

## **EFET response to the ESAs consultation on the 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**



14 July 2014

The European Federation of Energy Traders (EFET) welcomes the opportunity to comment on the 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, published by the European Supervisory Authorities (ESAs).

The draft RTS address key elements in relation to EMIR collateral requirements applicable to non-cleared OTC derivative contracts. While we welcome the clarifications brought about by the RTS, we would like to draw the ESAs' attention to a number of points, among which:

- The entry into force of the RTS will require a review and amendment of all existing collateral agreements in place (CSA) and/or the setup of new agreements running, at least in the first phase, in parallel to the existing ones. **Appropriate phase-in periods should be set up for specific provisions.**
- The **use of a number of existing market standards** in the RTS would facilitate the implementation of its proposed rules. In some instance, such as the collection of variation and initial margin within two business days after execution, the market standard is more than just a practice of reference: it is the only workable way for NFC to fulfill their obligations given their limited access to the money market.
- The **obligation to explicitly opt out of margining requirements where exemptions are provided by the RTS** increases the operational and contract management burdens on entities in scope, and in particular NFC-. This could also create inefficiencies in the market as NFC- could potentially exclude NFC+ and FC entities from their list of possible counterparties until the contractual 'opt-out' is formalised with such counterparties. It would be less burdensome to turn the provisions in the RTS around and choose an opt-in method, which would achieve the same results with less harmful consequences.
- Due to the **absence of implementation of EMIR in the EEA agreement yet**, EEA counterparties are for the time being considered as third country counterparties. The same aspect applies to **EFTA counterparties** which are equally considered as third country counterparties, although they are highly interconnected with the EU economy and in particular with the EU energy markets. The collateral requirements suggested in the draft RTS (and the inescapable VM) will cause disproportionate costs for EEA/EFTA NFC, distort competition and reduce liquidity in the energy markets.

Specific responses to the consultation questions and additional details on individual provisions can be found in the tables below:

## 1. General consultation questions

Question	Page	Question Text	Comments
1	17	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?	<p>The entry into force of the RTS will require a review and amendment of all existing collateral agreements in place (CSA) and/or the setup of new agreements running, at least in the first phase, in parallel to the existing ones.</p> <p>As a consequence, the starting phase risks showing a significant loss of netting effects (and consequently a significant increase in counterparty risks for market participants) if different treatments are to be applied to different transactions and a considerable increase in operational efforts for Collateral Management functions where the operational process would be duplicated.</p> <p>To estimate the costs of implementation for small or medium-sized entities, the following items/process chains need to be considered:</p> <ul style="list-style-type: none"> <li>- Legal documentation: negotiation, setup (amendments or new agreements) and maintenance</li> <li>- Exposure calculation for different netting logics (IM gross basis &amp; VM net basis)</li> <li>- OTC Collateral Management: maintenance of collateral agreements and aggregation of exposure data for the collateral CPs, generation and processing of margin calls (incoming and outgoing), invoicing and settlement of collateral interests, management of eligible collateral (cash, bonds, etc...)</li> <li>- IM calculation, collecting and segregation</li> </ul> <p>At this stage, it is quite difficult to deliver a precise cost estimation.</p>

2	17	<p>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.</p>	<ul style="list-style-type: none"> <li>• <b>Regarding collection of margins</b></li> </ul> <p>The current market standard for OTC Collateral foresees a collection of margin on the second business day following the execution of the contract by the earliest. With regards to the fact that risk calculation takes place on close of business of trade execution (so called valuation time under current CSA standards), the margin call can only be issued on the following business day (so called valuation day under current CSA standards) with a required payment on the following business day. As no payment can be processed on the same day as the issued margin call (due to bank payment cut-off times), <b><u>Variation margin and Initial margin can be called on the business day following the execution of the contract but collected first two business days after this execution</u></b></p> <p>It should also be allowed to have a lower frequency for variation margining than daily.</p> <ul style="list-style-type: none"> <li>• <b>Regarding eligible collateral</b></li> </ul> <p>Only cash, gold, debt securities and corporate bonds are determined as eligible collateral.</p> <p>NFC require to keep the possibility for non-financial companies to use non-fully liquid-asset backed (commercial) bank guarantees as collateral in relation to CCPs. At the very least, NFC should be allowed, during the phase-in period, to keep on using bank guarantees and standby L/C as eligible collaterals.</p> <p>All amounts (threshold, MTA, etc.) are set fixed to a EUR amount. OTC Collateral Management also deals with other currencies than EUR and thus a FX-rate should be provided for a conversion for the respective parameters.</p>
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3	27	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	N/A

		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?	
4	36	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?	N/A
5	38	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?	N/A
6	43	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?	<p>This represents a real issue for NFC, although it only covers IM, this because of:</p> <ul style="list-style-type: none"> <li>- a very limited access to money market</li> <li>- significant increase in funding costs</li> <li>-</li> </ul> <p>The incapacity (resources and processes) to maintain omnibus and/or individual custodian accounts for the respective counterparties.</p>

## 2. Detailed assessment of individual provisions

Section	Page	Section	Comments
3. Background and rationale	7	“EU entities would have to collect margin (...) from those that would be classified as non-financial entities <u>below the threshold</u> if they were established in the EU.”	<p>The extension of the scope of the RTS to non EU NFC- seems disproportionate, and inconsistent with article 11.3 (FC and NFC+) and 11.12 (third country counterpart) of EMIR. This was also the reasoning for not extending the RTS scope to non-EU FC and NFC+).</p> <p>Subjecting non-EU NFC- to the payments of VM in all cases (as no exemptions apply to VM requirements) distorts competition and affects the international competitiveness of EU entities trading worldwide.</p> <p>See in particular the comments above regarding counterparties established in the EEA and EFTA. Further, it has to be noted that Regulation (EU) No 648/2012 does not provide for a legal basis of the interpretation as expressed the section.</p>
Applicable transactions	21	“Exchanges of variation margin and initial margin on contracts not cleared by a CCP entered into before these dates are subject to existing bilateral agreements.”	<p>This provision would require two separate collateral agreements with one CP or an extension of existing agreements with exclusions for some rules for non-OTC derivatives (e.g. IM or custodian Extreme operational efforts to review existing documentation). Such arrangements would:</p> <ul style="list-style-type: none"> <li>- Significant loss of netting effects if different treatments are to be applied to different transactions</li> <li>- Significant increase in operational efforts for Collateral Management functions (at least duplicating daily efforts)</li> </ul>
Art.1 DEF	21	Counterparties defined by reference to EMIR	<p>The definition encompasses only EU entities, which makes the margining requirements in Art. 2 GEN only applicable between EU entities. The extension to non-EU NFC- is explicit and as such creates a clear disadvantage when compared to non-EU NFC+ and non-EU FCs. Not applying collateral requirements to non-EU NFC- becomes a “derogation” under Article 2.4(b) GEN, which is not in the spirit of EMIR.</p>

Art. 2 GEN, § 3	23	IM requirements can be waived by FCs only.	It appears that NFC+ don't have the option proposed to FCs to agree in writing to waive the exchange of initial margin under certain conditions. This puts NFC+ at a clear disadvantage and may distort competition: NFC+ will face higher costs when trading with each other and might "naturally" exclude other NFC+ from their list of potential counterparties.
Art. 2 GEN		Obligation to opt out of margin requirements by explicit writing agreement	The obligation to explicitly opt out of margining requirements where exemptions are provided by the RTS increases the operational and contract management burdens on entities in scope and in particular NFC-. This could also create inefficiencies in the market as NFC- could potentially exclude NFC+ and FC entities from their list of possible counterparties until the contractual 'opt-out' is formalised with the counterparties. It would be less burdensome to turn the provisions in the RTS around and choose an opt-in method, which would achieve the same results with less harmful consequences.
Minimum Transfer Amount	23	MTA is set fixed as a maximum of EUR 500,000	It is unclear whether this provision implicitly requires that all new collateral agreements have to be set to EUR as base currency. Can the amount also be used for other currencies as USD & GBP?  We suggest the MTA maximum be increased to EUR 1 million to align the RTS with current market standards and minimise the operational efforts and costs for small and medium sized organisations.
Art 1 VM – Variation margin	27	Daily "collection" of variation margins	Current market standards foresee a collection of margin on the second business day following the execution of the contract at the earliest. Considering that risk calculation takes place on close of business of trade execution (so-called "valuation time" under current CSA standards), the margin call can only be issued on the following business day (so-called "valuation day" under current CSA standards) with a required payment on the following business day.  As no payment can be processed on the same day as the issued margin call (due to bank payment cut-off times), <b><u>variation margin can be called on the business day following the execution of the contract but collected first two business days after this execution. It should be noted that most NFC (whether + or -) have only indirect access to payment networks.</u></b>

			It should also be allowed to have a lower frequency for variation margining than daily, or at least to allow this as part of a phase-in period. This should leave enough time for smaller sized organisations to setup the whole logistic around the collateral process, from the risk calculation to the processing of margin calls.
Art 1 EIM – Initial margins § 2		Daily “collection” of initial margins	<p>Current market standards foresee a collection of margin on the second business day following the execution of the contract at the earliest. Considering that risk calculation takes place on close of business of trade execution (so-called “valuation time” under current CSA standards), the margin call can only be issued on the following business day (so-called “valuation day” under current CSA standards) with a required payment on the following business day.</p> <p>As no payment can be processed on the same day as the issued margin call (due to bank payment cut-off times), <b><u>Initial margins can be called on the business day following the execution of the contract but collected first two business days after this execution. It should be noted that most NFC (whether + or -) have only indirect access to payment networks.</u></b></p>
Art 1 EIM, § 3 a	27	Recalculation of IM as soon as a new contract is entered into	Counterparties transact daily with each other, in both directions. It would be disproportionate and inconsistent to request a recalculation of the IM after each such transaction. A daily recalculation (at the end of each business day) should suffice.
Chapter 3 – Margin methods Art. 1 LEC – Eligible collateral for initial and variation margin	32	Only cash, gold, debt securities and corporate bonds are determined as eligible collateral.	<p>NFC require at least during the phase-in period, the possibility to keep on using bank guarantees and standby L/C as eligible collaterals.</p> <p>Because the access of NFC to eligible credit support is currently limited to cash or standby L/C, Guarantees, removing the possibility to use standby L/C will considerably increase the cost of funding Collaterals.</p>



Substitution of posted collateral	42	“(a) both counterparties agree to the substitution”	Current market standards foresee that collateral substitution may happen without agreement of the CP (informing the CP is sufficient). The proposed provision could cause disputes and conflict of interests between parties in contradiction with the legal documentation: the transferor of Collateral could always refuse the form of collateral requested to hide solvency issues.
Chapter 4 – Operational procedures Art 1 SEG – Segregation of initial margins	42	Segregation of IM	This provision may prove problematic for NFC, although it only covers IM, given that: <ul style="list-style-type: none"> <li>- NFC have very limited access to the money market</li> <li>- It could significantly increase funding costs</li> <li>- NFC are incapable (given resource and process reasons) to maintain omnibus and/or individual custodian accounts for the respective counterparts</li> </ul>
REU – Treatment of collected IM  1. No re-hypothecation	43	“The collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.”  -	This provision contradicts the legal rules implemented through the civil and commercial law provisions of each Member State on the validity of securities (pledges) and outright transfers of title (total title transfer).  The ESAs wish a TTT to occur in relation to IM, but the proposed rules do not ensure the TTT to be enforceable and valid (rather to the contrary: the rules will lead to an easy claim for re-characterisation of the TTT into a security agreement, that can be voided).
Art. 1 FP	46	Threshold for IM as from Dec 2019: 8 Billion EUR of notional amount of non-cleared OTCD	Given the fact the threshold is calculated on worldwide group level, includes all risk-reducing, non-cleared transactions and includes transactions in all asset classes, the threshold seems inappropriately low.