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European Banking Authority
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For attention of: Davide Vioto, Santiago Baron Escamez, Christian Moor
Prudential Regulation and Supervisory Policy Department

submitted via EBA online portal

Re: EBA/CP/2020/23 – Guidelines specifying the conditions for the application of the alternative treatment for institutions' exposures related to "tri-party repurchase agreements for large exposure purposes"

Introductory Comments

The Bank of New York Mellon Corporation (BNY Mellon) is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to this consultation.

BNY Mellon is the world's largest provider of triparty collateral management services. Within Europe, we provide our triparty collateral services through The Bank of New York Mellon London Branch, and The Bank of New York Mellon SA/NV (headquartered in Belgium).

General Observations

BNY Mellon plays a major role in providing services that enable the capital markets to function, and enabling liquidity and collateral to move to where it is needed. Triparty collateral management is one of the key services we provide in this context.

Effective collateral management plays an important role in delivering a unified and liquid capital market in Europe.

When thinking about the reforms in CRR2 Article 403, as a tri-party agent, we are thinking about this from the perspective of impact on collateral mobility and thus market liquidity. We want to encourage collateral mobility as a key building block of a European Capital Markets Union. We therefore think it is important to highlight any unintended consequences that CRR2 Article 403 may have on collateral mobility, and liquidity.

In this regard, BNY Mellon has some concerns regarding the practical implementation of CRR2 Article 403(3) from a tri-party agency perspective. We already support the management of certain concentration limits in the tri-party system already. Clients can set a limit in respect of a portfolio of a collateral provider, and/or in respect of an issuer within a portfolio, and/or in respect of an individual trade (including an individual trade within a portfolio of a collateral provider). However, we cannot support limit setting in respect of an issuer *across* collateral providers, and not in such a dynamic and real-time mode as contemplated under CRR2 Article 403(3).

Concentration limits can only be applied *per collateral receiver and collateral provider relationship*. For the relationship with a collateral provider (a "portfolio"), the collateral receiver can apply a concentration limit across all the profiles (ie, all the trades for all the collateral issuers in the portfolio).

It is important to note that the role of the tri-party agent must be neutral, given the relationship we have with both the collateral receiver and collateral provider. This is why the tri-party agent would not support the functionality to set concentration limits *across* collateral providers, as this would mean that the tri-party agent (rather than the collateral receiver) has to discriminate between collateral providers.

The **hierarchy** of limit setting is therefore:

Limit Setting (Hierarchy)	**Extent of usage**
Portfolio level (ie, for a collateral provider)	Sometimes used
Issuer *within a portfolio* (not across portfolios)	Not commonly used, but may become more frequently used by collateral receivers under CRR2 Article 403
Individual trade *relating to an issuer within a portfolio*	Selectively used

Any or all of these options can be used, but it is rare for all three to be applied simultaneously, and it is rare for a collateral receiver to set limits on all trades with a particular collateral issuer. In the context of tri-party collateral management, it is most typical to set limits at the trade portfolio level.

Whilst it is possible for a collateral issuer to set a limit for each issuer separately for each portfolio (ie, separately for each collateral provider), it is not possible for this limit to be "aggregated" across portfolios such that any unused limit in one portfolio is available for another portfolio, as this would damage the collateral allocation process and discriminate between collateral providers.

If collateral receivers are required to set limits across the board in respect of an issuer, the (unintended) consequence of this would be to **reduce the pool of collateral and liquidity in the market**, because collateral would be constrained from going to where it is most needed, and economies of scale in terms of transaction sizes would be diminished.

Ultimately there would be less collateral to lend out, and the knock-on effects of this would not only impact the repo market, but other types of transactions such as securities lending.

This would occur precisely at the time when the EU capital markets are more important than ever in the context of Covid-19, the relaunched CMU 2.0, and the green-led economic recovery.

We would also note that the setting of concentration limits does not occur in a commercial vacuum. The concentration limits that may be set in regard to a particular trade can impact the price of the trade - therefore the concentration limit *cannot typically be changed during the lifecycle of the trade* as it would have an impact on how it had been priced.

A key benefit of tri-party collateral management is that the collateral portfolios are typically better diversified, compared to the bilateral collateralisation process. In bilateral collateral management, counterparties tend to provide only a few, large lines of securities collateral, because the operational process to manage the collateral is too burdensome (both in terms of performing the eligibility checks (not confined to concentration limits) but also in managing the settlement process itself).

In contrast, the benefit of the tri-party mechanism is that the algorithm used by a tri-party agent allows the performance of more complex position eligibility checks, and optimises the use of collateral. This tends to result in more diversified collateral portfolios. In addition, given that tri-party agents perform several allocation runs per day (up to hourly runs) in respect of each collateral provider, there is a lower likelihood that breaches of concentration limits (and thus as a result breaches of large exposure limits) would be persistent.

Also, given that the large exposure limit is set at 25% of the tier 1 capital (or 15% for G-SIB to G-SIB exposure), it is also important to note that only very few collateral receivers in the tri-party program would actually ever reach such a large exposure limit in respect of tri-party repos.

We also note the broader context in which the tri-party agent operates. The tri-party agent is typically not only involved in regard to tri-party repo, but also for collateralising securities-based lending (“SBL”) and initial margin (“IM”).

The collateral is constantly being optimised by the tri-party agent, not only for tri-party repo, but for all the underlying trades managed by the tri-party agent, irrespective of the type of underlying trade (repo, SBL, IM) that is collateralised.

This means, even if the remit of the EBA Guidelines for CRR2 Article 403(3) is for triparty repo only, in practice a “group concentration limit” would be applied across the entire portfolio, and thus other transaction types (SBL, IM) would be impacted by the concentration limit approach.

This could have unintended consequences on the collateral provider’s ability to use its available liquidity to collateralise such trades. As mentioned above, ultimately there would be less collateral to lend out, and the knock-on effects of this would not only impact the repo market, but other types of transactions such as securities lending.

Responses to EBA Questions

We have further set out our responses to certain of the questions in **Annex 1** below, and we look forward to further engagement with the EBA on this topic.

Yours sincerely,

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Managing Counsel
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BNY Mellon

ANNEX 1 – Responses to Specific Questions

Definitions

Q1: Are the definitions and their use throughout the guidelines clear?

Yes.

Verification of the establishment of appropriate safeguards by the tri-party agent to prevent breaches of the limits instructed by the institution to apply to the securities issued by the collateral issuer

Q2: Do you think that this general framework is appropriate? Are there other elements that should be included to make the service agreement more comprehensive?

The general framework will deliver the EBA's remit under CRR2 Article 403. However, the overall consequence of CRR2 Article 403 when applied to tri-party repo is that it will reduce the pool of collateral and liquidity in the market, as mentioned in our general comments. This is because institutions (collateral receivers) will need to set and instruct conservative large exposure rules in order for institutions to comply with their regulatory obligations.

Q3: Do you agree with the list of proposed safeguards? If no, please explain why and present possible alternatives.

The list of safeguards in section 4.2.2 is generally OK (subject to our comments below and in Q4).

However, this list does not need to be replicated in the contract with the tri-party agent. Rather, there should be a general contractual obligation to ensure compliance with the limits and/or a regulatory obligation imposed on the tri-party agent to ensure it has appropriate safeguards / controls in place to enable the institution's compliance with the limits instructed by the institution. Whether any of the specific safeguards should be listed in the contract should be a matter left for negotiation between the tri-party agent and its client.

It is worth noting that the safeguarding of collateral held in custody is already a heavily regulated service under MiFID2.

Q4: Do you see any practical reasons that would prevent the implementation of any of the safeguards? If yes, please explain.

The proposed requirement in paragraph 12(g) for the right of the institution or a legitimate third party (inter alia the statutory auditor, the competent authority or third parties appointed by them) to verify the tri-party agent's compliance with the safeguards, is generally OK, but must be subject to appropriate advance notification and confidentiality obligations, as one would expect in any contractual provision dealing with audit rights.

The proposed requirement in paragraph 14 to obtain a written declaration of assurance is an unnecessary layer. The contractual undertaking and a *prompt* notification obligation in the agreement would ensure perpetual on-going compliance with the limits at all times and *prompt* notification if they are breached. The written declaration gives an institution no additional level of comfort over and above the independent internal and external audits that will be conducted on the process under existing regulatory requirements.

In regard to the notification requirement, we recommend that this is a *prompt* notification requirement rather than an *immediate* notification requirement, as it is not realistic to expect notification to occur in real time. In addition, we would recommend a clarification to ensure that notification can occur electronically and through existing online systems.

BNY Mellon as tri-party agent can generate intra-day reports at certain intervals, but it is not practicable to require the generation and distribution of real-time nor near-time reports, due to the dynamic nature of collateral allocation. Our online system is available to clients whereby the client's graphical user interface (GUI) enables the client to identify concentration limit breaches based on the instructed limits, in addition to the system notifications we would issue.

<u>Determination, revision and monitoring of the limits instructed by the institution to the tri-party agent to apply to the securities issued by the collateral issuer</u>

Q5: Do you consider that the criteria listed in this section, in particular in paragraph 18, provide a sufficient guidance for institutions to determine limits? Are there any other elements that would be useful to include?

This is a matter for institutions – as a tri-party agent, we do not have a specific view on this question.

Q6: Is it clear to you how to apply a 'margin of conservatism' as set out in paragraph 19?

The EBA understands that it is current market practice to determine limits and revisions to the limits on the basis of an absolute amount or of a percentage value of a specific type of security in the portfolio.

The meaning of the words "margin of conservatism" are sufficiently clear to us as a tri-party agent, but ultimately how to apply a "margin of conservatism" is a question for each institution to determine, and institutions may have a different risk appetite in this regard.

Given that institutions need to take into account various factors under paragraph 18, we think that in practice, the institution would need to instruct the tri-party agent with a limit based on an absolute amount rather than the percentage value of a specific type of security in the portfolio.

Q7: Do you think that applying the same criteria for the alternative treatment is a suitable method? Do you consider that there could be alternative ways?

We do not have a view on this question.

Revision of the Instructed Limits and its Frequency

Q8: Do you agree with the general approach for the revision of the instructed limits? Is this approach appropriate in the context of general revisions of concentration limits and exclusions that currently govern the relationships with tri-party agents?

Whilst the general approach seems reasonable, it should be noted that a tri-party agent cannot grant a client a *unilateral* right to set a concentration limit (as part of the contract between the client and triparty collateral agent), as this would violate the agent's neutral role.

BNY Mellon as tri-party agent can enable clients to agree with each other that one or both parties can unilaterally set concentration limits in respect of the other – but contractually this is an agreement between the clients, and it has a commercial impact that will be priced into the relevant trades.

We would also note that the setting of concentration limits does not occur in a commercial vacuum. The concentration limits that may be set in regard to a particular trade can impact the price of the trade - therefore the concentration limit *cannot typically be changed unilaterally by one party during the lifecycle of the trade* as it would have an impact on how it had been priced. Generally both parties to the trade would need to agree to the change. Taking this into account, it may require institutions to apply that "margin of conservatism" for limit setting, when negotiating the original trade.

We also note the following as current market practice: where a large exposure limit is breached (which will be identified by the clients themselves through their own systems that monitor *all types of large exposures*, not just tri-party exposures), clients would typically rather prefer to amend the concentration limits for *single bilateral trades*, rather than instructing changes of concentration limits to tri-party agents. This is more practical to clients, as they would isolate the market impact / liquidity impact to a single trade, rather than risking a spill-over effect to an entire portfolio of trades.

Therefore, we would advise against imposing any requirement to force unilateral rights to change concentration limits into all tri-party repo trades. The provision of client access to the online platforms of tri-party agents that facilitate the change of collateral schedules in a prompt manner – even where the counterparty needs to agree to these – is a reasonable and sufficient approach.

Q9: Do you agree with the general approach regarding when the limits need to be revised?

Please see our response to Q8.

Monitoring of the Instructed Limits and its Frequency

Q10: Do you think that the guidelines represent an appropriate approach to the monitoring of the instructed limit and in general of the implementation of the alternative treatment?

Paragraphs 25-27 would in practice impose an unnecessary level of audit and due diligence upon tri-party agents. Adequate assurance can be provided through the imposition of regulatory obligations on tri-party agents, national competent authority supervision and the requirement for internal / external audit of the systems.

Q11: Do you think that tri-party agents have in place such controls that would facilitate the management of the instructed limits? Would you assess that the control mechanisms should be more precise and prescriptive?

Yes, tri-party agents have in place such controls that would facilitate the management of the instructed limits – noting that the effect of CRR2 Article 403 and implementation of instructed limits, and the possibility of revisions to limits, will reduce the pool of collateral and liquidity in the market.

There is no need for control mechanisms to be more precise or prescriptive.

Material Concerns expressed by the Competent Authorities

Q12: Do you agree with the non-exhaustive list of material concerns?

Generally, yes.

In regard to material concerns regarding service agreements referred to in paragraph 35(e)(ii), the proposed requirement in paragraph 12(g) for the right of the institution or a legitimate third party to verify compliance with the safeguards, is generally OK, but must be subject to appropriate advance notification and confidentiality obligations, as one would expect in any contractual provision dealing with audit rights.

Q13: Are you aware of any other material concerns to be included in the guidelines?

No.

Q14: Do you see a need for further clarification of the procedure dealing with a material concern?

No.

Q15: Please specify what overall impact the proposed procedure would have on expected practices.

We do not have a view on this question.