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European Securities and Markets Authority (ESMA),
European Banking Authority (EBA),
European Insurance and Occupational Pensions Authority (EIOPA),
Joint Committee of the European Supervisory Authorities

2 April 2012

Re: 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

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to respond to the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories.

We agree that, as required by EMIR, there should be requirements to mitigate the risk arising from OTC derivatives transactions and not disincentivise central clearing, it should be noted that some OTC derivatives contracts, as a result of their bespoke nature, do not lend themselves to standardisation and therefore a central clearing requirement. It is important not to penalise unnecessarily genuine risk management tools. The final proposals should reflect this principle.

We believe a distinction should be made between the capitalisation of CCPs and banks. CCPs have adopted models that are primarily based on a defaulter pays approach, with only tail risk events being absorbed by the capital of members. In contrast, in the OTC market, financial institutions are not at risk that their capital will be depleted by absorbing the mutualised losses of others.

Finally, we would strongly discourage the adoption of a 'one size fits all' approach to initial margin. There should not be a requirement to collect initial margin on uncleared trades. Rather, firms should be able to choose initial margin or other risk mitigation tools as appropriate.

We appreciate the opportunity to submit our views on the discussion paper. Please do not hesitate to contact us should you have questions or if we can provide any more detail.

Yours sincerely,

Andrew Procter
Global Head of Government and Regulatory Affairs

Questions 2-13 Options for initial margins

- To avoid regulatory arbitrage and promote the efficient functioning of derivatives markets, consistent implementation of margin standards across jurisdictions is necessary. Rules should also seek consistency across all product types regardless of counterparty classification or margin models and thresholds. Rules that are complex and inconsistent will prove challenging to implement and vulnerable to operational risk.

- Option 1 (where PRFCs are required to post IM to NPRFCs and NFCs), would be a significant deviation from current practice and could increase credit risk as PRFCs will be required to post collateral to entities which are not required to be capitalised in any way to protect from a default. If PRFCs are required to post collateral to NFCs, the focus should be on segregated accounts.

- In the US, the proposed rules provide for an Initial Margin threshold applicable by a Swap Dealer to a Low Risk Financial End User and a Non Financial End User. To this end, Option 3 is most closely aligned with the US proposal as it allows PRFCs to apply IM thresholds to certain counterparties as appropriate.

- The proposed rules should allow PRFCs to use their internally designed models to determine what IM should be collected from counterparties (subject to meeting standards approved by regulation). Currently transactions with PRFCs, NPRFCs, & NFCs are based on Credit Support Annexes (CSAs), bilaterally negotiated at the time of inception, and on an ongoing basis. The capital framework for PRFCs ensures that un-collateralized risks are appropriately capitalised.

- Thresholds are in place for all counterparties with CSAs. In determining thresholds, counterparty credit quality is determined by reference to internal credit ratings. Thresholds may be modified dependent on a counterparty's credit status and where any triggers are breached. PRFCs should be able to determine the application of thresholds to different types of counterparty, however there should be an upper limit on thresholds as if counterparts were to negotiate a very high threshold, IM may not need to be transferred. Rules on thresholds need to be consistent to prevent arbitrage.

- In respect of options 2 and 3, consideration should be given to the fact that operational infrastructures may differ significantly within the PRFC category, and if

either option is selected, sufficient flexibility should be allowed to cater for this diversity. Furthermore, option 3 would require Investment Firms and Pension Funds – as PRFCs – to collect IM exceeding the IM threshold. This may put such firms at a disadvantage compared with UCITS and Alternative Investment Funds.

Question 14-15 Variation margin

- We agree with the proposal for daily exchange of collateral between PRFCs and NPRFCs, subject to a bilateral agreement on Minimum Transfer Amounts and Unsecured Thresholds.

- EMIR recognises that NFCs use OTC derivatives to protect themselves against risks directly linked to their commercial activities. As a result, these OTC derivatives and those that do not exceed a clearing threshold, are not subject to the clearing obligation. However, at the point where the clearing threshold would be exceeded, the clearing obligation would apply to all OTC derivative contracts entered into by the non-financial counterparty.

- To deal with this inconsistency, NFCs should be excluded from variation margin obligations for all non cleared OTC derivative contracts protecting them against risks directly related to their commercial activities. In many cases variation margin would continue to be applied on a case by case basis depending on the risks posed.

- The proposed US rules foresee at least a weekly exchange of collateral for Non Financial Counterparties. In order to ensure cross border consistency, if no exemption from VM requirements is applicable, the technical standards should allow the application of specific thresholds when daily exchange of collateral is required.

- As the process of the daily determination of the potential collateral exchange is already in place for the majority of our counterparties, the incremental cost of extending this process to all would seem to be manageable.

Question 16-26 Initial margin calculation

- In general, the appropriate method to calculate IM is the use of valuation/internal models developed by PRFCs. This approach is the core of current market practice for margining non-cleared derivatives and is codified in the Credit Support Annex (CSA)

published by ISDA. As part of their lending business, certain PRFCs are experienced at making the credit determinations necessary for unsecured lending. Similarly, IM models should be designed to take account of the unique set of factors presented by the individual counterparty and asset class in any particular case.

- With regard to questions 16, 17, 20 and 23, neither the 'mark-to-market' nor 'standardised method' are sufficiently risk-based. This is especially true for larger portfolios, such as those of intra-broker dealers, where capturing portfolio offsets precisely is necessary in order to gauge the risk appropriately. Whilst the IMM is the least problematic, it is currently not generally the way IM is collected in the market by dealers or CCPs. The 'mark to market method' or 'standardised method', even for counterparties which are familiar with IM posting requirements, would also represent a large deviation to current market practice.

- There are several additional approaches that should be considered, including historical simulations, internal model methods or other VaR, and factor or stress-based approaches. These would have the added benefit of being simpler for less sophisticated counterparties to understand and replicate.

- Regarding question 18, periodic initial margin recalculation is a concept that is generally only used for funds that fall within the prime brokerage business area and where initial margin would be recalculated on a daily basis. However, event-triggered initial margin has a wider scope. In the context of funds, initial margin might be recalculated based on market conditions (e.g. the VIX increasing beyond a certain threshold might require the client to post more initial margin) or contractual rights such as the triggering of an Automatic Termination Event. For other counterparties where initial margin is not typically taken, event-triggered initial margin requirements would more commonly be based on contractual rights.

- With regard to question 19, only entities that are prudentially regulated should be allowed to use internal models for the calculation of initial margin. This will ensure such models are validated internally and externally on an ongoing basis in line with high prudential standards. NPRFCs should not be able to benefit from an unlevel playing field with regard to internal model standards.

- With regard to question 24, it is important to note that IM methodologies should be sufficiently consistent and transparent to ensure that counterparties can replicate the model. Models which cannot be replicated have the potential to generate disputes

and unpaid margin calls that may leave PRFCs with further capital charges, blur the ability to recognise a client who is truly in distress and may divert resources to the management of margin dispute resolution.

- The difference in initial margin between counterparties should not of itself be considered to be a variable that needs to be solved, although it is advisable to ensure that internal models are generally consistent across a broad range of sample portfolios before approving such an approach. For example, it is normal that the same transactions could require different initial margin. For example, a seller of protection on a CDS is usually taking more risk and would thus be expected to have higher IM requirements than a buyer of protection on the same transaction.

- As to whether it should be possible to allow a party authorised to use an internal model to calculate the IM for both counterparties (question 25), it is questionable whether in practice such an approach would actually be used since one party calculating for both counterparties may create concerns about a conflict of interest. We recommend that it should be the responsibility of the requestor to calculate the IM. If a counterparty is required to collect IM, they should have an ability to calculate and obtain approval for that methodology under standards equivalent to those applying to PRFCs.

Question 27 – 31 Segregation and Re-use

- Segregated accounts may provide additional protections that would protect both parties should one default. However, there are cost implications for putting this in place (legal and administrative), increased concentration risk (significant collateral across the market is held with any one custodian) and larger liquidity implications for the market as a whole if re-use of collateral is limited. Thus, in view of its limited benefit, segregation should be required only for collateral exchange between PRFCs, and independent custodians should be able to re-use collateral subject to certain minimum protections.

- Outright transfer of margin is a simple means of collateralising a relationship facilitates economically beneficial activity by the recipient of the margin, and is legally secure provided an effective netting structure is in place (by contrast, charges of assets always require the completion of formalities, and are subject to human error).

Question 32-35 Eligible collateral

- In general, PRFCs are well placed to determine which type of assets should be posted as collateral for a given transaction. Allowing counterparties to negotiate which asset types should be accepted for a given transaction can help to avoid liquidity being unnecessarily constrained. PRFCs should be allowed to use their own methodologies to model the risk of collateral they receive. Any standardised haircuts set at the regulatory level would need to be dynamic in nature, and updated on a continuous basis.

- When reviewing eligible collateral, credit quality of the counterparty is the key criterion. If option 2 is selected, it should not lead to PRFCs being required to accept collateral that they do not believe is sufficient to cover the risks arising with a given counterparty.

- In general, eligible collateral should be of the highest quality and most liquid for the highest risk counterparties. Eligible collateral restrictions and haircuts should be at the discretion of the counterparties. In theory, it would be prudent to restrict eligible collateral for high risk clients to extremely liquid and high quality collateral with minimal volatility, but in practice this may not always be possible to achieve since, at present, not all counterparties have the necessary infrastructure nor access to high quality collateral.

Question 36-40 Collateral valuation/haircuts

- The current practice is for collateral to be subject to daily valuation, especially since market prices are available for the majority of the collateral exchanged. However, the more illiquid the collateral, the less frequently meaningful valuations can be made. It may be useful to define the technical standards on a ‘comply-or-disclose’ basis: daily valuations are the expectation, but firms may agree with clients less frequent valuations for more illiquid collateral.

- Notwithstanding the preceding point regarding illiquid collateral, a significant increase in cost is not expected as a result of more frequent valuation, since market prices are available for the majority of collateral used at present.

- As haircuts may fluctuate depending on the credit quality of a counterparty, allowing counterparties to use own estimates of haircuts will ensure the dynamic standards necessary in case of significant market volatility.

Question 41-44 Risk management procedures, operational process for the exchange of collateral and minimum transfer amount

- All parties involved in collateralisation should adhere to best practices and Deutsche Bank fully supports the ISDA 'best practices for collateral operations' published in 2011.

- Bilateral agreement should dictate the minimum transfer amounts, to take into account the relative size and credit quality of the two parties. As a result, there is unlikely to be a "one size fits all" standard.

- In general, maintaining robust operational processes will require large initial IT investments. Appropriate transitional periods will be necessary. In terms of a possible cap for the minimum threshold amount, we believe that EUR 500,000 should be sufficient to balance operational costs and effective risk management.

Question 45-46 Intragroup exemptions

- Capitalisation of intragroup exposures is conducted as required by local regulations. We note that the concept 'practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties is also referred to in the Capital Requirements Regulation. In that legislation, the determination is made by Member States, in part because of the differences in national insolvency regimes. Any more prescriptive legislation here beyond that principle should be consistent with the current approach to intragroup exemptions across all Member States within the EU to avoid distortions.