

19 March 2012

**UniCredit's reply
to ESMA Consultation on Draft Technical Standards for the
Regulation on OTC Derivatives, CCPs and Trade Repositories**

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches and more than 160.000 employees. UniCredit is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit operates the largest international banking network with around 4.000 branches and outlets. UniCredit Group is a market leader in the CEE region. Furthermore UniCredit was recently recognized as Global Systemically Important Bank.

In view of the tight deadline for the reply to this public consultation and its broad range of issues which are addressed, UniCredit experts have undertaken an internal exercise in order to identify only the crucial concerns related to this consultation and draw their attention upon. This UniCredit staff contribution is aimed at providing competent technical advisory supporting ESMA efforts in promoting better supervisory practices ensuring the level playing field.

Specific answers to the Consultation

Q1: In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

UniCredit: The list of clearing contracts “having direct, substantial and foreseeable effect within the EU” should be interpreted extremely narrowly and further clarified, specifying features of those contracts and/or giving some examples more than indicating a closes/open list of contracts. A narrow interpretation is highly desirable as it is a very onerous obligation to require third party users to submit to EU clearing, especially when they themselves may not be required to clear under their own home competent authority or may potentially be subject to competing requirements. Any lack of definitional clarity will lead to considerable confusion and therefore the

test should have clearly identifiable measures. It is also important that a very short timeframe be established for identifying such trades rather than ESMA retaining an open-ended right of enforcement. In light of this, it seems appropriate for the test of “direct, substantial and foreseeable effect within the EU” to in fact only apply where the contract was entered into for the evasion of any provision of EMIR. Broader interpretations of this requirement could lead to a significant competitive disadvantage for European banks entering into trades with non-EU counterparties. In this regard, also considering the obligation envisaged by art. 24.2 of the MiFIR proposal - that has the same objective perimeter of the clearing obligation set forth by EMIR - UniCredit believes that the cases where the prevention of the evasion of EMIR for contracts entered into between counterparties located in a third countries should be specified – e.g. through an open list of concrete cases to be updated each time.

Q2: In your views, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

UniCredit: The only possible means of defining such “evasive” trades would be trades which could have been executed in a jurisdiction covered by EMIR with an identical economic and strategic outcome to both counterparties but substantially different reporting or clearing requirements. It is extremely difficult, however, within this definitional framework, to effectively measure relative economic and strategic outcomes without a complete understanding of the trade rationale, which may not be possible through available trade reporting. In any event, the requirement should only apply where the contract is demonstrably entered into in order to evade EMIR provisions, without commercial purpose and not in the ordinary course of business between the parties.

Q3: In your views, what should be the characteristics of these indirect contractual arrangements?

Also taking into account the recent proposals for the technical standards on the Regulation on short selling and certain aspects of Credit Derivatives (especially CDS), UniCredit suggests to take into account even the following general items for defining the characteristics of the “eligible” indirect contractual arrangements:

- be entered into prior or concomitantly to the clearing obligation,
- be legally binding, and
- be recorded in a durable medium so the clearing member can provide evidence to e.g. the competent authority.

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

UniCredit: The information listed appears sufficient but there is no defined mechanism for on-going assessment of clearing eligibility. In other words, how will ESMA ensure that clearing is still applicable to certain classes of derivatives over time if volumes decline? Will ESMA rely on the

local competent authority to make a similar request to stop clearing certain derivatives?

In terms of assessing the “class” of derivatives, this should be sufficiently detailed as to distinguish amongst different types of derivatives within a class (e.g., “interest rate swaps” or “credit default swap” would be too vague but something like a credit default swap with a specific reference entity, currency and tenor would be more appropriate).

Q5: For a reasonable assessment by ESMA on the basis of the information provided in the notification, what period of time should historical data cover?

UniCredit: Historical data should cover a sufficiently long period (say at least 24 months) to ensure that market activity is consistent, sustainable and standardised.

Q6: What are your views on the review process following a negative assessment?

UniCredit suggests that the assumption for a new assessment of ESMA should be further specified, amending the proposed paragraph 20 by taking into account only the significant/relevant changes of the market conditions and/or information provided as a basis of the ability of competent authorities to submit a new notification to ESMA.

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, and availability of pricing information?

UniCredit: As far as the availability of pricing information is concerned (par. 22.c), UniCredit suggests to further clarify the meaning of information easily accessible to counterparties – e.g. mentioning the sources that can be considered eligible – also in relation to the meaning to be given to “reasonable commercial basis”.

Q8: What are your views, regarding the details to be included in ESMA register of classes of derivatives subject to the clearing obligation?

UniCredit believes that the public register available on ESMA website could also include an indication on how the classes of OTC derivatives subject to clearing obligation meet the criteria set forth by EMIR (degree of standardisation, volume and liquidity of relevant contracts, availability of pricing information) in the light of the assessment performed by ESMA.

Q9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

UniCredit agrees with the proposed definition concerning the derivatives contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity of non-financial counterparties.

However, taking into account for instance the provisions set forth by the Italian competent authority for transactions on illiquid products executed by intermediaries on behalf of their clients, we suggest to highlight that such specific purpose (protection) of the above mentioned OTC

derivatives should be checked on an ongoing basis, considering the evolution of positions or exposures entered into via derivatives by non-financial counterparties.

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

UniCredit: It would preferable that ESMA further investigate the pros and cons of the requirement to clear all derivatives once the clearing threshold has been exceeded for non-financial entities, whether they are deemed to be commercially risk reducing or not. While the clearing requirements for non-corporates creates some incentive to minimise non-commercial derivatives trading, this requirement could result in additional counterparty risk to the non-financial entity if existing maturing non-cleared positions (which can be subject to netting) are forced to be cleared before netting. Therefore, in other words, a transaction subject to the clearing obligation may actually increase counterparty risk.

To the extent that the concept of a threshold is maintained, on the other hand, the definition of “commercially risk reducing” must be sufficiently broad to capture “indirect” hedges which may not directly reference asset price movements or exposures within the entity’s business operations. In other words, proxy hedges need to be considered and captured within the definition of “commercially risk reducing”.

When considering objectively measurable standards for an entity on behalf of its group, the term “group” should be broad enough to include non-EU group members, i.e, an entity with operations outside of the EU shouldn’t be penalised when hedging its operations as against competitors who may only have EU group members.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

UniCredit: It is still undefined how the threshold will be measured except that it will “refer to the notional value of OTC derivatives subject to the clearing obligation” so it is difficult to opine on this question other to say that notional value is not necessarily reflective of actual risk. ESMA also argues that the “broad definition” of exempt transactions for non-financial counterparties (which are then excluded from the threshold) should allow for a low threshold. There is a suggestion to use a cross-asset threshold however it is not clear how this would work in practice. To the extent notional value is used as the measure, it would ignore asset correlations and possible cross-asset risk dampening effects.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically

processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

UniCredit: Generally, we consider the suggested times as realistic for confirming transactions, provided using electronic platforms for trade execution or processing is possible, with those non-financial clients that exceed the threshold. However, there has to be a clear provision that requires non-financial institutions to at least electronically acknowledge transactions via electronic affirmation tools, in order to ensure a well functioning process in the market.

For those products that cannot be transacted through any electronic platform, a same-day trade acknowledgement process via e-mail or fax has to be ratified and implemented by all market participants. The latter is, however, only feasible, if the legal framework of all relevant local jurisdictions understands confirmations via such channels as legally binding. If not, the respective local laws need to be properly adjusted.

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

UniCredit: Reporting rules for outstanding/unconfirmed trades to the competent authorities should comply with international best practice standards as outlined by various market associations. For those trades, which are eligible for electronic execution and/or processing, a reporting time of T+3 is in our opinion acceptable. However, for non-electronically executed and/or processed trades, especially with non-financial institutions in the role of the counterparty, the operational risk increases. As we also suggested in our answer to Q12, we are of the opinion that we have to work towards an appropriate intermediate solution. If implemented, this would allow for a more harmonized and feasible period of time for reporting purpose across all the trade typologies (standardized and not-standardized) and with all different categories of clients (financial and non-financial institutions).

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

UniCredit: We are of the view, that best practice as suggested by major market associations should apply.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

UniCredit: We suggest not to introducing a threshold for the exercise. Concerning the frequency, this should be at least once a year. However, both financial as well as non-financial counterparties should first be in position to access compression platforms and be obliged by law to use those.

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

UniCredit: We would opt for procedures agreed by the counterparties to deal with disputes that are not resolved within 5 business days. This solution is in line with the dynamism of this type of market.

Detailed procedures would not meet the market's need for slim solution of controversies.

Moreover, major market associations' best practice should set the benchmark. However, an independent valuation source for financial and non-financial parties will support the dispute resolution according to international standards.

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

UniCredit: Firstly, we believe that a combination of legal settlement, third party arbitration and/or a market polling mechanism could be included but should not consist of an exhaustive list.

Secondly, also in the light of the dynamism of this market sector, we consider these means to be sufficient.

Q69: What is your view on the need to ensure consistency between different transaction reporting mechanisms and the best ways to address it, having in mind any specific items to be reported where particular challenges could be anticipated?

UniCredit: We share the view of having a consistent reporting mechanism applicable for different transactions. In this regard we see three elements which need to be especially paid attention to:

- (i) extraterritorial issues to be resolved amid different legislations to ensure a harmonized global reporting ability;
- (ii) standardization of elements to be reported on a transaction level across all asset classes;
- (iii) provisions for rules to apply in case of not standardized sub-product types to support reporting transparency on a global level across various TRs.

Q71: How should beneficiaries be identified for the purpose of reporting to a TR, notably in the case of long chains of beneficiaries?

UniCredit: The LEI solution should be extended to cover any beneficiaries via a unique identifier which enables the allocation of a position to the final beneficiary.

Q74: How complex would be for counterparties to agree on a trade ID to be communicated to the TR for bilaterally executed transactions? If such a procedure is unfeasible, what would be the best solution to generate the trade ID?

UniCredit: We deem it appropriate to distinguish two cases:

- (i) electronically executed and/or processed trades: the references generated by trading or matching platforms could be used;
- (ii) non-electronically executed and/or processed trades: this case is more complex and encompasses operational risks. To avoid confrontation with technical limitations (e.g. how many characters is allowed a reference to consist of), a suggestion might be to use an ID issued by a TR. Such a solution, however, requires having first a market-wide agreed definition on which a party to a contract has the obligation to take out a ticket from a TR to use. Shall it be the buyer, the seller, the calculation agent or another criterion to be used?

Q75: Would information about fees incorporated into pricing of trades be feasible to extract, in your view?

UniCredit: With particular reference to paragraph 189, we highlight that Italian intermediaries have already to set up specific procedures aimed at fixing the *mark up* applied to transactions on illiquid products executed for (or with) their clients, where *mark up* means the margin, compared to the fair value, that covers expenses and profits of intermediaries.



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Please find below a list of the key people involved in this work, whose contribution made it possible to provide UniCredit answers to this Consultation. Of course, some other experts have been involved alongside the UniCredit, but are not listed below.

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