

**ISDA Comment Paper: A Prudent Approach to Collateral Requirements at CCPs**  
**(EMIR Article 43)**

**Introduction**

Article 43 of the draft regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation, or 'EMIR') sets out the collateral requirements for derivatives that are cleared through central counterparties (CCPs).

Given the extent to which counterparty risk will be concentrated in CCPs, it is vital that the rules on collateral do not undermine their robustness: CCPs have failed in the past, so it is important that collateral rules minimize risk of failure.<sup>1</sup> A CCP failure would have a significant impact on financial stability.

**Our preferred solution**

Given the importance of this issue, and its technical nature, we favour a solution whereby the European Securities and Markets Authority (ESMA) is tasked with producing technical standards on collateral at CCPs. That process should be designed to allow sufficient time for ESMA to make a decision, with full consultation of those operating and using CCPs.

**Issues for consideration**

We believe that there are a number of issues that ESMA should consider in this regard:

- **Types of collateral** that CCPs are able to accept by way of margin from those who are clearing contracts via that CCP: The Commission's proposal on EMIR states that a CCP "shall only accept highly liquid collateral with minimal credit and market risk to cover its exposure to its clearing members" (Article 43). We believe this is a good starting point. We caution against defining in Level 1 legislation the particular securities or assets that may be pledged as collateral – indeed, cash, corporate and sovereign bonds, gold and (for non-financials) commercial bank guarantees have all been named in the context of negotiations on the regulation. Attempting to hardwire all possible types of collateral into primary legislation could put commercial pressure on central counterparties to adopt a permissive approach to

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<sup>1</sup> Note that CCPs have failed in the past: One of the first, the New York Gold Exchange Bank, failed in the aftermath of the defaults by two large gold speculators in the aftermath of Black Friday in September 1869. More recently, the Caisse de Liquidation failed in 1974, the Kuala Lumpur Commodity Clearinghouse failed in 1983, and the Hong Kong Futures Exchange Clearing Corporation failed in the aftermath of the Crash of 1987).

collateral, leading to a race-to-the-bottom in collateral standards. The assessment of eligibility needs to take account several factors (see below), best addressed by ESMA.

- **Treatment of collateral:** Linked to the question of eligibility is the question of how collateral is treated. For example, some types of collateral might be appropriate if subject to a haircut on their value. Others might be appropriate as long as an excessive concentration of a particular type of collateral does not build up at a CCP, as such concentration might make it difficult for that CCP to liquidate the collateral in the case of a member default. Obviously some types of collateral are by their nature less liquid, e.g. commercial bank guarantees. It may be imprudent to permit commercial bank guarantees as eligible collateral, given the potential difficulty of liquidating such guarantees quickly in a crisis situation. Certainly, it would not seem prudent to permit commercial bank guarantees without limitation on CCPs' potential reliance on them and without direction as to haircuts to be applied therein.
- **The link between collateral and access:** Whether or not a given type of collateral is determined to be eligible may have implications for the ability of particular market participants to enjoy the benefits of central clearing. This is especially relevant in the context of smaller clients and corporate users, who might prefer particular forms of collateral as a function of availability and cost.

#### **The mandatory clearing requirement for eligible contracts makes this issue even more important**

We would also emphasise the fact that as central clearing will be mandatory for eligible contracts, even if only one CCP is clearing a specific eligible contract, this issue becomes even more systemically important. Market participants – including systemically important dealing firms – will not be able to exercise any discretion as to where/whether they clear. They may have major reservations as to the viability of a CCP's risk management systems (partly a function of their policies on acceptable collateral) but will have no choice but to clear contracts in that CCP.

In this context, it is extremely important that competent authorities' authorisation requirements, as well as ESMA eligibility deliberations and CCP authorisation (ESMA) peer review processes are robust.

#### **Conclusion**

In conclusion, the question of collateral posted with CCPs is a complex one, and requires careful technical consideration, something ESMA is well placed to provide. Rules around collateral should be designed with the overall resilience of the clearing system in mind and to ensure that those who prudently manage their risks and support a prudently managed system do not end up paying for market participants who take on risks they cannot afford.