ISDA Safe, Efficient Markets

afme/ Finance for Europe

05/11/15

ISDA/AFME response to the EBA Draft RTS on procedures for excluding transactions with non-financial counterparties (NFCs) established in a third country from the own funds requirement for CVA risk

INTRODUCTORY REMARKS

The International Swaps and Derivatives Association ("**ISDA**") and Association for Financial Markets in Europe ("**AFME**") welcomes the opportunity to respond to the consultation paper on the Draft regulatory technical standards ("**RTS**") on procedures for excluding transactions with non-financial counterparties ("**NFCs**") established in a third country from the own funds requirement for credit valuation adjustment ("**CVA**") risk under Article 382(5) of Regulation No 575/2013 (Capital Requirements Regulation ("**CRR**")).

We have summarised the key points raised in our response below. However, we would like to note in particular the following:

1. We believe it is correct to interpret Article 382 so that transactions with NFC-s will not attract a CVA charge for the life of the contract (even if such NFC- transitions to a NFC+), and that only contracts traded with a NFC+ that are not subject to the clearing obligation will attract a CVA charge. We also agree with the interpretation that should a NFC+ transition to a NFC-, all non-cleared transactions with such counterparty will no longer be subject to the CVA charge.

2. We believe that the process for both ensuring and documenting the status of third-country NFCs should also follow the same rules and practices as established under EMIR (as well as ESMA Q&As). Therefore, the RTS should allow the same flexibility for determining the status of an NFC as is the practice under EMIR.

3. As is the practice under EMIR, once a firm has reasonably determined the status of a NFC, based on publicly available information and any other information submitted by counterparties, it should be able to trade with the NFC assuming the given status for all future trades unless (i) it obtains information that clearly demonstrates the current status is incorrect or prevents it from clearly assessing the status of the NFC, and/or (ii) it receives information from the NFC informing it of a change in status. This approach places the onus on the bank to reasonably determine (and document) its classification and leaves it up to the bank as to the timing of renewal of due diligence for each NFC.

4. For the purposes of determining whether the CVA charge should or should not apply to trades between third-country subsidiaries and affiliates, that such third-country subsidiaries and affiliates of European firms should only be required to determine the status of third-country NFCs should the contract be deemed to have direct, substantial and foreseeable effect on the EU. In all other cases, we believe that such entities should be able to treat third-country NFCs as NFC-s for the purposes of the CVA charge, unless such entities are in possession of information, which clearly demonstrates that such NFC would be an NFC+. Failure to allow for this would create an unnecessary burden and additional legal and operational costs for third-country NFCs, which have never before been required to either perform the calculation under Article 10(3) or make representations to their dealer counterparties

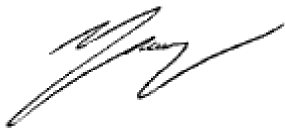
ISDA® Safe, Efficient Markets

afme/ Finance for Europe

05/11/15

Please do not hesitate to contact us if you have questions or wish to discuss these comments further.

Yours sincerely,



Matt Cameron
Assistant Director, European Public Policy
ISDA

Dee Ray
Director, Prudential Regulation
AFME

QUESTION 1: WHAT ARE STAKEHOLDERS' VIEWS ON THE PROPOSED INTERPRETATION?

With regards to the scope of application of CRR Article 382(4), ISDA/AFME agree with the EBA's interpretation, in that the intention of the EMIR cross reference was to align with EMIR as far as the definition of referred to counterparties is concerned. Therefore, we agree with the statement that in the context of Article 382(4)(a), transactions of an institution with a NFC are excluded when the NFC is a NFC- according to EMIR or would qualify as NFC- if it were established in the EU.

Furthermore, we agree with the EBA's interpretation, as detailed in Recital 3 of the RTS, of the last sub-paragraph of Article 382(4). The last sub-paragraph of the aforementioned Article states:

> In regard to point (a), where an institution ceases to be exempt through crossing the exemption threshold or due to a change in the exemption threshold, outstanding contracts shall remain exempt until the date of their maturity.

Where (4)(a) states:

> The following transactions shall be excluded from the own funds requirements for CVA risk:
>
> (a) transactions with non-financial counterparties as defined in point (9) of Article 2 of Regulation (EU) No 648/2012, or with non-financial counterparties established in a third country, where those transactions do not exceed the clearing threshold as specified in Article 10(3) and (4) of that Regulation;

Therefore, we believe it is correct to interpret Article 382 so that transactions with NFC-s will not attract a CVA charge for the life of the contract (even if such NFC- transitions to a NFC+), and that only contracts traded with a NFC+ that are not subject to the clearing obligation will attract a CVA charge. We also agree with the interpretation that should a NFC+ transition to a NFC-, all non-cleared transactions with such counterparty will no longer be subject to the CVA charge.

We note, however, that in the EBA's report on CVA under Article 456(2) of Regulation (EU) No 575/2013 (Capital Requirements Regulation — CRR), which was published on February 25, 2015, the EBA states on page 33 that:

> "CRR article 382(4)(a) exempts from the calculation of the CVA risk charge those 'non-hedging' derivative contracts of EU non-financial counterparties which fall below the clearing threshold. All the existing 'hedging' derivative contracts are also implicitly exempted since they are not included in the calculation of the total notional positions, which the thresholds are compared to.
>
> In line with the usual terminology, non-financial counterparties exceeding the clearing threshold are referred to as 'NFC+' and non-financial counterparties below the clearing threshold as 'NFC-'. In short, all the OTC derivative transactions with NFC- are exempted from the calculation of the CVA charge, whereas only a portion of OTC derivative transactions with NFC+ are included in the scope."

We believe this paragraph could be interpreted so as to imply that all hedging transactions would be exempt from the CVA charge regardless if transacted by an NFC- or NFC+. We would appreciate clarification of the intended meaning of the above paragraphs.

QUESTION 2: WHAT ARE STAKEHOLDERS' VIEWS ON THE BURDEN THIS MIGHT CREATE FOR NFCS ESTABLISHED IN A THIRD COUNTRY? WHAT COULD BE A CREDIBLE ALTERNATIVE TREATMENT?

The explanatory text for Article 2 of the RTS states:

> The reference to 'the clearing threshold as specified in Article 10(3) and (4)' of EMIR in Article 382(4)(a) of the CRR implies that the computation of the threshold for NFCs established in a third country should follow the same rules as for NFCs established in the EU (in particular, Regulation (EU) No 648/2012 ("**EMIR**") provisions, relevant delegated legislation, as well as ESMA Q&As).

We agree with such statement, but also believe that the process for both ensuring and documenting the status of third-country NFCs should also follow the same rules and practices as established under EMIR (as well as ESMA Q&As). Therefore, we believe that the RTS should allow the same flexibility for determining the status of an NFC as is the practice under EMIR.

Article 2 of the RTS implies that an EU firm can only rely on Article 382(4)(a) where the NFC has actually carried out the calculation detailed in Article 10(3) and (4) of EMIR. However, Article 382(4)(a) merely refers to the "clearing threshold as specified in Article 10(3) and (4) of EMIR". We interpret this to refer to the clearing threshold as calculated in accordance with the methodology specified in Article 10(3) and (4), including the requirement that the calculation is carried out at group level and excluding hedging transactions.

For example, many banks enter into swaps with small EU businesses where the bank is the sole financier and the total business size is such that it is inconceivable that the counterparty would exceed the threshold. In these circumstances, banks would not expect their counterparties to carry out the calculation themselves or even necessarily provide any representations. The bank would rely on its KYC knowledge of the counterparty to reach the conclusion that the counterparty is a NFC- for both EMIR and CVA purposes. If this is permitted in the context of EU counterparties, it should also be the same in relation to non-EU counterparties.

In addition, there are circumstances where NFCs solely transact OTC derivative transactions for hedging purposes, for example, NFCs based in jurisdictions where it is forbidden for NFCs to transact OTC derivatives for any other purpose than hedging. In such jurisdictions, and where NFCs communicate to their dealer counterparts that they solely transact OTC derivatives for hedging purposes, a bank would reach the conclusion that the counterparty is an NFC- for both EMIR and CVA purposes.

Therefore, we believe Article 2 of the RTS should be amended as follows:

> Article 2: Qualification as a non-financial counterparty that does not exceed the clearing threshold
> For the purposes of Article 382(4)(1) of Regulation (EU) No 575/2013, institutions shall assess, based on the publicly available information and any other information submitted by counterparties, whether a third country entity identified under Article 1 would, if it were established in the Union, qualify as an NFC whose positions in OTC derivative contracts do not exceed the clearing threshold as specified under Article 10(3) and (4) of Regulation (EU) No 648/2012. The institution shall keep a record of its determination.

Furthermore, as is the practice under EMIR, once a firm has reasonably determined the status of a NFC, based on publicly available information and any other information submitted by counterparties, it should be able to trade with the NFC assuming the given status for all future trades unless (i) it obtains information that clearly demonstrates the current status is incorrect or prevents it from clearly assessing the status of the NFC, and/or (ii) it receives information from the NFC informing it of a change in status. This approach places the onus on the bank to reasonably determine (and document) its classification and leaves it up to the bank as to the frequency of renewal of due diligence.

Furthermore, because there are already adopted practices (as per amended Article 2 above) under EMIR for documenting the status of NFC counterparties (both established in Europe and in third countries) in order to comply with EMIR requirements, <u>we also believe that firms should be able to rely on those same determinations for the purposes of determining whether the CVA charge should or should not apply to trades.</u> Establishing a separate mechanism for the determination of NFC status under the current RTS would lead to a bifurcated regime, will increase operational burdens and complexity for both NFCs (who will potentially be required to make multiple representations based on different calculation metrics) and FCs who will be required to potentially obtain different sets of representations for EMIR and the current RTS.

Currently, European firms establish, for the purposes of complying with higher standards of risk mitigation techniques and additional risk mitigation techniques set out in Article 11 of EMIR and in Chapter VII of the European Commission ("**EC**") Delegated Regulation (EU) No 149/2013 of 19 December 2012, whether third-country NFCs are NFC-s or NFC+s. The classification of counterparties determines whether or not (i) certain risk mitigation techniques required by EMIR and set out further in the regulatory technical standards published by the EC and (ii) in future, the clearing obligation, apply.

Additionally, we also believe, as is the case under EMIR, that when a firm receives a representation from a NFC, such firms should be able to rely on the representation (as per ESMA's EMIR Q&A Questions 4 and 13) unless it is in possession information to the contrary. OTC Question 13 of ESMA's EMIR Q&A states:

> In line with OTC Q&A no. 4, EU counterparties might obtain representations from their third country counterparties detailing the NFC's status. The EU counterparty is not expected to conduct verifications of the representations received from the third country entity detailing their status and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect.

Third-country affiliates of European firms trading with third-country NFCs

It is important to note that under EMIR, subsidiaries and affiliates of European-based firms would not be subject to EMIR requirements when trading with third-country entities, provided that such contract is deemed not to have a direct, substantial and foreseeable effect on the EU. Such subsidiaries and affiliates, therefore, have not sought to determine the status of their counterparties.

Therefore, we believe, similarly, for the purposes of determining whether the CVA charge should or should not apply to trades, that such third-country subsidiaries and affiliates of European firms should only be required to determine the status of third-country NFCs should the contract be deemed to have direct, substantial and foreseeable effect on the EU.

In all other cases, we believe that such entities should be able to treat third-country NFCs as NFC-s for the purposes of the CVA charge, unless such entities are in possession of information, which

clearly demonstrates that such NFC would be an NFC+. Failure to allow for this would create an unnecessary burden and additional legal and operational costs for third-country NFCs, which have never before been required to either perform the calculation under Article 10(3) or make representations to their dealer counterparties.

To achieve such an effect we believe Article 2 (as amended above) should also include the following paragraph:

> By way of derogation from paragraph 1, an institution may apply, for the purposes of compliance with the obligations laid down in Title VI of Part 4 of Regulation (EU) No. 575/2013 on a consolidated basis, the exclusion in Article 382(4)(a) of that Regulation in relation to transactions between an undertaking included in the consolidation which is established in a third country and a third country entity identified under Article 1 unless the institution has information which demonstrates that the third country entity would not, if it were established in the Union, qualify as an NFC whose positions in OTC derivative contracts do not exceed the clearing threshold as specified under Article 10(3) and (4) of Regulation (EU) No 648/2012. This derogation shall not apply if the transaction has a direct, substantial and foreseeable effect within the Union or where the application of obligations in Regulation (EU) No 648/2012 is necessary or appropriate to prevent the evasion of any provision of that Regulation (as specified under Articles 4(1)(a)(v) and 11(12) of that Regulation).

Alternatively, third-country subsidiaries and affiliates of EU firms could be required only to determine the status of third-country NFCs above a certain threshold (potentially based on the publicly available financial statements of such NFCs, for example total assets or turnover). The measure would be designed to serve as a proxy for OTC derivatives exposure and allow firms to treat NFCs below the 'threshold' as NFC-s, but require firms to determine the status of NFCs above the said threshold.

QUESTION 3: WHAT ARE STAKEHOLDERS' VIEWS ON THE RELEVANCE OF THE INCLUSION OF A SPECIFIC FREQUENCY? WHAT IS STAKEHOLDERS' PREFERRED OPTION?

As discussed in our response to Question 2 above, we do not consider that it is appropriate to require firms to repeat their due diligence on counterparties at a specified frequency.