EUR 50 million) should be counted as a separate entity (recital 5). This is consistent with European investment fund law (UCITS/AIF directives) where each investment fund managed by an investment fund management company is considered as a distinct entity. Moreover, German regulated investment funds are not guaranteed, collateralized or supported by other investment fund or the management companies themselves and should therefore be considered in all market conditions as distinct entities, for example also in the rare case of the suspensions/redemptions of fund units.

Therefore, we expect that the exchange of the initial margin requirement shall only apply to an investment fund (UCITS, AIF) which exceeds the minimum threshold of EUR 50 million. Below this threshold, no initial margin needs to be collected or posted by the investment fund.

Article 2 para 3 GEN considers to exempt only counterparties from the initial margin requirements at group level as defined in Article 2 (16) of the EMIR regulation. In order to enhance legal certainty for all market participants (including UCITS/AIF) and to align the verification proposed in recital 5 for regulated investment funds, we propose the following amendments to Article 2 para 3 GEN:

3. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties may instead agree in writing or equivalent permanent electronic form with its financial or non-financial counterparties that where the total initial margin calculated to be exchanged for all non-centrally cleared OTC derivatives between counterparties at group level as defined in Article 2(16) ***and single UCITS/AIF as defined in Article 2 (8)*** *of Regulation (EU) No 648/2012 is equal to or lower than EUR 50 million, they may agree that no initial margin will be exchanged and that they will hold capital against their exposure to their counterparties.*

According to recital 3 and Article 2 para 3 GEN, counterparties have the possibility either to post/collect initial margin or to hold own capital if the amount of the initial margin is below the threshold.

UCITS are subject to the cover rule (Article 51 para 3 of Directive 2009/65/EC and CESR guideline/10-108, Box 28[2]). That means, they are only allowed to enter into derivative contracts which can be executed with the assets of the investment fund. Therefore, investment fund management companies

[2] http://www.esma.europa.eu/system/files/10_788.pdf

acting on behalf of the investment funds should not be obliged to hold capital against their funds exposure to their counterparties below the initial margin threshold. We expect that UCITS should be able to meet this requirement by complying with the cover rule which can be deemed as equivalent to holding own capital. In order to avoid any misinterpretation, the ESAs should clarify this situation in Article 2 para 3 GEN and recital 3 accordingly.

- **Segregation of Initial Margin and obtaining legal opinions: Article 1 para 2 and 5 SEG**

Article 1 para 2 SEG requires that the collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of the other posting counterparty. This proposal could create operational shortcomings and could lead to the situation that the collecting counterparty is not capable to handle the numerous individual accounts for investment funds. If for instance one investment fund management company manages 1,000 investment funds and uses 20 counterparties, the mentioned provision would lead to the consequence that 20,000 accounts are to be opened.

Furthermore, the responsibility imposed on counterparties (e.g. UCITS/AIF) to obtain and apply legal opinions (Article 1 para 5 SEG) in all relevant jurisdictions in the context of the segregation of initial margins will clearly increase the legal burden and the costs for investment fund management companies outweighing the benefit of such legal arrangements. Moreover, the requirement imposed on counterparties to obtain and apply legal opinions is not covered by Article 11 para 3 of the EMIR regulation.

Therefore, the ESAs have to evaluate whether the annual operation and legal costs related to initial margins (accounts, transfers, trustee agreements, legal opinions etc.) are justified in comparison to the bilaterally concluded OTC derivative volume and the aim to mitigate counterparty (credit) risk.

- **"Qualified Master Agreements" as alternative for exemption of initial margin: Article 2 new para 3 (a) GEN and Article 1 new para 1 (o) DEF**

According to the ESAs explanation, initial margins shall mitigate the risk of losses occurring after the default of the counterparty, which could stem from movements in the market value of the derivatives position before a replacement contract is entered (recital 2).

In this context, we would like to differentiate between cleared and uncleared OTC derivatives. Uncleared OTC derivatives are subject to standardized Master Agreements. This includes the following provisions:

"The Agreement shall terminate, without notice, in the event of an insolvency."
(no. 7 para 2 Sentence 1 of the German Master Agreement for Financial Derivatives Transactions)

[…] *"In the event of Termination, the party giving notice or the solvent party, as the case may be, (hereinafter called "Party Entitled to Damages") shall be entitled to claim damages. Damages shall be determined on the basis of replacement transactions, to be effected without undue delay, which provide the Party Entitled to Damages with all payments and the performance of all other obligations to which it would have been entitled had the Agreement been properly performed. Such party shall be entitled to enter into contracts which, in its opinion, are suitable for this purpose. If it refrains from entering into such substitute transactions, it may base the calculation of damages on that amount which it would have needed to pay for such replacement transactions on the basis of interest rates, forward rates, exchange*

rates, market prices, indices and any other calculation basis, as well as costs and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be […].”

(no. 8 para 1 of the German Master Agreement for Financial Derivatives Transactions;
-emphasis added-)

This means: OTC derivatives end automatically with the insolvency of one of the counterparties. Claims are calculated on the basis of replacement transactions or hypothetical replacement transactions taking place with undue delay.

The mechanism is different for cleared OTC derivatives. It is our understanding that the required possibility of portability leads to the circumstance that cleared OTC derivatives cannot be closed-out in the same time frame than uncleared OTC derivatives. Therefore, initial margins make sense in the context of cleared OTC derivatives but not in the case of uncleared OTC derivatives.

We believe that an initial margin requirement should be applied only in case of counterparties of uncleared OTC derivatives that have not agreed that all OTC derivative contracts end automatically in case of an insolvency of one of the counterparties. In all other cases, we do not see a relevant risk that needs to be mitigated in order to make the financial markets more resilient.

Standardized Master Agreements include provisions which already mitigate this risk properly. We deem it necessary to include the following requirements in the RTS.

Therefore, we propose to add the following new paragraphs:

Article 2 new para 3 (a) GEN:

“3a. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties may instead agree in writing or equivalent permanent electronic form with their financial or non-financial counterparties that all OTC derivatives between them shall be subject to a Qualified Master Agreement.”

Article 1 new para 1 (o) DEF:

“(o) ‘Qualified Master Agreement’ means a standardized master agreement, setting out an automated early termination in case of the insolvency of one of its parties as well as a close-out netting provision, by which claims are calculated on basis of replacement transactions, to be effected without undue delay or hypothetical replacement transactions which are deemed being effected without undue delay.”

- **Usage of Repos: Recital 9, Article 2 para 1 (d) LEC in conjunction with Article 1 para 1 (b) DEF**

The ESAs deem it important that the collateral taker is able to liquidate the collateral and use the cash proceeds to replace the defaulted derivative contract by an equivalent contract with another counterparty.

The ESAs state:

"The pre-existing access to the market should enable the collateral taker to either sell the collateral or repo it within a reasonable amount of time. This capability shall be ensured independently from a possible default of the collateral provider, e.g. by having broker arrangements or repo arrangements with other counterparties than the collateral provider […]."

(Recital 9, -emphasis added-)

"Risk management procedures of the counterparty receiving collateral shall include the following operational and technical capabilities: […]
(d) access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions and in the case of default of the collateral provider;"

(Article 2 para 1 (d) LEC, -emphasis added-)

According to the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2012/832) UCITS lost their ability to use the purchase price received under a repurchase agreement to replace the defaulted derivative contract by an equivalent contract (please see para 42 and 43 (j) of the ESMA Guidelines on ETFs and other UCITS issues).

Therefore, we urge the ESAs to amend the mentioned ESMA Guidelines in order to allow UCITS to use the purchase price obtained under a repurchase agreement at least for entering into the aforementioned replacement transactions as well as for making cash collateral contributions.

An alternative would be to clarify in the RTS that UCITS should be allowed to use the purchase price received under a repurchase agreement at least for entering into the aforementioned replacement transactions as well as for making cash collateral contributions. The RTS would take precedent over the provisions of the ESMA guidelines. Otherwise, UCITS could have problems to comply with Article 2 para 1 (d) LEC.

In this context, Article 1 para 1 (b) DEF could be supplemented as follows:

(b) 'Collateral' means cash or other assets in the form of variation margin or initial margin, as the case may be, ***other than the purchase price gained under a repurchase agreement;"***

This amendment is necessary in order to make para 42 of the ESMA Guidelines on ETFs and other UCITS issues not applicable which reads as follows:

"All assets received by UCITS in the context of efficient portfolio management techniques should be considered as collateral for the purpose of these guidelines and should comply with the criteria laid down in paragraph 43 below."

(Para 43 limits the usage of collateral received)

- **Grand-fathering clause: Recital 18**

The regulation should only apply for transactions conducted after its implementation date.

The grandfathering should not only be mentioned in recital 18 but also included in the text of the regulation itself. Furthermore, a clarification should be added to make sure that "genuine amendments" as referred to in the final BCBS/IOSCO requirements (requirement 8.9 and footnote 20, p. 24) made to existing derivative contracts shall not be in the scope of the new regulation. An explicit mentioning of this issue in Article 1 para 4 FP would bring the necessary clarification.

Question 3. Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?
Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

We have no comment.

Question 5. How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

German investment fund management companies already apply concentration limits on collected collateral according to paragraph 43 (e) of the ESMA Guidelines on ETFs and other UCITS issues. The German regulator BaFin implemented this guideline into national law in 2013.

We propose that UCITS and other regulated investment funds (AIF) should have the possibility to further use the already implemented ESMA guidelines on concentration limits instead of being obliged to implement similar provisions laid down in this regulation. Therefore, regulated investment funds should be exempted from any new provisions of concentration limits as soon as they adhere to the ESMA Guidelines on ETFs and other UCITS issues. It is not justifiable to impose a new regulation and the associated costs of implementation on those who have been obliged recently to implement similar provisions on concentration limits. Moreover, it will create a market distortion between funds and other market participants which apply only one set of rules.

Furthermore, the ESAs should bear in mind that some banks are only willing to accept a small fraction of eligible security collateral (e.g. German and French government bonds) and cash. In such cases, banks focus all on the same kinds of eligible collateral, which will be in limited supply.

Regulated investment funds already have problems to meet the collateral requirements due to the following reasons:

- It is only possible to post securities as collateral which belongs to the investment fund. If no securities are eligible as collateral, only cash can be posted to the counterparty.

- According to Article 51 para 2 of Directive 2009/65/EC, UCITS have to agree on efficient portfolio management techniques. However, in most Member States, regulated investment funds are not allowed to borrow securities which they could use to provide as eligible collateral to their counterparty (recital 13 of Directive 2007/16/EC). If they were allowed to borrow, paragraph 42 and 43 (i) of the ESMA Guidelines on ETFs and other UCITS issues prohibit this possibility for UCITS to use the borrowed security for posting it as eligible security collateral. Due to the implementation of the ESMA guidelines in national law, UCITS lost their ability to access liquidity via repurchase agreements. According to paragraph 42 and 43 (j) of the ESMA guidelines it is not allowed to use the purchase price received under a repurchase agreement for posting cash collateral or for buying eligible securities as collateral.

- Loans as source for liquidity (and cash collateral contributions) are limited by 10 per cent of the investment funds assets (Article 83 of Directive 2009/65/EC).

- Investment fund management companies are obliged to hold any remaining liquidity or liquidity obtained by borrowing to fulfill redemption requests of the investment fund.

Since the entry of force of EMIR, we see an increased demand for liquidity and expect a further increase:

- According to Article 11 para 3 EMIR, it is necessary to collateralize uncleared OTC derivatives. If no eligible securities are available as collateral, a cash collateral contribution is required.

- In case of cleared OTC derivatives, variation margin can only be provided in cash.

- As the RTS oblige counterparties to consider initial margins for uncleared OTC derivatives, legal uncertainty regarding the numerous kinds of insolvency laws and property laws (differing from country to country) as well as the required legal opinions and the obligation specified under article 1 para 2 SEG of the draft RTS will set an incentive for banks to accept only cash collateral as initial margin for uncleared OTC derivatives going forward.

- The clearing obligation under MiFIR and Article 30 para 1 MiFIR will lead to the circumstance that market participants who use exchanged traded derivative either by becoming client of a clearing member or agreeing on indirect clearing arrangements will have to post variation margin in cash.

As explained, the new regulation will lead to a dramatic increase in liquidity demand. At the same time, the ESMA Guidelines on ETFs and other issues limit UCITS ability to obtain liquidity by closing the UCITS' main source of liquidity. The overlapping regulation makes it more and more difficult to hedge existing market risks which were not the goal of the G20 (G20, Cannes summit final declaration, para 24).

Question 6. How will market participants be able to ensure the fulfilment of all the conditions for the re-use of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require re-use or re-hypothecation of collateral as an essential component of their business models?

In Europe, re-hypothecation is not allowed for regulated investment funds. Re-hypothecation undertaken in a prudent way, with effective transparency is important to the financial system and a key

part of the optimization of collateral to minimize the reinvestment risk and cost of funding. We support any balanced approach that allows the re-use of collateral.

The possibility to re-use collateral received can be a major device to leverage a position and should not be granted without restriction. We consider that OTC transactions being conducted between responsible professionals, re-use should be allowed in exceptional conditions as defined by the BCBS/IOSCO requirements. The BCBS/IOSCO requirements have taken a prudent and pragmatic approach when authorizing under strict limitations the possibility to re-use or re-hypothecate received collateral. We think that there is no reason for the ESAs not to follow these requirements.

OTC derivatives are traded between professionals. There are many arguments that limit the re-use to a very few cases when professionals willfully agree to this regime:

- The required prior explicit approval by the poster of the collateral (transaction by transaction),
- the fact that it can check that the re-use is made in conjunction with a further transaction aiming at managing the risk initially taken from the fund and not to take further exposure,
- the possibility to earmark the collateral.

If a counterparty agrees that the re-use of collateral will be positive and made for the benefit of its clients, re-use should be allowed and duly reported for information to shareholders.

As mentioned above, it is prohibited for regulated investment funds (UCITS) to re-hypothecate, re-pledge or otherwise re-use collateral received. The prohibition or authorization of re-use should not be forbidden on a regulatory level and should rather be agreed on a case by case basis within a bilateral agreement.

When it is allowed under the RTS to fulfil Initial Margin requirements in cash, the default risk of the counterparty is just replaced by the default risk of the bank who maintains the account the initial margin is booked to (typically a counterparty to other OTC derivatives).