

Our Ref SRM020412
Your Ref
Direct Tel 020 3124 3099
Direct Fax 020 3124 3540
E-Mail steven.maton@lgim.com

Investment Management
One Coleman Street
London
EC2R 5AA

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European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Dear Sirs

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

Thank you for offering the opportunity to comment on the work undertaken by the EBA, ESMA and ELOPA in relation to the introduction of central clearing to the OTC derivatives markets.

Legal & General Group Plc is one of the UK's largest quoted companies. The core business of the group is the provision of board range of savings and protection products for individuals through our major retail channels. This product range includes term assurance, mortgage protection, household insurance, private medical insurance, saving for retirement, annuities, unit trusts and ISAs. Our corporate business (pensions, group life assurance and group income protection) complements our individual business, drawing on our fund management, actuarial and administrative skills.

Legal & General Investment Management Limited (LGIM) is a subsidiary of Legal & General Group Plc and provides fund management expertise to the Group's retail and corporate businesses as well as to trustees of pension schemes and other institutional clients. Total funds under management were €440 billion at 31 December 2011, underlining Legal & General's position as a major UK investment house.

Legal & General's primary focus is on UK business, but the Group has operations in the USA, the Netherlands and France. Some cross-border sales are also made in Germany and Ireland.

We believe that further work is required to ensure that the interests of our clients, such as pension funds, insurance funds and investors in UCITS, are fully considered. We have attached our own response to the consultation which is broadly similar to that of the IMA and a copy of the response submitted by the IMA, which we support, and ask that you take into account all the points raised within these.

Appendix A contains our response and Appendix B contains the IMA response.

Yours sincerely,

Steven Maton
Head of Fund Governance

Response to Specific Questions**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)?**

The requirement for insurers and pension funds regulated under IORPs (i.e. PRFCs) to provide initial margin could result in substantially lower investment returns for UK pension funds and insurance companies unless any such requirement is 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.

If these factors are not addressed, they will be forced to hold a greater proportion of funds in eligible collateral offering diminished returns in order to ensure they have sufficient liquidity to meet margin calls. A one-way requirement to post initial margin is also likely to have a disproportionate effect on pension funds and insurance companies as their use of derivatives is substantially directional, reflecting its use for investment purposes, risk management and liability matching. This may provide a disincentive to use derivatives, thus limiting the availability of means by which risk may be managed. Depending on the model adopted, the posting of initial margin could substantially increase counterparty risk to pension funds and insurance companies alike.

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

We believe that initial margin should either not be mandated for any counterparties, or should be mandated for all counterparties. This is 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).

At first glance option 1 would appear to provide a fair solution as it would make all relevant counterparties subject to the obligation. However, it will be unduly harsh on those non-systemically important market participants who are using derivatives primarily to hedge liabilities and other risks in their portfolios, who are not in the business of trading derivatives and who generally have conservative levels of gearing (e.g. pension funds, funds of insurance companies and many investment funds, particularly UCITS). The provision of initial margin is likely to affect returns for such counterparties. Their positions will generally be directional and so netting of exposures will rarely be available. By contrast credit institutions providing services to clients will have multiple exposures which are likely to net off.

Consideration should be given to providing an exemption to funds established for the provision of pension arrangements, not dissimilar to the exemption provided to such funds for the mandatory clearing requirements.

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

We believe that for transactions between well capitalised financial counterparties, an efficient collateral management process, relying on variation margin, with daily valuation of positions, collateral and margin requirements according to agreed calculation methodologies, robust dispute resolution procedures, daily exchange of margin, appropriate haircuts and appropriate minimum transfer amounts should be sufficient to minimise losses in the event of a counterparty default. Counterparties should still be free to negotiate initial margin requirements on a case by case basis where they consider the

risk of default of the other counterparty to be high. Such approaches have been adopted in cases where the creditworthiness of a counterparty has deteriorated.

The key cost not covered by variation margin is replacement cost, and bilaterally agreed initial margin arrangements should provide protection in cases of deteriorating creditworthiness.

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 Q2 above, the requirement to post and collect appropriate initial margin could, if handled inappropriately, result in lower investment returns, in particular, for pension funds, insurance companies and UCITS funds. In each case the margins could be very high due to the directional nature of exposures. This can be substantially mitigated if appropriate models using security over segregated accounts are set in place. These will in turn still have associated custody, legal and other operational costs, although these are likely to be a fraction of returns on assets foregone.

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 would suggest that in the interests of reducing systemic risk *and* (post Lehman and MF Global) improving investor protection, secured models are the only viable option to deliver on both ambitions.

Finally, a requirement to post and collect initial margins will require set up or enhancement of systems, and effective business as usual resourcing, 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?

The mandated collection of initial margin by PRFCs only would create an unbalanced market, and does not take into account the counterparty exposure of NPRFCs to PRFCs [or PRFCs position as significant investors in NPRFCs].

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. The investors in such funds also include pension funds and insurance companies who are themselves PRFCs (and whose underlying beneficiaries are individuals), as well as direct retail investors. Distinguishing between PRFCs and NPRFCs does not actually capture the true position in terms of exposure between market participants, nor does it take account of the stable and robust nature of many clients, including UCITS. This option would result in UCITS and other clients being used to bolster the capital position of PRFCs, in particular bank counterparties, at the expense of individual investors, savers and pensioners, with no benefit in terms of equivalent mandated protection in terms of initial margin from PRFCs such as banks.

As mentioned above, many pension funds will invest in UCITS funds for diversification and cost reduction. Option 2 would provide a clear disincentive for pension funds and insurance companies 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.

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 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. Please also see our response to Q5 above.

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?

Pension funds, insurance vehicles and other entities such as UCITS and other regulated funds are not currently required to lodge initial margin with bank counterparties. This recognises 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.

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

We believe that any threshold should reflect the likelihood of default of the counterparty as well as the level of exposure. It is difficult to see how this can be reduced to a simple threshold. Simplicity has virtues, but does not necessarily de-risk the market appropriately since it fails to acknowledge the wide range of risks presented by different clients.

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?

See answer to Q8.

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

We believe that the introduction of a threshold is likely to result in a change of behaviour, as counterparties are more likely to undertake only necessary OTC derivatives trades in order to avoid breaching the threshold limit.

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

If the provision of initial margin were to be mandated, the ESAs should consider a flexible approach which considers the underlying risk profile of each type of counterparty in addition to a threshold approach. This would be more appropriate.

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

Not that we are aware of.

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

We believe that the requirement to post initial margin will result in lower investment returns to for pension funds, insurance companies and UCITS funds, as counterparties

will be required to move away from assets that provide higher returns to those that provide greater liquidity, such as cash or near cash assets. There may also be a reduction in the volume of OTC derivatives trading and consequently less risk management of funds, and liabilities, where such contracts are used for hedging and investment purposes.

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?

Yes, we believe that collateral should move between counterparties on a daily basis to reflect movements in variation margin requirements and collateral valuations, subject to any agreed minimum transfer amount (see further below our response to Q43).

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

This is and has been standard practice for larger asset management companies and their clients for a number of years and is an important element of counterparty risk management within the OTC market.

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?

The models proposed are all bank models and do not reflect the broad range of participants in the OTC derivatives markets. We do not believe that the models should be mandated but should be agreed between the counterparties (or their agents/investment managers) and should be flexible. 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 the underlying risk of default of each.

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

We believe 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.

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

Current practices include the option within ISDA / CSA documentation to terminate open transactions or call for an independent amount in the event of a credit rating of the bank counterparty falling below agreed levels. In practice, the contract is generally constructed so that a waterfall of actions, including calling for additional security, are required before reaching a point where the contract may be terminated.

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

We do not believe that the use of internal models should be limited to PRFCs. NPRFCs, such as UCITS funds, should also be allowed to use internal models as should other NPRFCs which use regulated agents and intermediaries (such as investment managers) to manage their collateral positions. Such agents will 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?

See answer to Q20.

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?

See answer to Q20.

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

Such costs are difficult to quantify but may be substantial if overly complex or sophisticated.

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

We offer no comment on this.

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

The potential for discrepancies to arise and their impact can be minimised if parties agree the models to be used and/or there is full transparency of the models used, as well as having in place robust and effective dispute resolution processes.

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

Yes, we believe it would be feasible, perhaps as a default option in the absence of any other agreement between the counterparties, particularly where one counterparty's model(s) has been approved by the competent authority. However, such an arrangement should be subject to suitable safeguards, for instance to ensure that the other party has full details of the internal model used and any changes, so that it can check and where necessary challenge any margin call.

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

We 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.

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?

As stated above, we are concerned that the posting of initial margin will increase the counterparty credit risk of our clients and would also have an adverse effect on returns. These could both be mitigated by the use of security arrangements which (i) do not require outright transfer of assets to the other counterparty, except in an event of default, (ii) ensure that assets provided as collateral are 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, and (iii) a broad range of eligible collateral being allowed, subject to appropriate haircuts.

There will be cost implications in this approach, especially where new custody relationships are required (e.g. a pension fund may not be happy with initial margin being held by its custodian for a counterparty within the same group as the custodian). In these

circumstances additional custody fees would be incurred and there may also be additional charges for independent valuation and escrow agent services.

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

We would expect operational and legal segregation, together with client money type protection for our clients' funds.

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

We offer no comment on this.

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

Current practices allow re-use of collateral posted as variation margin in many circumstances, particularly by bank counterparties, subject to receipt back of collateral of the same nature as that posted. Current practices also provide for substitution rights, even where collateral is posted on a full title transfer basis, for example under an ISDA English law CSA. This is absolutely essential for the effective management of client portfolios by asset management companies.

Independent amounts are usually treated differently and ring-fence arrangements are often set up to ensure assets posted are neither re-used nor form part of the assets of the counterparty to whom they are posted, except in the event of a default. We note that independent amount is more frequently called from the bank counterparty than from the client.

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

As set out above in our response to Q27 we do not support the re-use of collateral posted as initial margin, however we have no particular view on the position of variation margin, provided that each party is able to get back the same type of assets as it has posted together with the income due on the asset posted. The extent to which re-use is allowed should depend on the nature of the commercial arrangements between the counterparties and the legal structure of the security arrangements. If re-use is not allowed, this could have an impact on pricing as it will restrict the ability of counterparties to enhance returns through the investment of assets held as collateral.

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

We believe that neither option is ideal.

Option 1 will create additional pressure on the pool of available collateral for clearing purposes. It will also be too restrictive given differences between central clearing house models and those of individual firms. For example, banks have the ability to post assets to the central bank in exchange for cash which is not necessarily the case for a clearing house. As such, banks are able on a bi-lateral basis to accept a wider range of collateral. They will also make a credit assessment of all their clients, whereas the clearing houses are restricted to assessing only their own clearing members. Restricting the pool in this way also ignores the different nature of contracts eligible to clear and those which are not including the more bespoke nature of these arrangements and the potentially wider range of the underlying.

Option 2 clearly allows more discretion, but would be too prescriptive for the wide range of client portfolios managed by asset management firms.

We would favour an approach that replicates the approach adopted in existing ISDA / CSA arrangements, whereby the parties to the documents agree acceptable collateral, with appropriate haircuts to mitigate market, credit and liquidity considerations.

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?

Yes, we believe that there should be a wider range of eligible collateral. We would suggest the inclusion of corporate bonds with appropriate haircuts applied to reflect the market, credit and liquidity risk of the asset type. We do not believe that a broader range of collateral should be restricted to particular participants. It should be left to the counterparties to determine what is appropriate given their individual circumstances, the nature of the OTC derivative concerned and the financial stability of the other counterparty.

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

Changing the range of eligible collateral may adversely impact the ability of asset managers to ensure client funds remain fully invested according to their specified investment objectives and result in reduced investment returns for pension funds, funds of insurance companies and many investment funds, particularly UCITS.

Additionally, changing the range of eligible collateral may result in differential pricing of OTC derivative transactions, depending upon the assets deemed to be acceptable.

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

Other criteria to consider should be the nature of the OTC derivative transaction(s) which are being collateralised. A high degree of correlation between collateral held and the derivative transactions themselves or the asset or liability underlying the derivative should be avoided to ensure that the value of collateral does not decline in line with any increase in losses associated with a particular derivative contract.

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?

Collateral is valued on a daily basis, a process which is integral to the daily exchange of variation margin.

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

See answer to Q36 above.

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

In Q36 above it is noted that collateral is valued on a daily basis for variation margin. Extending this process for assets included within initial margin arrangements will add further cost, although this is unlikely to be substantial.

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

We believe 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.

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

No, we do not support the use of own estimates of haircuts being limited to PRFCs. The capability to determine appropriate haircuts is not linked to a counterparty's regulated status as a PRFC or a NPRFC. Many NPRFCs (e.g. investment funds) are sophisticated users of derivatives and will themselves have sufficient expertise or will use investment managers with sufficient expertise, to determine appropriate haircuts. Many PRFCs (e.g. pension funds) will also use investment managers and other advisers to assist with this.

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

We support the ESA's proposal that counterparties should have a robust operational processes for the exchange of collateral including appropriate documentation, systems and controls.

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

A key determinant of operational cost will be the scale of change to the current market practices for collateral management. These could be substantial in circumstances where unnecessary complexity is introduced.

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

We believe that minimum threshold amounts should be allowed but that it should be set at a level which ensures an appropriate balance between operational cost and counterparty credit risk. We do not think that an upper limit to this should be mandated by regulation but that 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.

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

We offer no comment on this.

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?

We offer no comment on this.

Q46. What is the current practice regarding the collateralisation of intra-group derivative transactions?

We make no comment on this.

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?

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 and haircuts.

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 security arrangements which (i) do not require outright transfer of assets to the other counterparty, except in an event of default, (ii) ensure that assets provided as collateral are 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, and (iii) a broad range of eligible collateral being allowed, subject to appropriate haircuts. There are cost implications in this approach, especially where new custody relationships are required (e.g. a pension fund may not be happy with initial margin being held by its custodian for a counterparty within the same group as the custodian). In these circumstances additional custody fees would be incurred and there may also be additional charges for independent valuation and escrow agent services.

2 April 2012

European Securities and Markets Authority
European Banking Authority
European Insurance and Occupational Pensions Authority

Dear Sirs

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 Investment Management Association (IMA) is pleased to submit its response to the European Supervisory Authorities' (ESAs) 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”.

IMA is the UK based trade association for investment managers. Our members manage investments worth more than £4 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the “buy side” of the market, accessing capital markets on behalf of their clients.

We provide a fuller description of our members' role in Annex 1 attached.

Key IMA points:

- Any requirement to post initial margin is likely to have an adverse effect of the investment returns of clients of IMA members, may act as a disincentive to undertake OTC derivative transactions to manage investment risk, may increase counterparty exposure, and will increase operational, legal and potentially fees paid to third parties (such as custodians, collateral managers and escrow agents). This could lead to the unintended consequences of greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme's benefits.
- We believe that the potential adverse impact on the return on savings and pensions will discourage individuals from investing via pension funds and UCITS funds, which will result in a reduced demand for equity and fixed income securities making it more difficult for EU corporate and government bodies to raise funds from the capital markets.
- If a flexible approach is not adopted towards eligible collateral, there will also be a squeeze on the amount of collateral available to post as margin for both cleared and un-cleared trades.
- Depending on the model adopted, the posting of initial margin could substantially increase counterparty risk to pension funds, insurance companies and investment funds. We believe therefore that initial margin should be protected against the default of the counterparty to whom it has been posted, and should ideally be held in segregated accounts with no right of use except in an event of default.

- The requirement to post initial margin is likely to have a disproportionate effect on pension funds, insurance companies and many authorised funds, such as UCITS, as their use of derivatives is substantially directional, reflecting the fact that they predominantly use derivatives for investment purposes and to hedge risk, and therefore netting will not generally be available to reduce margin requirements.
- The Discussion Paper does not consider the position of investment funds, in particular regulated investment vehicles such as UCITS funds, and the impact that the proposals will have on these highly regulated and financially stable funds.
- The distinction between PRFCs and NPRFCs is not an appropriate one for considering the application and impact of the proposals as it does not reflect the underlying credit quality of the counterparties nor the fact that for many (such as pension funds, insurers and authorised investment funds) the primary use of OTC derivatives is for hedging risks, not for trading or seeking additional returns.
- The Discussion Paper focuses on the requirement to post initial margin, and yet there is no specific requirement of this nature in EMIR in respect of bilateral trades. Instead EMIR focuses on “appropriate exchange of collateral”.
- We understand that one of the aims of the proposals is to incentivise market players to clear. Whilst this is a sensible aim in the case of product types for which there is an option or an obligation to clear (e.g. IRS), and counterparties subject to the clearing obligation, this should not ignore the fact that many products (e.g. equity and inflation linked products) and some counterparties (e.g. pension funds) will fall outside the clearing net, at least initially, and therefore such products and counterparties should not be treated in the same way. In particular, we believe that pension funds should not be subject to any additional margin requirement on bi-lateral transactions, as proposed in this Discussion Paper, until they become subject to the clearing obligation at the expiry of the temporary exemption period specified in EMIR.
- Pension funds are able to take advantage of a temporary exemption from the clearing obligation under EMIR, the purpose of which is to allow time for the clearing houses to offer solutions appropriate to them. This type of bilateral contract is not separately addressed in the paper, i.e. contracts which can be cleared but to which an exemption from clearing applies, and so pension funds may be disadvantaged in the interim, if more stringent requirements are put in place for transactions which can be cleared. We also contend that, to the extent that the pension funds are able to net cash flows and other risks with their counterparty on a whole of portfolio basis, margin requirements should apply to the portfolio after netting.
- The phase-in of the risk mitigation techniques is not addressed, although it is a topic likely to be relevant to many investment managers and their clients. In particular, without further provisions on this the new requirements will apply to any OTC contract executed after the date of entry into force of the Regulation. At this stage, not only will the RTS not be finalised, but there will be no time for counterparties to make the changes necessary to their operational processes and legal documentation to ensure compliance. Appropriate timeframes for implementation of any proposals need to be provided.

We are, of course, very happy to discuss any of our comments with you in greater detail

IMA Responses to Specific Questions:

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)?

The requirement for insurers and pension funds regulated under IORPs (i.e. PRFCs) to provide initial margin could have the consequences set out below. These are also relevant to investment funds (i.e. NPRFCs), and so our response covers these entities as well.

(i) Substantially lower investment returns will be achieved, unless any initial margin requirement is mitigated by allowing a wide range of eligible collateral and ensuring that it is securely held without re-use. If pension funds, insurers and investment funds are required to post initial margin, they will be forced to ensure that they hold a greater proportion of funds in eligible collateral assets, which will generally offer lower returns, in order to ensure they have sufficient liquidity to meet margin calls. We set out in Annex 2 an example of the potential performance drag on funds of a requirement to provide initial margin. This is discussed in more detail in response to Q4 below. The true extent of the performance drag will depend on the nature of the restrictions placed on the types of assets that are eligible collateral for initial margin purposes (see further below our response to Q 32). A more limited list is likely to have a greater impact as more assets will need to be converted to provide collateral.

(ii) The costs of OTC derivative transactions will rise, even if the effect on investment returns can be mitigated, as there will be additional operational, legal and custody costs associated with the management of any such additional collateral requirement, as well as collateral transformation costs where portfolios do not hold sufficient eligible assets.

(iii) Depending on the model adopted, the posting of initial margin could substantially increase counterparty risk to pension funds, insurance companies and investment funds.

(iv) In addition, the requirement to post initial margin is likely to have a disproportionate effect on pension funds, insurance companies and many authorised funds, such as UCITS, as their use of derivatives is substantially directional, reflecting the fact that they predominantly use derivatives for investment purposes and to hedge risk, and therefore netting will not generally be available to reduce margin requirements.

(v) Pension funds are able to take advantage of a temporary exemption from the clearing obligation under EMIR, the purpose of which is to allow time for the clearing houses to offer solutions appropriate to them. This type of bilateral contract is not separately addressed in the paper, i.e. contracts which can be cleared but to which an exemption from clearing applies, and so pension funds may be disadvantaged in the interim, if more stringent requirements are put in place for transactions which can be cleared. We also contend that, to the extent that the pension funds are able to net cash flows and other risks with their counterparty on a whole of portfolio basis, margin requirements should apply to the portfolio after netting.

As a result of the consequences outlined above, any requirement to post initial margin may provide a disincentive to use derivatives, thus limiting the availability of means by which investment risks may be managed, and the extent of any such risk management by pension funds insurers and investment funds. This could lead to the unintended consequences of greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme's benefits.

On the other hand, funds may be encouraged to increase investment risk elsewhere in their portfolios in order to achieve a level of return consistent with those achieved prior to the imposition of initial margin requirements.

We believe that the potential adverse impact on the return on savings and pensions could discourage individuals from investing via pension funds and UCITS funds, which will result in a reduced demand for equity and fixed income securities making it more difficult for EU corporate and government bodies to raise funds from the capital markets.

We understand that one of the aims of the proposals is to incentivise market players to clear. This is a sensible aim in the case of product types for which there is an option or an obligation to clear (e.g. IRS), and counterparties subject to the clearing obligation, however this should not ignore the fact that many products (e.g. equity and inflation linked products) and some counterparties (e.g. pension funds) will fall outside the clearing net at least initially, and therefore such products and counterparties should not be treated in the same way. In particular, we believe that pension funds should not be subject to any additional margin requirement on bi-lateral transactions, as proposed in this Discussion Paper, until they become subject to the clearing obligation at the expiry of the exemption period specified in EMIR.

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

We believe that the optimal position is for the provision of initial margin not to be mandated. This is not a requirement of EMIR which requires only the accurate and appropriately segregated exchange of collateral. We believe that the counterparties to an OTC derivatives transaction should be left to determine themselves whether the circumstances warrant the provision of initial margin by either one of both of them.

If, however the ESAs determine that the posting of initial margin should be a mandated, the application of the requirement and the amount of any margin that is required to be posted should take into account the nature of the counterparty concerned, their business rationale, investment strategy and their financial stability, as well as the nature of the financial instruments concerned (in respect of underlying, price volatility and liquidity).

At first glance option 1 would appear to provide a fair solution as it would make all relevant counterparties subject to the obligation. However, it will be unduly harsh on those non-systemically important market participants who are using derivatives primarily to hedge liabilities and other risks in their portfolios, who are not in the business of trading derivatives and who generally have conservative levels of gearing and low risk of default (e.g. pension funds, funds of insurance companies and many investment funds, particularly UCITS) and often have concentration limits on counterparty exposure. The provision of initial margin is likely to affect returns for such counterparties (as mentioned in our response to question 1 above) and as their positions will generally be directional, netting of exposures will rarely be available. By contrast credit institutions providing services to clients will have multiple exposures which are likely to net off.

Thought should be given to providing an exemption to authorised retail funds and pensions funds, whose investment restrictions and diversification result in them posing almost no default risk to the counterparty.

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

We believe that for transactions between well capitalised financial counterparties, which undertake appropriate counterparty selection and due diligence procedures, an efficient collateral management process, relying on variation margin, with daily valuation of positions, collateral and margin requirements, according to agreed calculation methodologies, robust dispute resolution procedures, daily exchange of margin, appropriate haircuts and appropriate minimum transfer amounts should be sufficient to

minimise losses in the event of a counterparty default. Counterparties should still be free to negotiate initial margin requirements on a case by case basis where they consider the risk of default of the other counterparty to be high or deteriorating.

The key cost not covered by variation margin is replacement cost. Replacement cost will not be an issue if counterparties do not default.

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 Q1 above, the requirement to post and collect appropriate initial margin could, if handled inappropriately, result in lower investment returns, in particular, for pension funds, insurance companies and UCITS funds.

We attach as Annex 2 an example of the cost implications in terms of performance drag of an initial margin requirement for a UCITS fund investing in high yield bonds. The example deals with the cost of posting initial margin on OTC derivatives trades used to hedge currency risk. Using an initial margin of 10% of the notional value of the required hedging transactions, this could result in a performance drag of 0.25% if the value of the assets sold increases by 5%.

For pension funds, insurance funds and authorised investment funds, the margins could be very high due to the directional nature of exposures, and this could exacerbate the performance drag.

The impact on performance will also be increased to the extent that the list of eligible collateral assets is restricted, as this will affect the extent to which a fund will need to covert assets for collateral purposes.

The effect on fund performance can be substantially mitigated if appropriate models using security over segregated accounts, with a broad range of eligible collateral assets are allowed. However, these models will in turn still have associated custody, legal and other operational costs, although these are likely to be a fraction of returns on assets foregone. To the extent that the pension funds are able to net cash flows and other risks with their counterparty on a whole of portfolio basis, the costs of posting initial margin can also be reduced if margin requirements are applied to the portfolio after netting across all OTC derivative contracts.

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 would suggest that in the interests of reducing systemic risk and (post Lehman and MF Global) improving investor protection, secured models are the only 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 systems and legal costs and mean increased on-going administrative costs. It is difficult to quantify the amount exactly.

Q5. What are your views regarding option 2?

The mandated collection of initial margin by PRFCs only would create an unbalanced market, and does not take into account the counterparty exposure of NPRFCs to PRFCs, or PRFCs position as significant investors in NPRFCs.

Many NPRFCs are UCITS funds and as such are subject to stringent regulatory requirements including restrictions on investment, counterparty concentration limits and the use of leverage and derivatives (including the “cover rule” which requires a UCITS at all times to be capable of meeting all its payment and delivery obligations under financial derivatives transactions). The assets of such funds are held in safe keeping with custodians and depositaries, who will themselves be PRFCs. The investors in such funds also include pension funds and insurance companies who are themselves PRFCs (and whose underlying beneficiaries are individuals), as well as direct retail investors. Distinguishing between PRFCs and NPRFCs does not actually capture the true position in terms of exposure between market participants, nor does it take account of the stable and robust nature of many clients, including UCITS. This option would result in UCITS and other clients being used to bolster the capital position of PRFCs, in particular bank counterparties, at the expense of individual investors, savers and pensioners, with no benefit in terms of equivalent mandated protection in terms of initial margin from PRFCs such as banks. See also our response to question 1 above.

As mentioned above, many pension funds will invest in UCITS funds for diversification and cost reduction. 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.

Any requirement for one way posting of initial margin should not be based on broad counterparty categories, but should reflect the credit quality of the counterparties and the risk of default. This should be based on an assessment of each individual counterparty. See also our response to question 2 above.

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 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. Please also see our response to Q1 and Q5 above.

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?

Pension funds, insurance vehicles and other entities such as UCITS and other regulated funds are not currently required to lodge initial margin with bank counterparties. This recognises 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.

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

We believe that any threshold should reflect the credit quality and therefore the likelihood of default of the counterparty, as well as the level of exposure, in particular, counterparties such as pension funds, insurance companies and regulated funds which have a low risk of default should in a threshold model generally have a high threshold applied. It is difficult to see how this can be reduced to a simple threshold. Simplicity has virtues, but does not necessarily de-risk the market appropriately since it fails to acknowledge the wide range of risks presented by different counterparties.

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?

Although as mentioned above, a fixed amount would be easier to manage from an operational perspective, this will not reflect the true nature of the risk of the counterparty unless the level of the cap can be linked to the likelihood of default of the counterparty.

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

We believe that the introduction of a threshold is likely to result in a change of behaviour, as counterparties are more likely to undertake only necessary OTC derivatives trades in order to avoid breaching the threshold limit and thereby increasing their operational and opportunity costs by having to post initial margin. This will limit the availability of means by which investment risks may be managed, and the extent to which risk pension funds insurers and investment funds decide to manage investment risk. In the case of pension funds, this could lead to the unintended consequences of greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme's benefits.

See also our response to question 1.

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

Further options which the ESAs should consider include:

- (i) to not mandate the provision of initial margin but leave it to market participants to decide when this is appropriate; or
- (ii) the provision of a flexible, principles based approach which considers the underlying risk profile and in particular the credit quality of each type of counterparty, which could be used in addition to a threshold approach. This would provide a better fit. For example, as a starting point, pensions funds and UCITS could be exempt from the requirement, in order to reflect the low risk of default associated with such funds, with the obligation only applying to individual funds where their level of exposure is high considering their underlying risk profile and credit quality.

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

None that we are aware of.

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

We believe that the requirement to post initial margin will have the following impacts on the clients of investment managers, with a subsequent impact to the market more generally:

- (i) Lower investment returns, in particular for pension funds, insurers and investment funds, as counterparties will be required to move away from assets that provide higher returns to those that provide greater liquidity, such as cash or near cash assets.
- (ii) A reduction in the volume of OTC derivatives trading and consequently less risk management of funds, and liabilities, where such contracts are used for hedging and investment purposes.
- (iii) The move to more liquid assets such as cash will have the unintended consequence of reducing demand for equity and fixed income products making it more difficult for corporate and government bodies to raise funds in the capital markets.
- (iv) Greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme's benefits.

(v) A further squeeze on the availability of eligible collateral assets as the cleared and un-cleared OTC derivatives markets compete for the same pot of assets.

See also our responses to Q1 and 5 above.

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?

Yes, we believe that collateral should move between counterparties on a daily basis to reflect movements in variation margin requirements and collateral valuations, subject to any agreed minimum transfer amount (see further below our response to Q43).

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

We 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, for most market participants this is and has been standard practice for a long time.

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?

The models proposed are all bank models and do not reflect the broad range of participants in the OTC derivatives markets. We do not believe that the models should be mandated but should be agreed between the counterparties (or their agents/investment managers) and should be flexible. 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 the underlying credit quality and risk of default of each.

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

We believe that a key factor which should be taken into consideration is the credit quality and probability of a particular counterparty defaulting. That is the critical risk in each bilateral contract.

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

Current practices include the option for clients (usually pension funds) to call for an independent amount in the event of a credit rating downgrade of their bank counterparty. The contract is generally constructed so that a waterfall of actions, including calling for additional security, are required before reaching a point where the contract may be terminated.

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

We do not believe that the use of internal models should be limited to PRFCs. NPRFCs, such as UCITS funds, should also be allowed to use internal models as should other NPRFCs which use regulated agents and intermediaries (such as investment managers) to manage their collateral positions. Such agents will 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?

We make no comment on this.

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?

We make no comment on this.

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

We make no comment on this.

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

We make no comment on this.

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

Yes we do anticipate problems if different models are used by the counterparties and models cannot be agreed. However, the potential for discrepancies to arise and their impact can be minimised if parties agree the models to be used up front, and/or there is full transparency of the models used, as well as having in place robust and effective dispute resolution processes.

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

Yes, we believe it would be feasible, perhaps as a default option in the absence of any other agreement between the counterparties, particularly where one counterparty's model(s) has been approved by the competent authority. However, such an arrangement should be subject to suitable safeguards, for instance to ensure that the other party has full details of the internal model used, so that it can check and where necessary challenge any margin call, and that any changes to the model are not imposed without agreement of both counterparties.

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

We 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 and robust dispute resolution processes.

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?

As stated above, 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. These could both be mitigated by the use of security arrangements which:

- (i) do not require outright transfer of assets to the other counterparty, except in an event of default, and no right of re-use or re-hypothecation;
- (ii) ensure that assets provided as collateral are 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; and
- (iii) provide for a broad range of eligible collateral to be posted, subject to appropriate haircuts.

Counterparties should be able to agree between themselves what specific security arrangements are appropriate, which will depend amongst other things on the type and jurisdiction of available assets, the nature of the counterparty's portfolio, the jurisdiction of the counterparties, cost and timeframes.

There will be cost and time implications with this approach, especially where new custody relationships are required (e.g. a pension fund may not be happy with initial margin being held by its custodian for a counterparty within the same group as the custodian). In these circumstances additional operation costs (e.g. to perform reconciliations) and custody and legal fees would be incurred, and there may also be additional charges for independent valuation and escrow/security agent services. Furthermore, such arrangements generally take a long time to negotiate and implement (as an estimate, at least 6 months in general for each).

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

As a bare minimum, we would expect operational and legal segregation (individual accounts, segregated from house accounts and other client accounts – and perhaps further to sub-fund level within an umbrella fund structure). Ideally client money type protections should be provided to make it clear that the counterparty cannot treat the cash as its own.

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

We do not comment on this as it is not clear exactly what is meant by tri-party transactions in this context.

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

We understand that current practices allow re-use of collateral posted as variation margin in many circumstances, subject to receipt back of collateral of the same nature as that posted, but also provide for substitution rights, even where collateral is posted on a full title transfer basis, for example under an ISDA English law CSA. Some funds are restricted in their ability to re-use collateral received and this should be taken account of in any proposals on re-use.

Independent amounts (and initial margin) are usually treated differently and ring-fence arrangements are often set up to ensure assets posted are neither re-used nor form part of the assets of the counterparty to whom they are posted, except in the event of a default. We note that an independent amount is more frequently called from the bank counterparty than from the client.

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

As set out above in our response to Q27 we do not support the re-use of collateral posted as initial margin, however we have no particular view on the position of variation margin, provided that each counterparty is able to get back the same type of assets as it has posted and distributions and income equivalent to that earned on the collateral posted are paid to the transferor. The extent to which re-use is allowed should depend on the nature of the commercial arrangements between the counterparties, the legal structure of the security arrangements and any legal and regulatory restrictions on the counterparty. If re-use is not allowed, this could have an impact on pricing and performance as it will restrict the ability of counterparties to enhance returns through the investment of assets held as collateral.

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

We believe that neither option is ideal.

Option 1 will create additional pressure on the pool of available collateral for clearing purposes. It will also be too restrictive, particularly in the case of initial margin, given differences between central clearing house models and those of individual firms. For example, banks have the ability to post assets to the central bank in exchange for cash which is not necessarily the case for a clearing house. As such, banks are able on a bilateral basis to accept a wider range of collateral. They will also make a credit assessment of all their clients, whereas the clearing houses are restricted to assessing only their own clearing members. Restricting the pool in this way also ignores the different nature of contracts eligible to clear and those which are not including the more bespoke nature of these arrangements and the potentially wider range of the underlying. This will require counterparties, in particular pension funds, insurers and investment funds to transform higher yielding assets into assets with lower returns. Not only will the transformation process itself have costs attached (be it via repurchase arrangements, sale and purchase of assets or otherwise) but there will also be an adverse effect on the performance of these funds. In addition, as mentioned above, many funds are restricted in their ability to re-use collateral received from counterparties. See also our answer to Q1 above.

Option 2 clearly allows more discretion, but again may prove to be too prescriptive round the edges.

We would favour a flexible approach that is based on that proposed in Principle 5 of the CPSS-IOSCO Principles for Financial Market Infrastructures (Consultation Report, March 2011).

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?

Yes, we believe that there should be a wider range of eligible collateral with a principles based approach using the CPSS-IOSCO Principles as a starting point. We do not believe that a broader range of collateral should be restricted to particular participants. It should be left to the counterparties to determine what is appropriate given their individual circumstances, the nature of the OTC derivative concerned, the financial stability of the other counterparty and market conditions.

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

Changing the range of eligible collateral may result in differential pricing of OTC derivative transactions, depending upon the assets deemed to be acceptable.

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

Other criteria to consider should be the nature of the OTC derivative transaction(s) which are being collateralised. A high degree of correlation between collateral held and the derivative transactions themselves or the asset or liability underlying the derivative should be avoided to ensure that the value of collateral does not decline in line with any increase in losses associated with a particular derivative contract.

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?

Most IMA 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?

It may be sensible to include a de minimis threshold 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?

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

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

We believe 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, term, liquidity and credit quality of each type of eligible collateral on an on-going basis. This could be re-enforced by de minima set at an industry by way of guidance or otherwise to ensure some consistency of approach.

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

No, we do not support the use of own estimates of haircuts being limited to PRFCs. The capability to determine appropriate haircuts is not linked to a counterparty's regulated status as a PRFC or a NPRFC. Many NPRFCs (e.g. investment funds) are sophisticated users of derivatives and will themselves have sufficient expertise or will use agents (e.g. investment managers) with sufficient expertise, to determine appropriate haircuts. Many PRFCs (e.g. pension funds) will also use investment managers and other advisers to assist with this.

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

We support the ESA's proposal that counterparties should have robust operational processes for the exchange of collateral including appropriate documentation, systems and controls.

We suggest that ISDA Master agreement and CSA documentation is an appropriate starting point for this as it is already the OTC derivative trading infrastructure that many counterparties use. This documentation already provides for bilaterally agreed valuation models, and minimum transfer amounts that have been agreed bilaterally based on risk profiling and negotiation and includes dispute resolution terms. Using this as the starting point will reduce the amount of renegotiation and re-papering that could otherwise be required by the proposals.

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

We make no comment on this

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

We believe that minimum threshold amounts should be allowed but that it should be set at a level which ensures an appropriate balance between operational cost and counterparty credit risk. We do not think that an upper limit to this should be mandated by regulation but that 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.

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

This will depend on the level of the cap. If the cap is set too low, without taking into account the credit risk of the counterparties, it will unnecessarily increase the operational costs of transacting in OTC derivatives through the constant required movement of collateral, without providing any risk reducing benefits. It is unlikely that any arbitrary mandated caps will have the intended benefits and so we believe that the setting of minimum transfer amounts should be left to the counterparties.

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?

We make no comment on this.

Q46. What is the current practice regarding the collateralisation of intra-group derivative transactions?

We make no comment on this.

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?

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 and haircuts. We set out in our response to question 1 the key impacts of proposals on clients of our members.

In summary, 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 impacts could be mitigated by the use of security arrangements which (i) do not require outright transfer of assets to the other counterparty, except in an event of default, (ii) ensure that assets provided as collateral are 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, and (iii) a broad range of eligible collateral being allowed, subject to appropriate haircuts. However, there are cost implications in this approach, especially where new custody relationships are required. In these circumstances additional operational costs will be incurred, as well as custody and legal fees and there may also be charges for independent valuation and escrow or security agent services.

We also believe that the time spans taken to comply with the Regulation will need to take on board the time required to negotiate legal documentation, set up risk and operational processes and systems, appoint collateral managers and where required set up new custody or escrow/security agents arrangements. This will also need to be considered at the level of each trading relationship, and so could be extremely time consuming.

Annex 1

Annex 1 to IMA Response to ESAs' Joint Discussion Paper on draft regulatory technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under EMIR

Role of Investment Managers in relation to OTC derivatives transactions

Investment managers (called Portfolio Managers in MiFID) act for a wide variety of clients, ranging from pension funds, insurance companies, collective investment schemes, sovereign wealth funds, corporates, and government agencies through to high net worth individuals. Under EMIR many of these clients will be classed as "financial counterparties" and therefore subject to the clearing obligation under EMIR from the start (unless a transitional provision applies, such as for pension funds).

Investment managers generally have discretion to make investment decisions and carry out transactions as a result of those decisions on behalf of their clients in respect of a portfolio of assets. Typically this means that they will act in an agency capacity. The investment manager will not normally provide custody services in respect of those assets and the client will appoint a separate firm to act in that capacity. The extent of the investment manager's discretion is set out in the terms of the mandate agreed between the investment manager and the client from time to time.

Where the investment manager is permitted to use OTC derivatives for the client's portfolio, direct contractual arrangements are usually set up between the client and each counterparty (i.e. a bank) in the form of a market standard master agreement. The negotiation and execution of these documents may be facilitated by the investment manager, acting on behalf of the client, or the client may negotiate the documents directly. In either case, the investment manager will be given authority by the client to carry out transactions under these agreements on its behalf, and deal with the custodian in respect of settlement.

The investment manager will often accept responsibility for certain obligations in respect of the on-going management of outstanding OTC derivatives positions. This could include management of any collateral requirements, for example valuing positions, arranging for collateral to be posted or called, or ensuring there is sufficient available eligible collateral in a client's portfolio to meet future calls. It will often include monitoring of counterparties for example in terms of credit status and events of default, and dealing with a client's positions in a default scenario. At no point will the investment manager hold the actual collateral (or cash).

Investment managers are therefore key participants in the OTC derivatives markets on behalf of their clients, and this will continue to be the case in a cleared environment. Investment managers are likely to be involved in setting up the arrangements between the client, executing brokers, clearing members and CCPs. They will still be responsible for making investment decisions in respect of use of OTC derivatives, carrying out transactions with execution brokers, ensuring that these trades are given up to the appropriate clearing broker and dealing with the on-going management of positions on behalf of their clients. In this way the cleared and bi-lateral contact with counterparties will be similar. Nevertheless, the managers expect their responsibilities to increase in the cleared environment due to the additional complexities of the clearing model. Investment managers will also play a key role in assessing the capabilities of clearing members and CCPs and assessing the structural issues on behalf of clients, up front and on an on-going basis. Access to information directly by investment managers in respect of the organisational, operational, and legal position of CCPs as well as access to information in respect of client's portfolio is therefore of utmost importance in order for clients to be properly served by their appointed investment managers.

As a result, many of the obligations imposed on counterparties under EMIR will be performed by investment managers, where the counterparty is also a client of a clearing member, and therefore the position of investment managers in the clearing and non-clearing environments should be considered. Clients should be able to rely on investment managers to carry out their obligations under EMIR and be able to rely on the experience and capability of investment managers in managing collateral. The fact that a client's assets may be allocated across a number of investment managers should also be factored into the RTS in respect of the risk mitigation requirements for non-cleared derivatives.

Annex 2

Annex 2 to IMA Response to ESAs' Joint Discussion Paper on draft regulatory technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under EMIR

Impact on the investor: a practical example

- Example uses a high yield corporate bond UCITS fund.
- Fund would not typically hold government bonds or significant pools of cash.
- Fund manager will invest outside domestic market as the high yield market is not particularly large in any individual market
- Example takes a GBP fund that has an IMA Sector restriction requiring it to maintain a minimum 80% GBP exposure at all times, but where the fund has 50% invested in European high yield corporate bonds.

The following could occur:

	<u>No initial margin</u>	<u>Initial Margin</u>	
Total fund Value :	£100m		
<u>Day1</u> Holding of Cash:	£3m £3m (3%)	£3m	
GBP Assets :	£47m £47m (47%)	£41.9m	→ Sale from GBP assets to fund margin (had to sell £5.1m to fund £5m margin)
EUR Assets :	£50m (£50m (equivalent))	£50m (equivalent)	
EUR sold hedge:	-£50m (£50m (equivalent))	-£50m (equivalent)	
GBP bought hedge:	+£50m +£50m	+£50m	

Initial Margin Posted
In this example, it assumes the fund manager would have to sell £5.1m of assets to obtain cash to fund the initial margin. Here we assume a modest initial margin of 10%, although requirements could be much higher. If the prices of the assets sold had fallen by 2% from the fund price, this would cost the fund £100,000 or 0.1% in performance.

Day2
From that moment on, the fund is forced to hold an initial margin of 10% (i.e. £5m => 5% of total fund value) in cash in excess of its "natural" cash position, solely as a result of the FX hedge for its initial margin. If the value of high yield assets then increases by 5%, the fund would have lost out on a £250,000 gain or 0.25% in performance.

Showing the fund that margins (at 10%) and the fund that doesn't (therefore 0%) side by side, and assuming there are no other movements, we can see the following:

	<u>No initial margin</u>	<u>Initial Margin</u>
<u>End Fund Value</u>	£104.5m	£104.5m

This example shows that the investor in a fund with initial margin requirements will be 35 basis points (0.35%) worse off as a result of the fund manager being forced to sell assets in order to hold a permanent cash balance. The performance drag compounded year on year will in time be very considerable.

Moreover, the position in the example above could worsen if there was a liquidity squeeze owing to large numbers of investors having to sell assets to raise initial margin, in which case more than £5.1m of assets need to be raised on day 1 in order to meet the £5m initial margin requirement.

Hedged share classes

The position for a hedged share class would be significantly worse. Hedged share classes are used for investors who wish to minimise all currency risk when they invest. In a hedged share class the fund will return a purer performance result, stripped of the currency effect. This is not cost free, as the currency impact is taken out of the fund on a daily (or other agreed) basis. In the worked example where Initial Margin is required, a fund with a hedged share class would incur an additional 17 basis points (0.17%) performance drag.