Consultation Paper

Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012
Contents

1. Responding to this consultation ................................................. 3
2. Executive summary ................................................................ 4
3. Background and rationale ....................................................... 6
4. Draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 ................ 14
5. Accompanying documents ...................................................... 57
   5.1 Draft Impact Assessment .................................................... 57
   5.2 Overview of questions for Consultation ............................... 84
1. Responding to this consultation

The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) invite comments on all proposals put forward in this paper, in particular on the specific questions summarised in section 5.2.

Comments are most helpful if they:
- respond to the question posed;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed / rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the ‘send your comments’ button on the consultation page by 14.07.2014. Please note that comments submitted after this deadline, or submitted by other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA, EIOPA and ESMA’s rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA, EIOPA or ESMA’s Boards of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the European Supervisory Authorities (ESAs) is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the ESAs in their implementing rules. Further information on data protection can be found at www.esma.europa.eu, www.eba.europa.eu and www.eiopa.europa.eu under the heading ‘Legal Notice’.
2. Executive summary

The EMIR delegates powers to the Commission to adopt RTS specifying:

a) risk-management procedures for this type of contract;

b) procedures for counterparties and competent authorities concerning intragroup exemptions; and

c) criteria for the identification of practical or legal impediment to the prompt transfer of funds between counterparties.

The European Supervisory Authorities (ESAs) have been mandated to develop common draft regulatory technical standards (RTS) that outline the concrete details of the regulatory framework which implements Article 11 of Regulation (EU) No 648/2012(EMIR). The EMIR, specifically, introduces a requirement to exchange a margin on non-centrally cleared OTC derivatives. As part of the process, this Consultation Paper seeks stakeholders’ views on the proposals.

The EMIR mandates the ESAs to develop standards that set out in greater detail the specific aspects of this framework, including margin models, the eligibility of collateral to be used for margins, operational processes and risk-management procedures. In developing these standards, the ESAs have also kept in mind the need for international consistency and have consequently used the internationally agreed standards as the natural starting point. In addition, a number of specific issues have been clarified so that the proposal will implement the internationally agreed minimum standards while taking into account the specific aspects of the European financial market. This Consultation Paper consequently specifies the complete framework to be used.

The RTS prescribe the minimum amount of initial and variation margin to be posted and collected and the methodologies by which that minimum amount would be calculated. Under both approaches, variation margins are to be collected to cover the mark-to-market exposure of the OTC derivative contract. For the initial margin, counterparties can choose between a standard pre-defined schedule based on the notional value of the contracts and an internal modelling approach, where the initial margin is determined based on the modelling of the exposures. This allows counterparties to decide on the complexity of the framework to be used.

The RTS also outline the collateral eligible for the exchange of margins. The eligible collateral covers a broad set of securities, such as sovereign securities, covered bonds, specific securitisations, corporate bonds, gold and equities. In addition, criteria to ensure that collateral is sufficiently diversified and not subject to wrong-way risk have been established. Finally, to reflect

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the potential market and FX volatility on the collateral the RTS prescribes the methods for determining appropriate collateral haircuts.

Significant consideration has also been given to the operational procedures that have to be established. Appropriate risk management procedures should also include specific operational procedures. The RTS therefore set out operational requirements, including documentation requirements. Furthermore, the RTS provide the option to apply a minimum transfer amount of up €500,000 when exchanging collateral. Also with regard to intragroup exposures, a clear procedure is established for the granting of intragroup exceptions allowed under the EMIR. This will harmonise the introduction of operational procedures and provide clarity on these aspects.

The RTS also acknowledge that a specific treatment of certain products may be appropriate. This includes, for instance, physically-settled FX swaps, which may not be subject to initial margin requirements. Furthermore, to allow counterparties time to phase in the requirements, the standard will be applied in a proportionate manner; so the requirements for the initial margin will, at the outset, apply only to the largest counterparties until all counterparties with notional amount of non-centrally cleared derivatives in excess of EUR 8 billion are subject to the rules as from 2019. The scope of application for counterparties subject to initial margin requirements is therefore clearly specified.

During the development of the RTS, a number of considerations were made, which are important for the understanding of the final proposal and are therefore briefly explained in the consultation paper. Quantitative and qualitative aspects concerning costs and benefits are discussed in the last section together with a preliminary version of the Impact Assessment. This supplements the proposal and illustrates the reasoning behind the policy choices made.

Following this Consultation Paper, and on the basis of the relevant input received, the ESAs will finalise their jointly developed draft RTS and submit them to the Commission before the end of 2014.
3. Background and rationale

The EMIR establishes provisions aimed at increasing the safety and transparency of the OTC derivatives markets. Among other requirements, it introduces a legal obligation to clear certain types of OTC derivatives through central counterparties (‘CCP’). However, not all OTC derivative transactions will be subject to the clearing obligation or would meet the conditions to be centrally cleared. In the absence of clearing by a CCP, it is essential that counterparties apply robust risk mitigation techniques to their bilateral relationships to reduce counterparty credit risk. This will also mitigate the potential systemic risk that can arise in this regard.

Therefore, Article 11 of the EMIR requires the use of risk mitigation techniques for transactions that are not centrally cleared and, in paragraph 15, mandates the ESAs to develop RTS on three main topics: (1) risk-management procedures for the timely, accurate and appropriately segregated exchange of collateral; (2) procedures concerning intragroup exemptions; and (3) the criteria for the identification of practical or legal impediment to the prompt transfer of funds between counterparties.

To avoid regulatory arbitrage and to ensure a harmonised implementation at both the EU level and globally, it is crucial to be consistent with international standards. Therefore, these draft RTS consider the minimum international standards on margin requirements for non-centrally cleared derivative transactions issued by the Basel Committee for Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) on September 2013. The international standard outlines the principles behind margin requirements, which to the extent possible have been transposed into the RTS. This will help ensure global consistency.

The overall reduction of systemic risk and the promotion of central clearing are identified as the main benefits of this new international framework. To achieve these objectives, the BCBS-IOSCO framework introduces eight key principles and a number of detailed requirements. It is the opinion of the ESAs that this regulation is in line with the principles of the international framework and that the requirements are properly transposed.

This Consultation Paper is divided into three main parts: the introductory remarks, a draft of the RTS and accompanying material, including the cost-benefits analysis. The draft RTS document is further split into five chapters:

1. Counterparties’ risk management procedures;
2. Margin methods;
3. Eligibility and treatment of collateral;
4. Operational procedures;
5. Procedures concerning intragroup derivative contracts.

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2 Margin requirements for non-centrally cleared derivatives – final document, September 2013.
The sections below describe in greater detail the content of these chapters.

Counterparties’ risk management procedures required for compliance with Article 11(3) of Regulation (EU) No 648/2012

The first chapter of these draft RTS outlines the scope of the application of these requirements by identifying the counterparties and transactions subject to the following provisions. The EMIR requires financial counterparties to have risk management procedures in place that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts. Similarly, non-financial institutions must have similar procedures in place, if they are above the clearing threshold. Consistent with this goal, to prevent the build-up of uncollateralised exposures within the system, the RTS require the daily exchange of variation margin between counterparties.

Subject to the provisions of the RTS, the entities mentioned above, i.e. both financial and non-financial counterparties, will also be required to exchange two-way initial margin to cover the potential future exposure resulting from a counterparty default. To act as an effective risk mitigant, initial margin recalculations should reflect changes in both the risk positions and market conditions. Consequently, counterparties will be required to recalculate initial margin, at least when the portfolio between the two entities has changed, or the underlying risk measurement approach has changed. In addition, to ensure current market conditions are fully captured, initial margin is subject to a minimum recalculation period of 10 days.

In order to align with international standards, the requirements in the RTS will apply only to key OTC derivative market participants. The provisions of the RTS on initial margin will therefore apply to entities that have an OTC derivative exposure above a predetermined threshold, defined in the RTS as above EUR 8 billion in gross notional outstanding. This reduces the burden on smaller market participants, while still achieving the principle objective of a sizable reduction in systemic risk. The RTS impose an obligation on EU entities to collect margin in accordance with the prescribed procedures, regardless of whether they are facing EU or non-EU entities. EU entities would have to collect margin from all third-country entities, unless explicitly exempted by the EMIR or under the EUR 8 billion threshold, even from those that would be classified as non-financial entities below the threshold if they were established in the EU.

During the development of the RTS, the issue of the risks posed by physically-settled foreign-exchange contracts was carefully considered. There appears to be a risk involved in these transactions. However, to maintain international consistency, entities subject to the RTS may agree not to collect initial margin on physically-settled foreign exchange forwards and swaps, or the principal in currency swaps. Nevertheless, the counterparties are still expected to post and collect the variation margin associated with these contracts, which is assessed to sufficiently cover the risk and ensure a proportionate approach.

Yet it is also recognised that the exchange of collateral for only minor movements in valuation may lead to an overly onerous exchange of collateral and that initial margin requirements will
have a measurable impact. Therefore, the RTS propose a threshold to limit the operational burden and a threshold for managing the liquidity impact associated with initial margin requirements. Both thresholds are fully consistent with international standards.

The first threshold ensures that the exchange of initial margin does not need to take place if a counterparty has no significant exposures to another counterparty. Specifically, it may be agreed bilaterally to introduce a minimum threshold of up to EUR 50 million, which will ensure that only counterparties with significant exposures will be subject to the Initial Margin requirements.

The second threshold ensures that, when market valuations fluctuate, new contracts are drawn up or other aspects of the covered transactions change; an exchange of collateral is only necessary if the change in the margin requirements exceeds EUR 500,000. Similarly to the first threshold, counterparties may agree on the introduction of a threshold in their bilateral agreement as long as the minimum exchange threshold does not exceed EUR 500,000. Therefore, the exchange of collateral only needs to take place when significant changes to the margin requirements occur. This will limit the operational burden relating to these requirements.

**Margin methods**

The second chapter outlines the methods that counterparties may use to calculate initial margin requirements: the standardised method and initial margin models.

The standardised method mirrors the mark-to-market method set out in Articles 274 and 298 of Regulation (EU) No 575/2013. It is a two-step approach: firstly, derivative notional amounts are multiplied by add-on factors that depend on the asset class and the maturity, resulting in a gross requirement; secondly, the gross requirement is reduced to take into account potential offsetting benefits in the netting set. Unlike the mark-to-market method, the add-on factors are adjusted to be aligned with those envisaged in the international standards.

Alternatively, counterparties may use initial margin models that comply with the requirements set out in the RTS. Initial margin models can either be developed by the counterparties or provided by a third-party agent. The models are required to assume the maximum variations in the value of the netting set at a confidence level of 99% with a risk horizon of at least 10 days. Models must be calibrated on a historical period of at least three years, including financial stress; in particular, observations from the period of stress must represent at least 25% of the overall data set to reduce procyclicality. To limit the recognition of diversification benefits, derivative contracts must be assigned to asset classes based on their primary risk factors; as such, models can only account for offset benefits for derivative contracts belonging to the same netting set and the same asset class. Additional quantitative requirements are set out to ensure that all relevant risk factors are included in the models and that all basis risks are appropriately captured. Furthermore, the models must be subject to an initial validation, periodical back-tests and regular audit processes. All key assumptions of the model, its limitations and operational details must be appropriately documented.

**Eligibility and treatment of collateral**
Chapter 3 considers the minimum requirements for collateral to be eligible for the exchange of margins by counterparties and the treatment of collateral, in particular the haircuts to be applied. It also includes provisions relating to intragroup transactions.

Even if margin is exchanged in an amount appropriate to protect the counterparties from the default of a derivative counterparty, the counterparties may nevertheless be exposed to loss in case the posted collateral cannot be readily liquidated at full value should the counterparty default. This issue may be particularly relevant during periods of financial stress. Counterparties may still agree on the use of more restrictive collateral requirements, i.e. a subset of the collateral eligible as set out in the RTS, but given the risk posed by the collateral, minimum requirements on the collateral eligible are considered necessary.

Assets that are deemed to be eligible for margining purposes should be sufficiently liquid, not be exposed to excessive credit, market and FX risk and hold their value in a time of financial stress. Furthermore, with regard to wrong-way risk, the value of the collateral should not exhibit a significant positive correlation with the creditworthiness of the counterparty. The accepted collateral should also be reasonably diversified. To the extent that the value of the collateral is exposed to market and FX risk, risk-sensitive haircuts should be applied. This ensures that the risk of losses, in the event of a counterparty default, is minimised.

The RTS therefore propose a list of eligible collateral, eligibility criteria, requirements for credit assessments and requirements regarding the calculation and application of haircuts. Wrong-way risk and concentration risk are also addressed by specific provisions. Additionally, the RTS require that risk management procedures include appropriate collateral management procedures. A set of operational requirements is therefore included to ensure that counterparties have the capabilities to properly appropriate the collected collateral and manage the collateral in the event of the default of the other counterparty.

The RTS have adopted the key principles outlined in the international standards and have aligned these principles them to EU-wide market conditions. This will ensure a harmonised EU implementation of the RTS whilst respecting the conditions of the respective markets. The RTS consider it appropriate to allow for a broad set of asset classes, given that the requirements will apply to margin requirements between individual counterparties. As a starting point, the list of eligible collateral is based on the provisions laid down by Articles 197 and 198 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, relating to financial collateral available under the credit risk mitigation framework of institutions, and includes only funded protection. All asset classes on this list are deemed to be eligible in general for the purposes of the RTS. However, all collateral has to meet additional eligibility criteria such as low credit, market and FX risk.

As the RTS consider it necessary to limit excessive credit risk in the collateral, and several approaches for the assessment of credit risk on the collateral have been considered. In particular, there has been a concern about introducing an overreliance on external ratings, which, in accordance with Regulation No 462/2013 on credit rating agencies (CRA III) should be limited. In
particular, the risk of introducing ‘cliff effects’, where counterparties would be required to replace collateral, possibly triggering a market sell-off after a ratings downgrade, has been carefully considered in the development of the RTS.

In order to reduce reliance on external ratings and mitigate the risks of sole and mechanistic reliance, a number of measures have been introduced in the RTS. To reduce the reliance of external ratings, the use of either an internal or external credit assessment process will be allowed, which will stipulate a minimum level of credit quality. In particular, to reduce the reliance on external ratings, these draft RTS allow the use of internal-ratings-based (IRB) approaches to IRB banks. If there is not an approved IRB for the collateral or if the two counterparties do not agree on the use of the internal-ratings-based approach developed by one counterparty, the two counterparties can define a list of eligible collateral relying on the external credit assessments of recognised external credit assessment institutions (ECAIs). The minimum Credit Quality Step (CQS) is set to two for most collateral types. The use of the CQS must be consistent with the Implementing Technical Standards (ITS) on the mapping of the credit assessments to risk weights of ECAIs under Article 136 of the Capital Requirements Regulation (CRR), currently under development by the three ESAs.

The risk of cliff effects may not be sufficiently mitigated by the introduction of internal credit assessments. Therefore, these draft RTS also allow the minimum level of credit quality defined in the RTS to be exceeded for a ‘grace period’ following a downgrade. However, this is conditional on the counterparty starting a well-defined process to replace the collateral. It is believed that this will operationally allow counterparties more time to replace the collateral, sufficiently reducing any regulatory-induced cliff effect.

On top of the overall requirements on the collateral eligible for the exchange of margins, two additional requirements are considered necessary: measures preventing wrong-way risk on the collateral and the introduction of diversification requirements. Therefore, the RTS do not allow own-issued securities as eligible collateral, except on sovereign debt securities; however, the requirement extends to corporate bonds, covered bonds, other debt securities issued by institutions and securitisations. As regards the need to have a diversified pool of collateral available, the RTS introduce diversification requirements on three different asset classes: (i) sovereign bonds (and equivalent); (ii) non-sovereign bonds; and (iii) securities issued by credit institutions and investment firms. These requirements will reduce concentration risk in the collateral placed in margins, and are considered necessary to fulfil the requirements of having sufficient high-quality collateral available following the default of a counterparty.

The collateral requirements in the RTS strive to strike a good balance between two conflicting objectives. Firstly, there is the need to have a broad pool of eligible collateral that also avoids an excessive operational and administrative burden on both supervisors and market participants. Secondly, the quality of eligible collateral must be sufficient while limiting cliff effects triggered by the RTS in the form of introducing reliance on ECAI ratings. It is currently believed that the RTS strike this balance in an appropriate manner.
However, the risk of losses on the collateral is not only mitigated by ensuring collateral of sufficient high quality; it is also considered necessary to apply appropriate haircuts to reflect the potential market and FX volatility on the collateral. The current draft RTS allows the use of an internal model for the calculation of haircuts or the use of standardised haircuts that would provide transparency and limit procyclical effects.

In order to provide a standardised haircut schedule, haircuts in line with the credit risk mitigation framework have been adopted across the different levels of credit quality steps. It should be noted that the international standards provide haircut levels in the standardised method (‘standard schedule’), also derived from the standard supervisory haircuts adopted in the Basel Accord’s approach to the collateralised transactions framework. However, the standard schedule presented in the international standards only contains haircuts for collateral of very high credit quality with an external credit assessment mapped to CQS 1. Given that the list of eligible collateral in the draft RTS, as well as in the international standards, comprise collateral with a lower, albeit still sufficiently high credit quality, the draft RTS extend the standardised schedule of haircuts based on the credit risk mitigation framework in Regulation (EU) No 575/2013.

The chapter on eligible collateral has been drafted with the international standards developed in this area in mind, thus ensuring full compliance with the international standards. It has been considered important to align the requirements to European market conditions, but also to provide a harmonised approach that ensures consistency in the implementation across EU jurisdictions.

Operational procedures

In Chapter 4 these RTS recognise that the operational aspects relating to the exchange of margin requirements will require substantial effort to implement in a stringent manner. It is therefore necessary for counterparties to implement robust operational procedures that ensure that documentation is in place between counterparties and internally at the counterparty. These requirements are considered necessary to ensure, that requirements in the RTS are implemented in a careful manner that minimises the operational risk of these processes.

The operational requirements include, among other things, clear senior management reporting, escalation procedures (internally and with counterparties) and requirements to ensure sufficient liquidity of the collateral. Furthermore, counterparties are required to conduct tests on the procedures, at least on an annual basis.

Segregation requirements must be in place to ensure that collateral is available if a counterparty defaults. In general, operational and legal arrangements must be in place to ensure that the collateral is bankruptcy remote.

The international standards do not generally allow re-hypothecation of collateral posted on initial margins, but make an exception to this principle provided that a number of conditions are fulfilled. After careful consideration, the RTS do not contain the possibility to re-hypothecate
initial margins because the restrictions appear to be of limited use within the European market, and ruling out this possibility will simplify the overall framework.

**Procedures concerning intragroup derivative contracts**

In accordance with Article 11(6) to (10) of the EMIR, intragroup transactions can be exempted from the requirement to exchange collateral if certain requirements on the risk-management procedures are met and there are no practical or legal impediments on the transferability of own funds and the repayment of liabilities. Depending on the type of counterparties and where they are established, there is either an approval or a notification process.

Without further clarification, there is a risk that competent authorities would follow very different approaches regarding the approval or notification processes. Chapter 5 therefore specifies a number of key elements including the amount of time that competent authorities have to grant an approval or to object, the information to be provided to the applicant and a number of obligations for the counterparties.

To ensure that the criteria for granting an exception are applied consistently across the member states, the draft RTS further clarify which requirements on risk management procedures have to be met, and specify the practical or legal impediments on the transferability of own funds and the repayment of liabilities.

**Phase-in of the requirements**

A last article deals with transitional provisions and phase-in requirements. In order to adapt a proportionate implementation, the RTS propose that the requirements will enter into force on 1 December 2015, giving counterparties subject to these requirements time to prepare for the implementation. To mitigate the liquidity impact, the requirements will be phased-in over a period of four years.

This will ensure that, initially, the requirements will only apply to the largest market participants. Subsequently, after four years, more market participants will become subject to the requirements. Specifically, from 1 December 2015, market participants that have an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding EUR 3.0 trillion will be subject to the requirements from the outset. From 1 December 2019, any counterparty belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 8 billion will be subject to the requirements. This proposal also fully aligns the requirements with international standards.

The phase-in requirement is considered necessary to give especially smaller market participants more time to develop the necessary systems and implement the RTS. Moreover, it was deemed important to streamline the requirements in order to exchange bilateral margins with international standards to achieve a global level playing field.
Final remarks and next steps

The Consultation Paper gives a complete overview of the legal framework that will govern the implementation of the international standards in the area of margining non-cleared OTC derivatives.

With this Consultation Paper, the ESAs are now seeking further input on the proposal. Based on the input received, the ESAs will prepare the final draft RTS, and intend to submit these to the Commission before the end of 2014. This will clarify the overall framework to be used before its application as from 1 December 2015.

Contents

CHAPTER 1 - COUNTERPARTIES’ RISK MANAGEMENT PROCEDURES REQUIRED FOR COMPLIANCE WITH PARAGRAPH 3 OF ARTICLE 11 OF REGULATION (EU) NO 648/2012 ............................................................... 21
  ARTICLE 1 DEF - DEFINITIONS ................................................................................................................. 21
  ARTICLE 1 GEN - GENERAL COUNTERPARTIES’ RISK MANAGEMENT PROCEDURES ........................................... 22
  ARTICLE 2 GEN - RISK MANAGEMENT PROCEDURES IN SPECIFIC CASES ..................................................... 23
  ARTICLE 3 GEN - TREATMENT OF DERIVATIVES ASSOCIATED TO COVERED BONDS PROGRAMMES FOR HEDGING PURPOSES ........................................................................... 25
  ARTICLE 1 VM - VARIATION MARGIN .................................................................................................... 27
  ARTICLE 3 EIM - INITIAL MARGINS .................................................................................................... 27

CHAPTER 2 - MARGIN METHODS ............................................................................................................. 28
  ARTICLE 1 SMI - STANDARDISED METHOD ......................................................................................... 28
  ARTICLE 1 MRM - INITIAL MARGIN MODELS ....................................................................................... 28
  ARTICLE 2 MRM - CONFIDENCE INTERVAL AND RISK HORIZON ......................................................... 29
  ARTICLE 3 MRM - CALIBRATION OF THE MODEL ............................................................................... 29
  ARTICLE 4 MRM - PRIMARY RISK FACTOR AND UNDERLYING CLASSES ............................................ 30
  ARTICLE 5 MRM - INTEGRITY OF THE MODELLING APPROACH ........................................................... 31

CHAPTER 3 - ELIGIBILITY AND TREATMENT OF COLLATERAL .................................................................. 32
  ARTICLE 1 LEC - ELIGIBLE COLLATERAL FOR INITIAL AND VARIATION MARGIN ........................................ 32
  ARTICLE 2 LEC - COLLATERAL MANAGEMENT ...................................................................................... 34
  ARTICLE 3 LEC - CREDIT QUALITY ASSESSMENT ................................................................................ 34
  ARTICLE 4 LEC - CREDIT RISK ASSESSMENT BY THE COLLATERAL TAKER USING THE INTERNAL RATING BASED APPROACH .............................................................................. 36
  ARTICLE 5 LEC - ELIGIBILITY CRITERIA FOR UCITS .............................................................................. 36
  ARTICLE 6 LEC - ELIGIBILITY CRITERIA TO AVOID WRONG WAY RISK .................................................. 37
  ARTICLE 7 LEC - CONCENTRATION LIMITS FOR INITIAL AND VARIATION MARGINS .................................. 38
  ARTICLE 1 HC - CALCULATION OF THE ADJUSTED VALUE OF COLLATERAL ......................................... 39
  ARTICLE 2 HC - OWN ESTIMATES OF THE ADJUSTED VALUE OF COLLATERAL ........................................ 39

CHAPTER 4 - OPERATIONAL PROCEDURES ............................................................................................. 40
  ARTICLE 1 OPE - OPERATIONAL PROCESS FOR THE EXCHANGE OF COLLATERAL .................................. 40
  ARTICLE 1 SEG - SEGREGATION OF INITIAL MARGINS ............................................................................ 42
  ARTICLE 1 REU - TREATMENT OF COLLECTED INITIAL MARGINS ....................................................... 42

CHAPTER 5 - PROCEDURES CONCERNING INTRAGROUP DERIVATIVE CONTRACTS ............................. 43
  ARTICLE 1 IGT - PROCEDURE FOR THE COUNTERPARTIES AND THE COMPETENT AUTHORITIES .................. 43
  ARTICLE 2 IGT - INTRAGROUP RISK MANAGEMENT PROCEDURES .................................................... 45
  ARTICLE 3 IGT - PRACTICAL OR LEGAL IMPEDIMENT ............................................................... 45
supplementing Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories of the European Parliament and of the Council with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a CCP.
COMMISSION DELEGATED REGULATION (EU) No xx/20xx

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supplementing Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories of the European Parliament and of the Council with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a CCP.

Explanatory text for consultation purposes:

The Consultation Paper touches upon a number of issues. However, there may be specific aspects of the framework that have not been included which may be a cause for concern among respondents.

In particular, the proposal seeks to implement the rules in a proportionate manner for a number of aspects, taking note that the operational framework will take substantial effort to implement. The ESAs are committed to implementing its rules in a proportionate manner and would therefore welcome comments on how to ensure a proportionate implementation of the margin requirements.

**Question 1.** What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

**Question 2.** Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If so, please provide the rationale for the concerns and potential solutions.
THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) 648/2012 of 27 July 2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories and in particular Article 11(15) thereof,

Whereas:

(1) In order to clearly identify a limited number of concepts stemming from Regulation (EU) No 648/2012, as well as to specify the technical terms necessary for developing this technical standard, a number of terms should be defined.

(2) Counterparties of OTC derivatives contracts need to be protected from the risk of a potential default of the counterparty. In order to properly manage the risks to which counterparties of OTC derivatives are exposed to, two types of margins should be introduced. The first margin is the variation margin, which protects against losses in the market value of OTC derivatives position. The second margin is the initial margin which protects against losses occurring after the default of the counterparty, which could stem from movements in the market value of the derivatives position before a replacement contract is entered.

(3) Regulation No. 648/2012 recognises capital and collateral as important and complementary risk mitigants. Consequently, counterparties are permitted to hold capital against the counterparty exposure (up to a defined threshold), instead of collecting margin. To ensure harmonised implementation of these requirements across all types of counterparties and convergent international practices, a fixed threshold is introduced. When the amount of initial margin to be collected by a counterparty is below this threshold, the collateral taker has the option to mitigate counterparty credit risk by choosing between posting margins or holding own capital, or collecting initial margin. The threshold is defined as a fixed value of initial margin. Recognising the complexity in estimating initial margin requirements for those entities that would be below this figure, the threshold is also defined in terms of the aggregate notional value outstanding of the OTC derivative portfolio.

(4) The Regulation considers variation margin an appropriate exchange of collateral between counterparties trading in selected physically-settled FX products. This approach is to ensure consistency with the internationally standards.

(5) Whereas the threshold referred to in the Recital (3) applies at group level, for investment funds this threshold should be counted per single fund. This is consistent with international standards where investment funds that are managed by an investment advisor should be considered distinct entities and treated separately when applying the threshold. However, this should only apply as long as, in the event of

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3 OJ L 201, 27.7.2012.
fund insolvency or bankruptcy, the funds are distinct legal entities that are not collateralised, guaranteed or supported by other investment funds or the investment advisor itself.

(6) Counterparties should be allowed to apply a minimum transfer amount when exchanging margin in order to reduce the operational burden of exchanging limited sums of collateral when exposures move slightly. The minimum transfer amount is an operational tool, and is not designed to serve as an uncollateralised credit line between parties.

(7) Regulation No. 648/2012 considers in Recital (24), that this Regulation should take due account of impediments faced by covered bonds issuers or cover pools in providing collateral. As a consequence covered bonds issuers or cover pools are not required to post collateral under a specific set of conditions, including a requirement to use the derivatives for hedging purposes and a legal overcollateralization requirement. This will ensure that the risks on the counterparties of covered bonds issuers or cover pools are limited, while ensuring some flexibility for covered bonds issuers or cover pools.

(8) To ensure an accurate exchange of collateral, it is necessary that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that sufficiently protect collecting counterparties from losses on non-centrally cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should not be exposed to excessive credit, market and foreign exchange risk. To the extent that the value of the collateral is exposed to these risks, appropriately risk-sensitive haircuts should be applied. In addition, the value of the collateral should not exhibit a significant correlation with the creditworthiness of the collateral provider or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected. Accordingly, securities issued by the collateral provider or its related entities should not be accepted as collateral.

(9) If the collateral provider defaults, the collateral taker should have the operational capability to appropriate, liquidate (if necessary) the collateral and use the cash proceeds to replace the defaulted derivative contract by an equivalent contract with another counterparty. The pre-existing access to the market should enable the collateral taker to either sell the collateral or repo it within a reasonable amount of time. This capability shall be ensured independently from a possible default of the collateral provider, e.g. by having broker arrangements or repo arrangements with other counterparties than the collateral provider or by comparable measures.

(10) Collateral being posted for the purposes of margin requirements must be of sufficiently high liquidity and credit quality. This will allow a counterparty to liquidate the positions in the case of default of its counterparty without facing significant price changes. The credit quality must therefore be of sufficient quality to ensure stable prices. In order to mitigate the risk of mechanistic reliance on ratings, this Regulation introduces a number of safeguards in this regard. Specifically, it
allows the use of Internal Rating Based models, which has been already approved by supervisory authorities for use in institutions. Furthermore it allows counterparties to replace the collateral over a longer period, which should mitigate regulatory cliff effects.

(11) While haircuts, be it those prescribed in this Regulation or own estimates, serve a critical risk management function in ensuring that collected collateral is sufficient to cover margin needs in a time of financial stress, other risk mitigants should also be considered when accepting non-cash collateral. In particular, counterparties should ensure that the collateral collected is reasonably diversified in terms of an individual issuer, issuer type and asset type. For that reason concentration limits are established.

(12) In order to ensure timely exchange of collateral, counterparties need to have an efficient operational process. For this purpose, in respect of non-cleared transactions, counterparties should ensure that their operational processes for the bilateral exchange of collateral are sufficiently detailed, transparent and robust. A failure by counterparties to agree and provide an operational framework for efficient calculations, notification and settlement of margin calls can lead to disputes and fails that result in uncollateralised exposures under OTC derivative transactions. It is essential that counterparties set clear internal policies and standards in respect of their operational collateral requirements and that any deviation from those standards is rigorously reviewed by all relevant internal stakeholders required to authorise those deviations. Furthermore, all applicable terms in respect of operational exchange of collateral should be accurately recorded in detail in a robust, prompt and systematic way.

(13) Counterparties should be allowed to process their exchange of collateral themselves or use a service provider. In both case, counterparties should ensure that they comply with applicable provisions of this Regulation including ensuring that an efficient operational process is in place.

(14) The re-hypothecation, re-pledge or re-use of the collateral collected as initial margins would create new risks due to the claims of the third party over the margins. Legal and operational complications could delay or even make impossible the return of the collateral in the event of a default of the initial collateral taker or third party. In order to preserve the efficiency of the framework and ensure a proper coverage of the counterparty risks, the re-hypothecation, re-pledge or re-use of the initial margins should therefore not be permitted.

(15) When a counterparty notifies the competent authority regarding the exemption of intragroup transactions, the counterparty should provide a complete file including all information necessary to allow the competent authority to make an informed decision on the application of the exemption.

(16) When making use of intragroup exemptions, it must be made certain that no legislative, regulatory or other mandatory provisions of applicable law could legally prevent the counterparties to meet their obligations to transfer monies or repay liabilities or securities under the terms of the OTC derivative transactions between
themselves. Similarly, operational or business practices of the counterparties or of the group that could result in funds not being available on a day-to-day basis in order to meet payment obligations as they fall due, or in prompt electronic transfer of funds not being possible, should not exist.

(17) In order to achieve a proper balance between the risk mitigation in the field of OTC derivatives and the need to have a proportionate application of this Regulation, a phase-period of the requirements for groups and solo entities is introduced. In addition to avoiding economic disruptions it will also maintain international consistency and minimise possibilities of regulatory arbitrage. Consequently the phase-in period for the requirements introduced in this Regulation is consistent with the schedule agreed in the international standards for margin requirements for non-centrally cleared derivatives.

(18) In order to avoid any retrospective effect the margin requirements apply to new contracts not cleared by a CCP entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on contracts not cleared by a CCP entered into before these dates are subject to existing bilateral agreements.

HAS ADOPTED THIS REGULATION:

CHAPTER 1 - Counterparties' Risk Management Procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012

Article 1 DEF - Definitions

1. For the purposes of this Regulation, the following definitions shall apply:

(a) 'Counterparties' means financial counterparties within the meaning of Article 2(8) of Regulation (EU) No 648/2012 and non-financial counterparties referred to in Article 10 of Regulation (EU) No 648/2012.

(b) ‘Collateral’ means cash or other assets in the form of variation margin or initial margin, as the case may be;

(c) ‘Variation margin’ means margins collected or paid out to reflect current exposures resulting from actual changes in market price calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Article 16 of Commission Delegated Regulation (EU) No 149/2013;

(d) ‘Initial margin’ means margins collected by the counterparty to cover potential future exposure to the other counterparty providing the margin in the interval between the last margin collection and the liquidation of positions following a default of the other counterparty;

(e) ‘Excess collateral’ means collateral posted in excess of the required collateral.
(f) ‘Foreign exchange forward’ means a derivative contract that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed at the inception of the contract covering the exchange.

(g) ‘Foreign exchange swap’ means a derivative contract that solely involves:

i. an exchange of two different currencies on a specific date at a fixed rate that is agreed at the inception of the contract covering the exchange;

ii. a reverse exchange of the two currencies at a later date and at a fixed rate that is agreed at the inception of the contract covering the exchange.

(h) ‘Currency swap’ means a derivative contract by which the two counterparties solely exchange the principal (and any interest) payments in one currency for the principal (and any interest) payments in another currency at some points in the future according to a specified formula.

(i) ‘Netting agreement’ means a contract between two counterparties establishing a single legal obligation over all the OTC derivative contracts in the scope of the agreement such that, in the event of default of one counterparty, the non-defaulting counterparty is entitled to receive or has the obligation to pay the sum of the positive and negative mark-to-market values of the derivative contracts.

(j) ‘Netting set’ means netting set as defined in Article 272(4) of Regulation (EU) 575/2013.

(k) ‘Margin period of risk’ means margin period of risk as defined in Article 272(9) of Regulation (EU) 575/2013.

(l) ‘Securitisation’ means securitisation as defined in Article 4(62) of Regulation (EU) 575/2013;

(m) ‘Re-securitisation’ means re-securitisation as defined in Article 4(64) of Regulation (EU) 575/2013;

(n) ‘Probability of default’ or ‘PD’ means probability of default as defined in Article 4(54) of Regulation (EU) 575/2013;

**Article 1 GEN- General counterparties’ risk management procedures**

1. Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 shall include the collection of collateral except in the cases specified in Article 2 GEN.

2. The collateral referred to in paragraph 1 shall meet the eligibility criteria referred to in Chapter 3, and shall be adjusted according to the modalities referred to in Articles 1 HC and 2 HC of that Chapter.
3. Risk management procedures referred to in paragraph 1 shall include:

(a) the collection of collateral for the amount set in Article 1 EIM [initial margin] without the possibility of netting the initial margin amounts between each other;

(b) the collection of collateral for the amount set in Article 1 VM [variation margin]. Variation margin can be collected on a net basis;

(c) an upfront agreement on a list of eligible collateral fulfilling the requirements of Article 1 LEC.

Article 2 GEN - Risk management procedures in specific cases

1. Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may include the agreement in writing or through other equivalent permanent electronic means that initial margins are not collected with respect to physically settled foreign exchange forwards and physically settled foreign exchange swaps.

2. Risk management procedures referred to in paragraph 1 may include the agreement in writing or through other equivalent permanent electronic means that initial margins are not collected with respect to the exchange of principal of a currency swap.

3. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties may instead agree in writing or equivalent permanent electronic form with its financial or non-financial counterparties that where the total initial margin calculated to be exchanged for all non-centrally cleared OTC derivatives between counterparties at group level as defined in Article 2(16) of Regulation (EU) No 648/2012 is equal to or lower than EUR 50 million, they may agree that no initial margin will be exchanged and that they will hold capital against their exposure to their counterparties.

4. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties and non-financial counterparties as referred to in Article 10 of that Regulation may instead agree in writing or equivalent permanent electronic form on any of the following:

(a) where the total collateral amount as defined in paragraph 6 based on all OTC derivatives transactions between two counterparties is equal to or lower than EUR 500 000 (minimum transfer amount), they may agree not to exchange collateral. In case the total collateral amount owed to the collateral taker exceeds the minimum transfer amount, the collateral taker shall collect the full total collateral amount, without deduction of the minimum transfer amount.
(b) where they relate to transactions entered into with non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012, they may agree not to exchange initial and variation margin;

(c) where they relate to transactions entered into with entities referred to in paragraphs 4 and 5 of Article 1 of Regulation (EU) No 648/2012, they may agree not to exchange initial and variation margin;

(d) they may agree not to exchange initial and variation margin for indirectly cleared derivatives transitions that are intermediated through a clearing member or through an indirect clearing arrangement as long as a) the client or the indirect client is subject to the margin requirements of the CCP; or b) the client or indirect client provides margins consistent with the relevant corresponding CCP's margin requirements.

5. Where counterparties apply the threshold referred to in paragraph 3, the following shall also apply:

(a) counterparties may reduce the amount of initial margin exchanged by the value of the threshold;

(b) the group as defined in Article 2, paragraph 16 of Regulation (EU) No 648/2012 shall determine how to allocate the received initial margin amongst its relevant entities;

(c) the group shall monitor, at the consolidated level, whether the threshold is exceeded and shall maintain, to that effect appropriate records to record its exposures to consolidated counterparties.

6. For the purposes of point (a) of paragraph 4, the total collateral amount shall be the sum of the total amount of initial margins calculated in accordance with Article 1 EIM, the total amount of variation margins calculated in accordance with Article 1 VM, and any excess collateral that may have been provided to or returned by both.

Explanatory text for consultation purposes:

These RTS will enter into force as described in this article, which implies that market participants must make reasonable efforts to prepare for the practical implementation of the margin requirements described in this consultation paper. Nonetheless the ESAs also recognise that the implementation of the margin requirements framework will require time to fully implement and that a gradual introduction of the requirements to the entire market is necessary. In order to both ensuring that operational capabilities are in place and for the sake of international consistency, a gradual introduction of the requirements is therefore envisaged.

In the view of the ESAs, it appears disproportionate to require that all existing transactions to be subject to the framework. Should the existing contracts also be subject to the margin
requirements, this would most likely require a change in the contractual terms under which existing contracts are entered. Consequently, it is the intention of the ESAS that as a guiding principle throughout the implementation only new contracts at the time of entry into force of these RTS will be subject to the requirements. It is however also noted that, within reasonable limits, market participants should strive to extend the requirements to the widest set of non-centrally cleared OTC derivatives possible.

In the development of these RTS the clear objective of EMIR as set out in recital 23 to foster a financially stable system should be kept in mind. At the same time this must be balanced by a proportionate implementation of these RTS. It is therefore the intention of the ESAs that the largest market participants are subject to these requirements as quickly as operationally possible, whereas smaller market participants should be granted more time to implement these RTS. This will ensure that new market practices have time to evolve. Consequently, the internally agreed phase-in of the requirements has been taken into account, as this ensures internationally consistency while also implementing the requirements in a proportionate, but sufficiently ambitious manner.

**Article 3 GEN - Treatment of derivatives associated to covered bonds programmes for hedging purposes**

1. Counterparties risk management procedures may include the agreement in writing or through other equivalent permanent electronic means that initial and variation margins are not posted by covered bond issuers and cover pools if all the following conditions are met:

   (a) the derivative is not terminated in case of default of the covered bond issuer;

   (b) the derivative counterparty ranks at least pari-passu with the covered bond holders;

   (c) the derivative is registered in the cover pool of the covered bond programme in accordance with national covered bond legislation and is used only for hedging purposes;

   (d) the netting set does not include derivatives unrelated to the covered bond programme;

   (e) the covered bond programme meets the requirements of Article 129 of Regulation (EU) No 574/2013;

   (f) the covered bond programme is subject to a legal collateralization requirement of at least 102%.
**Explanatory text for consultation purposes:**

The margining requirements of derivatives in relation to covered bonds are considered in recital 24 of EMIR, where it is noted that:

‘When developing draft regulatory technical standards to specify the arrangements required for the accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA should take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions. ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer’s assets provides equivalent protection against counterparty credit risk’.

The recital requires consideration to be given to the impediments in posting collateral. The ESAs have given due consideration to the aspects raised in the recital and the cost-benefit analysis elaborates further on the options considered. The above proposal is the outcome of these deliberations.

The solution proposed in this consultation paper aims at ensuring the derivative counterparty a degree of protection if the covered bond issuer/cover pool would not be required to post collateral, by outlining specific conditions that have to be met. The protection of the counterparties to covered bonds/cover pools shall to a large extent be ensured by requiring that the derivatives contracts should not terminate in case of default of the covered bond issuer, and the existence of a certain amount of legal overcollateralisation in the respective legal frameworks for covered bonds. Other requirements are introduced to ensure a prudent use of the derivatives in relation to covered bond issuers/cover pools, while also providing some protection to counterparties. The proposal consequently takes into account the concerns raised in EMIR and to some extent balance the risk in this regard.

An alternative market-based solution, like the one described in the cost-benefit analysis in section 5 or other similar schemes, could supplement this solution and be available to covered bond programmes not fulfilling the conditions. Such solutions appear to provide viable alternatives, which may also extend to other situations that are similar in scope to the covered bond issue, such as special purpose vehicles.

As part of this consultation, the ESAs are seeking further feedback on this topic, acknowledging the various designs of cover bonds across Member states. Of particular interest are the risks faced by a counterparty to a covered bond issuer/cover pool default, but also on the specific aspects of the proposal, such as the overcollateralisation requirement, the requirement of continuation of the derivatives after default of the covered bond issuer and the use of a EU-harmonised classification of covered bonds. Also information on the current practices of one-way collateral requirements is of interest.

The ESAs do note that this aspect of the framework may be further re-considered, both in light of the responses received to the consultation, but also in the light of further regulatory considerations.
Comments could include suggestions for alternative treatments of the derivatives in covered bond/cover pools. It should however be kept in mind, that the purpose of the margin requirements is to limit the risk to counterparties and any proposal should balance this risk.

**Question 3.** Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?

**Article 1 VM - Variation margin**

1. Counterparties shall collect variation margins at least on a daily basis starting from the business day following the execution of the contract.

2. The collected variation margins shall be based on the current valuation of each derivative contract calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Articles 16 and 17 of the Commission Delegated Regulation No 149/2013.

**Article 1 EIM - Initial margins**

1. Counterparties shall calculate and collect in accordance with paragraphs 2 and 3 initial margin using either the standardized approach laid down in Article 1 SMI or the initial margin models laid down in Article 1 MRM.

2. Two counterparties shall agree in writing or other equivalent permanent electronic means on the method each counterparty uses and, in case of an initial margin model, on the characteristics of the model and on the data used for the calibration.

3. A counterparty shall collect initial margins within the business day following the execution of a new derivative contract.

4. The total amount of initial margins collected by a counterparty from another counterparty shall be recalculated and collected at least when:

   (a) a new contract is executed with that counterparty;

   (b) an existing contract with that counterparty expires;
(c) an existing contract triggers a payment, other than posting or collecting variation margins, or a delivery;

(d) an existing contract is reclassified in terms of asset category defined in Article 1 SMI by way of reduced time to maturity;

(e) the initial margin model is recalibrated;

(f) no initial margin recalculation has been performed in the last 10 business days.

CHAPTER 2 - Margin methods

Article 1 SMI - Standardised Method

1. When counterparties apply the Standardised Method, the initial margins for each netting set shall be calculated in accordance with the method referred to in Annex IV.

Article 1 MRM - Initial margin models

1. An initial margin model may be:

(a) developed by one of the two counterparties or jointly by the two counterparties;

(b) provided by a third party agent including a model based on a methodology endorsed for its use in the Union.

Explanatory text for consultation purposes:

The use of internal models in the legislation concerning prudential regulation is not new and it is widespread in the banking and insurance sectors. Similarly, the use of margin models for the calculation of the margin requirements will be a crucial aspect in the implementation of this framework.

However, contrary to the existing practice, this proposal will necessitate that counterparties agree on the results of the margin models on an ongoing basis and this raises a substantial number of new issues.

Therefore, the ESAs are closely monitoring the development of industry initiatives in this respect. At this juncture, there is no harmonised, industry-wide modeling common approach. While the potential and voluntary alignment on a single model could bear some appealing features, such an approach in the RTS would also create a number of material practical and legal issues that have to be carefully considered.

Should an acceptable unified modelling approach across banks, insurers and other market participants become the common market practice the issue of a European and even global
coordination of the model approval process across supervisors would have to be tackled.

If the decision was positive this could be reflected in the RTS as suggested in Article 1 MRM Par. 1 (b). The ESAs will explore all the possibilities and investigate their feasibility and practical and legal implications.

Article 1 MRM allows a firm to use models that has been developed by the firm, the counterparty, jointly with the counterparty or a third party entity. This allows firms to have access to the use of models, but also converge on the models used to reduce the materiality and probability of disputes occurring. The ESAs will continue to explore the effects of allowing the use of models without prior or post approval and assess the need to introduce conditions to reduce the risk of choosing to apply the model which produces the lowest initial margin calculation.

We welcome feedback on this issue.

2. Where a model is provided by a third party, the margin collector remains responsible for ensuring that the requirements set out in in this chapter are met.

3. The counterparties shall notify the relevant competent authorities if they are intending to use an initial margin model and be prepared to supply relevant documentation referred to in Article 6 MRM to those competent authorities if required.

4. If initial margin models cease to comply with the requirements laid down in this chapter, counterparties shall notify the relevant competent authorities and shall compute the required initial margins using the Standardised Method.

*Article 2 MRM - Confidence interval and risk horizon*

1. For the calculation of the initial margins, the assumed variations in the value of the contracts in the netting set are consistent with a one-tailed 99 percent confidence interval over a margin period of risk of at least 10 days.

2. The margin period of risk of a netting set for the calculation of initial margins shall take into account:

   (a) the period that may elapse from the last collection of the margins up to the declaration of the default of the counterparty;

   (b) the estimated period needed to replace the contracts in the netting set taking into account the level of liquidity, the size and concentration of the positions in relation to the markets where such positions are traded.

*Article 3 MRM - Calibration of the model*
1. Initial margin models shall be calibrated based on historical data from a period of at least three years.

2. The data used in initial margin models shall cover the most recent continuous period from the calibration date and shall contain at least 25% of data deemed representative of a period of significant financial stress (‘stressed data’).

3. The data shall be accurate, appropriate and complete.

4. If the most recent data period does not contain at least 25% of stressed data, the least recent data in the time series shall be replaced by data from a period of significant financial stress, until the overall proportion of stressed data is at least 25% of the overall data set.

5. The data within each of the identified periods shall be equally weighted for calibration purposes.

6. The parameters may be calibrated according to shorter periods than the margin period of risk and scaled up to the margin period of risk by an appropriate methodology.

7. The model shall be recalibrated at least every 6 months.

8. Counterparties shall establish transparent and predictable procedures for adjusting margin requirements in response to changing market conditions. These procedures shall allow each counterparty post the initial margin resulting from the recalibration of the model over a period longer than one day.

Article 4 MRM - Primary risk factor and underlying classes

1. Initial margin models shall assign a derivative contract to an underlying class based on its primary risk factor, defined in terms of sensitivity of the value of the contract to the market risk drivers.

2. For the purpose of paragraph 1, the following underlying classes shall be considered:

   (a) interest rates, currency and gold;

   (b) equity;

   (c) credit;

   (d) commodity and other.

3. Initial margin models shall consider derivative contracts that have as their primary risk factor inflation risk, as part of the same underlying class as interest rates and currency.
4. Initial margin models may account for diversification, hedging and risk offsets across the derivative contracts that are in the same netting set and belong to the same underlying class.

5. Initial margin models shall calculate initial margin requirements for a netting set first at underlying class level.

6. The total initial margin requirements for a netting set shall be the sum of initial margin requirements calculated for each underlying class within the netting set.

Article 5 MRM - Integrity of the modelling approach

1. Any initial margin models shall be conceptually and practically sound and shall capture all the risk drivers that are material for the derivatives included in the netting set. In particular, all of the following requirements shall be met:

   (a) the model shall incorporate interest rate risk factors corresponding to the individual foreign currencies in which the derivatives are denominated;

   (b) for material exposures to interest-rate risk in the major currencies and markets and for contract with residual maturity longer than 5 years, the yield curve shall be divided into a minimum of six maturity buckets, to capture the variations of volatility of rates along the yield curve;

   (c) the model shall also capture the risk of less than perfectly correlated movements between different yield curves;

   (d) the model shall incorporate risk factors corresponding to the individual foreign currencies in which the derivatives in the netting sets are denominated;

   (e) the model shall also use a separate risk factor at least for each equity or equity index that is significant for the netting set;

   (f) the model shall use a separate risk factor at least for each commodity or commodity index which is significant for the netting set;

   (g) the model shall capture the risk of less than perfectly correlated movements between similar, but not identical, underlying risk factors and the exposure to changes in values arising from maturity mismatches;

   (h) The model shall capture main non-linear dependences;

   (i) the model shall be subject to a back testing programme, comparing the risk measures generated by the model with realized risk measures and keeping record of the results at least once every three months.
2. The policies and procedures shall outline the methodologies used for undertaking back testing, including statistical tests of performance.

3. The procedures shall clearly identify what actions a firm has to take if the back testing results exhibit deficiencies in the risk estimation of the model.

4. The modelling approach shall reflect the nature, scale and complexity of the risks inherent in the underlying contracts. The initial margin model shall be calibrated in a sufficiently conservative manner such that aspects like parameter uncertainty and data quality are properly captured.

Article 6 MRM - Qualitative requirements

1. Any initial margin model shall be subject to an internal governance process that continuously assesses the validity of the model’s risk assessments and tests such assessments against realized data. In particular, all of the following qualitative requirements shall be met:

(a) an initial validation shall be carried out by suitably qualified and independent parties; the validation shall be also conducted whenever a significant change is made to the initial margin model and at least once a year;

(b) an audit process shall be regularly conducted to assess the integrity and reliability of the data sources and the management information system used to run the model, the accuracy and completeness of data used, the accuracy and appropriateness of volatility and correlation assumptions.

2. Counterparties shall have a process for verifying at least annually that the netting agreements considered for the initial margin calculation are legally enforceable.

3. The documentation shall be sufficient to ensure that any knowledgeable third-party would be able to understand the design and operational detail of the initial margin model.

4. The documentation shall contain the key assumptions and the limitations of the initial margin model. It shall also define the circumstances under which the assumptions of the initial margin model should no longer be considered valid.

5. The counterparties shall maintain clear documentation showing all changes to the initial margin model and the tests performed.

CHAPTER 3 - Eligibility and treatment of collateral

Article 1 LEC - Eligible collateral for initial and variation margin

1. The following asset classes shall be eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012 from which the counterparties can agree:
(a) cash in the form of money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits;

(b) gold in the form of allocated pure gold bullion of recognised good delivery;

(c) debt securities issued by Member States’ central governments and central banks;

(d) debt securities issued by Member States’ regional governments or local authorities according to Art. 115 (2) of Regulation (EU) No. 575/2013;

(e) debt securities issued by Member States’ public sector entities according to Art. 116 (4) of Regulation (EU) No. 575/2013;

(f) debt securities issued by Member States’ regional governments or local authorities not meeting the requirements of Art. 115 (2) of Regulation (EU) No. 575/2013;

(g) debt securities issued by Member States’ public sector entities not meeting the requirements of Art. 116 (4) of Regulation (EU) No. 575/2013;

(h) debt securities issued by multilateral development banks listed in Art. 117 (2) of Regulation (EU) No. 575/2013;

(i) debt securities issued by the International Organisations listed in Art. 118 of Regulation (EU) No. 575/2013;

(j) debt Securities issued by non-Member States’ governments and central banks;

(k) debt Securities issued by non-Member States’ regional governments or local authorities that meet the requirements of the first subparagraph of Art. 115 (2) of Regulation (EU) No. 575/2013 and non-Member States’ public sector entities that meet the requirements of Art. 116 (4) of Regulation (EU) No. 575/2013;

(l) debt securities issued by non-Member States’ regional governments, local authorities not meeting the requirements of the first subparagraph of Art. 115 (2) of Regulation (EU) No. 575/2013 or non-Member States' public sector entities not meeting the requirements of the first subparagraph of Art. 116 (4) of Regulation (EU) No. 575/2013;

(m) debt securities issued by credit institutions and investment firms including bonds referred to in Article 52(4) of Directive 2009/65/EC;

(n) corporate bonds;

(o) the most senior tranche of a securitization that is not re-securitisation;
(p) convertible bonds provided that they can be converted only into equities which are included in a main index as referred to in point (a) of Article 197 (8) of Regulation (EU) No 575/2013;

(q) equities included in a main index in accordance with Article 197(8)(a) of Regulation (EU) 575/2013;

(r) shares or units in UCITS, provided that the criteria in Article 5 LEC are met.

Article 2 LEC - Collateral Management

1. Risk management procedures of the counterparty receiving collateral shall include the following operational and technical capabilities:

   (a) daily re-evaluation of collateral;

   (b) legal arrangements and a collateral holding structure shall be in place to access the received collateral if held in third party custody;

   (c) where the collateral is maintained with the collateral provider, alternative custody accounts for all asset types in the list of acceptable collateral for the management of the assets following the default of the collateral provider;

   (d) access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions and in the case of default of the collateral provider;

   (e) cash accounts in all the acceptable currencies with a party other than the collateral provider for depositing cash collateral and for crediting the proceeds of repurchase agreements on the collateral;

   (f) the ability to return the unused collateral proceeds to the liquidator or other insolvency official of the defaulted counterparty;

   (g) arrangements to ensure that the accepted collateral is freely transferable, without any regulatory or legal constraints or third party claims, including those of the third party custodian, other than for costs and expenses incurred for that purpose) that impair liquidation or the return to the collateral provider on default of the collateral taker.

Article 3 LEC - Credit Quality Assessment

1. The collateral taker shall assess the credit quality of assets belonging to the assets referred to in paragraphs (f), (g), (j) to (n) and (p) of Article 1 LEC using one of the following methodologies:

   (a) an approved internal model as referred to in Article 5 LEC;
(b) the approved internal model defined in Article 5 LEC of its counterparty, where the counterparty is established in the Union, or third country counterparty, where the third country counterparty is subject to laws of a third country which applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union;

(c) a credit assessment issued by a recognised ECAI according to Article 4(98) of Regulation (EU) No. 575/2013 or export credit agency referred to in Article 137 of that Regulation.

2. The collateral taker shall assess the credit quality the assets referred to in paragraphs (c), (d) and (e) of Article 1 LEC that are not denominated or funded in the domestic currency using the methodologies referred to in paragraph 1 [IRB and ECAIs ratings].

3. The collateral taker shall assess the credit quality of assets referred to in paragraph (o) [securitisation] of Article 1 LEC using the methodology referred to in paragraph 1, subparagraph (c) [ECAIs ratings].

4. The risk management procedures shall require that only assets whose credit quality has been assessed with the methodologies in points (a) and (b) [internal models] of paragraph 1 and associated to a credit quality step 3 or above are eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012.

5. The risk management procedures shall require that only assets whose credit quality has been assessed with the methodologies in point (c) [ECAIs ratings] of paragraph 1 and associated to a credit quality step 2 or above are eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012.

6. The risk management procedures shall require that only assets referred to in paragraph 2 [Sovereign debt in non-local currency/ECAIs ratings] associated with credit quality step 4 or above are eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012.

7. For the purposes of paragraphs 4, 5 and 6 the credit quality assessment shall be mapped to credit quality steps in accordance with Articles 136 and 270 of Regulation (EU) No 575/2013.

8. The counterparties shall have procedures in place in case that the credit quality of the collateral assessed using the methodology referred to in subparagraph (c) of paragraph 1 no longer meets the requirements set out in paragraphs 5 to 6. Such procedures shall:

(a) prohibit the counterparties from accepting additional collateral assets which now fall below the level specified in paragraphs 5 and 6;

(b) define a schedule by which already accepted collateral is to be replaced over a period of time not exceeding 2 months;
(c) set a CQS level below the levels set out in paragraphs 5 and 6 that requires immediate replacement. For such CQS the provisions of subparagraph (b) do not apply;

(d) enable counterparties to increase the haircuts on the relevant collateral over the period set out in subparagraph (b).

Article 4 LEC - Credit Risk Assessment by the collateral taker using the Internal Rating Based Approach

1. Counterparties authorised to use the Internal Rating Based (IRB) approach according to Section 6 of Regulation (EU) No 575/2013 may use their internal ratings in order to assess the credit quality of the collateral collected for the purposes of this Regulation.

2. Counterparties using the IRB approach shall determine the credit quality step of the issuer of the security by applying the following methodology. An internal rating with a PD equal to or lower than the value in Table 1CQS of Annex I shall be associated to the corresponding credit quality step.

Explanatory text for consultation purposes:

The introduction of the use of IRB models mitigates the reliance on external ratings. As the use of IRB models is already subject to supervisory approval, applying also for assessing the credit quality of collateral is a natural extension of the existing use, as the framework already operates with rating scales. This is consequently a novel feature of this framework.

At the moment Article 3 LEC allows the use of the IRB approach not only for determining the eligible collateral that the institution can collect, but also extends the use to its counterparty. As, this counterparty has no detailed access to the model, it represents to a certain extent a ‘black box’.

Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

Article 5 LEC- Eligibility Criteria for UCITS

1. For the purposes of Article 1 LEC, counterparties may use units or shares in UCITS as eligible collateral where all the following conditions are satisfied:

(a) the units or shares have a daily public price quote;
(b) the UCITS are limited to investing in instruments that are eligible for recognition under Article 1 LEC;

(c) the UCITS meet the conditions laid down in Article 132(3) of the Regulation (EU) 575/2013.

2. Where a UCITS invests in shares or units of another UCITS, conditions laid down in points (a) to (c) of the paragraph 1 shall apply equally to any such underlying UCITS.

3. The use by a UCITS of derivative instruments to hedge permitted investments shall not prevent units or shares in that undertaking from being eligible as collateral.

4. For the purposes of paragraph 1, where a UCITS (‘the original UCITS’) or any of its underlying UCITS are not limited to investing in instruments that are eligible under Article 1 LEC, institutions may use units or shares in that UCITS as collateral to an amount equal to the value of the eligible assets held by that UCITS under the assumption that that UCITS or any of its underlying UCITS have invested in non-eligible assets to the maximum extent allowed under their respective mandates.

5. Where any underlying UCITS has underlying UCITS of its own, institutions may use units or shares in the original UCITS as eligible collateral provided that they apply the methodology in the first subparagraph.

6. Where non-eligible assets can have a negative value due to liabilities or contingent liabilities resulting from ownership, counterparties shall do both of the following:

(a) calculate the total value of the non-eligible assets;

(b) where the amount obtained under point a) is negative, subtract the absolute value of that amount from the total value of the eligible assets.

Article 6 LEC - Eligibility criteria to avoid wrong way risk

1. The risk management procedures shall only include securities referred to in subparagraphs (f), (g), from (k) to (r) of Article 1 LEC that fulfil the following criteria:

(a) they are not issued by the posting counterparty;

(b) they are not issued by entities which are part of the same group of the posting counterparty, as defined in Article 2(16) of Regulation 648/2012, or entities which have close links in accordance with Article 2 (24) of Regulation (EU) No 648/2012.

(c) they are not otherwise subject to significant wrong way risk.
Explanatory text for consultation:

Given the substantial amounts of collateral that will be required to be posted and collected on initial and variation margins, counterparties may risk becoming overly exposed to specific assets or issuers. This seems to warrant the introduction of diversification requirements on the assets to be posted and collected. Without concentration limits on the received collateral, a counterparty may have to liquidate substantial amounts of single securities or from a single issuer at time of significantly elevated, market uncertainty. This may impair the ability of counterparties to close their exposure.

Having in mind this significant risk, this consultation paper consults on the introduction of concentration limits on the collateral collected from a counterparty. It should clearly be noted that collateral posted in the form of cash would not be subject to concentration limits, but all other types of collateral is envisaged to be subject to concentration limits. This will help promote a diversified collateral pool, which will be less likely to face liquidation issues in the event of a counterparty default.

The ESAs are nonetheless aware that the introduction of concentration limits may cause operational issues and are therefore seeking further input on the issue. Counterparties with limited margin requirements will for instance need to diversify into smaller lots of many different issuers. This can be operationally quite burdensome while the overall exposure may be of such a size that a single security can be liquidated without significant effects even in stressed market conditions. The introduction of proportionality thresholds, below which the concentration limits would not apply, could be one a supplementary feature of the framework to balance costs and benefits.

Consequently, respondents are asked to consider the practical feasibility of introducing concentration limits, which in particular will also apply to variation margins. This could include considerations on the appropriate size of proportionality thresholds and the practical challenges in diversifying collateral, especially for non-bank entities subject to these requirements.

**Question 5.** How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?
1. The risk management procedures shall prescribe that the collateral collected from an individual counterparty for the purposes of Article 1 GEN shall meet the following conditions:

(a) The sum of the values of the securities (c), (d), (e) [Sovereign, regional auth. and PSEs], (j) and (k) [non-EU Sovereign, regional auth. and PSEs] in Article 1 LEC (1) issued by a single issuer, by entities which are part of the same group as defined in Article 2(16) of Regulation 648/2012 or entities which have close links in accordance with Article 2 (24) of Regulation (EU) No 648/2012 shall not exceed 50% of the collateral collected from that individual counterparty.

(b) The sum of the values of the securities (b) [gold], (f), (g), (l) [non-EU PSE and regional auth. not meeting conditions] and (n) to (r) in Article 1 LEC (1) issued by a single issuer or by entities which are part of the same group, as defined in Article 2(16) of Regulation 648/2012 or entities which have close links, according to Article 2 (24) of Regulation (EU) No 648/2012 shall not exceed 10% of the collateral collected from that individual counterparty.

(c) The sum of the values of the securities (o), (p), (q) [securitisation, convert. bonds and equities] and (r) [shares in UCITS] in Article 1 LEC (1), with (p) and (q) [convert. bonds and equities] limited to those issued by institutions as defined in Regulation (EU) No 575/2013, shall not exceed 40% of the collateral collected from that individual counterparty.

Article 1 HC- Calculation of the adjusted value of collateral

1. Risk management procedures shall include the application of haircuts to the market value of collected collateral using either the standard methodology prescribed in Annex II or using own estimates as prescribed in Article 2 HC.

Article 2 HC - Own estimates of the adjusted value of collateral

1. Counterparties may use own volatility estimates for calculating the haircuts to be applied to collateral if the requirements set out in this Article are met.

2. For debt securities that have a credit assessment from an ECAI, institutions may calculate a volatility estimate for each category of security.

3. Counterparties shall estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral or exchange rates.

4. In determining relevant categories, counterparties shall take into account the type of issuer of the security, the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates shall be representative of the securities included in the category by the institution.
5. The calculation of the adjusted value of the collateral shall be subject to all the criteria in Annex III.

6. Counterparties shall update their data sets and calculate haircuts at least once every three months. Counterparties shall also reassess their data sets whenever market prices are subject to material changes.

7. The estimation of haircuts shall meet all the following qualitative criteria:

   (a) a counterparty shall use the volatility estimates in the day-to-day risk management process including in relation to its internal exposure limits;

   (b) where the liquidation period used by a counterparty in its day-to-day risk management process is longer than that set out in this Article for the type of transaction in question, that counterparty shall scale up its haircuts in accordance with the square root of time formula set in paragraph 1 of Annex III of this Regulation;

   (c) a counterparty shall have in place established procedures for monitoring and ensuring compliance with a documented set of policies and controls for the operation of its system for the estimation of haircuts and for the integration of such estimations into its risk management process;

   (d) an independent review of the counterparty's system for the estimation of haircuts shall be carried out regularly within the institution's own internal auditing process. A review of the overall system for the estimation of haircuts and for the integration of those adjustments into the institution's risk management process shall take place at least once a year. The subject of that review shall include at least the following:

      i. the integration of estimated haircuts into daily risk management;

      ii. the validation of any significant change in the process for the estimation of haircuts;

      iii. the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of haircuts, including the independence of such data sources;

      iv. the accuracy and appropriateness of the volatility assumptions.

CHAPTER 4 - Operational procedures

Article 1 OPE- Operational process for the exchange of collateral
1. Robust risk management procedures shall be in place in order to ensure the timely exchange of collateral for contracts that are not centrally cleared. Those risk management procedures shall include:

(a) A detailed documentation of policy and procedures with regards to the exchange of collateral for non-centrally cleared contracts and any related limitation or constraint, covering collateral levels, types and eligibility, including applicable haircuts, which is reviewed and updated as necessary and at least annually.

(b) Documented, consistent and robust processes for escalation with counterparties, authorisation and recording of any exceptions to the existing policy and procedures under paragraph (a).

(c) Reporting of material exceptions to senior management;

(d) Agreement of terms with all counterparties in respect of the operational process for the exchange of collateral, including:

   i. the levels and type of collateral required and any segregation arrangements;

   ii. the transactions to be included in the calculation of margin;

   iii. the procedures for notification, confirmation and adjustment of margin calls;

   iv. the procedures for settlement of margin calls in respect of all relevant types of collateral;

   v. the methods, timings and responsibilities for calculating margin and valuing collateral.

   The terms specified in i. – v. shall be documented by way of written agreement or other equivalent permanent electronic means between the counterparties before the relevant transactions are executed.

(e) Procedures for the storing of agreements and for the prompt recording and application of the terms and arrangements under paragraph (d).

(f) Procedures and controls ensuring the timely notification and settlement of margin calls.

(g) Procedures and controls for measuring and mitigating risks arising from the collateral assets accepted.

(h) Robust processes for setting collateral levels.

(i) Procedures to periodically verify the liquidity of the eligible collateral.
2. The risk management procedures shall be tested on a periodic basis and, at least once a year and shall include at least those under Articles 12 to 15 of Regulation (EU) No 149/2013.

3. Alternative collateral may be substituted for any collateral already posted to the collecting counterparty whether as initial or variation margin, provided that:

   (a) both counterparties agree to the substitution;

   (b) the substitution is made in accordance with the terms of the counterparties’ agreement;

   (c) the alternative collateral is eligible pursuant to Article 1 LEC; and

   (d) the value of the alternative collateral after applying any relevant haircut is sufficient to meet the margin requirements.

*Article 1 SEG - Segregation of initial margins*

1. Collected collateral as initial margin shall be segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty.

2. The collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties (‘individual segregation’).

3. Where initial margin is collected in cash, it shall be segregated individually, unless the collecting counterparty can prove to its counterparty and to the competent authority that legally effective arrangements are in place to segregate it from proprietary assets.

4. The segregation arrangements shall meet both of the following conditions:

   (a) initial margins are immediately available to the collecting entity where the posting counterparty defaults;

   (b) the posting entity is sufficiently protected where the collecting entity enters bankruptcy or other insolvency proceedings.

5. At the inception of the transaction and on a regular basis thereafter, and at least annually, the counterparties shall obtain satisfactory legal opinion(s) in all relevant jurisdictions on whether the segregation arrangement meets the requirements set out in paragraph 3 and 4.

*Article 1 REU - Treatment of collected initial margins*
1. The collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.

**Explanatory text for consultation purposes**

As stated in the corresponding recital, and in BCBS-IOSCO margins framework, there is the possibility that a posting counterparty faces a risk in the case the counterparty to which it has posted initial margins defaults.

“The risk would be exacerbated if the counterparty re-hypothecates, re-pledges or re-uses the provided margin, which could result in third parties having legal or beneficial title over the margin, or a merging or pooling of the margin with assets belonging to the others as a result of which the firm’s claim to the margin becomes entangled in legal complications, thus delaying or even denying the return of re-hypothecated / re-used assets in the event that the counterparty defaults” (BCBS-IOSCO report, Element 5, p. 18).

Therefore, the BCBS-IOSCO, in order to achieve a delicate balance between allowing some flexibility and still preserve the efficiency of the IM framework has permitted each jurisdiction to allow if they deem it necessary a limited re-use of IM under strict conditions (see Key principle 5, Requirements 5, p. 19).

However, the implementation of those conditions leads to multiple legal and technical difficulties, such as the requested degree of insolvency protection of the initial posting counterparty (i.e. the “customer”) taking into account the diversity of insolvency laws, the return of the collateral from the third counterparty to the initial posting counterparty in case the collecting party defaults, or the one-time re-use of cash collateral. Those concerns have been confirmed by market participants during the ESA Roundtable of December 2, 2013.

The ESA’s have therefore considered it appropriate to introduce a full ban of the re-use of IM in the Union.

**Question 6.** How will market participants be able to ensure the fulfilment of all the conditions for the re-use of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require re-use or re-hypothecation of collateral as an essential component of their business models?

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**Chapter 5 - Procedures concerning intragroup derivative contracts**

**Article 1 IGT - Procedure for the counterparties and the competent authorities**

1. The application or notification from a counterparty to the competent authority according to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall be deemed to have been received at the time of receipt by the competent authority of all of the following information:
(a) all the information necessary to assess whether the conditions specified in Article 3 and in points (6) to (10) of Article 11 of that Regulation, as applicable, have been fulfilled;

(b) the information and documents referred to in Article 18 of Commission Delegated Regulation (EU) No 149/2013.

2. Where a competent authority determines that further information is required in order to assess whether the conditions of Articles 3 and of points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 as applicable are fulfilled, it may submit a written request for information to the counterparty.

3. Where a competent authority takes a positive decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012, it shall communicate it to the counterparty in writing including the following information:

(a) whether the exemption is a full exemption or a partial exemption;

(b) in the case of a partial exemption, a clear identification of the limitations of the exemption;

(c) any additional relevant information.

4. Where a competent authority takes a negative decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012 or it objects to a notification under Articles 11(7) or 11(9) of that Regulation, it shall communicate to the counterparty in writing and shall include:

(a) the identification of the conditions of Articles 3 and 11 (6) to (10) of Regulation (EU) No 648/2012 that are not fulfilled; and

(b) a summary of the reasons for considering that such conditions are not fulfilled.

5. If one of the competent authorities notified under Article 11(7) of Regulation (EU) No 648/2012 does not agree upon fulfilment of the conditions referred to in point (a) or (b) of the first subparagraph of Article 11(7) of that Regulation, it shall notify the other competent authority within 2 months of receipt of the notification, and the competent authorities shall notify the non-financial counterparties of the objection within 3 months of receipt of the notifications.

6. A decision by a competent authority under Article 11(8) of Regulation (EU) No 648/2012 shall be communicated to the counterparty established in the Union within 3 months of receipt of the complete application.

7. A decision by the competent authority of the financial counterparty under Article 11(10) of Regulation (EU) No 648/2012 shall be communicated to the competent authority of the non-financial counterparty within 2 months of receipt of the
complete application for exemption and to the counterparties within 3 months of receipt of the complete application for exemption.

8. Counterparties that have submitted a notification or received a positive decision according to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall immediately notify the relevant competent authority of any change in circumstance that could affect the fulfilment of the conditions of Articles 3 and of points (6) to (10) of Article 11 of that Regulation, as applicable. The Competent Authority may decide to object to the notification of the application of the exemption or to withdraw its decision.

9. Where a negative decision or objection is communicated by a competent authority, a counterparty shall not submit another application or notification unless there has been a material change in the circumstances that formed the basis of that decision or objection.

Article 2 IGT- Intragroup risk management procedures

1. Risk management procedures shall ensure the regular monitoring of the intragroup exposures and the timely settlement of the obligations resulting from the intragroup OTC derivative transactions.

Article 3 IGT- Practical or legal impediment

1. A legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No 648/2012 shall be deemed to exist where under the laws applicable to the counterparties, or under the contractual relationship between the counterparties, or between a counterparty and a third party, there are any current or anticipated restrictions including any of the following:

(a) Currency and exchange controls;

(b) Regulatory restrictions;

(c) Restrictions stemming from insolvency, resolution or similar regimes;

(d) Current or potential limitation on the ability of a counterparty to promptly transfer own funds or repay liabilities when due between the counterparties.

2. A practical impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No 648/2012 shall be deemed to exist where sufficient assets of the counterparties are or may not be freely available to the counterparty in the necessary form in order to satisfy such transfers or repayments when due, including due to obstacles stemming from operational, financial or commercial systems, processes or practices.
Article 1 FP - Final provisions

1. This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

2. It shall apply from 1 December 2015 with the exception of Articles 1 IGT, 2 IGT and 3 IGT which shall apply from the entry into force of this Regulation.

3. Counterparties’ risk management procedures may include the agreement in writing or through other equivalent permanent electronic means that initial margins are not collected in accordance with the procedures prescribed in this Regulation when the conditions in points (a) to (e) are met.

(a) From 1 December 2015 to 30 November 2016, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2015 is below EUR 3.0 trillion.

(b) From 1 December 2016 to 30 November 2017, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2016 is below EUR 2.25 trillion.

(c) From 1 December 2017 to 30 November 2018, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2017 is below EUR 1.5 trillion.

(d) From 1 December 2018 to 30 November 2019, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2018 is below EUR 0.75 trillion.

(e) From 1 December 2019, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year is below EUR 8 billion.

4. Only contracts entered into during the one-year period from 1 December of the year referred to in subparagraphs (a) to (e) to 30 November of the following year may include an agreement that initial margins are not collected in accordance with the procedures prescribed in this Regulation.

5. For the purposes of calculating the group aggregate month-end average notional amount referred to in paragraph 3, all of the group’s non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included.
6. The risk management procedures shall apply throughout the life of the contract, should the contract be subject to the requirements when entered.

7. This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the
President
[Position]
Annexes

Annex I - Mapping of PD to Credit quality steps

1. An internal rating with a PD equal to or lower than the value in Table 1CQS of shall be associated to the corresponding credit quality step.

<table>
<thead>
<tr>
<th>Credit Quality Step</th>
<th>Probability of default smaller or equal than:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.10%</td>
</tr>
<tr>
<td>2</td>
<td>0.25%</td>
</tr>
<tr>
<td>3</td>
<td>1%</td>
</tr>
<tr>
<td>4</td>
<td>7.5%</td>
</tr>
</tbody>
</table>
Annex II - Standard haircuts to the market value of collateral

1. The market value of the collateral shall be adjusted as follows:

\[ C_{\text{value}} = C \cdot (1 - H_C - H_{FX}) \]

where:

\( C \) = the market value of the collateral;

\( H_C \) = the haircut appropriate to the collateral, as calculated under paragraph 2;

\( H_{FX} \) = the haircut appropriate to currency mismatch, as calculated under paragraph 6.

2. Counterparties shall apply at a minimum the following haircuts:

<table>
<thead>
<tr>
<th>Credit quality step with which the credit assessment of the debt security is associated</th>
<th>Residual maturity</th>
<th>Haircuts for debt securities issued by entities described in Article 1 LEC (1) (c) to (e) and (h) to (l), in (%)</th>
<th>Haircuts for debt securities issued by entities described in Article 1 LEC (1) (f), (g), (m), (n) in (%)</th>
<th>Haircuts for securitisation positions meeting the criteria in Article 1 LEC (1) LEC (o) in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>≤ 1 year</td>
<td>0.5</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 5</td>
<td>2</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>&gt; 5</td>
<td>4</td>
<td>8</td>
<td>16</td>
</tr>
<tr>
<td>2-3</td>
<td>≤ 1 year</td>
<td>1</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 5</td>
<td>3</td>
<td>6</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>&gt; 5</td>
<td>6</td>
<td>12</td>
<td>24</td>
</tr>
<tr>
<td>4 or below</td>
<td>≤ 1 year</td>
<td>15</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 5</td>
<td>15</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>&gt; 5</td>
<td>15</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Table 2 VA
Haircuts for short term credit quality assessments

<table>
<thead>
<tr>
<th>Credit quality step with which the credit assessment of a short term debt security is associated</th>
<th>Haircuts for debt securities issued by entities described in Article 1 LEC (1) (c) and (j) in (%)</th>
<th>Haircuts for debt securities issued by entities described in Article 1 (1) (m) LEC in (%)</th>
<th>Haircuts for securitisation positions and meeting the criteria in Article 1 (1) (m) LEC in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.5</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2-3</td>
<td>1</td>
<td>2</td>
<td>4</td>
</tr>
</tbody>
</table>

3. Equities in main indices, bonds convertible to equities in main indices and gold shall have a haircut of 15%.

4. For eligible units in UCITS the haircut is the weighted average of the haircuts that would apply to the assets in which the fund has invested.

5. Cash shall be subject to a haircut of 0%.

6. Counterparties shall apply a haircut of 8% to the market value of the assets where the collateral currency is different from the settlement currency (‘currency mismatch’).
Annex III - Own estimates of the haircuts to the market value of collateral

1. The risk management requirements concerning the application of own estimates of the adjusted value of the collateral shall include all the following criteria.

   (a) Counterparties shall base the calculation on a 99th percentile, one-tailed confidence interval;

   (b) Counterparties shall base the calculation on a liquidation period of 10 business days.

   (c) Counterparties shall calculate the haircuts by scaling up the daily revaluation haircuts, using the following square-root-of time formula:

   \[ H = H_M \cdot \sqrt{\frac{N_R + (T_M - 1)}{T_M}} \]

   where:

   \( H \) = the haircut to be applied;

   \( H_M \) = the haircut where there is daily revaluation;

   \( N_R \) = the actual number of business days between revaluations;

   \( T_M \) = the liquidation period for the type of transaction in question.

   (d) Counterparties shall take into account the illiquidity of lower quality assets. They shall adjust the liquidation period upwards in cases where there is doubt concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility. Such cases shall be dealt with by means of a stress scenario;

   (e) The length of the historical observation period institutions use for calculating haircuts shall be at least one year. For counterparties that use a weighting scheme or other methods for the historical observation period, the length of the effective observation period shall be at least one year.

   (f) The market value of the collateral shall be adjusted as follows:

   \[ C_{\text{value}} = C \cdot (1 - H) \]

   where:

   \( C \) = the market value of the collateral;
H = the haircut as calculated in subparagraph (c) above.
Annex IV - Standardised Method for the calculation of initial margin for the purposes of Article 1 SMI

1. The notional amounts or underlying values, as applicable, of the derivative contracts in a netting set shall be multiplied by the percentages in Table 1 SMI

<table>
<thead>
<tr>
<th>Category</th>
<th>Add-on factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit: 0–2 year residual maturity</td>
<td>2%</td>
</tr>
<tr>
<td>Credit: 2–5 year residual maturity</td>
<td>5%</td>
</tr>
<tr>
<td>Credit 5+ year residual maturity</td>
<td>10%</td>
</tr>
<tr>
<td>Commodity</td>
<td>15%</td>
</tr>
<tr>
<td>Equity</td>
<td>15%</td>
</tr>
<tr>
<td>Foreign exchange</td>
<td>6%</td>
</tr>
<tr>
<td>Interest rate: 0-2 year residual maturity</td>
<td>1%</td>
</tr>
<tr>
<td>Interest rate: 2-5 year residual maturity</td>
<td>2%</td>
</tr>
<tr>
<td>Interest rate: 5+ year residual maturity</td>
<td>4%</td>
</tr>
<tr>
<td>Other</td>
<td>15%</td>
</tr>
</tbody>
</table>

2. The Gross initial margin of a netting set shall be calculated as the sum of the products referred in paragraph 2 for all OTC derivative contracts in the netting set.

3. The following treatment shall be applied to contracts which fall within more than one category:

   (a) If a primary risk factor can be clearly identified, contracts shall be assigned to the category corresponding to that risk factor;

   (b) If the condition in point (a) is not met contracts shall be assigned to the category with the highest add-on factor among the relevant categories.

   (c) The initial margin requirements for a netting set shall be computed in accordance to the following formula:

   \[
   \text{Net initial margin} = 0.4 \times \text{Gross initial margin} + 0.6 \times \text{NGR} \times \text{Gross initial margin}.
   \]

   Where:

   \[
   \text{Net initial margin} = \text{the reduced figure for initial margin requirements for all derivative contracts with a given counterparty included in a netting set.}
   \]
NGR = the net-to-gross ratio calculated as the quotient of the net replacement cost of a netting set with a given counterparty (numerator) and the gross replacement cost of that netting set (denominator).

4. For the purpose of paragraph 3, the net replacement cost of a netting set is defined as the bigger of zero and the sum of current market values of all derivative contracts in the netting set.

5. For the purpose of paragraph 3, the gross replacement cost of a netting set is defined as the sum of the current market values of all derivative contracts calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Articles 16 and 17 of the Commission Delegated Regulation No 149/2013 with positive values in the netting set.

6. A netted notional may be computed before applying the add-ons in Paragraph 1 between contracts that are of opposite direction but are identical for all the others contractual features with the only possible exemption of notional.
1. Accompanying documents

1.1 Draft Impact Assessment

1.1.1 Problem definition

1. This section identifies problems to be addressed by the current draft RTS. The core problem that the RTS aim to address is the lack of a harmonised regulatory framework for margin requirements for non-centrally cleared derivatives and associated problems including high systemic risk, regulatory arbitrage and an uneven playing field in the EU market for OTC derivatives. Specifically it is noted that:

a) The high volume of non-centrally cleared derivatives\(^4\) poses high systemic risk in the EU market as well as in the rest of the world\(^5\).

b) If the margin requirements for non-centrally cleared derivatives vary across the member states, then the regulatory framework would give competitive advantage to financial institutions that operate in the low-margin jurisdictions (uneven playing field for institutions in the EU). This would also incentivise institutions that initially operate in high-margin jurisdictions to relocate their business activities to another jurisdiction where the margin requirements are low (regulatory arbitrage).

2. These problems prevent the effective and efficient operation of not only the market for non-centrally cleared derivatives but also that of the internal market.

3. Section 2.1.4 presents an analysis of the alternative technical options that can effectively address these problems.

1.1.2 Objectives

4. The general and operational objectives of the EMIR\(^6\), as noted in the recitals of the EMIR, are to respond to the risks emerging from the interconnectedness between institutions operating in the OTC derivative markets by:

a) reducing counterparty credit risk, and

b) establishing robust risk management.

5. The objective of the current RTS is to establish a robust regulatory framework by:

a) improving prudential regulation so that non-centrally cleared derivatives are bilaterally collateralised and subject to either margin or capital requirements,

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\(^4\) See Section 1.1.5 where the key statistics in relation to the baseline are presented.
\(^5\) Such as the countries that are covered by the scope of BCBS/IOSCO.
\(^6\) Regulation (EU) No 648/2012.
b) harmonising regulatory practice on non-centrally cleared derivatives across the member states, and

c) converging the EU regulatory framework to international practice.

6. Article 11 of the EMIR outlines:

a) the framework for risk management procedures for contracts for non-centrally cleared derivatives,

b) the overall procedures for intragroup exemptions that national competent authorities must follow, and

c) the criteria for the identification of practical and legal impediment for the prompt transfer of funds between counterparties.

7. However, this article does not specify what these procedures and criteria could be. As a result, the provisions may lead to variations in the interpretation of these criteria and procedures and a lack of harmonisation in margin requirements across the EU.

8. Article 11(15) of the EMIR gives the ESAs power to issue RTS to promote harmonisation in risk-management procedures, the procedures for exemptions and criteria to identify legal and practical impediment to the prompt transfer of own funds and repayment liabilities between counterparties.

9. Specification of the rules on the above-mentioned provisions is a crucial aspect of the market for non-centrally cleared derivatives. The objective is to mitigate the high risk that the market for non-centrally cleared derivatives currently carries, by complementing the provisions under Article 11 of the EMIR and ultimately to contribute to the effective and efficient functioning of the internal market.

1.1.3 Baseline

10. The quantitative analysis in Section 2.1.5 shows the estimated value of aggregate non-centrally cleared activity that is captured by the scope of the current RTS for major European banks. Currently, the estimated value of total gross notional outstanding for non-centrally cleared derivative activities is about EUR 146 trillion. This figure is expected to decrease to about EUR 74.9 trillion (or by 49%) after the implementation of the central clearing obligation, which will require about half of these transactions to be subject to mandatory central clearing. In other words, after the implementation of the margin requirements, about 49% of the OTC derivatives market will be captured by the current RTS, and the remaining 51% will be cleared centrally.

11. Similar figures that are based on a larger sample and cover countries outside the EU (e.g. the US and Japan) show that the policy impact in the EU is similar to the development in international market for OTC derivatives.
12. In terms of initial margin the estimated value of total initial margin currently, collected among financial institutions is about EUR 40 billion in the EU. The figure is about 40% of the global value.

### 1.1.4 Assessment of the technical options

13. The current section analyses major technical options that are considered under each chapter of the current RTS. The assessment of the technical options presents the evidence and the logic behind the choice of a particular policy that shapes the current RTS, including:

   a) physically-settled foreign exchange swaps and forwards, and currency swaps;
   b) scope of applicability;
   c) covered bonds;
   d) eligibility and treatment of collateral;
   e) credit quality assessment;
   f) concentration limits;
   g) phase-in of initial margin requirements;
   h) procedures concerning intragroup transactions.

**Physically-settled foreign exchange swaps and forwards, and currency swaps**

14. The assessment relates to the scope of derivative instruments to which the margin requirements apply. The regulation covers all derivatives that are not centrally cleared, with the exception for derivatives with certain types of transactions.

15. The current options discuss the exclusion of the foreign exchange forwards and swaps from the scope of the margin requirements due to their unique characteristics (e.g. product availability) and due to their particular market practices (e.g. requirement on the product delivery).

   **Option 1: Exemption from the requirement to collect initial margin for physically-settled foreign exchange swaps and forwards, and currency swaps**

16. Physically-settled foreign exchange swaps and forwards are the derivative instruments of which the underlying financial products (i.e. foreign currency) are physically delivered in exchange for a specific payment. The physical existence and the availability of the underlying financial instrument decrease the counterparty risk.

17. However, the physical settlement characteristics do not minimise the counterparty risk against unforeseen events such as counterparty default.
Option 2: No exemption from the requirement to collect initial margin for physically-settled foreign exchange swaps and forwards, and currency swaps

18. An initial margin requirement for non-centrally cleared physically-settled foreign exchange swaps and forwards is expected to minimise the risk associated with counterparty default. This is true particularly for contracts with long maturities where the uncertainty is greater.

19. However, initial margin requirements will put additional costs on the industry, which may in turn downsize the market for physically-settled foreign exchange swaps and forwards. This is true particularly when the international market is taken into account, in particular EU trade with the US market and intra-EU trade across jurisdictions with different currencies.

20. Preferred option. The first option is the preferred option for the following reasons:

   a) The BCBS-IOSCO Principles specify that certain physically-settled foreign exchange products and swaps should be exempt from the exchange of initial margin, with the intention that the risks associated with the exemption will be considered by the monitoring group established in 2014.

   b) Given the interconnectedness of the market and international practice, in particular in the US market, the initial margin requirement for physically-settled foreign exchange swaps and forwards would give the EU a comparative disadvantage vis-à-vis other players.

   c) Therefore, to reflect the international dimension of the foreign exchange markets and to maintain international consistency between jurisdictions, it will be beneficial if the technical standards are consistent with the BCBS-IOSCO guidance.

Scope of applicability

21. The assessment relates to the scope of the RTS. It discusses the threshold for the size of the counterparties in terms of gross notional outstanding of OTC derivatives in order to establish which entities should be included in the scope of the current RTS.

Option 1: The RTS would apply to all entities undertaking OTC derivatives transactions

22. The option does not set a minimum threshold to differentiate the entities that can be exempt from the margin requirements. It sets uniform and comprehensive risk management requirements for participants in the OTC derivatives market. The approach is effective to achieve the objectives to reduce systemic risk in the OTC derivatives market.

23. However, the uniform application of margin requirements violates the proportionality principle. The Task Force recognises the significant change in market practice and potential costs associated with these requirements. This is also acknowledged in the BCBS-IOSCO Principles. These costs have the potential to fall disproportionately on smaller market
participants, and, in extremis, discourage the use of derivatives markets, in particular for risk-reducing activities such as hedging.

**Option 2: The RTS would apply to all entities undertaking OTC derivatives transactions, subject to a minimum level**

24. In line with international principles, the option considers a threshold value of EUR 8 billion for gross notional outstanding of OTC derivatives. The entities with aggregated notional outstanding under this threshold are not subject to the initial margin requirements.

25. Preferred option: the second option is the preferred option since it respects the proportionality principle and is in line with the international practice.

**Covered bonds**

26. Covered bonds are debt securities backed by a cover pool of predominantly mortgages or public-sector loans serving as collateral. Derivatives can be used in cover pools to hedge interest rate and currency risks, for instance with the purpose of issuing covered bonds in currency denominations other than the underlying collateral. Bilateral collateral exchange, as mandated by the EMIR, will require the cover pool to provide collateral to its derivative counterparty. This will give the derivative counterparty a preferential claim to the assets in the cover pool over the covered bondholders, which is incompatible with the senior rights of covered bondholders usually prescribed by existing covered bonds across Europe.

27. In this respect, Recital 24 of Regulation(EU) No 648/2012 (EMIR) provides that:

‘When developing draft regulatory technical standards to specify the arrangements required for the accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA should take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions. ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer’s assets provides equivalent protection against counterparty credit risk.’

**Alternative 1: one-way margin requirement**

28. Under this first alternative, the cover pool is exempted from posting collateral in the form of initial margin and variation margin to its derivative counterparty.

29. This alternative relies on specific risk mitigants embedded in covered bond programmes to ensure the derivative counterparty a certain level of protection as an alternative to the exchange of collateral. These risk mitigants include the derivative counterparty benefiting from the appropriate segregation of the assets in the cover pool from the issuer’s insolvency estate and a minimum level of legal over-collateralisation.

30. Specifically the ESA’s consider that the following conditions must be met:
a) the derivative is not terminated in case of default of the covered bond issuer;7
b) the derivative counterparty ranks (at least) pari passu with the covered bond holders;8
c) the netting set does not include derivatives unrelated to the covered bond programme;
d) the covered bond programme meets the requirements of Article 129 of Regulation (EU) No 575/2013 (CRR) (including covered bonds issued prior to December 2007);
e) the covered bond programme is subject to a legal collateralisation requirement of at least 102%;10

31. In cases where the conditions of alternative 1 are not met, the ESAs have considered the following alternative:

Alternative 2: collateral provider

32. Under this second alternative, the cover pool is not exempt from posting collateral to its derivative counterparty. Instead, this alternative relies on the interposition of a third-party collateral provider between the cover pool/covered bond issuer and its derivative counterparty to address the legal impediment faced by the cover pool when posting collateral.

33. Under this arrangement, the third party, as a collateral provider, acts as a guarantor for the derivative counterparty. In return, the third party receives a claim on the assets in the cover pool (ranking pari-passu or below the covered bond owners) and a fee paid by the covered bond issuer/cover pool.

34. There is no need to explicitly take into account the use of a third-party collateral provider, as there is currently no provision preventing a counterparty from using a third-party provider to post the collateral, as long as the collateral is available to the counterparty in the event that the covered bond issuers default.

35. It is noted that there appears to be significant scope for market-based solutions that will preserve the risk mitigation, which is an overall principle across the technical standards. Further considerations may therefore be given to the treatment of covered bonds, which is

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7 For the cover pool to be eligible, most European jurisdictions require that the payments on the derivatives cannot be accelerated in the case of the covered bond issuer’s default. Otherwise, the covered bondholders will lose the benefit of the protection provided by the hedge in of the covered bond issuer’s insolvency.
8 Under most European covered bond regimes, the claims of the derivative counterparty can rank equally with, but not in priority, to the claims of the covered bond holders.
9 Voluntary over-collateralisation is not taken into account due to the lack of restrictions for the issuer to suddenly reduce it. In the worst-case scenario, the issuer could reduce over-collateralisation to the legally required amount shortly before going into default.
10 A minimum collateralisation of at least 102% in respect of the covered bonds in circulation is required in certain jurisdictions.
considered a crucial element of this proposal. The proposal therefore also seeks input on this aspect in this Consultation Paper.

Eligibility and treatment of collateral

36. The assessment specifies the type of collateral that can be used when posting margins bilaterally for non-centrally cleared derivatives. Specifically, the objective of the policy is to ensure that the characteristics of the collateral are sufficiently liquid and of sufficiently high credit quality.

Option 1: to specify a list of eligible collateral based on the list from the international standards and further detailed qualitative requirements

37. This option gives market participants leeway to agree on eligible collateral and sets a framework to facilitate the review of these agreements. The option can be easily applied by all market participants and ensures the highest degree of consistency and comparability across all counterparties. The option is expected to minimise the operational cost for the supervisory authorities, since no further assessment of the adequacy of accepted collateral is necessary.

38. This framework could rely on existing classifications, such as the eligible financial collateral in the credit risk mitigation framework of the CRR. This will ensure consistency in the framework and provide overall clarity of it.

39. However, the approach will to some extent rely on additional liquidity and credit criteria, such as external ratings, to ensure consistency. This may risk providing a less harmonised implementation if conditions are not clearly specified. However, it is also noted that credit and liquidity risk assessment is an area subject to significant market fluctuations; therefore some flexibility will be needed, regardless of the approach adopted.

Option 2: to provide qualitative requirements that are linked to the requirements set out for collateral posted to a CCP

40. Under this option, the counterparty would be allowed to define its own list of eligible financial collateral based on a set of qualitative minimum requirements provided in the RTS.

41. The approach is flexible and easy to adapt. It allows the use of a wide range of collateral as long as it provides sufficient protection against counterparty default. Under this approach, the market forces decide on the eligibility of items as collateral.

42. With qualitative requirements, counterparties have the option to use their own assessment (e.g. of credit risk) instead of relying on external ratings. However, the approach does not harmonise the practice and gives counterparties considerable discretion in deciding on eligible collateral.
43. This is true particularly since the scope of the margin requirements for non-centrally cleared derivatives covers both financial and non-financial counterparties. This could lead to the collecting or posting of collateral that is not highly liquid and cannot be converted into cash rapidly and with minimal price impact.

44. The policy would put a high operational cost on national competent authorities. The competent authorities would have to ensure consistency amongst the individual market participants and to assess the adequacy of each market participant’s implementation of the qualitative criteria. The competent authorities would have to approve the eligibility criteria and revise them as part of their supervisory activity.

45. The technical option would also put the cost on the industry. Counterparties would have to demonstrate explicitly to the competent authorities that the conditions have been fulfilled and that the conditions are comparable with the approach for CCPs in the technical standards of the EMIR.

Option 3: a framework linked to market-based indicators similar to the one under development for the Liquidity Coverage Ratio (LCR) – by adopting the definition of liquid assets used for the liquidity framework

46. The purpose of the liquidity buffer under the liquidity framework is to raise cash by selling the assets outright or entering into secured funding transactions. The horizon of the LCR is 30 days, which is slightly longer than a normal margin period. However, much emphasis is placed on both the liquidity and credit aspects in the definition of liquid assets. There appears to be strong similarities with the eligible collateral for margin requirements, since the assets/collateral in both cases need to be sold off in the market within a relatively short interval. Alignment with an LCR approach that is founded on market-based indicators is therefore a credible option.

47. However, the liquidity framework is currently not finalised and may not be finalised before the finalisation of the RTS, which leaves a period of uncertainty. Furthermore the LCR proposal is aimed at institutions, whereas the scope here is broader, as it will also include non-institutions. It may also be argued that given that the scope of application concerns the relationship between two counterparties, which is significantly smaller than the scope of the liquidity risk profile of an institution, a broader set of collateral should be allowed.

48. Preferred option: a list of eligible asset classes constrained by qualitative requirements is the preferred option because it more effectively addresses the problems relating to the harmonisation and creating a level playing field in the market. The option is less costly and finds a balance between flexibility and harmonisation. This however raises the issue of specifying especially the credit quality in greater detail, bearing in mind the requirement of the CRA III regulation, which encourages the removal of mechanistic reliance on external ratings. This aspect is discussed in greater detail below.

Credit quality assessment
49. The policy objective is to provide a transparent and harmonised approach for counterparties without an approved internal model for a risk assessment. This approach should be easily applicable and traceable by the respective supervisory authority whilst ensuring that the accepted collateral is of appropriate credit quality.

**Option 1: the RTS could provide only a very high-level definition of high credit quality (e.g. “investment grade”)**

50. The technical option allows the use of a wide range of collateral as long as it provides sufficient protection against default by the counterparty. Market developments may suddenly render items on the list unsuitable as collateral. With qualitative requirements, counterparties have the option to use their own assessment (e.g. of credit risk) instead of relying on external ratings.

51. Adopting this approach, at least without requiring the counterparties to demonstrate to the competent authorities that the requirement is met, could leave the counterparties with a large amount of discretion. This could lead to the collection or posting of collateral that cannot be converted into cash rapidly and with minimal price impact. Requiring the counterparties to explicitly demonstrate to the competent authority that the criteria have been fulfilled (comparable with the approach for CCPs) will also most likely lead to a non-harmonised approach as the scope of the margin requirements for non-centrally cleared derivatives is extremely broad, covering financial and non-financial counterparties. An approach that works for a limited number of CCPs is more difficult for this very broad range of counterparties.

**Option 2: identifying types of collateral where minimum Credit Quality Steps (CQS), would be required and thereby indirectly referring to ratings of external credit assessment institutions**

52. This approach is, in part, similar to what is laid down by Regulation (EU) No 575/2013. In the case of deterioration in the quality of assets already accepted as collateral that leads to the non-eligibility of this collateral, the draft RTS also allow for a ‘grace period’ to replace this collateral.

53. The option provides an effective alternative for counterparties without an approved internal model. This would ensure transparency and accessibility for smaller market participants and non-banks to undertake their own assessments. The inclusion of a grace period would mitigate cliff effects by giving counterparties time to replace the collateral.

54. The institutions will need to rely on external credit assessments provided by ECAIs.

55. Preferred option: Option 2 is the preferred option as it provides an operational framework that also mitigates the mechanistic reliance on ratings. However, to mitigate the mechanistic reliance, the use of approved IRB models is allowed as an alternative, just as potential cliff effects are mitigated with the introduction of so-called ‘grace periods’, where
counterparties are given time to exchange collateral no longer eligible after rating downgrades.

Concentration limits

56. The policy objective is to ensure that the collateral taker is able to realise sufficient value from the collateral to replace the OTC contracts associated with a defaulted counterparty.

Option 1: no concentration limit

57. Concentration limits make it more difficult for counterparties to find suitable collateral. They also put an additional operational burden on counterparties as the limits have to be monitored and collateral might occasionally have to be replaced in order not to breach the thresholds. Regulators incur additional costs as they have to check whether counterparties are complying with the restrictions.

58. However, the process of appropriating the collateral and entering a new contract might take a number of days. Without concentration limits, the initial and variation margins collected might be highly concentrated and not hold their value in a period of significant market stress. The collecting counterparty might also have difficulties in exiting a large position.

Option 2: concentration limits for exposures from collected margins that represent a significant proportion of the overall exposures for the collecting counterparty

59. Ideally this option achieves the advantages of Option 1 while avoiding unnecessary burdens.

60. Option 2 may result in an insufficient protection if the threshold is set too high.

Option 3: concentration limits for margins irrespective of position size

61. The requirement ensures a minimum level of diversification for the collected collateral. It also reduces potential problems arising from having to liquidate a large position. The restrictions arising from concentration limits in Option 3 are more predictable for both counterparties than in Option 2.

62. Option 3 makes it more difficult to find suitable collateral than Option 1. Compared to this option, it also puts an additional operational burden on counterparties. Option 3 might force the collection of diversified collateral even though the initial margin in total is small compared to the overall credit exposure that the collecting counterparty has.

63. Preferred option: given the considerations above, these draft RTS propose Option 3 as the preferred option, but do note that Option 2 might provide a more proportionate approach and consequently consult on the possible introduction of proportionality thresholds for counterparties with more limited overall positions.

Phase-in of initial margin requirements
64. The assessment covers the approaches for transitional requirements. The policy objective is to specify the phase-in requirements of the current RTS.

**Option 1: the option proposes the adoption of the approach of the international standards that implement a phase-in period of four years, starting with the largest market participants from 1 December 2015**

65. The approach gives smaller participants more time in the transition period, i.e. more time to put into place all the necessary processes and systems. Additionally, by adopting the international standards, the policy accounts for the proportionality principle and sets a level playing field.

66. These requirements would privilege smaller players in terms of costs, but it also leaves smaller entities exposed to counterparty risk for this period.

**Option 2: not to consider a phase-in schedule**

67. An advantage is that there would not be any competitive advantage for smaller participants.

68. However, this option would put the smaller participants in a more disadvantaged position compared to the institutions in third countries.

69. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option. This will, furthermore, be aligned with internationally agreed standards.

**Procedures concerning intragroup transactions**

**When is the application for intragroup transactions (IGT) deemed to have been received by the competent authority?**

**Option 1: the application is deemed to have been received when it is deemed complete by the competent authority. This option consists of including in the RTS a possibility for the competent authority to ask for more information.**

70. The EMIR stipulates, in Article 11(6) to Article 11(10), that counterparties shall submit applications or notifications to their respective competent authorities. Depending on the nature of the counterparties (financial counterparties, non-financial counterparties or third-country entities), the exemption will be subject to either a decision or a potential objection from the competent authorities.

71. Advantages: this option adds flexibility to the intragroup exemption procedures. Instead of refusing or objecting to an exemption on the grounds that the competent authority does not have the necessary information to verify that the relevant conditions have been fulfilled, the competent authority will have the option to go back to the applicant and in this respect provide more time and explanations, which should be to the benefit of the counterparties seeking the exemption.
Another advantage is that the timeline within which the competent authorities are required to notify the counterparties of the outcome of the request for exemption will only start once the applications or notifications are deemed to be complete. Several requests for information may be sent, providing both the competent authorities and the counterparties with opportunities to reassess the files and complete the applications.

Disadvantages: the main disadvantage is the timing issue and the legal certainty. When counterparties apply for the exemption, they won’t be able to determine the time required to grant the exemption until their application is deemed complete. This may be particularly problematic under Articles 11(6), 11(8) and 11(10) where counterparties can only start using the exemptions after the decision has been taken by the competent authorities. The risk is that the completeness phase of the application has no time limit.

Option 2: the application is deemed to have been received upon the initial receipt of the application sent be the counterparty to the competent authority. This option consists of not including in the RTS a possibility for the competent authority to ask for more information.

The advantages and disadvantages are the opposite of those in Option 1.

Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(7)

Option 1: to set the length of the objection period at three months and to require the objection to be communicated to the other competent authority before it is communicated to the counterparties.

Article 11(7) specifies the procedure to be followed when two counterparties to an intragroup transaction are non-financial counterparties (NFC) within the meaning of Article 2(9) of the EMIR.

Under Article 11(7), each NFC shall notify its competent authority of its intention to apply the exemption, and the exemption is valid unless ‘either of the competent authorities does not agree upon fulfilment of the conditions; as mentioned in the Article. Therefore, both competent authorities have the option to object, which, if exercised, prevents the counterparties from using the exemption.

Option 1 proposes to specify how the competent authority which chooses to object must communicate this objection to the counterparties and to the other competent authority. More specifically, it requires that (1) the competent authority which chooses to object notifies the other competent authority within two months of receipt of the application and (2) each competent authority notifies its respective counterparty of the objection within three months of receipt of the application.
79. If the procedure is not defined, the following situation could arise: for an intragroup transaction between a counterparty established in country A, and a counterparty established in country B, the exemption is objected in country A and is in country B. It is unclear from Article 11(7) whether the objecting competent authority is obliged to inform the other competent authority, let alone the other counterparty. It could therefore be the case that for the same intragroup transaction, the counterparty established in country A considers itself exempted while the counterparty established in country B does not, which may create disputes between the counterparties.

80. In addition, the timeline within which the competent authorities may object is not defined in Article 11(7), whereas it is set at three months in Article 11(9) concerning the possibility for competent authorities to object to exemptions for intragroup transactions between an NFC and a counterparty established in a third country. Therefore, Option 1 seeks to achieve similar treatment for NFCs whose request may be objected, irrespective of the fact that the other counterparty is established in the EU or in a third country. Setting the non-objection period at three months provides an NFC applying under Article 11(7) with certainty over the period of time during which their exemption may be objected, and ensures consistency with Article 11(9).

81. Finally, Option 1 foresees a period of one month (between the notification of the objection to the other competent authority and the notification of the objection to the counterparties) for the two competent authorities to reach an agreement in the event that only one of the two intends to object. This one-month period may avoid disputes between competent authorities taking place after the counterparties have started to make use of the exemption.

82. A disadvantage of this option is that it entails additional costs for the competent authorities as they are required to notify the other competent authority which may disagree. However, this should foster cooperation between competent authorities.

**Option 2: the procedure to be followed under Article 11(7) is not further specified**

83. The advantages and disadvantages are the opposite of those in Option 1.

84. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

**Procedure to be followed under Article 11(8)**

**Option 1: To set a maximum period of three months for the competent authority to notify the counterparty of its decision regarding the exemption**

85. Article 11(8) specifies the procedure to be followed when the one counterparty to an intragroup transaction is a financial counterparty (FC) within the meaning of Article 2(8) of the EMIR, and the other counterparty is established in a third country.
86. Under Article 11(8), an IGT is exempted on the basis of a positive decision of the competent authority of the FC.

87. Option 1 requires the competent authority of the FC to communicate its decision to the FC within three months of receipt of the application.

88. Advantages: under Article 11(8), the counterparties are required to wait until the decision is made to make use of the exemption. There is no a priori exemption unlike in cases where the competent authorities merely have an option to object to the use of the exemption. Therefore, it is crucial for the counterparties to have a fixed timeline within which their request for exemption is granted or refused.

89. In addition, while the timeline within which the competent authority shall notify the counterparty of its decision is not defined in Article 11(8), it is set at 30 calendar days in Article 11(6) concerning intragroup transactions between two FCs. Setting the non-objection period at three months provides the FC applying under Article 11(8) with certainty over the period of time during which their exemption shall be granted or refused. It also ensures consistency with Article 11(6), although a longer time period (3 months instead of 30 calendar days) is justified by the fact that the other counterparty is established in a third country, which may complicate the assessment to be made by the competent authority.

90. Disadvantage: it could be argued that the absence of a defined period of time within which the competent authority has to notify the counterparty of its decision was an intention of Article 11(8) and therefore Option 1 would contradict the initial intention of the text. In practice, this is unlikely to be the case, in view of the legal uncertainty created by the absence of a defined time period as specified above.

Option 2: not to further specify the procedure to be followed under Article 11(8)

91. The advantages and disadvantages are the opposite of those in Option 1.

92. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(9)

Option 1: not to further specify the procedure to be followed under Article 11(9)

93. Article 11(9) specifies the procedure to be followed when one counterparty to an intragroup transaction is a non-financial counterparty (NFC) within the meaning of Article 2(9) of the EMIR, and the other counterparty is established in a third country.

94. Under Article 11(9), an IGT is exempted unless the competent authority of the NFC does not agree on the fulfilment of the conditions defined in the article within three months of the date of notification.
95. **Under Option 1,** no further specification would be added to the RTS.

96. **Advantages:** the timeline for the competent authority to object is already defined in Article 11(9). Furthermore, the other competent authority involved in the process is the one of a counterparty established in a third country, and the EMIR does not foresee that a competent authority would play a role in granting or refusing the exemption. Therefore, it does not seem necessary to further specify the procedure to reach a similar outcome to that of the other cases mentioned in Article 11(6) to (10).

97. **Disadvantages:** it could be argued that the competent authority of the counterparty established in a third country could, at a minimum, be consulted or informed of the outcome of an application for exemption. However, this would be outside the mandate defined in Article 11(15)(c) which requires the ESAs to specify the procedures for the counterparties and the relevant competent authorities to be followed when applying exemptions under Article 11(6) to (10). The definition of “competent authorities” provided in Article 2(13) only includes the competent authorities designated by the member states.

**Option 2: to further specify the procedure to be followed under Article 11(9)**

98. The advantages and disadvantages are the opposite of those in Option 1.

99. **Preferred option:** given the considerations above, these draft RTS propose Option 1 as the preferred option.

**Procedure to be followed under Article 11(10):**

**Option 1: to set a maximum period of three months for the competent authority to notify the counterparty of its decision regarding the exemption**

100. Article 11(10) specifies the procedure to be followed when one counterparty to an intragroup transaction is a financial counterparty (FC) within the meaning of Article 2(8) of the EMIR, and the other counterparty is a non-financial counterparty (NFC) within the meaning of Article 2(9) of the EMIR.

101. Under Article 11(10), an IGT is exempted on the basis of a positive decision of the competent authority of the FC, under the condition that the competent authority of the NFC does not object.

102. **Option 1** requires that (1) the competent authority of the FC informs the competent authority of the NFC within two months of receipt of the application and (2) the competent authority of the FC notifies the FC of the decision within three months of receipt of the application.

103. **Under Article 11(10),** the counterparties are required to wait until the decision is made to make use of the exemption. There is no a priori exemption unlike in cases where the competent authorities merely have an option to object to the use of the exemption.
Therefore, it is crucial for the counterparties to have a fixed timeline within which their request for exemption is granted or refused.

104. While the timeline within which the competent authority shall notify the counterparty of its decision is not defined in Article 11(10), it is set at 30 calendar days in Article 11(6) concerning intragroup transactions between two FCs. Setting the period at three months provides the FC applying under Article 11(10) with certainty over the period of time during which their exemption shall be granted or refused. It also ensures consistency with Article 11(6), although a longer time period (3 months instead of 30 calendar days) is justified by the fact that the other counterparty is a NFC.

105. Article 11(10) requires the competent authority of the financial counterparty to notify the other competent authority of its decision, and provides the latter with the option to object the decision of the former. Option 1 proposes the establishment of a timeline within which those communications should be made, to ensure that the FC is made aware of the final decision no later than three months after the submission of its application. Therefore, the competent authority of the financial counterparty should notify the other competent authority of its decision within two months, leaving one month for the two authorities to agree on the final decision to be communicated to the FC within three months.

106. A disadvantage of this approach would be that the main cost of this Option is borne by the competent authority of the FC as it must be ready to communicate its decision to the other competent authority within two months of receipt of the application.

Option 2: not to further specify the procedure to be followed under Article 11(10)

107. The advantages and disadvantages are the opposite of those in Option 1.

108. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed after an exemption has been granted

Option 1: to require counterparties benefitting from an exemption to inform the competent authority in the event of a change that could affect the fulfilment of the conditions under which the exemption has been granted

109. An exemption from the requirements of Article 11(3) is granted on the basis of a number of conditions stipulated in Article 3 and in Article 11(6) to 11(10). It may be the case that at a certain point in time, a counterparty has been granted an exemption, and at later point in time, there is a change (e.g. in the risk management procedures of the counterparty) affecting the fulfilment of the conditions under which the exemption has been granted. This change could mean that if the counterparty was to submit another application after the change has occurred, the exemption would not be granted. By requiring the counterparties benefiting from an exemption to inform the competent authority in the event of a change that could affect the fulfilment of the conditions under which the
exemption has been granted, Option 1 ensures equal treatment between all counterparties. Furthermore, it ensures that the competent authority is comfortable at all time that the conditions under which the exemption has been granted continue to be fulfilled, and that it is able to reassess the exemption after such a change has occurred.

110. A disadvantage of this option is that it entails additional costs for both the counterparty and the competent authority, as the exemption cannot be considered as having been granted once and for all. It requires counterparties to monitor the changes that may affect the fulfillment of the conditions under which the exemption has been granted. It requires competent authorities to reassess the conditions upon receipt of a notification of those changes.

**Option 2: not to further specify the procedure to be followed after an exemption has been granted**

111. The advantages and disadvantages are the opposite of those in Option 1.

112. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

**How to define practical and legal impediments?**

**Option 1: define specific cases in which practical and legal impediments are envisaged**

113. This option has the following advantages:

   a) Limiting legal uncertainty to counterparties applying for the exemption;

   b) Proving guidance to the competent authorities on the criteria to grant the exemption;

   c) Limiting the disputes or divergent assessments between competent authorities.

114. A disadvantage is that this approach might be seen as too specific, limiting significantly the cases in which the exemption can be granted. However, it should be noted that it was the specific intention of the legislator when adopting the EMIR to apply this exemption in a restrictive manner. This is the reason for all the different procedures to be followed depending on the counterparties involved and for the inclusion of the reference to practical and legal impediments, with a mandate to ESMA to further specify what those practical and legal impediments are.

**Option 2: define in a very broad manner what practical legal impediments might be**

115. The advantages and disadvantages are the opposite of those in Option 1. In addition, this option would not respect in full the mandate given to ESMA to develop technical standards.
116. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

**Should restrictions stemming from insolvency, resolution or similar regimes be included in the legal impediments?**

**Option 1: include the restrictions**

117. This option has the advantage of specifying one particular case of legal impediment, with the advantages and disadvantages included in the previous section. In addition, these restrictions are the typical restrictions impeding the proper transfer of funds between entities of the same group.

118. Finally, if one entity within a group does not have access to the funds necessary to liquidate its exposure with another entity of the same group that has entered into insolvency and an IGT exemption is granted, the first entity would have an uncollateralised exposure with an entity of the same group and will face all the risks stemming from the default of the second entity, which is exactly the opposite of the purpose of the bilateral margins requirements.

119. However, there are different insolvency rules affecting IGT and many of those rules limit the prompt transfer of funds, from an operational or legal perspective. If applied in a restrictive manner, reference to insolvency proceedings might leave a very limited number of transactions benefitting from the exemption.

**Option 2: exclude the restrictions**

120. The advantages and disadvantages are the opposite of those in Option 1.

Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

1.1.5 Quantitative analysis

121. This section provides the baseline for the RTS in the EU market for non-centrally cleared derivatives. The statistics are based on the most recent comparable data. Describing the baseline, i.e. the current situation in the EU market, helps the reader to understand the magnitude of the current problem and potential improvements in the market that the technical options under the current RTS will achieve.

**(i) Introduction and main findings**

122. The descriptive statistics partially complement the arguments presented in Section 2.1.1 on problem definition, Section 2.1.1 on baseline and Section 2.1.3 on the assessment of technical options, and provide insights on:

a) the value of non-centrally cleared derivatives in the EU market,
b) the value of OTC derivatives that are cleared bilaterally under the current RTS and those that fall under the central clearing mechanism,
c) the impact of the threshold regime on the EU market for non-centrally cleared derivatives, and
d) the effect of the phase-in requirements on the total notional amount of derivatives.

123. The BCBS-IOSCO quantitative impact study on margins (‘Basel-QIS’) launched a quantitative survey in July 2012 before the final proposal for margin requirements on non-centrally cleared derivatives to assess the liquidity costs of margin requirements for non-centrally cleared OTC derivatives. The results for an international coverage were published together with the revised version of the international standards\textsuperscript{11} (‘the second consultative document’).

124. This section aims to give an overview of the liquidity costs that are generated by the margin requirements in the EU market. Please note that the current section is a preliminary analysis and it is possible that, after further analysis, the figures could change. However, the ESAs do not plan to collect any further data during the consultation period, despite the limitations of the data available. It is believed that the data available will be sufficient for the purposes of this Impact Assessment, considering that the further collection of data represents a significant burden on counterparties.

125. The ESAs have engaged with industry experts and stakeholders to monitor the initiatives of the market participants and the extent to which they will influence the impact of this Regulation, most notably, the introduction of common internal models with a widespread application.

126. Furthermore, an overview of the initial phase of the transitional provisions shows the coverage of the non-centrally cleared OTC derivatives markets during the transitional period, giving a rough indication of the number of counterparties.

127. The assessment has been undertaken under the assumption that the figures provided by the European contributors, despite their limited number, were a reasonably good representation of the liquidity costs across the EU. Furthermore, the implementation of the EUR 50 million threshold impacted heavily on the overall initial margin requirements. The BCBS-IOSCO quantitative impact study was conducted under the assumption that the threshold was available at counterparty level but the final framework only allows it at a consolidated group level.

128. This preliminary analysis shows that:

\textsuperscript{11} Margin requirements for non-centrally cleared derivatives – Second consultative document, issued by BCBS and IOSCO in February 2013.
a) looking both at notional amounts and at the initial margin requirements, the European institutions cover around one half of the overall sample;

b) the results for the EU concerning the fraction of OTC derivatives expected to be subject to central clearing and the levels of initial margins estimated under the internal models are broadly in line with the results of the BCBS-IOSCO findings; and

c) the overall estimate of initial margin requirements for the EU ranges from EUR 200 billion to EUR 420 billion. The details of the calculation of these estimates are reported in Section (iii). The following sections elaborate on all of these aspects in greater detail.

129. The ESAs will however continue to follow the work of the expert group that the BCBS and IOSCO set up for monitoring the implementation of the margin framework in the various jurisdictions. Therefore any potential deviations on the overall impact of this reform will be noted.

(ii) Methodology and assumptions

130. For the QIS, BCBS and IOSCO collected information with a reference date of 30 June 2012. Nonetheless, some of the respondents provided the most recent data available. For this analysis, the ESAs asked the national competent authorities that are also members of the BCBS or IOSCO to disclose the same datasets reported to the BIS for their exercise. Therefore, the global and European results should be comparable. For this analysis, the data sample comprises 20 institutions from 6 jurisdictions\(^\text{12}\) in the EU against the 39 respondents (of which 36 banks or insurers) from ten jurisdictions of the global QIS. The data were reviewed by national supervisors in September 2012 to ensure quality, accuracy and consistency\(^\text{13}\).

131. For this analysis, the ESAs followed roughly the same approach used by BCBS-IOSCO in their analysis. The major degree of uncertainty on these results is due to the fact that the assumptions of the original survey do not perfectly fit the final framework, in particular:

a) This study is based on two calculation methods, namely the standard schedule and internal estimates of the initial margins; the possible introduction of widespread used third parties’ models is not included.

b) The estimates delivered for the QIS were based on the assumption of the first consultative document\(^\text{14}\) that the threshold could apply at counterparty level; the

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\(^{12}\) 15 banks, two Insurers, one in the utility sector, one non-financial and one classified as ‘other’ from France, Germany, Italy, the Netherlands, Spain and the United Kingdom.

\(^{13}\) In addition to the data collected during the survey, other sources and references were used such as: the FSB progress report on OTC derivative reform, the BIS official statistics, and the data on EU banks provided by SNL Financial.

\(^{14}\) Margin requirements for non-centrally-cleared derivatives – consultative document, issued by BCBS and IOSCO on 6 July 2012.
current draft RTS prescribe that the EUR 50 million threshold can be implemented only at group level.

c) The results of the global QIS survey disclosed in the second consultative document were based on the assumption that no netting is allowed in the standard model (the ‘standard schedule’ in the BCBS- IOSCO terminology). However, the final framework and the Consultation Paper of the ESAs assume that using the standardised method netting benefits can be captured applying the net-to-gross ratio (NGR). Firstly, this analysis cannot really be adjusted for that. Secondly, this means that the estimates relating to the standardised model can be interpreted as an upper limit.

d) The same correction factors are applied to rescale the data from the FSB estimates and the global QIS estimates to take into account differences in the sample of data providers. These adjustments may not perfectly fit the conditions of the European market.

132. For example, the overall activity of non-centrally cleared derivatives in the EU can be estimated by comparison with the results of the Basel-IOSCO QIS.

(iii) Summary of the results

133. Making an appropriate comparison to the QIS conducted by BCBS-IOSCO is a non-trivial exercise for which a number of considerations need to be taken into account. Firstly, the data presented by the BCBS-IOSCO underwent a data cleansing procedure that took into account double reporting, i.e. two counterparties reporting the same trade, and adjustments for the fact that the full sample did not cover all banks. This complicates an outright comparison, as the same procedures cannot be consistently applied to the EU sample.

134. Consequently a number of assumptions have to be made, in particular that the European markets mirror to a large extent the conditions in the global derivatives markets. This assumption does not appear to be widely controversial given the global nature of the derivatives markets. Any scaling being made in the BCBS-IOSCO quantitative impact study is consequently also reflected in the European analysis. However, this does introduce some elements of estimation error.

135. The following two tables provide idea on the share of European respondents in the BCBS-IOSCO sample.

Table 1: European and global derivatives activity according to underlying asset classes (in EUR billion). These results include centrally and non-centrally cleared derivatives.
The overall size of the EU OTC market, prior to the introduction of centralised clearing, is around EUR 146 billion among the participants in the EU sample, which covers the largest European counterparties. Table 1 shows that the EU counterparties consist of 46% of the overall QIS sample and that the majority of EU exposures stem from foreign exchange and interest rate derivatives. The total share is slightly higher than the figures presented in other surveys investigating the European derivatives market, probably reflecting an overweight of European institutions in the BCBS-IOSCO QIS.

However, the above figures are affected by a number of issues, as some contracts have been double counted, as counterparties have individually reported the overall activity. Therefore, trades where both counterparties have reported will be included twice. This is difficult to adjust given that it requires details of the specific counterparties, so the un-adjusted numbers are presented and provide an upper limit. However, adjustments have been made to account for the differences in sample size and the size of the overall derivatives market.

Table 2: QIS data for EU countries: non-centrally cleared derivative activity after central clearing takes effect (in EUR billion).

<table>
<thead>
<tr>
<th>Respondents</th>
<th>Foreign exchange</th>
<th>Interest rate</th>
<th>Credit</th>
<th>Equity</th>
<th>Commodity</th>
<th>Other</th>
<th>Current total gross notional outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>26 182</td>
<td>107 029</td>
<td>8 912</td>
<td>3 208</td>
<td>478</td>
<td>132</td>
<td>145 939</td>
</tr>
<tr>
<td>BCBS-IOSCO</td>
<td>54 958</td>
<td>230 136</td>
<td>24 265</td>
<td>6 596</td>
<td>2 027</td>
<td>515</td>
<td>318 497</td>
</tr>
</tbody>
</table>

The notional amount of derivatives contracts, presented on a gross basis, shows that potentially 75 trillion of derivatives could fall under the scope of the current RTS. However, in practice, it will be significantly lower, as contracts between the large counterparties in the sample have been counted twice, not all counterparties will be above the EUR 8 billion threshold applying from 2019 and physically-settled foreign exchange contracts will not be subject to initial margins. Consequently, the overall potential for non-centrally cleared contract is expected to be substantially lower.

(iv) Estimates for the European market

In this section, the estimates based on the European sample are compared to the results published in the second consultative document.

15 Compare with Table 2, row 1, p. 29 of the second consultative document.
16 Table 3, p. 30 of the second consultative document.
140. The estimates based on the European sample are labelled ‘EU’. In all the tables below figures are reported in EUR billion and rounded to the nearest billion for readability.

Table 3: QIS data for EU countries: non-centrally cleared derivative activity before and after central clearing takes effect (in EUR billion)

<table>
<thead>
<tr>
<th>Respondents</th>
<th>Foreign exchange</th>
<th>Interest rate</th>
<th>Credit</th>
<th>Equity</th>
<th>Commodity</th>
<th>Other</th>
<th>Total gross notional outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU Before</td>
<td>26 181</td>
<td>107 029</td>
<td>8 912</td>
<td>3 208</td>
<td>478</td>
<td>132</td>
<td>145 939</td>
</tr>
<tr>
<td>After</td>
<td>21 447</td>
<td>48 338</td>
<td>3 392</td>
<td>1 469</td>
<td>233</td>
<td>42</td>
<td>74 920</td>
</tr>
<tr>
<td>Reduction</td>
<td>18%</td>
<td>55%</td>
<td>62%</td>
<td>54%</td>
<td>51%</td>
<td>68%</td>
<td>49%</td>
</tr>
<tr>
<td>BCBS-IOSCO</td>
<td>Before</td>
<td>54 958</td>
<td>230 136</td>
<td>24 265</td>
<td>6 596</td>
<td>2 027</td>
<td>515</td>
</tr>
<tr>
<td>After</td>
<td>47 863</td>
<td>107 209</td>
<td>12 132</td>
<td>2 908</td>
<td>1 212</td>
<td>409</td>
<td>171 733</td>
</tr>
<tr>
<td>Reduction</td>
<td>13%</td>
<td>53%</td>
<td>50%</td>
<td>56%</td>
<td>40%</td>
<td>21%</td>
<td>46%</td>
</tr>
</tbody>
</table>

141. Table 3 summarise the previous tables presenting a breakdown of the derivatives that are expected to be centrally cleared and those non-centrally cleared as gross notional amounts. The last row in the table shows that the estimated reduction in total gross notional outstanding after mandatory clearing enters into force at about 49%.

142. Once an estimate of the overall activity for non-centrally cleared derivatives is available, a comparison can be carried out between the current practice concerning the exchange of initial margins and the amount of initial margins collected after the full implementation of the margin framework. This is based on the simplifying assumption that the overall activity in 2019, end of the phase-in period, and the data used for this analysis remain similar.

143. In line with the supervisory guidance on foreign exchange transactions,¹⁸ these draft RTS prescribe minimum regulation for the exchange of variation margins but not for initial margins relating to physically-settled FX forward and swaps (and a similar treatment of cross currency swaps). Table 4 gives an overview of the activity relating to these kinds of derivatives and compares the EU estimates with the BCBS-IOSCO estimates.

Table 4: Gross notional outstanding amounts (EUR billion) of foreign exchange OTC derivatives (after CCP clearing) subject to these RTS.

<table>
<thead>
<tr>
<th>Respondents</th>
<th>Maturity &lt; 1 month</th>
<th>Maturity between 1 and 6 months</th>
<th>Maturity between 6 months and 1 year</th>
<th>FX derivatives after removing swaps and forwards included in the other columns</th>
</tr>
</thead>
</table>

¹⁷ Table 3, p. 30 of the second consultative document.
¹⁸ Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, issued by BCBS in February 2013.
144. It should be noted that refers to non-centrally cleared transactions after mandatory clearing. Those figures represent a significant amount yet a relatively small share of the overall derivatives subject to margin requirements. It should be noted that, under this proposal, physically-settled FX forward and swaps are subject to a variation margin but not to an initial margin.

145. With regard to existing practices, only very limited initial margins are exchanged today, as illustrated in Table 5.

Table 5: Comparison between estimated and provided initial margin amount under the current practice (EUR billion)

<table>
<thead>
<tr>
<th>Respondents</th>
<th>Total notional outstanding</th>
<th>Initial margin posted</th>
<th>Initial margin collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>145 939</td>
<td>2</td>
<td>37</td>
</tr>
<tr>
<td>BCBS-IOSCO&lt;sup&gt;20&lt;/sup&gt;</td>
<td>318 497</td>
<td>6</td>
<td>95</td>
</tr>
</tbody>
</table>

146. The exchange of variation margins seems to be common practice among financial institutions but the exchange of initial margins is rare. Initial margins are currently collected under very specific circumstances and only with respect to certain counterparties. Therefore, the estimate of approximately EUR 100 billion on a global basis and less than EUR 40 billion in the EU for initial margins currently collected is in line with expectations.

147. The introduction of the EUR 50 million threshold (‘the threshold’) has a substantial impact on the overall amount of initial margin required. Data are available only under the assumption that the threshold is applied at counterparty level. These draft RTS prescribe that the threshold can be applied only to the total amount of initial margin required when calculated at consolidated group level.

148. BCBS and IOSCO report the final results as an estimate of the effects that the introduction of the threshold would have on top of the possibility of allowing netting among asset classes. These are reported in Table 6 and compared with the EU estimates in the following table. The netting effect is limited, although not negligible, to around 8–14%. The last column is obtained multiplying the estimates based on the QIS sample by 1.3, i.e. the assumption is that the Basel-QIS sample covers around 75% of the global market.

Table 6: Initial margin requirements under the threshold regime, global estimates

<table>
<thead>
<tr>
<th>Initial margin requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<sup>19</sup> Table 6, p. 33 of the second consultative document.

<sup>20</sup> Table 4a, p. 31 of the second consultative document.
### Initial margin requirements

<table>
<thead>
<tr>
<th>Threshold level (EUR/Euro million)</th>
<th>QIS-sample No netting across asset classes (EUR billion)</th>
<th>QIS-sample Netting across asset classes (EUR billion)</th>
<th>Rescaled to global market(^{21}) No netting (EUR billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BCBS-IOSCO(^{22})</td>
<td>0</td>
<td>1 271</td>
<td>1 095</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>558</td>
<td>513</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>725</td>
</tr>
</tbody>
</table>

149. The results of the BCBS and IOSCO conclude that the overall impact, i.e. the amount of initial margin required once the framework enters fully into force, varies between EUR 1.7 trillion (threshold set to 0) and EUR 0.7 trillion (threshold set to EUR 50 million).\(^{23}\)

150. With the same assumptions, a similar range can be estimated specifically for the EU, based on the European sample. To take note of that, to avoid double counting, the second and third columns were estimated using only the margins collected.

**Table 7: Initial margin requirements under the threshold regime, European estimates**

<table>
<thead>
<tr>
<th>Initial margin requirements</th>
<th>Threshold level (EUR million)</th>
<th>European sample No netting across asset classes (EUR billion)</th>
<th>European sample Netting across asset classes (EUR billion)</th>
<th>Rescaled to EU market(^{24}) No netting (EUR billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>0</td>
<td>323</td>
<td>260</td>
<td>420</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>155</td>
<td>116</td>
<td>201</td>
</tr>
</tbody>
</table>

**v) Scheduled implementation in the European Union (‘phase-in’)**

151. EBA evaluated the phase-in requirements using available public data. Data were extracted from SNL financial reports for year-end 2012. The data sample covers 143 banks from 25 different European countries representing a total notional amount of EUR 233 874 billion.

152. In the sample, the number of banks subject to initial margin requirements during the phase-in described in the final article of the draft RTS, assuming unchanged derivatives activity, will be relatively limited during the first four years. However, it should also be

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\(^{21}\) Rescaled to entire global market: second column (no netting) multiplied by 1.3 = 1/75%

\(^{22}\) Table 5, p. 32 of the second consultative document.

\(^{23}\) p. 33 of the second consultative document.

\(^{24}\) Rescaled to entire EU market: second column (no netting) multiplied by 1.3 = 1/75%
noted that Table 8 refers only to banks and not to other counterparties and therefore only provides a lower limit of the counterparties subject to the requirements.

153. However, it should also be noted that the EUR 3 trillion threshold for the first period does not exactly identify the amount of transactions that will be subject to initial margins requirements in the first phase. This is due to the fact that counterparties exceeding the EUR 3 trillion threshold will be subject to initial margin requirements only if their counterparty also meets the same condition. In other words, the exchange of collateral for initial margin is required only if both counterparties are above the threshold. The ESAs estimate that fewer than half of the contracts will actually meet this condition as of December 2015.

Table 8: Phase in thresholds for initial margin requirements (EUR billion)

<table>
<thead>
<tr>
<th>Phase-in dates</th>
<th>Thresholds</th>
<th>Number of institutions above the threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/12/2015</td>
<td>3 000</td>
<td>12</td>
</tr>
<tr>
<td>01/12/2016</td>
<td>2 250</td>
<td>13</td>
</tr>
<tr>
<td>01/12/2017</td>
<td>2 000</td>
<td>14</td>
</tr>
<tr>
<td>01/12/2018</td>
<td>1 000</td>
<td>17</td>
</tr>
<tr>
<td>01/12/2019</td>
<td>8</td>
<td>59</td>
</tr>
</tbody>
</table>

154. For the European institutions as a whole, the largest implementation burden will be at the end of the period in terms of number of institutions (not necessarily in terms of the amount of margins collected).
1.2 Overview of questions for consultation

Question 1. What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If yes, please provide the rationale for the concerns and potential solutions.

Question 3. Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in the cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?

Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

Question 5. How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

Question 6. How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?