

2 April 2012

To Whom It May Concern:

Goldman Sachs International welcomes the opportunity to comment on 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” published by the European Securities and Markets Authority (“ESMA”), the European Banking Authority (“EBA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”, and together with ESMA and EBA, the “ESAs”) on 6 March 2012 (the “Discussion Paper”).

We have focused our response on certain key themes in the Discussion Paper. We support the comprehensive response submitted by ISDA, to which we have contributed as a member firm, but also provide these comments individually on issues which we consider to be of particular importance.

We look forward to continuing an open dialogue with you on these issues and would welcome a meeting in person to discuss in more detail. Please do not hesitate to contact Martine Doyon (+44 20 7051 5237) should any questions arise.

Overall comments

Goldman Sachs endorses the ESAs’ aim of developing standards to ensure that counterparties apply robust risk mitigation techniques to their bi-lateral OTC derivatives relationships. However we consider it important to avoid mandatory requirements which are duplicative or incremental, given the liquidity effects and costs associated with different risk mitigation techniques.

In connection with the development of such standards, we submit the following general comments:

- **Strong and appropriately calibrated risk mitigation measures.** We believe that strong risk-based capitalisation and robust collateral requirements make financial institutions and the wider financial system safer. Collateral requirements should though be appropriately calibrated in order to avoid liquidity drains, misallocation of resources and increased counterparty risk, as such requirements carry costs, introduce their own risks and represent an allocation of finite resources.
- **Risk mitigation.** The Regulatory Technical Standards (“RTS”) should adopt a holistic criteria-based approach, reflecting a number of risk mitigation techniques.
 - Risk mitigation rules should set high standards for the quality of models used to calculate potential future exposure to counterparties, including the robustness and frequency of the margining process and the accuracy of mark-to-market calculations.
 - Initial margin is only one of a number of tools which can be permitted to be used to mitigate counterparty risk, with capital being a key risk management tool for regulated entities to protect against counterparty default.
 - Large, complex and/or illiquid portfolios should be subject to additional capital buffers as will be the case under Basel III.
 - Margining should take into account portfolio effects and counterparty netting, where appropriate.
 - Margin rules should require that consideration be given to the quality and liquidity of collateral exchanged and to haircuts applied, with a focus on liquidation certainty and timeliness.

- **Non-cleared OTC Derivatives.** Market participants already have numerous incentives to centrally clear derivatives, whether or not clearing is a regulatory requirement. Central clearing reduces counterparty risk and allows some (though not all) market participants to realize netting efficiencies. The Regulation on OTC derivatives, CCPs and Trade Repositories (“EMIR”) will encourage the development of new clearing products which should enhance these incentives. However, client requirements are such that there will continue to be a need for tailored OTC derivatives for which central clearing is not available or appropriate and these products should remain capable of being traded if subject to appropriate risk-mitigation techniques.
- **Variation margin.** We agree with the overall approach of the ESAs, requiring the exchange of variation margin between the counterparties covered by the bi-lateral risk management requirements imposed by EMIR. However, the approach should also allow Prudentially Regulated Financial Counterparties (“PRFCs”) to set thresholds above which variation margin requirements apply, thereby effectively extending credit to their counterparties. Credit extension is a core function of PRFCs in the financial system and risks arising from such credit extension can be managed through robust capital standards (per Basel III), as well as other risk mitigation techniques.
- **Initial margin.** While initial margin can be a useful counterparty credit risk mitigant, it may not always be the best or most efficient one for bilateral OTC transactions (whereas it is essential for CCPs, given their role as credit intermediaries), and carries a number of disadvantages and risks. See our responses to Q 2-10, 16-17 and 27-29 for a more detailed discussion.
- **Recognition of portfolio netting.** Current market practice, as well as the Basel Accord, the Banking Directive, the Capital Requirements Directive and member state rules recognise netting as an effective risk-reduction tool. Where a legal basis for netting exists (evidenced by legal opinions where appropriate) it should be recognised in any initial or variation margin requirements. Gross exposure, on the other hand, typically materially overstates potential losses. A requirement to post initial margin against gross exposure would therefore increase market participants’ costs of trading disproportionately to the reduction in risk. We recommend that should the ESAs choose to mandate initial margin the requisite initial margin be calculated as a function of the net, rather than the gross, exposure.
- **Regulatory requirement to “collect”, not “post” margin.** Consistent with EMIR’s requirement for certain market participants to implement risk management processes, we think that collateralisation requirements should be described as being an obligation to collect, rather than post, margin. As the regulatory basis for this requirement relates to prudent management of a market participant’s risk, the collection of initial and variation margin should be driven by that party’s mitigation requirement.
- **Effective date.** Recital (50b) EMIR clarifies that obligations imposed by EMIR and further developed by RTS will only apply once the RTS take effect. This is important for legal certainty, but it will be important that the RTS specifying that the margin requirements only apply with respect to transactions entered into after the RTS take effect. Otherwise there could be a concern that the requirements also apply (once the RTS takes effect) to transactions entered into before that time, which would affect the value and characteristic of existing OTC derivative transactions and raise economic and legal uncertainty.

Our specific comments on several questions are set out further below:

Q2-10: Initial margin requirements / other ways of protecting against losses

Although we agree that initial margin can be a valuable part of the risk mitigation tools available to market participants, it comes with several disadvantages compared with other forms of risk mitigation:

- The imposition of mandatory initial margin requirements has the potential to increase costs for end users who are subject to such requirements, with the largest impact likely to be on entities with long-term structural positions.
- Although posting of initial margin reduces the secured party's risk to the posting party, it leads to additional risks for the posting firm, thereby arguably increasing the overall risk in the system. If initial margin is posted on a transfer-of-title basis, the posting party would typically be an unsecured creditor for this initial margin in a default of the counterparty to which it is posted. Where initial margin is posted on a segregated basis, various different risks arise (as discussed in the answers to Q 27 to 29 below).
- Given its overlap with capital as a mitigation tool, mandatory initial margin requirements also have the potential to introduce disproportionate additional costs and counterparty and systemic risks. This potentially drains significantly more liquidity from the financial system than reliance only on properly sized capital requirements, since market participants will have to divert capital from other activities, thereby potentially increasing costs for end users. Risk mitigation through capital further acknowledges portfolio effects through the diversification of risk across many counterparties, whereas margin by its nature looks at bilateral exposure. Furthermore, demand for forms of acceptable collateral may increase the price of those assets relative to others.

To the extent that initial margin is mandated, we discuss in our response to Q16 and 17 below our views on the manner in which such initial margin should be calculated.

Q14: Requirement for daily exchange of collateral

As discussed above, we think that counterparties that are required to exchange variation margin should be able to set appropriate thresholds (thereby effectively extending credit) if agreed between the parties. Subject to this, we are supportive of the suggestion that variation margin should generally be exchanged daily.

Q16 and 17: Standardised approaches for the calculation of initial margin

To the extent that initial margin is mandated, we do not consider either the "Mark-to-market method" or the "Standardised Method" to be reasonable approaches. Both assess risk on a trade-by-trade basis, severely limiting the impact of enforceable netting across transactions and therefore materially overstating risks. When netting is enforceable between parties, the actual exposure between them is the net risk in the portfolio of trades. Since margin posting is by its nature a risk transfer, its benefits come from the reduction of *net* risk rather than gross risk between counterparties to a portfolio of transactions.

Calculating the amount of initial margin based on *gross* risk exposure would therefore be contrary to the EMIR's intent and have a number of other detrimental effects. It would greatly increase the demand for margin assets, diverting liquidity and capital from other areas without the clear benefit of a reduction (and the potential for increase) in counterparty risk. We think that the initial margin should be risk-sensitive and that appropriate internal models, including, for example Value-at-Risk ("VaR") models, should be authorised for the calculation of such initial margin. This would require robust control and oversight, similar to the process used in the capital requirements for derivatives.

Another consideration with the introduction of initial margin requirements arises from the relationship between existing portfolios, where no initial margin would have been required, and new portfolios. Requiring initial margin for existing trades would lead to a significant change in the economic characteristics of existing transactions, effectively transferring mark-to-market value from one party to the other. Such interference in existing contractual arrangements would be unwarranted and would have significant economic consequences.

Q27 – 29: Collateral Segregation

We agree that segregation of initial margin can help mitigate a posting party's credit risk and that the main methods of segregation would be those addressed in the Discussion Paper. However, we consider that both methods raise significant legal and practical issues which could substantially reduce the extent to which the posting party's credit risk is mitigated by segregation and in some respects may increase that risk. The extent to which segregation mitigates counterparty risk will be a function of the insolvency and customer assets regimes in the jurisdictions of both the secured counterparty and the place in which the margin assets are actually located. The insolvency, customer assets and other relevant laws impacting these outcomes are not currently harmonised across the EU, no less across other jurisdictions in which counterparties and margin assets may be located.

Given the varied complex matrix of legal considerations relevant to this determination, it is not clear that segregation in a segregated account held with the secured party will give the posting party sufficient legal and practical certainty that it will be able to promptly reclaim its margin if its counterparty defaults. Furthermore, where a secured party holds margin in a segregated account it may in fact itself hold that account with a third party, thereby exposing the posting party to the credit risk of another entity.

The use of a tri-party collateral structure only partly mitigates these risks. In the event of a default of the secured party the posting party would require certainty that the third party would rely solely on its instructions and, more importantly, that the secured party (or its insolvency official) would not be able to interfere in this process. Furthermore, the posting party would become exposed to the credit risk of the third party. Given that there are a limited number of institutions which we anticipate would be willing to provide tri-party collateral structures, this would potentially result in significant (new) risk concentration.

We therefore submit that:

- rather than being mandated, collateral segregation should be a matter for agreement between the parties; and
- the ESAs should give further consideration to ways in which the posting party can be given sufficient certainty that it will be able to promptly reclaim its margin if its counterparty defaults.

Q30 and 31: Current practice regarding the re-use of received collateral

Today, collateral is overwhelmingly taken as variation margin with legal title to such collateral typically passing to the receiving party. This enables a party to use collateral received in its own business, for example to satisfy collateral requirements for offsetting transactions. To the extent that margin is required to be segregated, this will greatly reduce liquidity available for other purposes, since segregated margin is effectively being taken out of the financial system without sufficiently clear benefit.

Q33 Range of Eligible Collateral

We strongly support the focus on the quality and risk management of collateral in order to serve as an effective risk mitigant. We generally support high quality collateral, characterised by low market risk, credit risk and liquidity risk. However we think that counterparties should be able to agree to a broader range of collateral (and corresponding haircuts) if accompanied by robust risk management and regulatory oversight of collateral risk. This may include tools such as collateral risk models, appropriateness of haircuts, frequency of marking to market of the collateral and liquidation tests. This is particularly important should the ESAs not wish to cause potential imbalances in the prices of various forms of collateral and to enable end users to use their inventory assets for collateralisation purposes.

Q43 Cap for minimum transfer and threshold amounts

We do not think that it is appropriate for EMIR to impose caps on minimum transfer amounts and thresholds. As noted above, uncollateralised derivatives exposure essentially constitutes an extension of credit. Institutions should be permitted to make such credit available in accordance with their usual credit and risk management frameworks.

Q45: Practicable and legal impediment to the transfer of own funds

EMIR recognises the importance of group-wide risk management for the global financial system and that the availability of group funds in practice often serves as an important risk mitigant. This can only work if procedures exist under which such funds can be advanced in time of need. It would for example not work, if exchange controls prevent prompt transfer.

On the other hand we do not think that the provision should be read to reference an insolvency scenario. If the counterparty credit risk has materialised in this way, a prompt transfer of funds will rarely be possible. The exemption recognises that group-wide risk management serves as an important mitigant that this scenario does not arise in the first place.