



European Securities and Markets Authority, ESMA
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– Submitted online via ESMA's website –

30 March 2012

Comments of the EAPB on the ESA's joint discussion paper on draft technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP

Dear Madam or Sir,

The European Association of Public Banks, EAPB, welcomes the opportunity to comment on the ESA's joint discussion paper on draft technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and trade repositories.

Answers to selected questions:

Q3. The main source of default protection is the banks' capital and the collateralisation of the derivatives mark-to-market exposure by VM. Any losses in the close-out period of the Lehman default have not been materially damaging for the financial counterparties.

Q4. This depends on the re-use possibility and the list of possible eligible collaterals that can be posted as well. Additionally, the operational costs that would arise from this requirement need to be mentioned. In connection to the latter, the highest costs would arise if no threshold amounts would be defined, resulting in additional margin calls with each counterparty and therefore doubling the costs that arise from this process. This could lead to the unintended result that some smaller banks minimize their counterparty basis making the systemic important institutions even bigger. To the former, the collateral itself, funding costs based on the institutions financing costs are the minimum costs that require from additional requirements. If only securities from a certain quality – such as LCR Cat 1 securities – were eligible, the institutions would be required to hold more liquid assets available. All these measures could also have an effect on the balance sheet of the institutions, as these would normally result in an increase of the balance sheet where some institutions need to decrease these and the availability of credits to the economy. The

incremental cost of compliance is to set up necessary processes, which could easily lead to long term projects within the institutions.

Q5+6. Option 2 would be a competitive advantage of the NPRFC in relation to the PRFC. This could result in better pricings and a higher market share of less regulated counterparties. The second fact is that for the NFC+ the protection resulting from a higher regulated institution could be intransparent to the customer, resulting in a higher risk levels to the client.

Q7–10. Thresholds for VM are usually not used. The counterparty credit quality only has an impact on the minimum transfer amounts. It would be possible to implement them based on the counterparty (e.g. municipal utilities having a local government guarantee) or general available to all counterparties. It is possible that the implementation of thresholds could incentive the use of CCPs or the use of lots of counterparties in order to keep the remaining bilateral transactions below the threshold amount. Although banks are already calculating internal limits today (above which additional steps are taken to mitigate risks), there will be an additional operational workload to monitor the threshold.

Q13. A mandatory requirement for posting IM in bilateral relations will produce a very high request for collateral in the market. Even with respect to the margins to be posted to the clearing house this problem is a very often discussed issue in the market and can cause instability in the money market because of the high request for collateral. As consequence only option 3 with defined rules for thresholds would work out. The approach should also be global in this matter. Any additional administrative burdens could lead to a competitive disadvantage of the European financial sector.

Q14. The execution of OTC derivatives is based on legal agreements. Usually the executing parties agree to an additional credit support annex (CSA) arranging collateralisation of their positions. The legal framework defines the valuation frequency, the terms applicable for the exchange of collateral, minimum transfer amounts or thresholds and the products covered by the master agreement. If both parties agree to a longer valuation periods, collateralisation is not necessary on a daily basis, but is performed daily if no thresholds are granted and the defined minimum transfer amounts are exceeded. Both parameters are defined bilaterally and take into consideration the credit quality of the institutions and their risk profile.

Q15. The collateral process is fragmented in the industry. For some institutions it is a highly standardised process with a high degree of automation, for others it is done manually or with little IT support. Depending on allowed minimum transfer amounts and thresholds the operational costs would increase, as on an average day for only 1/3 of our counterparties an exchange of collateral is necessary. If this is rolled out to all counterparties, a higher degree

of automation would be necessary which could not be achieved in a short timeframe. The existing CSA would also need to be amended to reflect the regulatory changes.

Q16. Yes, but the implementation of a model-based approach is more complex than the mark-to-market method. Not all institutions have the possibility of implementing such calculations, and a common approach would be recommended. Also, models need approval from the supervisory authority, which should be considered in the necessary timeframe for the implementation of such a model.

Q17. It should be possible that the IM can be calculated as a percentage of the NPV, depending on the type of product – although a method which is able to capture the effect of risk-offsetting trades may be more desirable.

Q18. It is not a common approach bilaterally. It is adapted by centrally cleared transactions, e.g. futures or repos. In this circumstance it is calculated on a daily basis.

Q22. These costs could easily lead to costs of more than 1M EUR per institution, depending on the product range of the institutions. Maintenance should be about 20–30% of the implementation costs, as these are usually integrated in a complex IT landscape and the functions need to be tested in release upgrades.

Q23. One possible scenario could be that the institutions internally use the mark-to-market method and externally the standardised method or vice versa, which could have a negative impact on the institution internally, as its reporting figures are not stringent.

Q24. The problems would be the same as with VM. Both institutions would only transfer undisputed amounts, so the dispute process for an additional margin class will result in more operational processes.

Q25. No institution would accept figures of the counterparty without recalculating them.

Q26. The relevant authorities should specify such methods.

Q27. A third party custodian would be more transparent but also more complex and time wasting from an operational perspective.

Q29. Both parties are exposed to operational and credit risk with regards to the third party. Also legal agreements are necessary and both parties need to agree on a qualified third party custodian.

Q30. Unlimited re-use is possible today based on VM.

Q31. This will result in greater balance sheets, as these amounts need to be funded. Higher cash requirements, which could rise even more in stressed times and resulting in liquidity problems. The re-use of the collateral needs to be possible since interest has to be paid/received on these amounts. Otherwise there would be serious pricing and valuation problems for derivatives.

Q33. All counterparties should be treated equal.

Q35. Eligible collateral could be linked to eligible collaterals of the CCPs, thus same standards would apply. Another option would be to use the eligible asset database of the ECB.

Q36. Affected members usually do a collateral valuation on a daily basis. Most positions are collateralised in EUR cash and high liquid EUR government bonds. Daily prices and arranged haircuts are used to evaluate securities and cash collateral positions on a daily basis.

Q37. Collateral might not be exchanged on a daily basis for transactions with a very low volatility or transactions with difficult pricing models where both parties agree to a longer valuation frequency or one party adopt the role of a valuation agent and provides the counterparty with the price of the transaction on a regular basis.

Q38. A daily valuation of collateral takes place when using high liquid collateral with a daily, fair and transparent market price. A more frequent valuation of collateral is not necessary.

Q39+40. The use and the concept of applying haircuts to certain transactions shall be explained in more detail first. If this is adopted in bilateral trading, common haircuts should be applicable to all counterparties. It could be a disadvantage to PRFC using higher margin requirements from a cost perspective.

Q41. Most counterparties have had robust processes for the exchange of collateral in place for years. The most important factor for a robust collateral management is that counterparties act under the individual CSA framework day by day, meaning that they follow the notification time for margin calls and answers to margin calls, make fast and smooth collateral payments on the value day, use accepted valuation models for OTC derivatives and collateral positions, resolve disputes regarding different valuations or unmatched trades in a short time, have seldom differences in collateral interest calculation and daily reconcile collateral movements. Market initiatives like the Standard Credit Support Annex from ISDA, with the aim of standardising the framework around collateral management, should enhance the operational procedures in place.

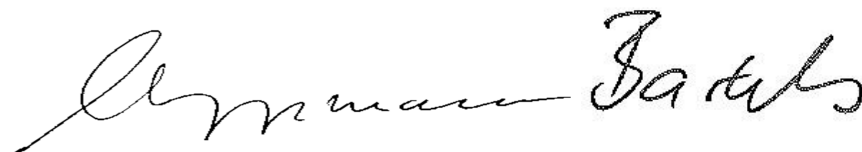
Q42. At the moment there are no incremental costs related to the pure exchange of collateral under the current individual CSA frameworks between the counterparties. The question is whether or/and when new standardised CSA frameworks are published by ISDA and which RTS will be implemented from ESAs in case of initial margining, exposure collateralisation by currencies, dispute resolutions and portfolio reconciliation processes. Any changes in the current market practice due to new regulatory requirements will require huge efforts for implementation, as more automation and changes in core functions like pricing models would be necessary. These costs are not one-off, also maintenance costs for testing, monitoring and supporting new functions will incur.

Q43. Different caps for the MTA should be defined depending on the counterparty's assessment including the financial strength of the counterparty. This is true since an MTA being appropriate for a certain class of counterparts may be too large for another counterpart. A "global cap" is difficult to define. We further on assume that instead of "minimum threshold amount" it should be "minimum transfer amount".

Q47. The implementation of IM as a general concept will take about two years after the final specifications have been made. The level of segregation, the security arrangements necessary for a secure posting of initial margins, the way currencies are treated and how Herstatt risk could be minimized is unclear so far but needs to be solved in advance. Also the institutions are working to full capacity on the implementation of clearing requirements and the Capital Requirements Directive (CRD) and other regulatory initiatives. The focus should lie on these projects first in order to ensure a smooth and sound transition.

Should you have additional questions or comments, please do not hesitate to contact us.

Kind regards,

Two handwritten signatures in black ink. The signature on the left is 'Henning Schoppmann' and the one on the right is 'Boris Bartels'.

Henning Schoppmann
EAPB

Boris Bartels
EAPB

The European Association of Public Banks (EAPB) represents the interests of 40 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.