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Joint 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/Madam:

State Street Corporation ("State Street")[1] appreciates the opportunity to comment on the Consultation Paper ("CP") jointly issued by the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority (the European Supervisory Authorities ("ESAs")) regarding the draft Regulatory Technical Standards ("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").

Headquartered in Boston, Massachusetts, with branches and subsidiaries throughout the European Union ("EU"), State Street specialises in providing institutional investors with investment servicing, investment management and investment research and trading. With USD 27.47 trillion in assets under custody and administration and USD 2.38 trillion in assets under management, State Street operates in 29 countries and in more than 100

[1] State Street's identification number in the European Transparency Register is 2428270908-83.

markets worldwide.[2] Our European workforce of 9,000 employees provides services to our clients from offices in ten EU Member States.

State Street welcomes the ESAs' objective of ensuring harmonised implementation of margin requirements for uncleared derivative transactions at both EU and global level. Such consistency is crucial in order to not only avoid regulatory arbitrage and a fragmentation of global financial markets but also to ensure a level playing field.

From the outset, State Street has been a supporter of regulators' work on margin requirements for non-centrally-cleared swaps OTC derivative transactions. We share the view with regards to the benefits of such margin, both to reduce systemic risk and to promote central clearing.

However, State Street is concerned about the suggested general requirement to have gross two-way exchange of initial margin using the same methodology. In our view, the resulting lack of netting of offsetting margin requirements could result in over-collateralization of transactions and hence in unnecessary costs and unintended consequences for parts of the industry. Subject to there being global consistency on this point, we believe that the decision to exchange initial margin in respect of any type of derivative transaction should be left to the counterparties and be based on their risk appetite.

With regards to foreign exchange ("FX") derivatives more specifically, as also expressed in our response to the Basel Committee of Banking Supervisors-Internal Organisation of Securities Commissions ("BCBS-IOSCO") consultation in September 2012, State Street believes that these transactions should be exempt from the requirement to provide mandatory margin. We therefore agree with the CP's proposal that for physically-settled FX forwards and swaps, counterparties should be able to waive the requirement to provide initial margin, subject to an agreement between them. This exemption should however be extended to cash-settled FX derivatives, including to non-deliverable forwards ("NDFs"). In our view, there is no reason to distinguish between physically and cash-settled FX forwards and swaps in this respect.

Moreover, we believe that FX forwards and swaps, subject to their being global consistency on this point, should also be exempt from the variation margin requirements. Adopting this recommended approach would recognize that FX forwards and swaps are materially different from other types of swaps and other derivatives as they involve the straightforward exchange of currencies on fixed and pre-determined terms in a highly transparent and liquid global marketplace. While settlement risk is an important consideration with FX swaps and forwards, it has largely been addressed, at the urging of regulators, through creation of the CLS Bank International. As a result, these FX forwards and swaps do not significantly contribute to the interconnectedness or systemic risk concerns the margin rules are intended to address. If the approach described in this paragraph with respect to variation margin for FX forwards and swaps is not acceptable

[2] As of March 31, 2014.

then, as an alternative, we would suggest that only long dated (which we believe should be, at a minimum, 3 months) FX forwards and swaps should be subject to the variation margin requirements.
In this context, the question of in-scope FX transactions subject to these requirements is key and further highlights the importance of the currently on-going work undertaken by the European Commission on the definition of FX financial instruments in the EU. The final definition will determine the range of FX products to which the requirements under EMIR, including the requirements for non-cleared derivatives will apply. In our response of 9 May 2014 to the European Commission's consultation on the definition of FX financial instruments, State Street recommended applying a single cut-off period of T+7 banking days to delineate between spot and forward FX transactions. As a second-best option, we recommended to at least combine a T+2 banking days settlement period with an exemption for securities conversion FX transactions as delineation between these transactions.

In addition to these general comments, please see the following comments with regards to the specific questions raised in the CP:

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?

The proposed RTS impose detailed operational and legal documentation requirements on counterparties. This is inconsistent with the BCBS-IOSCO framework which does not prescribe additional operational processes or how to confirm thresholds. We would therefore encourage the ESAs to align the draft RTS with the BCBS-IOSCO framework.

As mentioned in our general comments, ensuring global consistency will minimise both the cost and regulatory burden. In order to ensure consistency of approach, operational requirements (over and above when margin should be posted and what collateral is eligible), should be limited and kept to a high level in order to maintain flexibility for investors to operate on a global basis. Too much prescription in each jurisdiction will inevitably lead to inconsistencies and increased operational costs with little overall benefit.

For example, the requirements for counterparties to verify (a) at least annually the enforceability of netting for the initial margin calculation pursuant to Article 6 (2) MRM; and (b) at inception and at least annually in respect of the compliance of initial margin segregation arrangements with the requirements of Article 1 (3) and (4) SEG by way of satisfactory legal opinions in all jurisdictions (pursuant to Article 1(5) SEG) will impose significant cost. We suggest that these kinds of requirements should be modified to require firms to be in a position to provide on request a written and reasoned legal basis for enforceability and compliance, and have procedures in place to ensure that the legal

validity of these arrangements is kept under review in the light of possible changes in the relevant laws.

We would also like to seek clarity on the segregation requirements of Article 1 SEG: presumably this requires segregation in the books and records of the third party holder or custodian, rather than the establishment of individual accounts on behalf of each counterparty which would be costly and administratively burdensome.

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

One particular operational concern is that investment managers acting on behalf of institutional clients may not necessarily have sight of the details of all of the institutional clients' derivative trading relationships. For example, in the case of split mandates where a client has appointed more than one investment manager, it will be difficult if not impossible for an investment manager to know or calculate the clients' total outstanding derivatives notional or whether the thresholds for posting initial or variation margin has been exceeded by their institutional client at an entity level. Obtaining this information from the institutional client will be hard to document or implement operationally. In addition, there is a risk that institutional clients with multiple investment managers will not be able to net positions with the same counterparty across separate portfolios for margin purposes. This will cause excessive margining impacting negatively the overall performance of funds to the detriment of the end-investor.

We note that managers often enter into 'currency overlay' mandates with clients whereby the managers enter into FX forwards or swaps on behalf of clients in order to hedge the currency risk in securities held by the client but which are not managed by the manager. To the extent that the margin requirements did apply to FX forwards and swaps entered into in connection with currency overlay mandates then this would create significant operational difficulties as an entity (potentially a third party collateral manager) would need to be appointed by the client to enable margin to be transferred and received by the client in connection with such transactions.

Furthermore, as funds authorised under the UCITS Directive as well as under the AIFMD already are subject to strict requirements in the area of risk management, should be exempt from the obligation to provide initial margin.
Article 51 (1) of the UCITS Directive requires a management or investment company to "[…] *employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. It shall employ a process for accurate and independent assessment of the value of OTC derivatives. It shall communicate to the competent authorities of its home Member State regularly in regard to the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS.*"

In addition, Article 15.2 of the AIFMD requires AIFMs to "[…] *implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.*" AIFMs must, according to Article 15.3 AIFMD, also "*implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF.*"
Article 52.1 of the UCITS Directive further limits counterparty exposure to a maximum of 10% of the value of the UCITS and under Article 51.3, a UCITS must ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio. These risk measures reduce the impact of any counterparty default.

Moreover, State Street would welcome clarification with regards to the UCITS framework where we see an inconsistency between the proposed ban of the re-use of initial margin and the requirements of ESMA's Guidelines on ETFs and other UCITS Issues. The guidelines require cash collateral to be placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive; invested in high-quality government bonds; used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis or invested in short-term money market funds as defined in ESMA's Guidelines on a Common Definition of European Money Market Funds. We believe existing UCITs rules providing for limited reinvestment of received cash collateral fully address the goals of the RTS with respect to ensuring immediate availability of posted cash collateral, and suggest the proposal be revised to permit reinvestment of cash collateral pursuant to the UCITs regulatory framework.

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 the 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?

State Street does not have comments in response to this question.

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?

State Street would support the development of an industry-wide standardised approach with respect to valuation of margin that can be used by the parties to the transactions. This will create greater certainty between the parties to the transaction.

At the same time, counterparties should be allowed to use internal models for the calculation of the required initial margin should they agree to do so.

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?

In line with ESMA's recent decision in the context of its Guidelines on ETFs and other UCITS issues, we would strongly recommend to not apply the concentration limits to collateral in the form of transferable securities and money market instruments issued by sovereigns, their local authorities or other public international bodies.

Portfolios may hold a concentrated portfolio of assets and so may have difficulty complying with the margin concentration requirements. For example, many liability driven investment ("LDI") portfolios managed by managers for pension schemes hold a mixture of cash and government securities and so introducing concentration requirements on margin which the portfolios can post and receive would mean that the LDI portfolios would need to diversify into holding other assets or markets in order to satisfy the concentration requirements, which could result in the pension schemes assuming additional risk or unwanted exposure.

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

State Street strongly supports the proposed requirement that initial margin be "[…] *segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty*." We also support the proposed requirement that collectors of collateral must always offer the posting counterparty the option of "individual segregation", particularly for posting of cash.

Tri-party custodian arrangements are particularly effective for segregation of margin, and are increasingly requested by parties posting collateral, even in the absence of a regulatory mandate. Tri-party custody arrangements protect the interests of both the poster and collector of collateral, and ensure that margin is not rehypothecated or otherwise reused by the collecting party.

While the proposed framework suitably encourages the use of robust segregation arrangements, such as tri-party custody, some additional clarification regarding the treatment of cash posted to such arrangements would be useful.

Under tri-party custody arrangements, cash is posted to a demand deposit account of the custodian bank. While we believe such deposit accounts qualify as eligible collateral under proposed Section 1(a) of Article 1 LEC as "*cash in the form of money credited to an account in any currency* […]", it is unclear whether such accounts are limited to those provided by the counterparties to the swap. The suggestion in the Executive Summary that the "[…] *list of eligible collateral is based on the provision laid down by Articles 197 and 198 of Regulation (EU) No 575/2013,*" adds to the lack of clarity, since the referenced articles specifically refer to "*cash on deposit with, or cash assimilated instruments held by, the lending institution*" (emphasis added). As a result, we suggest clarification that the account to which eligible collateral is credited is not limited to those provided by the counterparties, and could be an account with a third party custodian.

Similarly, we suggest clarification under Article 1 REU of the requirement that the "[…] *collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.*" We support this requirement, but suggest clarification related to posting of cash to custody bank deposit accounts. Cash held in such accounts is, by definition, a liability on the bank's balance sheet, and the cash received by the bank is invested as part of the banks' asset/liability management plan, consistent with extensive capital and liquidity prudential standards, which could conceivably create questions as to whether such activities constitute "re-use." As drafted, Article 1 REU appropriately focuses on possible re-use by the "collecting counterparty," placing custody banks in tri-party arrangements out of scope. Nevertheless, to provide certainty and encourage tri-party custody arrangements, we suggest the final rule clarify that the deposit of cash in a demand deposit account with a custody bank as part of a tri-party custody arrangement satisfies the segregation requirements, and does not give rise to prohibited re-use by the custody bank in the ordinary course of its business for purposes of the RTS.

Thank you once again for the opportunity to comment on the matters raised within this CP. Please feel free to contact me should you wish to discuss State Street's submission in greater detail.

Sincerely,

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and Government Affairs