

EFAMA's comments to the ESA's Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (EMIR).

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 57 corporate members approximately EUR 14 trillion in assets under management of which EUR 8 trillion was managed by approximately 54,000 funds at the end of 2011.

Thank you for giving us the opportunity to submit evidence on the proposed ESA's Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (EMIR).

EFAMA welcomes as very positive and fully supports the initiatives aimed at enhancing safety and transparency in the over-the-counter derivatives market.

Although we agree with many of the ESMA's guidelines, we wish to submit the following answers and comments to the consultation.

GENERAL REMARKS

- We agree that counterparties should be encouraged to use CCPs whenever it is economically justified (e.g. due to hedging need, prevailing liquidity or transaction size). However, we do not agree on the view that market participants should be encouraged to use standardized transaction types just for the sake of it.
- The foundation of derivatives market and product development is to find an optimal product to a given (mostly hedging) need. Now the emphasis seems to be on finding suitable risk management needs that could be tackled with standardized derivatives and/or trying to eliminate uncovered exposures in the bilateral market at any cost. This approach should be re-considered as it would lead to less sustainable innovation and less protection for new instruments.
- In our opinion, regulation should remain neutral in terms of different product types (standardized vs. non-standardized). In a case where the regulation leads to a situation that the most adequate product type is made too expensive for the end user, the end user may drift away from hedging or prefer less regulated instruments, moving and increasing risks. On an economic level this would increase the systemic vulnerability as hedging levels could generally decrease. This would be quite the opposite from what the EMIR regulation is trying to achieve.

- Overall, however, we believe that the additional cost and liquidity implications of, in particular options 1, 2 and to a lesser extent 3, could create barriers for a number of derivatives users and therefore has potential to add systemic risk.
- Regulated funds and specifically UCITS should be considered as PRFCs although recital 13 does not consider them as such. Speaking of Prudentially Regulated Financial Counterparties (PRFC), UCITS seem to be safer and more tightly regulated than any other financial institution. The question may be debated as far as AIFs are concerned before full implementation of AIFM.
- Retroactivity has to be banned: the many existing deals should not be affected by the new regulation in their dispositions that might impact their economic conditions. A grand fathering clause for the existing deals is an absolute necessity, as introducing new rules in terms of collateralisation can only lead to a change of the financial terms of the deal.
- Mitigation of risk is the only objective: as we understand it, the proposed regulation essentially aims at organising proper risk management and reducing risk in order to avoid systemic fragility in the finance industry. Thus, regulation should avoid imposing collateralisation in situations where there is no increase of risk and providing for mechanisms reducing collateral in case when offsetting previous risks.

These points are very important in EFAMA's view and complement the commentaries already provided to the consultation by ESMA on its discussion paper on draft technical standards for the regulation on OTC derivatives, CCPs and trade repositories.

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)?

EFAMA believes that the requirement for Insurers and IORPs (i.e. PRFCs) to provide to provide initial margin will result in lower returns for investors, especially UK pension funds, as they will be forced to move further into cash and near cash assets to ensure there is sufficient liquidity to meet the margin calls.

Whilst we recognize the existence of an exemption from clearing proposal for pension fund exemption under EMIR, we understand that this would not apply to non-cleared transactions which are likely to be subject to even higher IM levels than cleared transactions. Depending on the model adopted, the posting of initial margin could substantially increase counterparty risk to pension funds and insurance companies alike.

Such requirement could be mitigated by allowing a wide range of eligible collateral and ensuring that it is securely held without re-use. Even so, the cost will rise, as there is a cost associated with additional collateral management.

We are also concerned that there will be a disproportionate impact for pension funds operating in the UK, Ireland and Netherlands as other EU jurisdictions do not generally operate retirement provisions as funded schemes.

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

EFAMA agrees that requiring an initial margin should, at least to some extent, prevail. Any losses that a non-defaulting counterparty may incur following a default should be avoided as they are key elements in building a systemic risk.

As the ESAs agree, the loss of initial margin should affect the defaulting party only. Further, as margin requirements may be tailored to reduce risks attributable to a particular transaction, we do believe that the “defaulter pays” concept would be more purposeful than the more broad-sided capital requirement regime. We support also the symmetrical feature of option 1, as both parties would be treated equally and this avoids shifting the risk to the NPRFC only.

However, we see different limitations:

- 1) it is important to note that the counterparty to a PRFC is less exposed to risks relating to the insolvency of the PRFC and, for such purpose, IM requirement of the PRFC should inherently be less extensive than that for a NPRFC or NFC+. To the extent capital requirements are relating to the details of a particular transaction, the IM requirement should be reduced proportionally, since there would otherwise be a double counting of risks resulting in unnecessary capital and transaction costs. Correspondingly, IM posted for the purpose of mitigating the same risk that the capital requirements is said to reduce should have the effect of minimising any such capital requirement.
- 2) If PRFCs, NPRFCs and NFCs+ are all required to post and collect appropriate IM then the requirements should not be punitive for the sake of being so.
- 3) Level playing field must be maintained and regulatory arbitrage must be avoided, consequently those requirements could put European institutions at a disadvantage vis à vis their American competitors as Dodd Frank does not require that both sides put initial margin (IM).

Consequently we believe that initial margin should be subject to the caveat that the requirement to post initial margin should take into account the diverse nature of the counterparties, their business rationale, investment strategy and their financial stability, as well as the different nature of the financial instruments concerned (in respect of underlying, price volatility and liquidity).

This option could be combined with option 3 (threshold) – particularly for the more regulated funds, which, in our view, should be subject to a higher threshold or to no IM at all.

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

According to EFAMA members' experiences, supervisory authorities regulate and control PRFCs adequately. UCITS are even more tightly regulated. Provided PRFCs have daily collateral management processes with low collateral thresholds in place then this would be sufficient to minimize losses in the event of a counterparty default.

However, in our opinion, the absence of capital requirements for NPRFCs and NFCs+ could lead to a situation where PRFCs would not be protected against a default by those counterparties. Taking into account the consequences that would apply on PRFCs only, the scenario does not seem sensible.

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.

As mentioned in our response to Question 1, the requirement to post and collect appropriate IM would result in lower investment returns on funds and, in particular, for pension and insurance funds where the margins could be very high due to the directional nature of exposure. We would refer ESMA to the work that we undertook together with UK's Investment Management Association on the impact of IM on pension funds.

Our members also foresee that an increased cost on derivative transactions will increase the total borrowing costs for corporates. This is mostly due to the fact that the hedging costs on derivatives in the interbank market will increase.

Globally, EFAMA estimates that the cost will greatly vary according to the level of collateral required, the type of collateral that will be eligible and the level of haircuts applicable. Most funds could indeed not post cash as IM and could offer as collateral only those securities that are compliant with their investment strategy. Any intermediation to get eligible collateral would be costly for the fund holder, burdensome for the asset manager and introduce new risk.

We note also that whilst an asset rich client such as a UCITS or pension fund would benefit from well secured arrangements, preventing re-use of assets, credit institutions may find it harder to accommodate having their assets tied up in secured IM. However we believe that in the interests of reducing systemic risk and (post Lehman and MF Global) improving investor protection, secured models could be viable option to deliver on both ambitions.

Finally a requirement to post and collect initial margins will require many participants to set up new or improved systems which will incur upfront costs and mean increased on-going administrative costs. It is difficult to quantify the amount exactly.

Q5. What are your views regarding option 2?

Whilst we recognize the intent in the US regulation to ensure the most systemically important institutions are adequately capitalised, the collection of IM from NPRFCs, such funds and their clients, would result in an increase in counterparty risk for our clients to these institutions.

Many NPRFCs are UCITS funds and as such are subject to stringent regulatory requirements including restrictions on investment and the use of leverage and derivatives. The assets of such funds are held in safe keeping with custodians and depositaries, who will themselves, be PRFCs.

As the majority of our clients are unleveraged long-term savings, life and pensions related, Option 2 is essentially asking better rated counterparties to post additional collateral to lower rated institutions to protect them at the expense of "the man on the street".

EFAMA is then against that proposal as option 2 would provide a clear disincentive for pension funds to continue to use this option because of potentially higher costs and lower risk mitigation. We see no purpose in disrupting this beneficial flow of business which carries no added systemic risk to the market.

Should the option 2 be the option chosen by ESA considering the fact that this option is close to the proposed US regulation and that it is important to get a level playing field on both sides of the Atlantic, we would strongly recommend that option 2 be completed by option 3.

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

EFAMA members believe that the proposal to limit the requirements to post IM would impact the level playing field between PRFCs and NPRFCs/NFCs+, leading to a situation where the NPRFCs and NFCs+ would have more capital to invest and take use of.

The return on the savings and pensions of individuals invested directly or indirectly into investment funds is likely to be impacted adversely, and additional counterparty exposure could be created for investment funds to banks, depending on the nature of the security structure of the initial margin. There may also be incentives for NPRFCs to trade with each other directly rather than via PRFCs to avoid one way posting of Initial Margin. PRFCs such as pension funds and insurance companies may also decide to invest directly in derivatives, rather than via investment funds.

We also refer to our answer to question 5.

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?

EFAMA reads recital 29 as presenting option as a supplement to either option 1 or 2. It allows PRFCs not to collect IM from a given PRFC or NPRFC if the exposure to that counterparty is below a threshold. Could you confirm our understanding?

Currently, our members are either receiving IM or don't give any IM. The threshold is often used on a counterparty basis with reference to the counterparty and reciprocal clauses in the agreements.

Generally speaking, EFAMA would like to stress that pension funds, insurance vehicles and other entities such as UCITS and other regulated funds are not currently required to post initial margin with their counterparties. This situation reflects the extremely low risk of default given the extensive degree of regulation applied to the funds, their underlying investment profile, historically low leverage levels and their focus, which is investment rather than trading.

EFAMA believes that UCITS should not be required to post IM on non-cleared trades if the global net absolute exposure, aggregating all the OTC derivatives transactions traded with a same counterparty, is below the regulatory threshold set out in article 52 of UCITS Directive n°2009/65/CE on the coordination of laws, regulations and administrative provisions relating to UCITS ("UCITS Directive"). This threshold is set at 10% of the fund assets when the counterparty is a credit institution or 5% of its assets, in other cases.

A different approach than the use of thresholds is the use of haircuts, connected to the type of collateral eligible, and concentration limits, connected to the issuer or the issue of the collateral used. The stricter the type of collateral, the less important the haircuts become. The more important the type of collateral, the bigger the holding of an issue or an issuer can be. On the opposite, if a broad range of collateral types is allowed, it is extremely important to apply the relevant haircut and concentration limits.

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

EFAMA believes that the ESAs should not only focus on a threshold and should apply those amounts to every OTC derivatives counterparty.

All counterparties should be allowed to benefit from the threshold approach. It is for the PRFC to decide of the appropriateness to call IM or not and to define the level where it will not have the choice not to call.

As funds (UCITS or AIFs) are highly regulated investors, they should be the typical beneficiaries of a threshold.

We believe that any threshold should reflect the likelihood of default of the counterparty as well as the level of exposure.

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?

EFAMA members believe that, for funds, the threshold could be set according the leverage, the risk exposure and the liquidity of the portfolio and the counterparty.

EFAMA also believes that a same way of calculating IM should be applied to funds (e. g. Value at Risk ("VaR")) that enhances consistency and simplicity.

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

EFAMA believe that a threshold change is likely to result in a change of behavior that could lead to different disincentives to follow the level of risk of their counterparties. Introducing undifferentiated IM calls would increase cost and reduce liquidity without addressing adequately the issue of counterparty risk coverage.

We believe that the approach in option 3 would then be the most reasonable approach as it would require actions from the parties that are significant enough for the systemic risk.

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

For excellent reasons, ESAs do not ask for a default waterfall with respect to OTC derivatives not cleared by a CCP. Therefore, EFAMA believes, that for the same reasons, the implementation of Initial Margins for non-cleared should be avoided.

Nevertheless, if the ESAs deem the daily exchange of collateral due to market standards not being sufficient, and therefore intend to further tighten the collateral requirements, even when not necessary in light of the commitments of G-20 and the provisions of EMIR, EFAMA believes that

- ESAs should properly consider regulatory specialties applying to groups of market participants like regulated funds resulting in a release from any Initial Margin obligations;
- ESAs should allow market participants to increase the haircut on all or specified class of collateral as alternative to considering Initial Margins.
- ESA should consider that, where a counterparty (e.g. a pension fund) is exempt from clearing, it is not penalized by excessive IM requirements in an non-cleared environment.

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

EFAMA believes that maintaining a level playing field at different levels is crucial.

Those levels are mostly (i) clearing obligations between the EU, US and other jurisdictions and (ii) competing products (such as Funds or Notes e.g. specific exemptions for intra-group deals on structured notes should not put structured funds at a disadvantage).

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

EFAMA believes that, instead of creating benefits or incentives, a mandated IM would result in lower investment returns (as counterparties will be required to move away from assets that provide higher returns) and a reduction in the volume of OTC derivatives trading and consequently less risk management of funds (as such contracts are used mostly for hedging purposes).

Consequently, this could also lead to an increased incentive, either not to hedge existing risks any more or to hedge existing market risks via certificates and warrants, which are not subject to collateral obligation.

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?

EFAMA believes that, generally and from a risk management perspective, the daily exchange of collateral is the most efficient counterparty risk “mitigant”.

Nevertheless, any exchange of collateral on a daily basis would put Middle and Back offices under pressure for non significant amounts and would result in extra costs. Therefore, we deem necessary to have Minimum Transfer Amounts (MTAs) subject to any agreed minimum transfer amount.

Additionally, some of our members are managing funds which calculate a NAV on a weekly or monthly basis should be allowed not to exchange collateral daily. Some clients like insurance companies may not be in a position to exchange collateral more frequently than monthly (except if contractually predetermined conditions are reached).

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

EFAMA believe that some smaller market participants may find it challenging to carry out a daily exchange of collateral to cover variation margin, both from an operational and a cost perspective. However, it is a standard practice for most of our members and for a long time.

The cost impact would however strongly derive from the complexity and strictness of regulatory requirements.

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?

EFAMA believes that the models proposed are all bank models and do not reflect the broad range of participants in the OTC derivatives markets. Both mentioned methods appear reasonable but not very useful in practical implementation for an investment management company.

We do not believe that the models should be mandated. We believe that the model used should be agreed between the counterparties (or their agents/investment managers) and should be flexible. Additionally, whichever method is to be used by the counterparties should be aligned to the CCP's requirements and should not be punitive for the sake of it.

However, we also believe that it would be helpful for regulated counterparties (and their agents) to agree their models with regulators; and that models should reflect the different types of counterparties and their underlying risk of default.

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

Together with our members, EFAMA believes that a key factor which should be taken into consideration is the probability of a particular counterparty defaulting. That is the critical risk in each bilateral contract. As expressed for Q7, this shouldn't apply to UCITS.

Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

The current practice across EFAMA members is to include in contracts the option constructed so that a waterfall of actions, including calling for additional security, are required before reaching a point where the contract may be terminated by the default of their bank counterparty.

That option may be a call for an independent amount in the event of a credit rating downgrade of their bank counterparty.

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

According to EFAMA, internal models should not be limited to PRFCs as NPRFCs, such as UCITS funds, use regulated agents and intermediaries to manage their collateral positions and as those agents have developed internal models appropriate to their client base.

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?

EFAMA believes that Internal Model Method is a reasonable solution. In general, we believe that internal models should be preferred over standardised approaches for calculating IMs.

We also believe that it could be problematic to determine any Initial Margin on a transaction-by-transaction basis.

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?

As said above, the Internal Model Method would be our preferred method.

We are then in favor of an approach by the authorities to make sure that applying CRR and Solvency II frameworks simultaneously by different market participants will not distort pricing and will not impact level playing field.

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

EFAMA has no comment.

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

EFAMA considers that the scope defined questions 16 to 23 and related answers, referring to Capital Requirements Regulation in order to calculate IM, is acceptable. In that respect using Internal models, as long as they have been approved by a relevant local authority placed under the supervision of an ESA, should be authorised.

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

EFAMA members do not foresee any practical problems, provided that both counterparties agree on the calculation methodology and a dispute resolution process prior to the agreement on any OTC derivative transaction.

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

Most of our member believe that it would be feasible, at least as a default option in the absence of any other agreement between the counterparties, especially if the model used by the competent authority.

This should however be subject to suitable limits such as the communication of the full details of the internal model used and any changes and allowance of the formal authorization to challenge any margin call when necessary.

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

EFAMA members believe that, with reference to questions 24 to 26, it is not problematic for different counterparties to calculate different amounts for IM as counterparties' situation may differ in terms of exposure and capital requirements. These differences may constitute market opportunities and differentiate counterparties when looking for best execution.

EFAMA members believe that the most flexible solution is to allow counterparties to agree the methods that will be used and to have full transparency of methodologies and calculations.

Consequently, there is no need for equal IM. For market simplicity it may be suggested that parties agree on Dispute Resolution methods or to designate one as calculating agent (as it may be the case today).

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?

Most of EFAMA members are of the view that segregation of collateral in segregated accounts held by third party custodians should be possible, although in some EU member states or for some clients (e.g. some pension fund), it would not be permitted for collateral to be held by a custodian who is part of the same group as the counterparty. We would request that ESMA clarifies this situation.

The obvious benefit to holding collateral in segregated accounts with an independent third party is that the collateral will be ring-fenced and therefore afforded the necessary protections.

However, additional costs would be incurred due to the requirement to pay custody fees etc.

Additionally, we are concerned that the posting of initial margin will increase the counterparty credit risk of our members' clients' and would also have an adverse effect on returns.

Another point to consider is the impact on interest amount calculation (and frequency of payment). Under title transfer parties typically agree to pay interest on collateral received (up to Eonia (Euro OverNight Index Average) that is part of the valuation of transactions.

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

EFAMA members believe that whatever the solution is, there will always remain a risk.

According to the country of residence and the bankruptcy law applicable, some funds could remain with a credit against the bankrupt cash correspondent (cash depository) as the collateral would not be taken into account in the ratios required for cash deposits.

Some other countries consider that, for regulated investment funds, the risk of a default of the credit institution storing the amounts received as collateral on an account is limited, because they are only allowed to have a maximum default risk of 20% of the Net Asset Value of the investment fund with regard to one credit institution providing a cash account. As consequence, the default risk regarding the credit institution providing the cash account is being diversified by the obligatory usage of more than one credit institution, if the 20% limit is reached (cf. Art. 52 para. 1 of Directive 2009/65/EC).

An option to meet those points could be the creation of third-parties cash collateral agent with sound credit capacities but the regulatory and capital required to face those activities would have to be subject to a separate analysis and in-depth debate.

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

EFAMA believes that Tri-party contracts could be a workable way to achieve real segregation and achieve counterparty risk, especially if the assets posted as collateral are securities.

EFAMA fears however that this could lead to issues of liquidity and substitution of assets for some funds, even UCITS funds.

EFAMA foresees also issues over applicable model and related applicable law and possible additional costs, both in terms of establishing the agreement and ongoing operational costs.

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

According to their respective national laws, EFAMA members have different practices.

Some members have strict conditions to allow re-use collateral, often leading to the effective absence of re-use. Some other can re-use collateral received, which is part of the increased value benefitting to clients.

Whatever the countries, the conditions are however the same criteria, despite applied differently. The collateral must re-invested in low risk, liquid assets and cannot impact the risk ratio of the funds.

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

EFAMA members consider that the impact would be different according to the nature of the collateral exchanged.

If the collateral is made of securities, the impact would be limited as it is not a well-spread approach and would lead mostly to loss in revenues for final investors.

If the collateral exchanged is cash, it could lead to severe losses in performances as custodians pay on average Eonia-30 bps to Eonia-50 bps on standard cash deposits whereas a return of up to Eonia can be achieved by posting collateral. The rationale behind this different treatment is often viewed as the result of the overall stability in cash amounts exchanged between parties over a longer period of time.

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

EFAMA believes that, from the perspective of an investment management company, we have to admit that none of the suggested options is suitable.

Differing from banks which are able to accept a wider range of collateral, regulated investment funds have to comply with statutory and contractual limits regarding the class of assets which are eligible for investments as well as their volume. Therefore, the intended limitations on the variety of collateral eligible for CCP clearing would lead to the situation where repos are required in order to enable investment funds to provide cash collateral while remaining invested in accordance with the investment duties. It will also be too restrictive given differences between central clearing house models and those of individual firms.

The ESAs should therefore consider that an additional increase of requirements for collateralization creates an incentive for market participants not to hedge existing risks or to purchase securities like certificates, not subject to a collateralization which would have serious impact on level playing field for funds and would have direct impacts on financial pillars such as UCITS funds.

EFAMA would favor an approach that replicates that set out in the CPSS-IOSCO draft standards.

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

Following market global liquidity constraints, EFAMA members believe that a wider range of assets should constitute eligible collateral based on the CPSS-IOSCO draft standards. We would suggest the inclusion of corporate bonds and potentially asset backed securities or shares of funds. We also believe that this broader range of collateral should be accessible to all participants.

EFAMA supports a two-steps approach when defining eligible collateral:

1. Creation by ESA of general principal for collateral eligibility. This would be that these principles could be based on efficient and frequent valuation of the every asset, especially in times of market stress, thus creating a system where the eligible collateral would not have to be based on asset classes.
2. Introduction of a broader range of collateral. As said, considering the current liquidity constraints especially for NFCs+, some market participants don't have relevant assets to post as collateral. It could then be credit risk lines against physical collateral (which does not differ from traditional funding, excluding the challenge to estimate adequately the Exposure at Default (EAD)) or corporate bonds or equities or some asset-backed securities or shares of funds.

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

As said in question Q32, EFAMA believes that changing the range of eligible collateral might lead to the consequence that some market participants will become unable to hedge existing risks.

Also, an additional increase of requirements for collateralization creates an incentive for market participants not to hedge existing risks or to purchase securities like certificates, not subject to a collateralization and may result in differential pricing of OTC transactions, depending upon the assets deemed to be acceptable.

As said for Q33, maintaining or, even better, expand liquidity is a key factor to restore financial stability. In our view, a situation where only cash would be seen as eligible collateral would lead to a Thus limiting collateral to cash would increase the systemic risks especially in times of market stress.

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

When discussing Q32 to 35 over the eligible collateral, EFAMA believes that ESAs should keep in mind that investors are subject to different regulations that limit the type and the quantity of assets they may hold.

Fund industry is particularly sensitive to that type of regulation.

Therefore EFAMA believes that the range of eligible collateral should be very large, larger than either CCPs or CRR lists, with detailed and efficient use of haircuts and concentration limits to take into account the different characteristics of different securities.

From a market perspective, if there is too short a list of eligible collateral, this creates volatility and settlement risks over the eligible securities which may just become overvalued and illiquid as all participants will either keep them to be used as collateral or try and buy some for the same purpose. We also believe that collateral should not be allowed to be posted which is issued by or linked to the performance of the counterparty/group company of the counterparty posting it.

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

EFAMA reminds that, currently, the frequency of valuation depends on the type of funds and the types of collateral. Most of our members who are managing collateral for their clients will undertake daily collateral valuations and exchange on variation margin.

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

As said above, in EFAMA views, when a fund publishes a weekly NAV, the weekly valorization of collateral would be sufficient, except in extraordinary circumstances.

Another set of exceptions could be optional for non-financial institutions and certain non-financial non-systemically important institutions.

It may finally be sensible to include a “minimum amount” threshold (e.g. based on notional value) for clients using derivatives on a very restricted basis. This would allow clients such as UCITS funds that only occasionally use derivatives for short term efficient portfolio management purposes to continue to engage in this activity without undue costs relative to the benefits of the activity.

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

EFAMA members are against this proposal.

According to our view, more frequent valuation of collateral will result in increased operational, systems and people costs. Any obligation valuation more frequent than daily valuation and to post/call for margin will have a significant cost impact on all members and their clients, as it will potentially double the operational requirements for each OTC derivatives contract executed and held in a portfolio.

This could also lead to an impact on liquidity as alternatively investors may just decide to post excessive margins to meet the minimum required during all the period between two calculations.

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

EFAMA believes that counterparties should be allowed to use their own estimates of haircuts, and agree between themselves what should apply. This allows maximum flexibility so that participants can take into account market conditions and the volatility and liquidity of each type of eligible collateral on an on-going basis.

Additionally, in the case of non-financial collateral, financial institutions have strong tradition of sophisticated valuation methods, approved by local authorities.

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

EFAMA members do not support the use of own estimates of haircuts being limited to PRFCs, as we believe that a number of NPFRCs (e.g. investment funds) are sophisticated users of derivatives and have sufficient capability to determine appropriate haircuts. Many PRFCs (e.g. pension funds) will also use investment managers and other advisers to assist with this. Any counterparty having a competent risk management team should be in a position to estimate haircuts.

However it is important to know that the procedures for establishing such estimates should be under the supervision of a local or European authority.

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

EFAMA members agree with the ESA's view that counterparties should have a robust operational process, which could vary depending on the countries legal framework, for the exchange of collateral and put in place appropriate documentation and systems and controls. We are supportive of a daily exchange process and a low minimum transfer amount. We are also of the view that there should be an agreed collateral dispute resolution mechanism between counterparties.

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

Most of EFAMA are already operating daily margining. Consequently, we expect any costs to be minimal, given that we already operate a daily process. However, this may not be the case for some smaller participants and the expected costs may vary depending on the complexity and strictness of regulatory requirements.

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

EFAMA supports the setting of a cap for the minimum threshold amount while leaving the issue otherwise to the counterparties. We do not think that an upper limit to this should be mandated by regulation.

It should be left to the counterparties to agree on a case by case basis depending on the assessment of the credit risk of the other counterparty and the level of exposure that the counterparties will take.

In our members view, another possible approach would be to have a zero threshold and a low minimum transfer amount depending on the counterparties and the operational needs and capacity.

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

EFAMA believes that a cap would decrease the costs of the collateralization.

The determination of a minimum transfer amount (questions 43 and 44) has to be done client by client, i.e in the asset management at the Fund level and not at the Management company level.

The aim of this threshold is to avoid unnecessary transfers as long as the amount is not significant and does not represent too important a risk. Fixing a cap in absolute terms might be irrelevant. A cap conceived as a percentage could be more appropriate. A difference should be established according whether or not there is an IM posted or not: the lower the IM, the lower the cap on the transfer amount.

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?

EFAMA would welcome clarity as to what is captured by the definitions of 'intra-group transactions'.

The current practical advantage of "intra-group" transactions is that the holding is a rated entity that may be in a better position to fund the required collateral than the intra-group entities that are part of the holding. However if the intra-group transactions would become subject to similar (e.g. daily collateral exchange) requirements between entities of the same group, any benefit of using an intra-group transactions would be gone.

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

Depending on the structures among our members, there is either no collateral exchanges or no intra-group derivative transactions.

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?

In EFAMA members' view, the impact of the proposals from a cost perspective will depend on the initial margin model adopted and the degree of flexibility permitted in relation to eligible collateral but it should not be punitive. Anything close to the CCP margins would provide an incentive to clear.

We have concerns, however, that the one-directional nature of funds activity would result in clients (such as pension funds) paying the majority of initial margin both in central clearing and outside which seems counter-intuitive given the low level of counterparty risk that these entities pose to the financial system.

If initial margin is required to be collected, this will impact the returns on portfolios of those counterparties required to post, especially pensions funds, insurance companies and regulated funds, and potentially increase counterparty risk (which may require some market participants to further diversify their OTC derivatives portfolio to lower rated counterparties, if they have prescribed limits on counterparty exposure). It will also increase operational overheads for many counterparties as it will involve setting up a whole new set of processes and procedures and legal documentation.

As mentioned above in answer to Q27, these could both be mitigated by the use of assets provided as collateral held in a segregated account by a third party custodian, with flexible substitution rights, independent valuation, and ownership of all income and gains in the hands of the party posting collateral.

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