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"EMIR"

AFG comments to the 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

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The Association Française de la Gestion financière (AFG)[1] welcomes the 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.

The French market is recognized for its expertise in derivatives markets since 1986. Our members, as buy side actors, have been using OTC derivatives as an investment tool in

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[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

various types of strategies since then. As an industry, if we favour globally more standardisation in the derivatives space, we are also using nevertheless OTC derivatives that are customized for specific needs and ineligible to compensation.

General Comments

We would like to preface our detailed comments by stressing several points:

Regulated funds and specifically UCITS are safe products: the regulation prevents UCITS from leveraging, limits risk exposure and requires portfolio diversification and continuous risk management. As far as capital requirement is concerned, the assets of a fund are totally dedicated to capital holders with a NAV calculated on a marked to market basis. Speaking of Prudentially Regulated Financial Counterparties (PRFC), UCITS are safer and more tightly regulated than any other financial institution and do not present any systemic risk. As a consequence, collateralisation thresholds and eligible collateral should be adapted when a fund is the counterparty.

Retroactivity has to be banned: existing contracts should not be affected by the new regulation in the sense of impacting their economic set-up and impeding to fulfil their fiduciary duty. For instance, structured funds have been marketed to the public, typically with a guaranteed capital and a participation in the performance of an index. **A grand-fathering clause for the existing contracts 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.

The proposed regulation essentially aims at organising proper risk management and reducing risk in order to avoid systemic fragility in the finance industry. Any decision should be weighted to assess its relevance in that respect on all market, counterparty, liquidity and operational risks. 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. **Back to back transactions or mirroring should then be considered as a whole.**

Mutual agreement is key when negotiating OTC contracts and some **flexibility** should be left to the parties. Our members feel that **eligible collateral, level of threshold to implement, initial margin on top of variable margins or level of minimum transfer amount should be principle-based while their precise calibration should fall on counterparties.**

Due to their very low risk of default, **UCITS should be exempted from posting initial margins**.

Some questions hereunder will not be commented as our members do not feel they have a strong view to express on the point they raise.

<u>Please see our detailed responses below:</u>

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)?

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

We believe a fourth option should permit counterparties to choose not to exchange IM. This view is justified by the following elements:

- IMs do not correspond always to a market practice. Risks are already captured at the bank's capital requirements level that are reflected in the transactions' prices.

- IMs represent an additional cost and finally bring more constrains than safety, in particular in relation with the freezing of amounts.

- An investment fund does not always have the amount at hand to constitute the IM.

Relative to option 1, our members believe that requiring that all parties deposit initial margin may sound a very safe way to mitigate risk if full segregation in hands of a third party is established. To favor such a requirement, our members would also question if it won't put European institutions at a disadvantage vis à vis their American competitors as apparently Dodd Frank Act does not require that both sides put initial margin (IM).

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

In our members' view, a PRFC is adequately protected against default without IM if he holds enough capital. We believe UCITS should be exempted from posting IMs.

UCITS are even more tightly regulated than PRFCs. This should be recognized and permit them to benefit from specific arrangements when necessary. Pursuant to UCITS Directive, a UCITS is subject to very stringent rules that ensure that it will not default, such as:

- Counterparty risk limits with two thresholds (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);

- Diversification rules;

- Limitation of the global exposure relative to derivative instruments: the global exposure shall not exceed the UCITS total net asset value.

As a consequence, **<u>UCITS should be exempted from posting IMs</u>**.

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.

Our members estimate 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 would 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 risks.**

Q5. What are your views regarding option 2?

From a level playing field perspective, our members appreciate the fact that this option is closer to the proposed US regulation. However, our members would be more favor of option 3 in what concerns the use of a threshold (with the difference that it would be better to have reciprocal treatment and apply it to all actors).

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

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?

UCITS should not be required to post IM on uncleared 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.

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

All counterparties should be allowed to benefit from the threshold approach.

As UCITS are highly regulated, they should be the typical beneficiaries of the threshold (as defined at Q7 above).

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?

We believe that the threshold should be calculated based on the credit risk and commercial judgment of the firms concerned. The UCITS should be free to set appropriate thresholds for collecting IM depending on the type of counterparty, as set out in article 52 of the UCITS Directive.

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

No change would appear from the current business model as investment banks can call for initial margin if and only if a certain level of risk exposure is reached. On the contrary, introducing undifferentiated IM calls would change present practice and disincentives actors to follow the level of risk of their counterparties.

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

A fourth option should permit counterparties to choose not to exchange IM. This view is justified by the following elements:

- IMs do not correspond always to a market practice. Risks are already captured at the bank's capital requirements level that are reflected in the transactions' prices.
- IMs represent an additional cost and finally bring more constrains than safety, in particular in relation with the freezing of amounts.
- An investment fund does not always have the amount at hand to constitute the IM.

As explained for other questions above, UCITS are more tightly regulated than PRFCs and should benefit from specific arrangements in some instances.

Pursuant to UCITS Directive, a UCITS is subject to very stringent rules that ensure that it will not default, such as:

- Counterparty risk limits with two thresholds (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);
- Diversification rules;
- Limitation of the global exposure relative to derivative instruments: the global exposure shall not exceed the UCITS total net asset value.

As a consequence, and due to their very low risk of default, UCITS should be exempted from posting IM.

Furthermore, UCITS should also be exempted from collecting IM, or the collection of IM should be left to UCITS discretion. One of the main functions of UCITS managers is to assess the risk-return of the available investments. As a consequence, and since an individual UCITS is not a source of systemic risk, the collection (or not) of IM should be left to its discretion.

A UCITS may obtain a better price from a counterparty if it does not collect any IM from that counterparty.

Our members strongly believe that there should be no requirement to collect IM on uncleared trades. Counterparties should be allowed to exercise proper commercial judgment to deploy other procedures to mitigate credit risk.

- Some UCITS use financial derivatives, usually a total return swap (TRS), to provide investors with a predefined payout at the end of a specific period based on the return on underlying assets. Generally the UCITS portfolio is comprised of a TRS with a single counterparty that is a PRFC.

- The UCITS undertakes to pay the return of the portfolio of securities (unfunded swap) to the swap counterparty. In return the counterparty provides the UCITS with a return based on the underlying assets. The UCITS portfolio is dynamically managed in order to maintain the market value of the TRS below the limits set out in article 52 of UCITS Directive.

- The swap counterparty and the UCITS management company can agree that the counterparty risk will be mitigated by resetting the portfolio of securities on a regular basis rather via the posting of collateral.

- ESA should consider that in the case of such swaps, the portfolio of securities is economically acting as collateral and neither IM nor VM should be posted by the UCITS.

In ay case, the calculation method chosen for calculating IM should:

- be sufficiently clear so as to permit verifying and contesting, if needed;
- take into account netting of positions;
- its amount should vary relative to the frequency of calls, as its goal is to cover the risk between two calls;
- be applicable starting with a certain threshold.

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

Maintaining a level playing field among competing products such as funds or notes is of prime importance for our members. 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?

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?

Imposing a daily frequency for all will have a high operational impact (and a high cost).

Generally the counterparties should be free to make their own risk-mitigation decisions and to set appropriate thresholds for collecting VM in order to minimize costs (notably to implement the necessary systems) and operational risks. Notwithstanding this principle, UCITS should not be required to post VM on a daily basis 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.

Daily transfer may constitute a good practice for funds with a daily NAV (and if required by the parties) with the caveat that a minimum transfer amount should be adequately determined. Furthermore we think that funds which calculate their NAV on a weekly or monthly basis be allowed not to exchange collateral daily.

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

Middle and back offices will have to increase staff. Wiring and settlement fees will expand.

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 our opinion, the "Mark-to-market method" is easier to verify given that the initial margins are expressed as a percentage of the notional of the OTC transactions but usually determined in a more conservative way by the counterparties. The "Standardized Method" which is based on risk sensitive can be less expensive in terms of amounts to be posted for swaps given that it integrates amongst others the notion of netting between the two legs of the transactions.

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

We don't have more reasonable alternative methods to suggest for the calculation of initial margin requirements. This remark does not apply to UCITS funds as mentioned in Q7.

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

Current practices are mostly static for the initial requirements at the trade level during the maturity of the transaction. Some exceptional cases documented in the ISDAs can trigger a recalculation of the initial independent amounts such as the super collateralization process. In the event of an additional termination event trigger (such as a monthly NAV decline), the total amount of initial margins will be increased by a certain percentage agreed in the legal documentation.

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

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?

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?

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

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

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.

It is expected that under this approach the case of a transaction where a PRFC is both the counterparty of a performance swap and the guarantor of the performance of the fund will be considered as a whole and not subject to IM.

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

The largest issue that our members can envisage is the fact that the trade does not happen due to discrepancies in the calculation of the initial margin. This could also potentially delay the execution of a particular trade.

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

In our view, this is a feasible option assuming that the internal model has been presented and explained in a clear manner to the other party.

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

An alternative option can be the use of a third party agreed by both counterparties to calculate the initial margin in case of disputes.

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?

Segregation is an important concept in order to ensure that collateralisation will result in a diminution of risk. IM should be posted in a segregated account held by a third party in favour of the designated counterparty. The depositary of a Fund could be such third party. Access to the collateral, be it cash or securities, will be restricted to specific cases of default. Tri party contracts are the only workable way to achieve real segregation. The possibility of segregating collateral at a third party custodian would permit limiting daily moves of cash and securities. VM should not be subject to segregation.

Segregated accounts for initial margins or the use of a third party custody account with a tri-party agreement among dealer, counterparty and custodian can provide a better protection. However there would be an additional cost that should be considered and balanced with the additional protection provided. Furthermore, the use of a third party custodian implies legal, credit and operational specificities to be taken into consideration.

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

Reinvestment of cash collateral should be possible.

The first option is to create a segregated account. The second option could be to segregate the initial margins posted with a counterparty in an omnibus account segregated from the own assets of the bank but commingled with the initial margins of all the other clients of the bank.

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

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

Most commonly, cash is re-used by both parties with a bilateral rating threshold documented in the CSA, meaning that if the rating of one of the parties is below a certain threshold, re-utilization of cash is not longer permitted.

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

Our members believe that VMs could be re-used as they are paid and belong to the beneficiary to ensure its solvency. On the other hand, re-use of IM should be restricted to specific situations where there is no increase of risk. For example re-use of a collected IM to post an IM relating to a back to back transaction aimed at offsetting the initial risk should be authorised.

One of the impacts would be the lack of remuneration for the cash posted as collateral.

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

It should ne reminded 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, members believe that the range of eligible collateral should be very large with an important use of haircuts to take into account the different characteristics of different securities. As an example, a fund specialised in European stocks holds mainly European stocks and should not be prevented from contracting OTC derivatives. If there must be collateral for the derivative transaction it would be much more efficient to accept stocks as collateral and not require the fund to turn its stocks into treasuries (with the associated counterparty risk) to post collateral.

From a market point of view if there is too short a list of eligible collateral the eligible securities 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. One way market is not advisable and squeeze situations could arise.

Our members are highly concerned that the current consultation held by ESMA on ETF and other funds suggests an inclusion of collateral when calculating diversification ratios of a fund. It would make it very difficult to deal on derivatives and would delay final confirmation to after the check of proposed collateral and the simulation of the possibility for the fund to receive such collateral.

Our members strongly recommend a large approach in eligible collateral, larger than either CCPs or CRR lists, and a systematic use of haircuts.

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?

We suggest keeping the collateral management process as simple as possible and as such we don't recommend including non-financial assets (as gold) because it can create volatility, liquidity and/or valuation issues. We also recommend a large approach in eligible collateral so as to allow for a needed flexibility relative to specific regulations but also to markets behaviours. Our members favour qualitative criteria (such as quality, liquidity, valuation readiness, etc) that are appreciated by market players.

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

Please refer to our answers to Q32-33.

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

Please refer to our answers to Q32-33.

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

On OTC derivatives not mandatorily cleared, the current practice varies very much from an absence of collateral to collateral valued weekly or daily in a few cases.

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

When a fund publishes a weekly NAV, our members think that a weekly valorisation of collateral would be sufficient, except in extraordinary circumstances. Insurance portfolios may as well not require a daily calculation. Collateral valuation should be linked to both the frequency of exchanges and volatility of the collateral.

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

Middle office would have to reinforce staff. Alternatively investors may just decide to post excessive margins to meet the minimum required during all the period between two calculations. It should be noticed that one counterparty may value collateral daily and the other not.

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

Yes, our members are of the opinion that haircuts should be left to the counterparties to decide.

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

Any counterparty having a competent risk management team should be in a position to estimate haircuts. However it is important to remind that procedures for establishing such estimates are under the supervision of a local or European authority. Thus PRFCs as well as fund managers are legitimate to estimate haircuts.

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

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

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

Determination of a minimum transfer amount 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 (for instance € 1 million).

Our members believe it is up to the counterparties to decide between themselves the appropriate level. However, fixing a cap in absolute terms might not be relevant in all cases. A cap conceived as a percentage could be more appropriate. A difference should be established according whether or not there is an IM posted: the lower the IM, the lower the cap on the transfer amount.

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

Please see our answer at Q43.

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?

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

If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr) or Stéphanie Saint Pé, at +33.1.44.94.96.69 (s.saint-pe@afg.asso.fr) or myself at +33.1.44.94.94.29 (p.bollon@afg.asso.fr).

Sincerely Yours,

Pierre Bollon