



JOINT COMMITTEE OF THE EUROPEAN  
SUPERVISORY AUTHORITIES

**Joint Discussion Paper**  
**on**  
**Draft Regulatory Technical Standards**  
**on risk mitigation techniques for OTC derivatives not cleared by a CCP under**  
**the Regulation on OTC derivatives, CCPs and Trade Repositories**  
**(JC/DP/2012/1)**

**London, Frankfurt, Paris, 6 March 2012**

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## Acronyms Used

CCPs	Central Counterparties
FC	Financial Counterparty
NFC	Non Financial Counterparty
PRFC	Prudentially Regulated Financial Counterparty
NPRFC	Non Prudentially Regulated Financial Counterparty
RTS	Regulatory Technical Standards
ITS	Implementing Technical Standards
ESAs	European Supervisory Authorities
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pension Authority
ESMA	European Securities and Markets Authority
EMIR	European Market Infrastructures Regulation – Regulation of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as “the Regulation”.

## **I. Responding to this Discussion Paper**

EBA, ESMA and EIOPA (the ESAs) invite comments on all matters in this paper and in particular on the specific questions stated in the boxes below (and in the Annex of this paper). Comments are most helpful if they:

- indicate the specific question to which the comment relates;
- respond to the question stated;
- contain a clear rationale;
- provide evidence to support the view expressed;
- describe any alternatives the ESAs should consider; and
- provide where possible data for a cost and benefit analysis.

The ESAs will consider all comments received by **2 April 2012**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

### **Publications of responses**

All contributions received will be published on the ESAs’ websites following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the ESAs’ 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 ESAs’ Board of Appeal and the European Ombudsman.

### **Data protection**

Information on data protection can be found at [www.eba.europa.eu](http://www.eba.europa.eu) under the heading ‘Copyright & Disclaimer’, at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Legal Notice’, and at [www.eiopa.europa.eu](http://www.eiopa.europa.eu) under the heading ‘Legal Notice’.

### **Who should read this paper**

All interested stakeholders are invited to respond to this discussion paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions and central counterparties (CCPs), clearing members of CCPs and their clients.

### **Disclaimer**

The views expressed in this discussion paper are preliminary and will not bind in any ways the ESAs in the future development of the draft Regulatory Technical Standards. They are aimed at eliciting discussion and at gathering the stakeholders’ opinion at an early stage.

## **II. Executive Summary**

### **Reasons for publication**

Following the European Commission's (EC) legislative proposals for a Regulation on over-the-counter (OTC) derivatives, central counterparties (CCPs) and trade repositories (the Regulation) of 15 September 2010<sup>1</sup>, a political agreement was reached by the EC, the European Parliament and the Council of the EU, during their so-called 'Trilogue' meeting of 9 February 2012. The present discussion paper is based on that political agreement, in order to allow the ESAs to prepare their work on developing the TS more efficiently.

This discussion paper seeks stakeholders' views on the regulatory technical standards the ESAs are required to draft under what is currently Article 6/8. The Regulation delegates powers to the Commission to adopt Regulatory Technical Standards (RTS) specifying the requirements on risk mitigation techniques for OTC derivative contracts not cleared by a CCP. EBA, ESMA and EIOPA are expected to jointly develop draft RTS, and submit them to the Commission by 30 September 2012. This discussion paper relates to those draft RTS.

The discussion paper expresses the ESAs' preliminary views on the topic and aims at gathering the stakeholders' opinions at an early stage of the process. The input from stakeholders will help the ESAs in the development of the relevant RTS to be drafted and submitted to the European Commission for endorsement in the form of Commission Regulations, i.e. a legally binding instrument directly applicable in all Member States of the European Union. One essential element in the development of draft RTS is the analysis of the costs and benefits that those legal provisions will imply. Input in this respect and any supportive data will be highly appreciated and kept confidential where required.

### **Contents**

Article 6/8 of the Regulation requires Financial Counterparties (FC) and Non Financial Counterparties above the clearing threshold, as referred to in Article 5/7 of the Regulation (NFC+), to exchange appropriate collateral for OTC derivative contracts not cleared by a CCP. Financial Counterparties are also required to hold appropriate capital for risks not covered by the exchange of collateral.

The first section of the discussion paper focuses on preliminary considerations regarding collateral (margin) and capital requirements. The second section outlines potential options regarding combinations of collateral and capital requirements. The third and fourth sections discuss the application of variation and initial margins. The fifth and sixth sections focus on identifying eligible collateral and collateral valuation. The seventh section highlights potential issues related to transactions with counterparties outside of the EU. The eighth and ninth sections elaborate on risk management procedures, operational processes for the exchange of collateral and minimum transfer amounts as well as intra-group exemptions. The last section provides a data request for the cost-benefit analysis.

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<sup>1</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF>

## **Next steps**

As provided for by Regulations No 1093/2010, 1094/2010 and 1095/2010 of the European Parliament and Council establishing the ESAs, before submitting the draft RTS to the Commission, the ESAs will conduct a public consultation and analyse the potential costs and benefits of proposed standards. Following this discussion paper and on the basis of the relevant input received, the ESAs will finalise their proposed draft RTS and publish a consultation paper. The consultation paper will include the legal text of the provisions constituting the proposed draft RTS, an explanation of measures proposed for adoption and a draft cost-benefit analysis. The publication of the consultation paper and the commenting period will depend on the date of publication of the Regulation in the Official Journal of the EU and the final deadline for the ESAs to deliver the draft RTS to the Commission.

Besides this discussion paper, other discussion papers address the technical standards that need to be drafted under the Regulation. Thus, on 16 February 2012 ESMA issued a discussion paper on the draft regulatory and implementing technical standards it is required to develop under the Regulation. The consultation period for this discussion paper will last until 16 March. This discussion paper is available on the ESMA website<sup>2</sup>.

Further, the EBA is issuing a discussion paper on draft regulatory technical standards on capital requirements for CCPs, it is required to develop under this Regulation. This discussion paper is also available on the EBA website.

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<sup>2</sup> <http://www.esma.europa.eu/system/files/2012-95.pdf>

### **III. Background**

Following the European Commission's (EC) legislative proposals for a Regulation on over-the-counter (OTC) derivatives, central counterparties (CCPs) and trade repositories (the Regulation) of 15 September 2010<sup>3</sup>, a political agreement was reached by the EC, the European Parliament and the Council of the EU, during their so-called 'Trilogue' meeting of 9 February 2012. The present discussion paper is based on that political agreement in order to allow the ESAs to prepare their work on developing the RTS more efficiently.

The Regulation establishes provisions aimed at increasing the safety and transparency of the OTC derivatives markets. Among other matters, it introduces a legal obligation to clear certain types of OTC derivative transactions through CCPs. Central clearing involves the CCP interposing itself between two counterparties to a transaction, assuming the obligations of each counterparty to the other.

CCPs are the Regulation's primary tool for mitigating the contagion – or, systemic – risk posed by one counterparty's default to the solvency of others within the derivatives market. The Regulation establishes organisational, conduct of business and prudential requirements for CCPs to ensure that those institutions have robust risk management and are financially sound irrespective of the financial instruments cleared, such that CCPs apply:

- robust margining requirements to all cleared transactions, ensuring that modelled future exposures are collateralised to a certain degree of confidence;
- pre-funded default management resources to mutualise losses between the surviving clearing members in case of the default of another member; and
- clearly defined default management processes to reallocate or liquidate positions in an orderly way in the event of a default.

However, not all OTC derivative transactions will meet the requirements that are necessary before they can 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 mitigate the counterparty credit risk, and potential systemic risk that can arise. Therefore, Article 6/8 of the Regulation requires the use of risk mitigation techniques for transactions that are not centrally cleared and mandates the ESAs to develop RTS on these risk mitigation techniques.

#### **Consistency with international standards**

In order to avoid regulatory arbitrage, it is crucial to align international standards. Therefore, these RTS will consider the proposals of international standard setting bodies on margining requirements for derivative transactions that are not subject to clearing requirements. Currently, the Basel Committee for Banking Supervision (BCBS), the Committee for Payment and Settlement Systems (CPSS), International Organisation of Securities Commissions (IOSCO), and the Committee on the Global Financial System (CGFS) have established a working group to set margining standards for non-centrally cleared derivatives, with a consultative report expected in mid-2012.

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<sup>3</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF>

## IV. Discussion Paper

### IV.1 Collateral and capital requirements

1. In the absence of central clearing, collateral and capital requirements are the necessary tools to contain the risk arising from OTC derivatives transactions. Further, appropriate capital and collateral to reflect the risks they are meant to cover, can attribute the right costs to trading bilaterally, thus not dis-incentivising central clearing or creating incentives to use less standardised derivatives with the objective of circumventing the clearing obligation. Further, it can actually encourage the promotion of standardisation by market participants in an effort to make products suitable for clearing.
2. Article 6/8 of the Regulation primarily requires:
  - for Financial Counterparties (FC)<sup>4</sup> and Non Financial Counterparties above the clearing threshold, as referred to in Article 5/7 of the Regulation (NFC+), to proceed to a timely, accurate and appropriately segregated exchange of collateral for OTC derivative contracts not cleared by a central counterparty (CCP); and
  - for FCs to hold capital that is appropriate and proportionate to the remaining risks, i.e. those not covered by the exchange of collateral.
3. To that end, the Regulation mandates the ESAs to determine, in relation to non-centrally cleared transactions, the appropriate level of collateral and capital, the eligible collateral, and the frequency of exchange of the collateral.

#### Collateral requirements

4. In standard practice, collateral posted and exchanged as part of derivative transactions can take the form of variation margin and/or initial margin. Variation margin (VM) represents collateral exchanged by counterparties to reflect current exposures resulting from actual changes in the value<sup>5</sup> of the relevant transactions. Initial margin (IM) collateral is provided to cover potential future exposures arising from the relevant transactions in the interval between the last exchange of margins and the liquidation of the relevant positions.
5. Upon a default, the collateral can be liquidated or effectively netted by the non-defaulting counterparty to close out the transaction. Without collateralisation, the non-defaulting counterparty would be treated as an unsecured creditor for its claims against the defaulting counterparty. This situation could result in a loss for the non-defaulting counterparty (e.g. a part or all of the replacement costs in the case no IM would be exchanged), which the counterparty would have to cover by its own financial resources.

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<sup>4</sup> The term “Financial Counterparty as defined in Article 2, paragraph 1, point 6 EMIR comprises the following entities: Investment firms as authorised in accordance with Directive 2004/39/EC; Institutions authorised in accordance with Directive 2006/48/EC.; Insurance undertakings authorised in accordance with Directive 73/239/EEC; Assurance undertakings authorised in accordance with Directive 2002/83/EC; Reinsurance undertakings authorised in accordance with Directive 2005/68/EC; Undertakings for collective investments in transferable securities (UCITS) and their managers as authorised in accordance with Directive 2009/65/EC; Institutions for occupational retirement provision as defined in Directive 2003/41/EC; Alternative investment funds managed by alternative investment fund managers authorised or registered in accordance with Directive 2011/.../EU

<sup>5</sup> This could be dependent on market value prices or mark to model pricing.

## **ESA proposals for collateral requirements and rationale**

6. It is the ESAs' view that, in order to comply with the requirements set forth in Article 6/8 there should be at least an exchange of VM by both counterparties where the transaction is between FCs and/or NFCs+. In addition, the ESAs continue to consider a requirement to exchange, post or collect IM.
7. Firstly, the exchange of VM would ensure that the exposure to a counterparty will be limited to the exposures due to market movement between margin calls. This will provide protection to participants against the market value losses that could otherwise be incurred upon the default of counterparty.
8. Secondly, the requirement to exchange, post or collect IM is viewed by the ESAs as the most effective risk reduction tool against residual counterparty credit risk. IM provides the collateral taker with "defaulter pays" protection against the future replacement cost in case its counterparty defaults (i.e. the posting party), where the non-defaulting party holds collateral for potential monies that could be owed.
9. Notwithstanding these advantages of IM in reducing the potential loss in the event of default and in increasing the stability within the derivatives market, IM requirements can result in liquidity constraints for participants and the financial markets, notably depending on the type of eligible collateral, the level of segregation and the limit on the re-use. In addition to these potential new risks that may be introduced into the financial system, the requirements for posting IM can lead to an increased cost of trading. These issues are analysed in the following sections of this discussion paper.

## **Considerations regarding procyclical effects and collateral requirements**

10. Procyclicality in margining practices has destabilising implications for financial markets, including through its impact on the availability of funding and the extent of financial system leverage. Procyclical effects can arise from practices that result in sudden and large calls for margin (e.g. related to a downgrade in the creditworthiness of a counterparty or the quality of non-cash collateral, or sudden changes in the valuation of non-cash collateral) as well as through a more gradual decline in collateralisation over 'good times' through the business cycle. These effects may be transmitted beyond participants to particular transactions and through the financial system more broadly. For these reasons, collateral posted and exchanged as part of a transaction should not be assessed using only an external rating issued by a CRA/ECAI. Hence it is important that counterparties develop other criteria to assess creditworthiness such as in depth due diligence and internal models. The setting of conservative requirements for margins in RTS may help to mitigate these pro-cyclical effects on the financial system. Therefore, and in line with current considerations at an international level, it should be noted that in developing



draft RTS on margins and collateral, due regard should be given to the role that margin requirements can play in limiting these procyclical effects.

## **Capital requirements**

11. Capital requirements act as a risk mitigant that absorbs unexpected losses and should protect the firm from becoming insolvent. Capital is held to protect against low frequency, high impact events. Other mechanisms in an institution's functioning should protect against day-to-day, high frequency, low impact losses.

## **ESA proposals for capital requirements and rationale**

12. It is the view of the ESAs that some existing capital regimes could be considered to provide a sufficient degree of confidence, such that the FCs subject to these regulations would hold appropriate and proportionate amount of capital for the remaining risks. These prudentially regulated financial counterparties (PRFC) would include: investment firms, credit institutions, insurance undertakings, assurance undertakings, reinsurance undertakings, and institutions for occupational retirement provision. Therefore the RTS do not need to introduce new additional capital requirements for PRFCs.
13. Non-prudentially regulated financial counterparties (NPRFC) would include: undertakings for collective investments in transferable securities (UCITS) and their managers and alternative investment funds managed by alternative investment fund managers. These entities, by definition, are not subject to specific prudential capital requirements in sectoral legislation<sup>6</sup>. Against this background, it is the opinion of the ESAs that it is not appropriate to establish specific risk-based capital requirements for NPRFCs through RTS without a corresponding regime in basic act.
14. However this would mean that, in order to comply with the requirements set in the Regulation, NPRFCs and NFC+ (for which no requirement to hold capital is required) should cover through adequate exchange of collateral the risks arising from positions in OTC derivatives.
15. For the avoidance of doubt, it should be noted that transaction with NFCs that are not above the clearing threshold, are not required by the Regulation to hold adequate capital or collateral, therefore they should not be required to exchange either VM or IM, irrespective of their counterparties. It should also be noted that the counterparty of a NFC+ does not necessarily know whether the NFC is above the clearing threshold. The ESAs would, therefore, need to consider the most appropriate way to ensure the application of the requirement to collect collateral to counterparties of NFC+.

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<sup>6</sup> It should, however, be noted that in a number of cases there are specific regulations addressing the risk related requirements for NPRFC, that limit the level of leverage risk taking of these institutions. This typically implies that NPRFC maintain a lower ratio between liabilities over capital than PRFC.

## **The interplay between initial margin and capital**

16. Both collateral and capital can act as a form of risk mitigation. In contrast to collateral, capital ultimately absorbs loss through the non-defaulting party's resources, meaning the non-defaulting party's balance sheet is affected by its counterparty's default if any sums are owed, whereas collateral in the form of initial margin is provided by the defaulter to absorb any losses through the defaulter's resources and potentially insulating the non-defaulting party from incurring any losses.
17. Against this background, if the "exchange of collateral" in the case of bilateral transactions is restricted to VM and no further capital requirements are applied to NPRFCs and NFCs+, the following issues need to be considered:
- Whether the same risks are covered by capital and initial margin.
  - NPRFCs and NFCs+ could have no additional resources to protect against residual exposures not covered by VM, presenting a risk to them and to the wider financial system.
  - NPRFC and NFCs+ would incur lower costs when undertaking bilateral non-cleared transactions, which could act as a disincentive to migrate towards central clearing and therefore could be viewed to be contrary to the objectives of the Regulation.
  - PRFCs could be incentivized to migrate towards undertaking transactions through NPRFC members of their groups, affiliates or entities to arbitrage the requirements.

## **Summary of proposals**

### 18. Summary of proposals

- VM should be exchanged between all counterparties subject to the collateral requirements;
- the ESAs are considering to what extent counterparties should be required to provide IM;
- capital requirements specified in prudential legislation for PRFCs provide a sufficient regime for any remaining risks not covered by the exchange of collateral; and
- capital requirements should not be developed for NPRFCs, the risk arising should therefore be fully covered through the adequate exchange of collateral.

**Q1. What would be the effect of the proposals outlined in this discussion paper on the risk management of insurers and institutions for occupational retirement provision (IORPs)?**

## **IV.2 Options for initial margins**

19. The following three sub-sections consider proposals for the provision of initial margin between counterparties:
1. The posting of IM by all counterparties;

2. The collection of IM by PRFCs only; or
3. PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold.

### **Option 1: The posting of IM by all counterparties**

20. As explained in the previous section the exchange of IM would provide further protection to the system and to individual counterparties from the default of the posting party.
21. Given that, as mentioned above, NPRFC and NFC+ are not required to apply resources other than exchange of collateral to protect their exposures and that the exchange of variation margins only will not be sufficient to protect them from future exposures of the outstanding positions, it can be considered appropriate for NPRFC to collect initial margin from their counterparties in line with the requirements in Article 6/8 of Regulation and future RTS.
22. Further, in a transaction between a PRFC and a NPRFC or NFC+, the PRFC may be even more exposed to the risk of default of its counterparty given that the latter is not required to have adequate capital at its disposal to protect against its own insolvency. For this reason it would not be appropriate to apply the requirement to collect IM to NPRFC and NFC+ only, as this would leave the PRFC at risk.
23. Counterparty credit risk in transactions between PRFCs may be mitigated by the holding of adequate capital by both parties. However, as explained in the previous section, IM provides “defaulter pays” protection which can be considered preferable to relying on capital for absorbing losses.
24. Against this background it is proposed that PRFC, NPRFC and NFCs+ are all required to post and collect appropriate initial margins.

#### **On option 1:**

- Q2. What are your views regarding option 1 (general initial margin requirement)?**
- Q3. Could PRFCs adequately protect against default without collecting initial margins?**
- Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.**

### **Option 2: The collection of IM by PRFCs only**

25. An alternative option would consider the perceived systemic relevance of the counterparties and look at the best way to ensure the protection of those deemed most systemically relevant, so as to ensure protection against the impact of their default on the wider financial system. This

approach is similar to the current proposals of U.S regulatory authorities in respect of margin requirements for non-cleared transactions, and so could also avoid regulatory arbitrage. However, it should be noted that the current U.S. proposals may require the collection of IM by NFCs where they are classified as ‘Major Swap Participants’.

26. This option implies that PRFCs are typically more systemically relevant than NPRFCs and so warrant a greater level of protection in the interests of the financial system. Therefore, the option anticipates that in addition to the exchange of VM between all covered counterparties, IM is only *collected* by PRFCs, whereas NPRFCs and NFCs+ will only be required to *post* IM. This means that in a transaction between two PRFCs they will both post and collect, whereas in a transaction between a PRFC and a NPRFC or a NFC+ only the latter will post.

	PRFC	NPRFC	NFC+
Transaction with a PRFC	Both sides post and collect IM and VM	NPRFC posts IM both sides post and collect VM	NFC+ posts IM both sides post and collect VM
Transaction with a NPRFC	PRFC collects IM both sides post and collect VM	Only VM	Only VM
Transaction with a NFC+	PRFC collects IM both sides post and collect VM	Only VM	Only VM

27. However, under this option, NPRFCs and NFCs+ remain exposed to the default of a PRFC counterparty and other NPRFC and NFC+ counterparties to the extent that the exposure is not covered by the exchange of VM. This could endanger the stability of the financial system if a systemically relevant counterparty were to default.

28. Given that transactions between and among NPRFCs and NFC+ would not be collateralised, this could create scope for avoidance of margin requirements by those parties, with potential significant risk for the financial system.

On option 2:

- Q5. What are your views regarding option 2?**
- Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?**

**Option 3: PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold**

29. This option would offer the possibility to PRFCs to use a threshold approach within the above mentioned options by allowing potential future exposures to certain counterparties to be uncollateralised where those exposures remain below a given threshold amount. In this case the uncollateralised exposure would need to be covered by capital.
30. This option takes account of the fact that, when well managed, taking on credit exposure does not automatically lead to unacceptable levels of systemic risk given that credit exposure can arise from a number of activities that regulated firms are permitted to engage in with a counterparty (e.g. grant a loan).
31. Although the option would permit such credit exposure in certain circumstances, it has to be ensured that IM is collected in amounts that are appropriate to the risks posed by the counterparties.
32. It is the ESA's view that if a threshold approach is provided, only PRFCs would be allowed to use this approach for their counterparties, because they would be at least subject to capital requirements for the credit risk inherent in the threshold amount.
33. With this approach the counterparty of a PRFC would only have to post IM when they exceed the threshold<sup>7</sup>. This option assumes the collecting counterparty is willing to take a certain amount of credit risk. It should be noted that the threshold can be determined explicitly or through criteria by the draft RTS, in order to ensure consistency in application by PRFCs and to enable regulators to limit the level of uncollateralised risk in the markets. It should also be noted that the threshold would simply represent an option for the PRFC to put at risk their capital instead of collecting collateral; they would still have discretion to collect IM instead where preferable.
34. However, it should be noted that a threshold related to the credit quality of a counterparty can contribute to procyclicality in the case that a counterparty's creditworthiness deteriorates and a new liquidity burden is required at the same time. Moreover, the threshold should not be assessed using only external rating issued by a CRAs/ECAI. For this reasons it might be relevant that PRFC develop other criteria to assess the creditworthiness such as in depth due diligence run by the bank, internal models.

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<sup>7</sup>For example, the threshold can take a form of a credit line extended to certain counterparties which would not be required to post collateral to the extent that their exposures are covered by the credit line and that would start posting collateral when they have exhausted the credit line. The way in which the threshold should be calculated and whether or not it can be applied only to counterparties meeting certain criteria is still to be determined.

On Option 3:

**Q7. What is the current practice in this respect, e.g.**

- If a threshold is currently in place, for which contracts and counterparties is it used?
- Which criteria are currently the bases for the calculation of the threshold?

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

**Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?**

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

On all options:

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

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

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

### **IV.3 Variation margin**

35. The method and frequency for pricing/calculating the value of outstanding contracts, is determined by Article 6/8 of the Regulation: “Financial counterparties and non-financial counterparties referred to in Article 5/7 shall mark-to-market on a daily basis the value of outstanding contracts. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used by the financial and non-financial counterparties referred to in Article 5/7.” In this respect, ESMA is required to draft RTS on the conditions preventing mark-to-market and the criteria for using mark-to-model. For further considerations on that, please refer to the ESMA Discussion Paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories.

36. In view of the above requirements, it might be considered whether the same framework should apply to the valuation of margin; namely that this should be daily, on a mark-to-market basis where possible, and otherwise in accordance with marking to model as defined in the relevant RTS. In this respect, the ESMA discussion paper highlights that the choice between marking-to-market or marking-to-model of contracts that have been assessed as insufficiently standardised for central clearing seems to heavily push towards the second option. Indeed, the fact that standardisation of the class of OTC derivative is deemed insufficient shows that there is a limited number of other similar products in the OTC market and therefore marking-to-market may be difficult to achieve.

**Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?**

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

**IV.4 Initial margin**

37. The ESAs' IM requirements will comprise the method of pricing/calculation, aspects regarding segregation and re-hypothecation of collateral as well as the potential liquidity and capital impact of initial margin requirements.

**Initial Margin Calculation**

38. It is important that the methods for calculating IM are transparent and consistent for all counterparties subject to the requirements of Article 6/8 of the Regulation, in order to provide certainty. It is therefore the ESAs' view that there should be at least a standardised approach available in order to ensure that all counterparties subject to the requirements will be in a position to calculate their margin requirements. However, the ESAs also consider the option to allow for the use of appropriate internal models for the calculation of initial margins, subject to further specified minimum requirements. The methodology for the calculation of initial margins should also take into account the requirements established for CCPs (see ESMA Discussion Paper Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories) in order to ensure a similar degree of protection and to set the right incentives.

39. For the standardised approach, the ESAs may consider the "Mark-to-market method<sup>8</sup>" and/or the "Standardised Method<sup>9</sup>" as set out in the European Capital Requirements Regulation (CRR) as a feasible option.

40. For the internal model, the "Internal Model Method" as set out in the CRR could be the starting point. It should also be considered to what extent internal models under other sectoral legislation may provide a sensible basis for margin calculation models. However, in our view an internal model should only be applicable if it is approved by the competent authority. Internal models have several drawbacks: they may produce lower margin requirements than CCPs thus creating competitive advantages for counterparties with sufficient resources to build them and also disincentivising central clearing.

41. When setting the minimum level of IM requirements and the parameters that need to be considered for the calculation of IM, due respect should be given to macroprudential considerations and possible procyclical effects that these could play.

**Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?**

<sup>8</sup> The "Mark-to-market method" is a simple approach for calculating financial derivative exposures where the potential future exposure is calculated by multiplying the notional amount of a contract with a given multiplier (add-on) which is varying according to the product type and the maturity.

<sup>9</sup> The "Standardised Method" is a model-based approach for calculating financial derivative exposures which is more risk sensitive than the "Mark-to-market method".

- Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?**
- Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?**
- Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?**
- Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?**
- Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?**
- Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?**
- Q23. To what extent would the ‘mark-to-market method’ or the ‘standardised method’ change market practices?**

42. Without prejudice to issues related to dispute resolution, which are analysed in ESMA’s discussion paper, in case of transactions where the counterparties calculate different initial margin requirements (e.g. where one counterparty uses a standardised approach and the other counterparty uses an internal approach), in our view the following treatments are conceivable:
- Either both counterparties actually require different initial margin amounts for the same transaction or set of transactions; or
  - one of the counterparties may be designated to calculate the IM requirements for both counterparties (e.g. the one that uses the internal model).

- Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.**
- Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?**
- Q26. Do you see other options for treating such differences?**

### **Segregation and Re-use**

43. For IM to be effective, it should be held on a segregated basis, away from the receiving party’s own assets and should not be reused. Without segregation, IM posted two-ways is off-setting and the protection is nullified.
44. Regarding the IM the ESAs are therefore of the opinion that collateral received has to be segregated, at least in the case of an exchange of collateral (i.e. where both counterparties provide collateral). For transactions where only one counterparty posts collateral, the collateral only has to be segregated if the posting counterparty requests such segregation.



45. In case of a segregation of the collateral the ESAs are currently of the view that a re-use of the collateral should not be permitted.

**Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?**

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

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

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

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

#### **IV.5 Eligible collateral**

46. The ESAs are required to define the level of collateral which should be specified depending on the type of collateral exchanged to satisfy IM or VM requirements. It should be ensured that the scope of eligible collateral is not too broad, so that it provides sufficient protection to limit/remove any counterparty credit risk in all plausible stress market conditions, and so that it avoids setting incentives to circumvent central clearing. On the other hand possible liquidity constraints on counterparties posting margin need to be considered. Taking these considerations into account the following options are considered:

##### Option 1

47. The collateral requirements could be linked to ESMA's criteria-based collateral requirements as defined in Part III.II, Collateral requirements (Article 43), paragraphs 118-120 of the ESMA Discussion Paper and hence restricting it to the same types of collateral that are also eligible for the central clearing.

##### Option 2:

48. A prescribed list of eligible collateral could be provided, e.g. by referring to the list of financial collateral eligible under the CRR. PRFCs could deviate from this list by applying the eligible collateral requirements recognised by the specific regulation they are subject to (e.g. Solvency II).

49. Any extension of the scope of eligible collateral beyond that described under Option 2 may result in the inclusion of collateral of insufficient credit quality and liquidity and might have a negative effect in terms of setting incentives for central clearing.

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

**Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so, which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?**

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

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

#### **IV.6 Collateral valuation / Haircuts**

50. In order to ensure that the exchanged collateral cover the respective risks appropriately over time, the collateral needs to be re-valued regularly. It is the ESAs' view that this valuation of collateral should be done daily. However there may be conditions under which the valuation could be made less frequently.

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

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

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

51. In order to ensure collateral provides sufficient protection, appropriate haircuts must be set to protect against changes in the valuation of the collateral (including, where relevant, in order to protect against foreign exchange risks). For the determination of the respective haircuts the ESAs are currently considering two options:

- All counterparties have to use standardised haircuts.
- Those counterparties that meet certain minimum requirements will be allowed to use their own estimation of haircuts.

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

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

#### **IV.7 Transactions with counterparties outside the EU**

52. Although the mandate for draft RTS analysed in this discussion paper does not leave room for outlining a third country regime to the exchange of collateral, it is essential that transactions between EU counterparties and non-EU counterparties are also subject to margin requirements that adequately protect against counterparty credit and systemic risk. It is also important to ensure that collateral posted outside the EU is adequately protected. This would either be done by the European Commission while monitoring the effective implementation by third countries of the provision of the Regulation (Article 9a) or through RTS to be drafted by ESMA, aiming

at determining the contracts that have a direct, substantial and foreseeable effect in the EU or preventing the evasion of any provision in the Regulation.

#### **IV.8 Risk management procedures, operational process for the exchange of collateral and minimum transfer amount**

53. Pursuant to the Regulation, the ESAs shall develop, draft technical standard specifying the risk management procedures for the exchange of collateral and in particular the operational process relating to the exchange of collateral.
54. The exchange of collateral is a key risk mitigation technique for non-centrally cleared OTC derivative. The operational process for the exchange of collateral should therefore be robust. The ESAs are of the opinion that counterparties should have appropriate documentation and processes including systems and controls in place.
55. Also, the ESAs are considering setting a cap to the minimum transfer amount below which no collateral needs to be transferred. The minimum transfer amount aims at avoiding the transfer of limited amount of collateral in order to avoid heavy back office work and limit operational costs. The ESAs believe that the minimum transfer amount should be left to the agreement of the counterparties, but that such minimum should not exceed a cap to be determined in the draft RTS. The reason for this is that the objective of the minimum transfer amount is to reduce operational costs. The cap on the minimum transfer amount would, therefore, aim at ensuring that the minimum transfer amount is set at an appropriate level and does not circumvent the requirement to transfer collateral.

- Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?**
- Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?**
- Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?**
- Q44. How would setting a cap impact markets, transactions and business models?**

#### **IV.9 Intra-group exemptions**

56. For the application of the intra-group exemption to the exchange of collateral, the ESAs shall develop draft technical standards specifying the procedure competent authorities should follow to apply an intra-group exemption. In particular, it should be considered what constitute a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.
57. ESAs have initiated preliminary work with the competent authorities to develop this technical standard including a possible co-ordinating role of ESMA.

**Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?**

**Q46. What is the current practice regarding the collateralisation of intra-group derivative transactions?**

#### **IV.10 Cost-benefit analysis**

58. A cost-benefit analysis is an essential part of the process of developing RTS. Respondents to this discussion paper are kindly invited to provide, together with their responses, quantitative evidence to support their views. Please provide data for the purpose of the ESAs' cost and benefit analysis of proposed rules and currently used methods.

**Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?**

## **Annex - Summary of Questions for the Consultation**

- Q1. What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?**
- Q2. What are your views regarding option 1 (general initial margin requirement)?**
- Q3. Could PRFCs adequately protect against default without collecting initial margins?**
- Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.**
- Q5. What are your views regarding option 2?**
- Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?**
- Q7. What is the current practice in this respect, e.g.**
- If a threshold is currently in place, for which contracts and counterparties, is it used?
  - Which criteria are currently the bases for the calculation of the threshold?
- Q8. For which types of counterparties should a threshold be applicable?**
- Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?**
- Q10. How – in your opinion - would a threshold change transactions and business models?**
- Q11. Are there any further options that the ESAs should consider?**
- Q12. Are there any particular areas where regulatory arbitrage is of concern?**
- Q13. What impacts on markets, transactions and business models do you expect from the proposals?**
- Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?**
- Q15. What would be the cost implications of a daily exchange of collateral?**
- Q16. Do you think that the “Mark-to-market method” and/or the “Standardised Method” as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?**
- Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?**
- Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?**
- Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?**
- Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?**
- Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial**

margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?

- Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?
- Q23. To what extent would the 'mark-to-market method' or the 'standardised method' change market practices?
- Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.
- Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?
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- Q30. What are current practices regarding the re-use of received collateral?
- Q31. What will be the impact if re-use of collateral was no longer possible?
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- Q36. What is the current practice regarding the frequency of collateral valuation?
- Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?
- Q38. What are the cost implications of a more frequent valuation of collateral?
- Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?
- Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?
- Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?
- Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?
- Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?
- Q44. How would setting a cap impact markets, transactions and business models?

- Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?**
- Q46. What is the current practice regarding the collateralisation of intragroup derivative transactions?**
- Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?**