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Dear Mrs. Fabregas,

Variation Margin (VM) Timing Requirements for Counterparties Outside The Scope of Initial Margin (IM) - RTS on risk mitigation techniques for OTC derivatives not cleared by a central counterparty

We are writing to you to express the concerns we continue to hold regarding the requirement in the European Supervisory Authorities (ESAs) final draft *RTS on risk mitigation techniques for OTC derivatives not cleared by a central counterparty* for counterparties outside the scope of IM to call or collect VM within a business day of the Variation Margin call calculation date.

We ask the European Commission (EC) to consider asking the ESAs to propose a more practically achievable and proportionate timeframe within which such counterparties can settle VM. Banks, asset managers, pension funds and other market participants are concerned that this requirement will mean that it will no longer be feasible or sustainable for buyside firms to use OTC derivatives to hedge risks on behalf of their ultimate clients. This would be to the wider detriment of the investment climate in the EU.

Executive Summary

In this letter, we outline our concern about the requirement for firms outside the scope of IM to settle VM within a business day of the calculation of the VM call in the ESAs' final draft RTS on risk mitigation techniques for uncleared derivatives.

We believe that this requirement will severely limit the ability of investors (including asset managers and pension funds) to hedge risks, to the detriment of their end clients and the wider EU economy.

This requirement – intended to implement a G20 commitment regarding risk management of uncleared derivatives - will also further fragment a previously global market (as counterparties – especially in Asia - will seek to avoid dealings with EU firms), an outcome G20 leaders had wished to avoid.

We highlight that:

- A supposed concession whereby counterparties could get up to 2 business days post calculation date to settle VM is too expensive and onerous (requiring pre-funding of an already significantly higher IM-based VM calculation) to be of any practical use.

- Buyside firms are either prevented from being able to comply with this requirement (for example by settling VM in cash) by other regulation applying to them either at national (e.g. UK rules on defined benefit pension schemes) or EU level (EMIR, UCITS, AIFMD, ESMA Guidelines on ETFs) or face a damaging impact on returns associated with securities having to be on hand to use as VM rather than for purpose of investment for savers. As EFAMA and Pensions Europe have pointed out, the EU post-trade landscape for funds cannot otherwise facilitate VM settlement within a day.
- It is disproportionate to apply this impractical requirement to counterparties that represent limited systemic risk. Industry data shows that the margin calls and exposure associated with these counterparties is small, yet the requirement imposed on them calls into question their participation in hedging via non-cleared derivatives.
- This requirement is likely to increase risk in the system or at counterparty level. The solutions required to try to meet the deadline would result in higher counterparty risk (associated with unsecured pre-funding of collateral) and operational risk (given the pressure placed on firms' operational processes by this deadline). If firms find they cannot continue to use uncleared derivatives, important risks (e.g. longevity risk, for pension funds) will go un-hedged.
- The BCBS-IOSCO Working Group on Margin Requirements did not propose a same day VM settlement requirement for buyside firms.
- Market participants have called into question the ability of buyside firms to meet a similar requirement under US rules. Irrespective, the EU post-trade landscape is more complex and fragmented than that in the US, as recognized on many occasions by the EC. While one day it may be integrated enough to facilitate T+1 VM settlement, enabling a reasonably high degree of compliance (albeit subject to significantly higher cost), it will not be sufficiently developed by 1 March 2017 (from when VM requirements will apply to these firms) to do so. Even if a significant portion of US market participants will struggle to comply with a T+1 requirement, US regulators have more flexible means of responding (e.g. via no action letters and supervisory guidance) to such challenges than are afforded NCAs and ESAs under EU rules.
- Lastly, we point out that jurisdictions such as Australia, Canada, Hong Kong, Japan, Singapore and Switzerland chose not to apply such a stringent deadline for VM settlement to such counterparties.

1. The VM call and collection requirement

Under the draft RTS, VM must be collected within one business day of the calculation of value of the portfolio between the two counterparties. Where the counterparties concerned are in different time zones, the calculation will refer to the netted derivatives portfolio as entered into before 16h of the previous business day in the easternmost time zone (this is of very limited benefit[1]).

[1] For every daily valuation, firms need sufficient time after the official valuation processes and close of books in the last time zone of the global day (i.e. New York) to complete official pricing and risk calculations. The supposed concession provided would be of limited benefit for a globally active firm whose VM calculation with many of their counterparties (in different jurisdictions) will be provided too late for those counterparties to be practically able to settle VM within the required deadline.

In certain scenarios, settlement of collateral within 2 business days of calculation date is permitted (Article 13(3)). However the conditions associated with this concession are too narrow and onerous to be met in practice. As a result, market participants will be faced with a T+1 deadline.

2. **Buyside firms – including asset managers and pension funds – will not generally be able to comply with a T+1 settlement deadline for VM**

We understand that the ESAs may believe that the market participants concerned by this requirement will have cash or securities on hand that they can use as VM within this timeframe.

This is not the case for a range of reasons, including, for example

For cash:

- the investment drag associated with holding cash in a low interest rate environment

- rules in some jurisdictions (such as the UK, e.g. for defined benefits pensions schemes) limiting access to credit lines which might otherwise facilitate fast posting of cash VM;

- other demands for cash, faced by highly regulated funds, under the EMIR Regulation (cash VM requirements under the clearing obligation) and UCITS/AIFMD (a demand for cash to cover redemption of fund units).

For securities:

- the need (particularly in buyside firms) to use securities for investment purposes in the ultimate interest of savers.

Such market participants would – absent the T+1 requirement – source such collateral via the repo market and other market infrastructure. This route would not necessarily allow them to meet this deadline, however. As EFAMA and Pensions Europe summarised it, *the requirement 'seems infeasible, given the various intermediaries and service providers that have to interact in the collateral fund chain (e.g. custodian, external collateral manager, (external) portfolio manager, counterparties, valuation service provider)*' and the requirement conflicts with the ESMA Guidelines on ETFs and other UCITS issues[2] *'which have the effect of restricting recourse to repo services for the purpose of posting collateral on derivatives transactions'*.

Even if such counterparties could use repo services without such strictures, however, it is not clear that the repo market could help them to achieve T+1 exchange, given that the efficiency of the repo market itself is in any case linked with securities settlement cycles, which for the most part operate on a T+2 basis.

3. **The risk associated with these counterparties does not justify this requirement**

Data collected from ISDA firms, shared with the ESAs, shows that counterparties concerned by the T+1 VM timeframe pose a much lower level of counterparty risk than warranted by such a requirement.

[2] Guidelines on ETFs and other UCITS issues (2014/937)

Six ISDA member firms recently assessed the size of their average margin call in a) relationships with other Phase 1 firms (large firms subject to IM and VM as of September 2016) and b) Non-Phase 1 firms (who would be subject to VM as of 1 March 2017) finding that the average call size with Phase 1 firms was US $23m, over eight times the average VM call size with non-Phase 1 firms ($2.81 m).

To further illustrate the lower risk associated with these counterparties, in January 2015 six global dealers assessed their books regarding mark to market positions (for positive and negative directional portfolios) and exposure associated with a total number of 84,692 portfolios held with clients.

This data showed the number of portfolios that falls into buckets representing MTM (Mark To Market Value) and exposure (MTM minus value of collateral) ranging from the largest (over $100 million) to the smallest ($0-5 million) levels. Numbers of portfolios were also broken down according to counterparty classification (FC, NFC+, NFC- and not classified), and according to whether or not a CSA (Credit Standing Agreement) exists with the clients, for each bucket. Of 84,692 counterparty relationships involving the six firms, 73,978 (87.349%) were in the smallest ($0-5m) bucket for MTM and 77,282 (91.251%) were in the smallest bucket for exposure. We attach the file including this data in attachment with this letter.

This illustrates that the large majority of users of uncleared derivatives represent little risk. However it is these less systemically important counterparties that face mandatory T+1 for VM settlement.

4. The settlement timing rules will result in an increase in risk

One theoretical way around this would– as ESAs officials have suggested – be for end users to pre-fund VM with their dealer counterparty (either to meet a T+1 requirement, or to benefit from the concession in Article 13(3). As a technical point, we don't feel that pre-funding would ever be successfully achieved (if its purpose was to address the counterparty risk that VM is intended to cover)).[3]

Even if pre-funding could achieve this aim, it would itself imply significant new counterparty risk for these counterparties, and for the financial system. Pre-funded VM would be exchanged using title transfer. Such VM would almost always be exchanged in excess of any eventual margin call, and this excess VM would represent an unsecured credit exposure for the collateral payer.

The VM requirements would also result in a buildup of other risks e.g.

- Operational risk – the compressed timetable for call and collection will put pressure on the efficiency and accuracy of calculation processes.
- Longevity risk – if pension and investment funds cannot hedge.

[3] ISDA would be happy to provide more detail on this point.

Another theoretical alternative – suggested by the ESAs to ISDA and its members – would be for end users to avail of tri-party custodians in meeting this requirement. We address the challenges associated with this possibility in more detail in the following section.

5. International convergence

a) The BCBS-IOSCO Working Group on Margin Requirements conclusions did not require T+1 for VM

The final report of the WGMR does not require VM to be settled T+1. Rather, it says that 'covered entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin (i.e. a zero threshold) on a regular basis (e.g. daily)'.

b) The US approach

Both the US Prudential Regulator and CFTC have opted for a T+1 approach to VM. We make the following comments in this regard:

- ***Market participants have raised concern with the US regulators regarding the difficulties and uncertainty of complying with a T+1 VM requirement***

Apart from ISDA, other commenters that expressed this view to the CFTC e.g. the Japanese Financial Markets Council and the Global Pension Coalition (GPC). As the GPC said in their submission '*longer time periods to post margin could mitigate significant operational disruptions, errors, and costs as a result of industry-wide operational limitations*.'

Security dealers and end-users have opined to the US regulators that the key impediments to T+1 delivery of margin in the US are (i) the complicated processes and communications between the end-user and the ultimate custodian who processes the instruction and (ii) the loss of economic return for investors associated with (pre-) funding T+1 margin exchange.

- ***The US post-trade landscape may be conducive to a higher potential for compliance than is feasible in Europe***

The US has a more harmonized and rapid security delivery infrastructure than that in Europe, as securities are transferred on the books and records of two Central Securities Depositories (CSDs): DTCC (corporate bonds and equities) and the Fed (US Treasuries).

Unlike the US settlement system there are numerous CSDs and ICSDs in Europe. To settle collateral at these locations, firms either have direct access to each CSD/ICSD (usually on the largest market participants have direct access) or via sub custodians.

This greater fragmentation has been recognized by the European Commission itself, both in its 2012 Impact Assessment in relation to proposal for the Central Securities Depository Regulation (CSDR)[4] and in the FAQ published by the European Commission after agreement on the CSDR had been reached in April 2014: '*There are over 30 CSDs in the EU, generally*

[4] See http://europa.eu/rapid/press-release_MEMO-14-312_en.htm?locale=en

one in each country, and two 'international' CSDs (ICSDs – Clearstream Banking Luxembourg and Euroclear Bank)….. by comparison, the US market is very concentrated, with only two CSDs, one for government securities (Fedwire Securities Service), and the other for all other securities (the Depositary Trust Company (DTC)).'[5]

For EU funds, for example, there is typically, a chain of intermediaries between the fund custodian, sub custodians and CSDs. Every link in that chain works to deadlines that take into account the deadlines faced and imposed by the next party in the chain. This process would have to be accelerated considerably to meet T+1.

UK pension funds also typically outsource the settlement of collateral to a third party. Generally the settlement of Free of Payment (FoP) collateral in the EU takes 2 days (though there are exceptions e.g. at Crest, where eligible UK Gilts settle T+1). UK Unit Trusts on the other hand currently settle T+8.

There are also domestic supervisory obstacles which would have to be surmounted in order to effect this structural change. For example, in Germany, the fund custodian *("Verwahrstelle")* is officially approved by the supervisory authority of the fund. The fund would have to obtain approval from its regulator to transfer its custom to the custodian of the counterparty (for each of its counterparties).

A further challenge to the ability to use tri-party custodians would be the need for the market to change from the widespread use of title transfer to the use of security pledge, to facilitate book entry transfer. This would be a lengthy process overall, as well as at counterparty relationship level.

In time, advances in the EU post-trade landscape may facilitate T+1 exchange of margin (even if increased costs faced by end users will be significant) for a broad range of market participants. It is difficult to see how such connectivity could be achieved by March 2017, however.

- ***The 'no action relief' tool is not available to EU regulators***

The US regulators have the scope to respond to compliance challenges which may become more evident after implementation through their supervisory role (including the issuance of no-action letters and supervisory guidance) which may allow particular types of counterparty time to develop compliance capability. However the European regulators have no such ability. Adopting this requirement and applying it to EU end users - such as UCITS/AIFS and pension funds – will at best create huge legal uncertainty, and at worst, prevent hedging and trading in general, by these market participants, with consequences for other financial markets and the EU economy at large.

c) The approach in other major jurisdictions

[5] See Section 2, paragraph 3 of the EC 'Impact Assessment a*ccompanying the document '*Proposal for a Regulation of the European Parliament and of the Council
on improving securities settlement in the European Union and on Central Securities Depositories (CSDs) and amending Directive 98/26/EC' (SWD(2012) 22 final)

In major jurisdictions other than the US and Europe, regulators have permitted or are planning to permit more flexibility for counterparties to avail of more time to exchange VM. We list some of these jurisdictions and their approaches below:

- **Australia**: In the consultation on the Australian rules, APRA states that VM should be calculated and called on a daily basis, and settlement of VM should be conducted ‘promptly’. An explanatory document accompanying the draft rules says that settlement of VM should ideally take place within a day of the margin call (rather than within a day of the trade) but that certain cases warrant more flexibility, citing timezone and cross-border considerations. The use of the word ‘promptly’ is intended to reflect this principles-based approach.

- **Canada**: In the final Guidelines, counterparties subject to IM must exchange VM no later than on the second business day following the calculation and call, while counterparties that are not subject to IM are given until the end of the third business day following the calculation and call.

- **Hong Kong**: In the HK draft rules, VM must be called within T+1 and collected within 2 business days from when VM is called.

- **Japan**: Again, a principles-based approach is taken, with calculation of MTM daily, call taking place immediately after identification of residual amount after subtracting collected margin amount from aggregated MTM, and posting and collecting ‘without delay’.

- **Singapore:** VM must be exchanged within 2 business days of execution of a new uncleared contract (whether Singapore adopts a post-and-collect or collect-only regime).

- **Switzerland:** No prescription on deadline for settlement of VM. The Swiss rules say that VM must be calculated daily.

We believe that application of a T+1 requirement for settlement of VM for counterparties outside the scope of IM will not only severely affect derivatives business, including important hedging activity by financial investors and other end users, with consequences for European market liquidity and the wider European investment climate, it will also accelerate the trend towards fragmentation of previously global markets that we have seen in recent years.

We would be very happy to discuss these issues with you at your convenience, and are at your disposal should you have any questions on any of the issues addressed in this letter.

Yours sincerely,

Scott O’Malia
CEO

For more information please contact Roger Cogan (rcogan@isda.org).