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Response of the German Banking Industry to the Joint Discussion Paper - 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

12-04-02

Dear Sir or Madam,

Please find enclosed the German Banking Industry Committee's response to the Joint Discussion Paper - 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.

The German Banking Industry thanks the European Securities and Markets Authority (ESMA) for the invitation to comment on the discussion paper and welcomes the opportunity to provide input at this stage of the process.

In our responses, any reference to the Regulation is to be taken as a reference to the future Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories. All references to specific provisions of the Regulation are made to the text adopted by the European Parliament on 29 March 2012.

Yours faithfully,
on behalf of the German Banking Industry Committee
National Association of German Cooperative Banks

by proxy


Dr. Holger Mielk

by proxy


Dr. Diedrich Lange

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Response of the German Banking Industry to the Joint Discussion Paper - 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

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Berlin, 2 April 2012

*The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.*

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I. Introduction

The German Banking Industry thanks the Joint Committee of the European Supervisory Authorities for the invitation to comment on the discussion paper concerning the draft technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the regulation on OTC derivatives, central counterparties and trade repositories (the Regulation) and welcomes the opportunity to provide input at this stage of the process.

We limit our responses to queries with particular relevance to our members and to key aspects and concerns. In some cases, our comments address issues covered by more than one question. In this case the relevant queries have been combined and the response is to be understood to relate to these questions.

In our responses, any reference to the Regulation is to be taken as a reference to the future Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories. All references to specific provisions of the Regulation are made to the text adopted by the European Parliament on 29 March 2012.

II. Responses to Individual Queries in the Discussion Paper

1. Collateral and capital requirements

Q1. What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

In view of the fact that the query is primarily addressed to insurers and IORPs we limit our comments to the following general observations:

With regard to paragraph 15 of the discussion paper, we believe it to be essential that the responsibility of classification as NFC or NFC+

- is not shifted to the counterparty of said non-financial counterparty –rather the classification needs to be made either by an independent third party or the non-financial counterparty itself, and
- that such classification is made transparent to all potential counterparties.

To this end we recommend establishing a register (ideally to be maintained by ESMA) listing the identity (where possible by LEI) of all NFC+.

Furthermore, we agree that additional capital requirements for PRFC are not called for, especially against the backdrop of recently implemented or soon to be implemented changes to these rules.

2. Options for initial margins

Option 1: The posting of IM by all counterparties

Q2. What are your views regarding option 1 (general initial margin requirement)?

We have serious concerns over the proposal to introduce mandatory posting/collection of IM by/from all counterparties.

The purpose of IM is to cover any residual risks not covered by collateralisation (VM), in particular the risk of fluctuations of the value of collateral posted as VM in the period before a readjustment of the VM (potential future exposure). In view to the comparatively short periods of time involved PRFCs (in particular those applying internal models) can address this risk efficiently with adequate risk management, either by sufficiently sophisticated collateralisation via VM or capitalisation under the capital requirements regime or a combination of both. Moreover, the posting/collection of IM introduces considerable additional operational (and where third parties are to be involved in the process) also credit risks. These additional risks significantly reduce or even outweigh the potential risk mitigating effects attributable to IM in bilateral situations.

Thus, whenever at least one counterparty (paragraphs 22 and 23) is a PRFC, we see no practical need to make collection/posting of IM mandatory.

Furthermore, the proposal to demand mandatory posting of IM from both counterparties raises serious concerns because of liquidity burdens for counterparties (either cash or eligible securities). This burden will be exacerbated by collateral needs for centrally cleared transactions as well as demand for the same assets in order to fulfil the liquidity coverage ratio requirement.

- Against this background, we strongly argue in favour of a more flexible approach (option 3), permitting risk adequate solutions.
- Should, however, option 1 be pursued despite these concerns, it will be even more of a necessity to significantly relax the eligibility requirements for collateral (see our answers 32-35).

Otherwise, we fully concur with the conclusions drawn regarding the interplay between collateralisation requirements (initial margin) and capital requirements. We also fully support the clear differentiation made between initial margin on the one hand and variation margin on the other.

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Yes: Adequate protection can be procured by adequate use of other risk mitigation techniques and through capital requirements, e.g. through counterparty limits in addition to posting VM. Even fully uncollateralised transactions can be addressed via the capital requirements without ramifications for institutional or financial market stability.

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

We are unable to provide quantitative data, but would expect very significant costs stemming from:

- additional risk weighted assets for the provider of cash collateral held with a third party custodian
- consumption of balance sheet (leverage ratio) for the provider of cash collateral held with a third party
- costs of the provider for maintenance of cash and securities accounts with third party custodians (including account fees and costs for legal due diligence),

- costs for transfers of margins between accounts held with third party custodians (including transaction fees and costs for internal reconciliation), these costs increase if thresholds and MTAs are low,
- opportunity costs for the recipient who is not able to use collateral, these costs increase if the list of eligible collateral is limited to only few asset classes.

Option 2: The collection of IM by PRFCs only

Q5. What are your views regarding option 2?

In view of the serious concerns raised in relation to Option 1, Option 2 would be slightly more preferable than Option 1. However, Option 2 does not alleviate most of the above mentioned concerns. We therefore clearly favour Option 3. As to the potential negative competitive and regulatory effects, see response to Q6 below. As to the negative impact of Options 1 and 2 on the markets, see our response to Q13.

As pointed out in response to Q2 we do not see collection of IM by PRFCs as necessary or superior in comparison to other risk mitigation instruments.

As regards the similarity of the approach under Option 2 with that pursued in the US mentioned in item 25 of the discussion paper, we concur that consistency with rules of other jurisdictions should be a very important objective, not only to prevent regulatory arbitrage but also to avoid incompatible or even conflicting rules. However, we believe that full consistency will be difficult to attain because of a number of general structural differences between the US and the EU approach.

Considering the systemic relevance of NPRFCs or NFCs+ this is a question which should be addressed by primary law and not only by technical standards. As the EU is in the process of evaluating options for shadow banks (some NPRFCs could fall within the ambit of the future regulatory regime for shadow banks) there may be an opportunity to address these central issues on the level of primary law.

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

The proposal is likely to favour transactions between NPRFC and/or NFC+(only VM) over transactions involving PRFC (IM + VM). These can have adverse effects on competition and also work as an incentive to move transactions to NPRFCs/NFC+.

In contrast thereto, any minor advantages for PRFCs (if any at all) would be offset by the capital requirements exclusively applicable to PRFCs.

Option 3: PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold

Q7. What is the current practice in this respect, e.g.

- If a threshold is currently in place, for which contracts and counterparties, is it used?
- Which criteria are currently the bases for the calculation of the threshold?

Q8. For which types of counterparties should a threshold be applicable?

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

Q10. How – in your opinion - would a threshold change transactions and business models?

We are not aware to what extent market participants currently apply thresholds in respect of IM requirements.

However, the setting of thresholds is one viable method, where these thresholds are defined by the relevant institution itself in manner consistent with the institute's risk management system. Such systems may include additional risk mitigation measures where certain limits are exceeded.

It would be very difficult to define in advance a sub-group of non-PRFCs where collection of IM will generally be necessary.

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.

Any criteria to be set out by technical standards need to be as objective/neutral as possible and have to be based on factors which can be assessed/determined easily by both counterparties. Where possible, these should be external factors (such as ratings or – in the case of PRFCs – regulatory capital ratios).

To the extent that a threshold were to be linked to the exposure at default, the notional amount and/or the number of transactions, the off-setting/netting effects of transactions should be taken into account. In any event it would need to be taken into account that exposure at default is not a sufficiently objective/neutral criterion and that the notional amount bears very little relation to the actual risk involved.

Negative impact of thresholds can be alleviated to some extent by reliance on objective criteria and by allowing a sufficient degree of discretion permitting integration into or harmonisation with the specific risk management system of the institution.

However, it can be expected that a threshold system may improve the competitive advantage of better rated counterparties.

On all options

Q11. Are there any further options that the ESAs should consider?

One potential approach could be to connect the need to post IM to parties with no or very limited capital in view of the interplay between capital requirements and initial margin.

Q12. Are there any particular areas where regulatory arbitrage is of concern?

Inconsistencies between the regulatory frameworks of the EU and other jurisdictions may enable some degree of regulatory arbitrage. However, the more acute concern is that of incompatible and even conflicting requirements.

We also believe that too rigid/formal solutions often induce arbitrage.

Q13. What impacts on markets, transactions and business models do you expect from the proposals?

A mandatory requirement to post IM in bilateral relations will significantly increase the demand for collateral and thus further strain the liquidity of eligible collateral in the market. This liquidity will already be subject to a substantial strain as a consequence of the demanding margining requirements for CCP transactions. This combined strain on liquidity will have far reaching effects on the markets.

In view of these far reaching implications to be expected from the collateralisation requirements and also taking into account the considerable operational challenges arising, the proposals will therefore have a very significant impact on market practice and beyond. It is, however, very difficult to specify or quantify these potential effects.

As a consequence, we strongly believe that option 3 - with adequate threshold system – is the only viable approach.

3. Variation margin

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

No. A general requirement to exchange VM on a daily basis in respect of all transactions between FCs and NFC+ regardless of the specific circumstances would be unreasonable: Especially in the case of transactions involving a smaller/medium sized FCs (such as a UCITS or other smaller FC with a limited transaction volume) or a NFC+ daily exchange of VM will not be merited in all cases.

Even in transactions with more sophisticated counterparties on both sides, where daily valuation and margining is good practice, counterparties should generally have the right to deviate from this practice on a contractual basis where appropriate, for example where thresholds and minimum transfer amounts have been agreed upon.

Q15. What would be the cost implications of a daily exchange of collateral?

We are unable to provide quantitative data, however, we are certain that the cost implications following from a significant increase in the frequency of margin calls would be substantial.

4. Initial margin

Initial Margin Calculation

Q16. Do you think that the “Mark-to-market method” and/or the “Standardised Method” as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

In general, both the “Mark-to-market method” and the “Standardised Method” are comparatively conservative and thus tend to overestimate the potential future exposure. This tendency will result in an overcollateralization.

Notwithstanding the foregoing, the "Mark-to-market method" and the "Standardised Method" should be offered as an option for smaller/less sophisticated counterparties.

Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?

Institutions relying on internal models should be able to rely on their internal expected exposure model for the calculation of the IM requirement.

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. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

No comment.

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

The use of internal models should be limited to counterparties that have the operational capabilities to implement such models and are adequately supervised by relevant authorities with regard to a consistent and effective implementation of the model. This is at least to be assumed where a PRFC has received approval for the use of the internal model by the relevant competent authority.

Q20. Do you think that the "Internal Model Method" as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?

Yes.

Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?

No comment.

Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?

We are unable to provide any quantitative data.

Q23. To what extent would the „mark-to-market method" or the „standardised method" change market practices?

See above, response to Q16 (tendency to result in overcollateralisation, however, valid/useful option for smaller/less sophisticated counterparties).

Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.

Discrepancies cannot be completely avoided – these can, however, be minimised, where the models used are similar, in particular the model for the calculation of the potential future exposure.

Extended disputes over the calculation could have considerable implications in view of the proposed future capital requirements regime under which disputes continuing over a certain period of time may trigger additional capital requirements.

However, counterparties are generally able to settle disputes in a timely manner. The contractual documentations for bilateral transactions used by market participants provide for dispute resolution mechanisms.

Also, where counterparties are able to contractually agree on the applicable methods etc. this limits potential discrepancies and disputes.

Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?

Where this is contractually agreed in advance and where both counterparties agree on the calculation method to be applied, yes. Disputes could then be addressed under the contractually agreed dispute resolution mechanism.

However, this will generally not be an option where both counterparties apply internal models.

Q26. Do you see other options for treating such differences?

No.

Segregation and Re-use

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

a) Segregation in accounts

Adequate segregation in accounts (that is booking of positions/collateral in such a manner that the relevant positions can be clearly distinguished from other positions, in particular from own positions of the relevant counterparty holding the account) should generally be expected from all counterparties.

Of course, segregation in accounts can expose the counterparty whose collateral is held in this account to some level of counterparty risk in the event of an insolvency of the receiving counterparty in the event the collateral is provided as cash or securities via title transfer (as opposed to a pledge or securities held in a deposit account with a third party). In said situations, segregation in accounts may not be sufficient

to ensure legal segregation of these assets from the assets and liabilities of the account holder in case of an insolvency under applicable insolvency laws (generally, insolvency laws of the Member States do not recognise booking in separate accounts as a legally effective segregation of assets). However, this risk can be significantly reduced through the use of netting agreements, especially where collateral is provided under a financial collateral arrangement within the meaning of the Financial Collateral Directive (Directive 2002/47/EC).

In addition, the disadvantages of a full legal segregation (specifically the operational challenges, additional risks involved and the increased costs may outweigh the remaining counterparty risk (see below). This applies in particular to cash collateral which is always exposed to some degree to the credit risk in relation to the account holder: the use of a cash account held with a third party instead of the secured counterparty only replaces the credit risk *vis à vis* the secured counterparty with that of the account holding third party.

b) Third party segregation

There are a number of reasons which argue against making full legal segregation by involvement of third parties (as custodian maintaining the cash account or the depository account for pledged securities) mandatory:

- One, the involvement of third parties (as custodian or in a similar function) can be operationally very challenging and has a negative impact on the efficiency of the margining process (timely access to account information, timely adjustment of amounts). The involvement of a third party also increases the general operational, transactional and legal complexity. Counterparties require a certain degree of sophistication to address these complexities.
- Two, it will also introduce an additional layer of credit risk as well operational risks and maybe even concentration risk into transactions. As set out above, in relation to cash, the credit risk existing in relation to the cash account held with the secured party would be replaced by the credit risk in relation to the account holding third party.
- Three, third party segregation may limit the scope of collateral which counterparties may use for transactions. Third party segregation will presumably only be available for certain types of highly liquid collateral, such as cash and certain bonds and securities. This type of collateral will increasingly be sought after as a consequence of other regulatory developments also setting out more restrictive collateral requirements. Market participants will face considerable difficulties in procuring collateral meeting these eligibility requirements in order to satisfy all their collateralisation needs.
- Four, because of the above mentioned operational complexity and the additional layers of risk involved, there will be a considerably increase of transaction costs.

In many cases the negative impact on the efficiency on the margining process, the operational challenges raised, the limitations on eligible collateral and additional cost incurred will outweigh any putative advantages of third party segregation.

Hence, in general, the decision concerning the level of segregation, in particular whether to rely on third party segregation or on segregation in accounts should be left to the discretion of counterparties who will take this decision on the basis of their specific needs and risk profile.

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

In general: Booking in separate accounts held with the receiving/secured counterparty, clearly assigned to the relevant counterparty having provided the collateral. As an alternative, where this is requested by the counterparty, in third party held (custodian) accounts. However, we refer to our response to Q 27 and 28 above as regards the limited risk mitigating effects of such third party held accounts.

Q29. What are the practical problems with Tri-Party transactions?

See above, response to Q 27 under lit. b).

Q30. What are current practices regarding the re-use of received collateral?

The question of re-use of collateral arises in connection with non-cash collateral (securities) and where no title transfer occurs, e.g. where the collateral is pledged or held by a custodian. However, the majority of collateralised transactions currently involve full title transfer as this significantly facilitates efficient margining processes and reduces transactional costs.

Where full title transfer occurs, re-use of collateral is a common feature as this significantly reduces transactional costs.

Q31. What will be the impact if re-use of collateral was no longer possible?

This will necessarily have a direct impact on the liquidity (availability of collateral) and also transactional costs (no generation of interest on assets used as collateral, impact on the valuation/pricing).

5. Eligible collateral

Q32. What are, in your view, the advantages and disadvantages of the two options?

Option 1

While we generally agree that the criteria for eligible collateral should not be too broad, Option 1 would severely limit the ability of counterparties to procure collateral for their transactions: The eligibility criteria to be developed by ESMA concern CCP transactions which need to be very restrictive in view of the systemic role of a CCP. CCPs require exceptionally liquid collateral in order to be able to address defaults in extremely tight timelines to reduce the systemic impact of such defaults and in order to avoid repercussions for the other CCP members and the market in general. The same does not apply to bilateral transactions.

Applying the same standards (that are applicable to CCPs) to bilateral transactions will effectively mean that many market participants (especially NFC+) can no longer rely on assets they have at their disposal for collateralisation purposes (liquid securities, bonds etc. which do not meet the standards for collateralisation of CCP-transactions). These market participants will have to acquire assets meeting these strict standards from third parties. This of course not only imposes a considerable financial burden but also introduces additional risks. It is also to be expected that the general increase of demand for such quality of collateral will put a severe strain on liquidity. This holds even more true as other parallel regulatory initiatives (e.g. Liquidity Coverage Ratio) will also increase the demand for these assets which

could lead to further problems. E.g. a formerly liquid instrument could become illiquid, because market participants acquire and hold it for the aforementioned reasons thereby reducing liquidity.

The scope of collateral eligible for bilateral transactions thus needs to be significantly broader than that eligible for CCP transactions. Any potential risks can be addressed through adequate valuation of the collateral/haircuts. At the same time, no party should be required to accept each and any collateral deemed eligible. If, for certain reasons, the institution wants to apply stricter standards, it should not be barred from doing so.

Option 2

In view of the serious concerns over Option 1, Option 2 is clearly preferable. However, a list of financial collateral is a good starting point but could still result unnecessarily restrictive, in particular for NFC+.

While a broader definition of criteria for bilateral transactions (compared to CCP transactions) could be seen to dis-incentivise central clearing if looked at in isolation, this does not hold true in general. All transactions subject to the clearing obligation will need to be centrally cleared. This limits the potential disincentives to derivatives where clearing is optional: these are only those transactions not subject to a clearing obligation but in respect of which a CCP nevertheless offers clearing. This will apply to only a very limited section of the market. Furthermore, the general expansion of CCP clearing offers other incentives for using CCPs offsetting any potential disadvantages of a broader set of eligible collateral.

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included?

Yes. Counterparties will anyway have internal requirements limiting the eligibility of assets to be accepted as collateral. Within these internal requirements, they should have a sufficient degree of discretion to accept collateral.

A practical example of assets which may be acceptable as collateral for a counterparty but which may not conform to rigid/standardised eligibility criteria may be a mortgage, pledges on moving property/stock/materials of an industry client or bank guarantees. The specific risks connected to such collateral can be effectively addressed through adequate haircuts and other risk mitigation instruments.

Specifics regarding covered bonds

We ask the ESAs to consider the preferential claim given to covered bond issuers counterparties on the cover pool as an equivalent and appropriate collateralization.

As stated in recital 24 of the final text of the Regulation, covered bond issuers face impediments in providing collateral, which should be taken into account when drafting the regulatory technical standards. Derivatives used in covered bonds are bilaterally collateralized, but in a special way: the counterparty is posting collateral to the covered bond issuer in the usual ways, whereas the covered bond issuer does not have to, because the counterparty's claims are adequately collateralized by his preferential claims on the cover pool assets securing the covered bonds. Hence, in the event of the covered bond issuer's default, the source of payment switches to the cover pool, on which the derivative counterparty has a preferential claim alongside with the covered bond investors.

We believe that the high legal standards for covered bonds, especially concerning the quality of cover pool assets, guarantee the same safety level for the counterparty as receiving collateral. In addition, cover pools of covered bonds are generally over-collateralized. Some member states even have statutory overcollateralization, i.e. in Germany: Pfandbrief Banks are required to keep a statutory overcollateralization of at least 2% of the volume of Pfandbriefe outstanding in their cover pools on a net present value basis. In recital number 24 of the Regulation covered bonds are given a great level of recognition that fully reflects their safety, liquidity and resilience in times of stress, as witnessed during the recent crisis. Thus, only the counterparty should be obliged to posting collaterals, not the covered bond issuer that already provides collateralization by claims on the cover pool.

Should a broader range of collateral be restricted to certain types of counterparties?

No. The above mentioned effects are not only burdensome for NFCs but also FCs as they will generally affect all market participants.

Q34. What consequences would changing the range of eligible collateral have for market practices?

Limiting the range of eligible collateral will have far reaching effects: See above, response to Q 32 (liquidity constraints/cost implications etc.).

A retroactive obligation in respect of existing transaction would have even more serious and far-reaching repercussions and has to be avoided under all circumstances.

Q35. What other criteria and factors could be used to determine eligible collateral?

Counterparties need sufficient flexibility to determine the eligibility of collateral (see also response to Q33). Considering the broad range of assets that could be eligible, it will be very difficult to set out general criteria or indicators for eligibility of collateral. One solution could be to make recommendations and set out examples combined with a recommendations regarding the consistency of the system applied for determining the haircuts etc.

6. Collateral valuation / Haircuts

Q36. What is the current practice regarding the frequency of collateral valuation?

We understand that, currently, daily valuation is a common practice for the majority of PRFCs, potential NFC+ and also NPRFCs, at least where the collateral consists of traded instruments on deep and liquid markets which are subject to a certain level of volatility.

Weekly valuation is not uncommon in the case of smaller FCs with lower trading volumes and NPRFCs.

Q37. For which types of transactions/counterparties should a daily collateral valuation not be mandatory?

For NFC+ and counterparties below the (potentially established) threshold under Option 3 for posting of IM, a daily valuation would be very onerous. In addition, many less sophisticated counterparties with low

trade volumes will lack the operational capabilities for a regular valuation and thus would need to rely on their counterparty or third parties (valuation agents). Counterparties with low trade volumes which do not have the operational capabilities should not be subject to mandatory daily valuation.

Furthermore, regardless of the counterparty involved, daily valuation should not be required in respect of transactions with low volatility and/or insufficient liquidity for a daily valuation.

Q38. What are the cost implications of a more frequent valuation of collateral?

We are unable to provide quantitative data. However, the cost implications could be substantial in view of the operational challenges involved (depending of course on the scope of collateral to be covered by this obligation).

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

Yes. Generally, counterparties should be able to agree on the applicable haircuts with their counterparties (subject perhaps to certain minimum levels set).

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

PRFCs should be able to determine and agree on the haircuts to be applied. However, it may be considered to extend the right to use own estimates also to other counterparties having the requisite operational capabilities.

7. Risk management procedures, operational process for the exchange of collateral and minimum transfer amount

Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?

One key element will be the use of an adequate legal framework by reliance on generally accepted standard market documentation such as the ISDA Collateral Support Annex or the Collateral Annex to the German Master Agreement for Financial Derivative Transactions. In addition, the counterparties will need internal processes/guidelines to address all key aspects of the collateralisation process, including disruption events.

Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?

For counterparties having to implement the operational processes for the first time, the cost implications will be substantial.

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?

We oppose the idea of a rigid cap or even a scaled system of rigid caps for the minimum threshold/transfer amount.

The minimum transfer amount is influenced by a number of factors, including but not limited to the credit worthiness of the counterparty and the specific risks generated by the transaction. It thus has to differ depending on the counterparties and the specific transaction involved. A single uniform cap or a scaled system of fixed/uniform caps will impede efficient and risk adequate solutions.

In this connection we assume that question addresses the concept of "minimum transfer amount" as addressed in item 55 of the Discussion Paper.

Q44. How would setting a cap impact markets, transactions and business models?

We are unable to provide any quantitative data on the potential impact.

8. Intra-group exemptions

Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?

Under the laws of any jurisdiction, the transfer of assets or payment of liabilities between different legal entities, even within the same group, is always subject to a certain level of legal restraints and/or to the observance of some legal requirements, regardless of the type of group involved.

For example, all jurisdictions may have consent requirements (involving the governing body of the relevant entities involved in the transaction) or other formal requirements which need to be obtained/observed before making a transfer or payment of a liability. Also, all jurisdictions have some degree of legal constraints regarding transfers and payments under exceptional circumstances: e.g. in the case of an insolvency of one of the entities involved or where the payment or transfer amounts to the transfer of essentially all assets or in cases of fraud or breach of fiduciary duties.

Against this background, the exemption for intragroup transactions under the Regulation would have no practical effect if such general legal constraints or requirements were to be considered to constitute a transfer/payment impediment for the purposes of Art. 11 of the Regulation.

This would have far reaching negative effects on the effectiveness and efficiency of group-wide risk management: Without the exemptions, all intragroup transactions would be subject to mandatory collateralisation. This would effectively result in a fragmented and highly complex risk mitigation structure, thereby introducing additional and layers of operational and also credit risks. Also, the need to collateralise intragroup transactions would further increase the strain on the liquidity management (which will already be very significantly affected by the collateralisation requirements in respect of CCP transactions and the increased liquidity demands resulting from other regulatory requirements). The negative effects clearly outweigh any risk mitigating effects which may be attributed to a collateralisation of bilateral intergroup transactions.

Consequently, only extraordinary restrictions or requirements materially affecting a prompt transfer of own funds or repayment of liabilities can be considered to constitute an impediment within the meaning of Art. 11 (5) to (9) of the Regulation.

In this context it also needs to be taken into account that the technical standards to be defined may have an inadvertent impact on unconnected issues addressed under the present Directive 2006 /48/EC: Under

Art. 80 (7) (e) and also Art. 80 (8) (a) – which refers to Art. 80 (7) (e) of Directive 2006/48/EC, the non-existence of material impediments to the transfer of own funds or repayment of liabilities is already a prerequisite for the recognition as a group within the meaning of Art. 80 (7) or (8) of Directive 2006/48/EC. In order to avoid unwanted effects or conflicts between the connected but nevertheless distinct regulatory regimes, it will be essential to take this potentially far reaching impact into account.

In any event in view of the fact that the recognition as a group within the meaning of Art. 80 (7) and as institutional protection schemes within the meaning of Art. 80 (8) of Directive 2006/48/EC necessarily involves the determination that no material legal/practical impediments exist, groups which have been recognised as being in compliance with the requirements of Art. 80 (7) and (8) of Directive 2006/48/EC should automatically be recognised as qualifying as groups for the purposes of the relevant intragroup exemptions of the Regulation.

Q46. What is the current practice regarding the collateralisation of intragroup derivative transactions?

Intragroup transactions are currently generally not collateralised. This reflects the fact that the counterparties of these transactions do not constitute a credit risk. This fact is not only recognised by the existing capital requirements regime under the Directive 2006/48/EC but will also be recognised by future capital requirements regulation under which intragroup exposures will continue to be weighted with 0%.

Collateralisation of intragroup transactions of a group applying a group wide risk management, respectively, suitable and uniformly stipulated systems for the monitoring and classification of risks in institutional protection schemes, would generally be counterproductive for the effectiveness of the risk mitigation measures within the group.

Collateralisation will generally have no impact on the stability of the group as a whole. Rather, it adds additional levels of operational and legal complexities as well as additional strains on the liquidity management, thereby introducing additional credit and operational risks. These additional risks and complexities outweigh any putative benefits of collateralisation.

Furthermore, there are no benefits to mitigate the considerable additional costs resulting from the challenges posed by intragroup collateralisation.

9. Cost-benefit analysis

Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?

We are unable to provide any quantitative data.

However, it is already clear that the integration of such IM/collateralisation requirements under the Regulation into the existing collateral management processes will have considerable cost implications and will also be operationally very challenging.

The implementation of the new structures will also be very time consuming. Thus, it should be considered to provide for a sufficiently long phasing-in period (not less than 12 months).