Question 1: Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU

French Banking Federation (FBF) welcomes the ESA’s proposal concerning the treatment of non-EU non-financial counterparties (NFC) that fall below the mandatory clearing threshold. Indeed, as already highlighted in the FBF’s answer to the first consultation dated 2014, it is crucial to ensure consistency and alignment concerning the treatment of EU NFC – and non-EU entities that would be considered NFC – if they were established in the EU because both types of entities share the same risk profile.

Thanks to the exemption of these non-EU entities (notably, corporates) from the EMIR’s margin requirements for uncleared transactions, these non-EU entities will be not be refrained from trading with EU credit institutions.

However, and as previously highlighted in its answer to the first consultation dated 2014, FBF recalls that it is crucial to avoid any major disruption of competition for banks submitted to EMIR and for their clients and to ensure a level playing field between all markets participants involved in the OTC derivative market, which is global by nature. Any material divergence between the European framework and other regimes will increase market fragmentation, reduce market depth and liquidity and increase the price dispersions.

That is why FBF considers that harmonization is still needed, notably in the scope of financial instruments. Indeed, the scope of instruments covered by EMIR is wider than for instance in the US: instruments such as equity options and derivatives on equity indices are neither considered as “swaps” nor as “security based swaps” under the ‘Dodd-Frank Act’ and hence are not subject to the margin requirements set out by BCBS- IOSCO, contrary to Europe where EMIR is applicable. Consequently, EU firms may be rejected from the US market if they have to collect initial margins on these instruments while US banks do not.

Therefore, we are of the opinion that for such products – namely equity options and derivatives on equity indices – the ESAs should indicate that the collateral requirements will be applicable according to a specific timeline. We would propose 1st December 2020 as a starting date for mandatory initial margins and variation margins exchanges to give sufficient time (1) for the other major jurisdictions to impose equivalent collateral rules and (2) to be able to review the RTS if need be as permitted in Recital (40).

At last, we are still wondering what is the exact treatment of non-EU sovereigns and specifically whether they will benefit from the same exemptions than the ones for EU sovereigns. We note that the proposed Article 3 GEN seems to be flexible enough to
consider this issue but we would appreciate if the ESAs could expressly indicate what is the applicable regime in such a case.

**Question 2:** Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins

As a preliminary remark, we are wondering whether the proposed timing for collection of margins implies the complete collection of margins (call made and collateral moved) or only the fact that the collateral call should be made. In the case the proposed timing would be imposed for the complete collection of margins, we do think that it would be operationally infeasible. Even for cash, market practice is as such that calculation could be performed in T and the call could be made in T+1 which would mean that the collateral would generally move not before T+2. This timeline enables a sound management of operational risk.

FBF considers that the timing proposed for calculation and collection of initial and variation margins does not address the issues raised in the FBF’s previous answer to the first consultation paper dated 2014. It may de facto unduly restrict the type of collateral used by counterparties to the cash, the latter being in most cases the sole way for counterparties to comply with the timing imposed on counterparties. Indeed:

- Concerning initial margins, the draft RTS provide for that counterparties remain required to calculate, call and deliver them within one business day; and

- Concerning variation margins, the draft RTS provide for that the timing for collecting variation margins may be extended to three business days but subject to the fulfillment of two conditions: (i) both counterparties are subject to initial margins requirements and (ii) the increase of the "margin period of risk" shall be increased by the number of days between the calculation and the collection of margin. FBF wishes to stress that (i) the first condition is very strict as it covers only major banks, biggest insurance companies and money managers (ii) the second condition, as it extends the period of risk, will increase the amount of initial margins to be exchanged between counterparties and, consequently, may increase the cost of funding the initial margin for such counterparties.

FBF considers that the ESA’s proposals would de facto materially limit or prevent the potential use of securities, to the sole transactions entered into by and between banks, which is not justified. In addition, we think that such outcome would be inconsistent with the BCBS-IOSCO recommendations and would also place European banks in a competitive disadvantage.

Consequently, FBF reiterates its request to ensure the consistency of the timing imposed for calling and collecting initial and variation margins with the standard settlement / delivery regimes applicable to eligible collateral assets (i.e. broadly between one and three business days) with daily calculation and margin calls.

Regarding the wording used in relation to the collection of variation margins, we would like to point out that the words "settling exposures in cash" in Art. 1 VM (2)(a) should be replaced with the words "exchanging cash in amounts sufficient to extinguish exposures". The current language is not a correct general description of variation margins transfers for OTC derivatives because the transfer of cash variation margins does not necessarily settle current exposure. This change should also be reflected in Recital 11 (p.19).

**Question 3:** Respondents are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models
FBF welcomes the confirmation by the ESAs that counterparties will be entitled to use internal initial margin models.

FBF also welcomes the greater flexibility granted by the ESAs on some issues, and notably the consent by the ESAs to a follow-up validation of initial margin models on a yearly basis (unless significant changes within this time-period) and not twice a year.

However, FBF wishes to highlight the following concerns:
Classifying derivatives by assets classes rather than risk sensitivities for the purpose of calculating initial margins raises a couple of issues:

- a practical one first: assigning a trade to a single asset class can be difficult in certain cases as some trades can show a significant exposure to several asset classes. This is the case of swaps on convertible bonds for instance which generate credit, equity and rate sensitivities;

- calculating initial margins by asset class is not consistent with the way portfolio are traditionally hedged. The standard hedging practice is to aggregate exposures by risk sensitivities (across asset classes) and then cover these exposure with risk-offsetting transactions. Hence, aligning the way initial margins are calculated with hedging practices would bring the value of initial margins closer to the actual risk of the portfolio.

The consultation paper provides that the Margin Period Of Risk (MPOR) should account for the liquidity of the derivative portfolio. Calibrating the MPOR to take into account the liquidity of the portfolio can be done in 2 ways: (i) assigning each derivative of the portfolio to a pre-defined liquidity bucket, then calculating an initial margin for each individual liquidity bucket before aggregating them or (ii) set the MPOR of the whole portfolio such that it covers the risk of the most illiquid derivatives of the portfolio.

We would like to stress that both approaches are not only very complex to implement operationnally but also very punitive as they significantly overstate the risk of the portfolio, hence the amount of initial margins.

Finally, the consultation paper prevents covered entities from cross margining the derivative exposure with the collateral. As stated several times by the Industry, taking into account the correlation between the collateral and the derivative portfolio would provide a much more accurate measure of the FX risk than the proposed 8% haircut.

**Question 4:** Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

FBF understands the wish of the ESAs to exempt some market participants (the entities which are not qualified as “global systematically important institutions” (G-SIIs) or “other systematically important institutions”) from the diversification requirements on sovereign debt securities (i.e. a 50 % cap for the collateral collected in excess of 1 billion euro).

However, FBF wishes to highlight the following issues raised by the ESA’s proposals on the concentration limits:

- In its answers to the consultation paper dated 2014, FBF specified that imposing restrictions on small amounts of exchanged collateral would indeed “impose significant operational burden for many counterparties” (such as SPVs, small
financial institutions as well as funds, insurers and pension funds, which must comply with strict investment rules and therefore may not afford a sufficient diversification in the collateral offered). In other words, FBF proposed an exemption based, on the one side, on a specific threshold of collateral exchanged (consistent with the ESAs’ proposal), on the other side, on the regulatory burden imposed on some counterparties whatever their size (whereas the ESAs propose a distinction based on the size of the counterparties);

- FBF would also like to point out that there is an inconsistency in limiting the exemption to government securities and subject all other collateral type to concentration limits.

- The 1 billion euro threshold raise some specific issues:
  - The calculation modalities of the 1 billion euro threshold should be clarified: shall this threshold be calculated individually (i.e. by netting set as precised during the EBA’s public hearing) or globally (i.e. taking into account all the collateral exchanged with all the counterparties of the bank)? The second option seems more consistent with the purpose of the regulation – and would be more practicable from an operational viewpoint;
  - The calculation period of the 1 billion euro threshold should also be clarified: shall it be calculated on a daily basis (and in that case pre or post collateral acceptance ?) or over a specified time-period? The second option would be more practicable from an operational viewpoint;
  - The ESAs should also clarify the consequences of a potential evolution of the amount of the collateral exchanged with counterparties just above or just under the said 1 billion euro threshold, notably in cases where this evolution takes place within the timeframe of the threshold calculation period;

- While FBF understands the need for entities which are not qualified as G-SIIs and may not diversify their collateral offered, FBF also recalls that such proposal will require from the banks to categorize their clients into tiers (a tier 1 covering clients benefiting of the exemption mentioned / a tier 2 covering the non-exempted clients), which would impose a significant operational burden for the banks.

**Question 5: Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.**

FBF welcomes the ESAs’ proposed more general requirements covering all the aspects relating to the trading relationship documentation. Indeed, these new proposals address the FBF’s request (already stressed in its answer to the previous 2014 consultation paper) not to impose any excessive administrative and operational burden within the context of trading relationship, notably with counterparties that would not be subject to margin requirements (i.e. SMEs).

However, FBF wishes to raise an issue, linked to the requirement for a counterparty to perform an “independent” legal review of the trading documentation. We consider that this wording is rather confusing as it is not clear whether it implies an external legal review (i.e. by an external law firm) to be provided.

FBF considers that in-house legal advisors should be authorized to perform such a legal review as they are deemed “independent” from the front office and operational teams. There
are a number of applicable laws, like the French law, under which in-house lawyers do not benefit from a legal privilege.

To avoid any confusion and any discrimination among Member States, we would advise the ESAs either to remove the word “independent” or to explicitly indicate that such word implies only a hierarchical separation from the front office.

**Question 6: Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.**

The revised version of the draft RTS on segregation of initial margins clearly indicates that concerns previously raised in response to the first consultation have been taken into consideration (as the risk that cash is not eligible as collateral for initial margins). We welcome these efforts by ESAs to make segregation rules more feasible. However, there are still some provisions in the revised draft RTS that would highly impede the proper functioning of initial margins.

The first point we would like to raise is that, in accordance with the BCBS-IOSCO recommendations, it should be made clear that in addition to the third-party holder or custodian initial margins could be collected by the collecting counterparty provided that the latter complies with the requirements of Articles 1 LEC and 1 SEG. We think that the first paragraph of Article 1 SEG is not sufficiently clear in that matter and therefore could be modified as such:

“1. Collateral collected as initial margin shall be segregated from proprietary assets on the books and records of the collecting counterparty, a third party holder or custodian, or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty, third party holder or custodian.”

The second point is on cash posted as initial margin. In our view, it is crucial that rules eventually adopted by ESAs should not prohibit cash being posted as eligible collateral whereas cash is seen by BCBS-IOSCO as the most liquid and quickly and easily transferable category of asset.

The third point is about securities posted as collateral. We also note that some changes have been made on the initial version of the RTS. Our main comment is the apparent conflict of the approach retained with the use of title transfer collateral arrangements (such as the ISDA Credit Support Annex).

The last point is linked to Question 5 here above, FBF wishes to raise an issue, linked to the requirement for a counterparty to perform an “independent” legal review of the segregation arrangements. We consider that this wording is rather confusing as it is not clear whether it implies an external legal review (i.e. by an external law firm) to be provided.

FBF considers that in-house legal advisors should be authorized to perform such a legal review as they are deemed “independent” from the front office and operational teams. There are a number of applicable laws, like the French law, under which in-house lawyers do not benefit from a legal privilege. To avoid any confusion and any discrimination among Member States, we would advise the ESAs either to remove the word “independent” or to explicitly indicate that such word implies only a hierarchical separation from the front office. Consequently, FBF considers that it would be advisable either to delete the word “independent” or to specify that this provision refers both to external law firms and to in-house legal advisors.
**Question 7:** Does this approach address the concerns on the use of cash for initial margin?

FBF welcomes the ESAs' proposal to authorize the re-investment of cash for initial margins. This new proposal addresses the FBF's request (already stressed in its answer to the 2014 consultation paper) not to ban completely the re-use of collateral as it would have been contradictory with BCBS / IOSCO guidelines.

Besides, the authorization to re-invest the cash is consistent with the fact that cash is already authorized as eligible collateral for initial margins. Conversely, prohibiting the re-investment of cash on the basis of a segregation requirement, if any, would have resulted in a de-facto ban of cash as eligible collateral, as acknowledged by the ESAs.

However, FBF considers that the ESAs' proposal is too restrictive. Indeed, the cash must be reinvested "only for the purpose of protecting the collateral poster" in case of default of the collateral beneficiary. For such purpose, ESAs specify that the cash must be reinvested in securities and that the latter have to be segregated and not re-used. We understand that the amended version is mainly designed to transform cash posted as collateral in other eligible collateral to circumvent the inapplicability of segregation rules on cash.

Nevertheless, we favor the maintaining of this possibility for cash reinvestment as it will provide counterparties with additional flexibility on the cash collateral.

**Question 8:** Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.

FBF understands that the treatment on the FX mismatch (a 8% haircut to the market value of the assets posted as collateral) remains unchanged, which in our opinion is not positive (see the FBF's answer to the previous 2014 consultation paper).

FBF acknowledges positive developments in relation to the 8% haircut:

- Cash variation margins and initial margins are exempted from the 8% haircut;

- The reference currencies to be used for non cash collateral are respectively the transfer currency for variation margins and the termination currency for initial margins ;

- The transfer currency and termination currency are bilaterally defined by the 2 contracting parties and included in the legal documentation.

**Additional remarks:**

**1- Assessment of the effectiveness of the segregation agreements**

According to Recital (8), European counterparties should identify “alternative processes to post collateral” when their counterparties are located in jurisdictions in which it is not possible to guarantee “the effectiveness of the segregation agreements”. Relying on third-party banks or custodians will not have any positive effect if the insolvency law of the third-country counterparty does not recognize the effect of such segregation. This is why for instance the impact of any collateral that might be posted in this circumstance would not be taken into account when computing the CVA risk charge.
Therefore, FBF considers that such requirement could increase the systemic risk in the transactions with counterparties located in jurisdictions where the close-out netting is not enforceable and would recommend to remove the obligation to post collateral in the context of transactions entered into with counterparties domiciled in jurisdictions in which it is not possible to guarantee the effectiveness of the segregation agreements.

We would suggest that the ESAs maintained a list of these jurisdictions and that banks be in a position to explain at the simple request of its supervisors why there is no “alternative process to post collateral”.

2- Intragroup exemption (pages 51 and 52)

There are additional criteria on the condition referred to in Article 11.6 of EMIR under which the intragroup exemption is granted provided that “there is no practical or legal impediment to the transfer of own funds or repayment of liabilities between the counterparties”. It is not clear at all how competent authorities will apply them and in fine will grant such exemption.

3- The provisions concerning the covered bonds (pages 30 and 31)

FBF welcomes the ESAs’ proposed treatment of derivatives associated to covered bonds for hedging purposes. Indeed, the proposed wording of Article 8.2 (b) ensures the exemption from margin requirements (i) where the counterparty to the OTC derivative contract ranks at least pari-passu with the covered bond holders and also (which was a FBF’s request) (ii) where such counterparty does not rank pari-passu with said covered bond holders because it is either the “defaulting” party or the “affected” party.

This FBF’s request was linked to the “flip clause”, applicable for both SFH and SCF covered bonds programs. Our purpose was to mirror the clause included in the covered bonds documentation and which refers to the cases where the derivatives counterparty is the “defaulting” or the “affected party”. This clause triggers the loss of the senior rank of the derivatives counterparty in the payment priority order of the privileged creditors.

FBF wishes to obtain confirmation that such notions are compliant with and are covered by all the provisions / definitions under the master documentation provided for by ISDA and other professional banking associations. Such confirmation would ensure the efficiency of the provisions proposed by the ESAs. This confirmation may be brought by a specification included either in the EMIR level 2 provisions or (if considered as more practicable) within a Questions & Answers document.