

CONSULTATION PAPER

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

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)?

Not applicable.

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

IM is a mechanism that increases protection to the system as a whole and to the posters, and agents in general.

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

Not always.

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.

Collateral is very scarce and is more and more subject to scrutiny nowadays. The cost cannot be determined without a comprehensive list and detailed composition of the asset portfolio.

Q5. What are your views regarding option 2?

It can work with less operational costs and less structures and resources involved from the part of the market participants, but the level of protection would be somewhat lower. A recent case can be an example of this, the MF Global in the USA.

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

It would generate an unbalanced position between the market different agents and players, and would enhance market specific risk.

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?

- Standard bilateral contracts between counterparties that have already signed CSA agreements between themselves including daily collateral valuation agreements and monitoring in place with each other;

- The threshold could be reviewed under a dynamic mechanism for market risk assumption and that should be enough to cover IM plus earnings at risk.

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

Multi ratings criteria or, if not feasible, a CSA mechanism in place between the parties.

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?

Please, see Q7 on its second answer.

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

It would probably mean less collateral costs and less operational risks.

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

Not at this point.

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

Not applicable.

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

Less systemic risk, more transparency, more sophistication and probably a bigger dynamic of the valuation models applied.

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?

The collateral valuation should be done on a daily basis and should have a fair buffer and well defined trigger levels. The collateral should only be required if trigger levels are triggered.

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

A huge increase in operational costs.

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?

Yes. With the current market environment, the M-t-M approach seems to be the most appropriate.

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

We could look at other credit related methodologies, like the CVA approach, but the referred 2 can work.

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

Weekly or fortnight evaluation seems to be the market current practice.

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

No.

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

Yes.

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

One can move in the direction of having an internal model approach, adjusting to external market and risk parameters and pricing variables, but again, these models must be recognized and validated by the supervision authorities. The most important difficulty is in getting the right external feed on a timely manner. One has to invest in the right technology and capture systems.

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

Operational framework gets more and more complex, that means normally, more expensive to operate. Compliance needs more system and software licensing investment.

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

To our knowledge, most of the counterparties and clearing members are already using or at least are familiar with the concept.

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

Only if they relate to different risk concepts.

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

Yes, under the same previous principal.

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

Not applicable.

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?

One should always allow for as much segregation as needed or wanted. What one should really avoid is not having segregation at all. The main disadvantages relate to less negotiation power and increasing operational costs. The bigger advantages relate to transparency and less systemic and sector risk.

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

Collateral should always be viewed as a minimum allowance for each segregated account.

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

Operational and legal complexity and risk tend to increase.

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

Constitution of liquidity pools and liquidity interest circulation.

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

The clearing house operating costs would immediately jump. Risk and transparency would increase at the same time.

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

Option 1 – Increased liquidity, more restrictions and less eligibility;

Option 2 – Less liquidity, increased eligibility and more risk.

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?

No, to both questions.

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

It would depend on the type and level of change one would make.

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

One could use Central Bank eligibility standards for each country.

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

The standard range from weekly to quarterly, but every player is investing to move to a daily basis.

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

None should be mandatory, but there should be caps at, let's say, one month and a target to getting daily valuations with benefits for those who achieve it.

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

A significant increase in overhead, systems and operations.

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

Yes.

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

No.

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

One has to be up to date with recent market standards. One has to be able to get the right feeds and therefore one must assure they comply with the technical standards and supervision requirements.

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

Investment costs arising from systems and software licensing.

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

As a percentage of the effective cost of capital allocation, per example.

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

It would prevent cascade effects and would allow for a bigger accountability of the clearing institutions.

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?

One has to be compliant with all the standard supervision requirements first. Margins should be fulfilled in advance.

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

We don't use intra group collateralization for moment.

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?

Not applicable.

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