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To:

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Response to draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 ("EMIR")

1. Introduction

1.1 The Association for Financial Markets in Europe ("AFME")¹ welcomes this opportunity to respond to the Consultation Paper on the draft regulatory technical standards (the "**Draft RTS**") on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Art. 11(15) of EMIR published by the European Securities and Markets Authority ("**ESMA**"), the European Banking Authority ("**EBA**") and the European Insurance and the Occupational Pensions Authority ("**EIOPA**"), and together with ESMA and EBA, the European Supervisory Authorities, the "**ESAs**") on 14 April 2014.

1.2 This letter focuses on those elements of the Draft RTS which are of most direct relevance for prime brokerage businesses and swaps entered into in connection with securitisation transactions ("**Securitisation Swaps**"). In relation to Securitisation Swaps, and in light of the special treatment for Securitisation Swaps which is proposed in Sections 8 and 9, this letter does not discuss in detail many of

¹ AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the US Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

the more technical and operational elements of the Draft RTS such as the requirements for initial margin models, what constitutes eligible collateral and the detail surrounding documentation requirements. In this regard, AFME notes that a number of other industry bodies, including the International Swaps and Derivatives Association, Inc., the European Banking Federation and the Regulated Covered Bond Council have also submitted responses to the Draft RTS, some of which discuss these other matters in more detail.

1.3 Central banks and policy makers are calling for a revival of Europe's securitisation market. The European Commission's March 2014 Communication on Long-Term Financing of the European Economy explicitly noted the ability of securitisation to "unlock capital resources, increasing the ability of banks to expand their lending and finance economic growth." The regulatory treatment of securitisation in Europe is complex and under review.

1.4 However, while there have been significant positive changes in other areas of regulation affecting securitisation, representatives of key sectors of the economy – including the car industry, small- and medium-sized enterprises (“**SMEs**”) and mortgage lenders – remain concerned that new regulations will reduce their access to capital and raise the cost of financing.

1.5 The Draft RTS risks having precisely such a negative effect as a result of its significant implications for Securitisation Swaps.

1.6 The Draft RTS also has significant implications for the business model and activities of prime brokers, in relation to the provision of both variation and initial margin. AFME and its members are concerned that the provisions of the Draft RTS were developed without enough consideration for the workings of and the impact to prime brokerage business.

1.7 In light of these significant implications, AFME and its members wish to make the following comments and proposals in connection with the Draft RTS. AFME strongly supports the goals of strengthening systemic resiliency in the non-centrally cleared derivatives market by establishing risk mitigation techniques and margin requirements in accordance with the requirements of EMIR.

1.8 It is important that the ESAs continue to focus on the practical issues relating to the implementation of the rules and the overall purpose of reducing systemic risk. This letter is intended to continue the constructive ongoing dialogue with AFME and to focus on the practical concerns and risks surrounding the implementation of the margin rules, including equivalence with rules being imposed by other regulators in accordance with the BCBS-IOSCO framework. We hope that our comments in this letter and any follow-up discussions will further shape the Draft RTS that are submitted to the European Commission.

1.9 This letter is broadly structured in two parts. After the summary of proposals which appears in Section 2, this letter analyses the key issues and related discussion in relation to the impact of the Draft RTS on prime brokerage businesses. The second part of this letter then focuses on the implications of the Draft RTS on Securitisation Swaps.

2. Summary of Proposals

For convenience, we have summarised below the proposals which we have made in this paper. Each of these proposals is discussed in detail in the body of this letter.

Proposals in relation to prime brokerage businesses

2.1 Cross-product margining: The Draft RTS should be modified to permit initial margin models for uncleared derivatives to account for risk reductions and risk offsets provided by other products subject to legally enforceable netting arrangements and supervisory approval of the models correlation assumptions.

This proposal is discussed in Section 4.1 of this letter.

2.2 Segregation of initial margin: It would be more beneficial to all parties to offer optional segregation of initial margin rather than to require mandated segregation, such that if counterparties opted for segregation, the prime broker would provide the relevant operation processes and procedures to enable this to take place.

This proposal is discussed in Section 4.2 of this letter.

2.3 Reuse and rehypothecation of collateral collected as initial margin: The proposed ban on rehypothecation of initial margin should not be introduced.

This proposal is discussed in Section 4.3 of this letter.

2.4 Collection of variation margin via prime brokerage accounts: We recommend that the variation margin requirements should permit prime brokerage clients subject to the margining requirements to collect variation margin from a prime broker via a prime brokerage account, if the required amount of variation margin is credited by the prime broker as “account equity” in the prime brokerage account.

This proposal is discussed in Section 4.4 of this letter.

Proposals in relation to Securitisation Swaps

2.5 Special treatment for posting by Issuer: Securitisation Swaps should be treated in a similar way to swaps connected with covered bond transactions for the purposes of the Draft RTS. Accordingly, the Issuer should not be required to post initial or variation margin to the Swap Counterparty (as defined in Paragraph 5.1).

This proposal is discussed in Section 8 of this letter.

2.6 Special treatment for posting by Swap Counterparty: Where a securitisation contains certain structural features which provide for effective risk mitigation, the circumstances in which the Swap Counterparty is required to post collateral, and the amount of collateral which the Swap Counterparty is required to post, should be modified.

This proposal is discussed in Section 9 of this letter.

2.7 *Third Country Entities:* The requirements to exchange both initial and variation margin should apply to swaps entered into with third country entities in the same way as they would apply to such third country entities if they were established in the EU.

This proposal is discussed in Section 11 of this letter.

2.8 *Time for determining applicable Risk Management Procedures:* Paragraph 6 of Article 1 FP should be amended to clarify that the risk management procedures which counterparties are required to comply with throughout the life of a transaction shall be those risk management procedures which the counterparties were required to comply with on the date the relevant transaction was entered into.

This proposal is discussed in Section 12 of this letter.

2.9 *Timing of implementation and application of Thresholds:*

(a) The definition of "Counterparties" should be amended, at least for the purpose of paragraph 3 of Article 1 FP, so that it includes entities established in both the EU and outside the EU.

(b) Each party should be responsible for determining its own aggregate month-end average notional amount for the purposes of the application of the thresholds. Each party should be entitled to rely on information provided by its counterparty for the purpose of determining that counterparty's aggregate month-end average notional amount.

These proposals are discussed in Section 13 of this letter.

2.10 *Application to future transactions only:* The Draft RTS should be amended to reflect the intention expressed in Recital (18) and the explanatory notes on pages 24–5 of the Draft RTS that they do not apply to transactions which are first entered into prior to the date on which the RTS enter into force.

This proposal is discussed in Section 14 of this letter.

2.11 *Requirement expressly to agree exemptions:* The parties should be free to determine which requirements apply to swaps entered into between them and the transaction documentation should only be required to reflect those requirements which do actually apply.

This proposal is discussed in Section 16 of this letter.

3. Key Issues for Prime Brokers

3.1 There is a significant risk that there will be global inconsistencies in the way local regulators apply the provisions in the BCBS/IOSCO paper titled "Margin requirements for non-centrally cleared derivatives", September 2013, (the "**BCBS-IOSCO Paper**"), especially with regard to reuse of initial margin, to the detriment of firms established and trading under the laws of EU member states. If Europe waits

for the US to implement the rehypothecation provisions and then follows with its implementation, a more pragmatic and globally consistent approach may be achieved.

3.2 Prime brokers are not permitted to calculate the initial margin collected using cross-margining structures offered by prime brokers, under which the prime broker calculates the applicable initial margin requirement across multiple products taking into consideration risk reductions and risk offsets between such products. We believe this restriction would be disadvantageous to end-clients. If a prime broker has executed a legally enforceable master netting agreement, then a more capital efficient, risk-based portfolio margin requirement across a broader range of products should be permitted by allowing the dealer to include the other products subject to the master netting agreement in the initial margin model for the uncleared derivatives.

3.3 We recommend that it would be more beneficial to all parties to offer optional segregation of initial margin rather than to require mandated segregation, such that if counterparties opted for segregation, the prime broker would provide the relevant operational processes and procedures to enable this to take place.

3.4 Under Article 1 REU ("*Treatment of collected initial margins*"), the ESAs propose to ban rehypothecation, re-pledging or re-use of collateral collected as initial margin for uncleared derivative transactions. AFME disagrees with the ban and believes that it could have significant and broad funding implications for the end-clients, especially if firms are unable to calculate initial margin for uncleared derivatives on a cross-margined basis.

4. Discussion of Prime Brokerage Issues

4.1 Cross-product margining

(a) Under the Draft RTS, initial margin models would be permitted to account for risk on a portfolio basis, but only taking into account those derivatives approved for model use that are subject to a single, legally enforceable netting agreement. In our view, this proposal is unduly restrictive because it would appear to prohibit cross-product margining structures offered by prime brokers, under which the prime broker calculates the applicable initial margin requirement across multiple products taking into consideration risk reductions and risk offsets between such products. The covered products typically include cash positions (margin loans and short positions), uncleared derivatives, cleared derivatives, listed options and futures.

(b) Proposal: We recommend that the Draft RTS are modified to permit initial margin models for uncleared derivatives to account for risk reductions and risk offsets provided by other products subject to legally enforceable netting arrangements and supervisory approval of the models correlation assumptions.

(c) Example: A client has entered into uncleared derivatives with the prime broker that are hedged with cash positions (margin loans and short positions) and cleared derivatives with the same prime broker. Assume that based on the

prime brokers risk model, the total margin requirements of the entire portfolio (i.e., including all three product types) is EUR 100. Further assume that the initial margin requirement on the uncleared derivatives (without cross-margining with the hedging cash positions and the cleared derivatives) is EUR 125. Under the Draft RTS, the prime broker would be required to collect EUR 125 from its client, which would have two adverse consequences: (i) the client would be required to post significantly more collateral than appropriate given the lower total risk across the three products and (ii) the entire initial margin of EUR 125 would not be available for rehypothecation and therefore (1) the prime broker would have to pay the clearing house margin requirement on the cleared derivatives out of his own pocket (or ask its client to post even more collateral) and (2) the prime broker could not fund the margin loans and shorts because there would not be assets remaining for re-use.

(d) These adverse consequences would be significantly mitigated, if the initial margin model for the uncleared derivatives would be permitted to take into consideration the risk reductions and risk offsets caused by the cash positions and the cleared derivatives: returning to the example in the paragraph above, suppose that the new initial margin model (with cross-margining) would result in an initial margin requirement of EUR 75, rather than EUR 125. The prime broker would collect the full EUR 100 from the client (the total margin requirement across the three products). EUR 75 of the EUR 100 would be segregated under the uncleared derivatives segregation rules. The remaining EUR 25 would be available to (i) post collateral on to the clearing house to meet the cleared derivatives margin requirement and (ii) fund the margin loans and shorts, for instance through tri-party repo.

(e) The permissibility of these arrangements should be premised on their legal enforceability. We believe that the determining factor of what requirements are applicable should turn on whether the prime broker has executed a legally enforceable master netting agreement with its customer. The presence of a legally enforceable master netting agreement creates additional risk mitigants and protections against undesirable prime broker-specific or systemic effects that could result from a customer default. These protections, embedded in the master netting agreement, include: (i) cross-default and close-out netting upon the occurrence of a customer default; (ii) mechanics that allow for dynamic margin calculations that reflect real portfolio risk; (iii) ability to apply excess collateral under one product, following a customer default, against amounts owed by a customer to the prime broker pursuant to the other covered products; and (iv) in the case of cross-entity master agreements, the ability to apply receivables collateral owed to the customer against amounts owed by the customer to the prime broker.

(f) For these reasons, we believe that, if a prime broker has executed a legally enforceable master netting agreement, then a more capital efficient, risk-based portfolio margin requirement across a broader range of products should be permitted by allowing the dealer to include the other products subject to the master netting agreement in the initial margin model for the uncleared derivatives. Please note that we are not advocating that the initial margin model for the uncleared derivatives should also determine the margin requirements of

the other products – this would not be in scope of the mandate under EMIR and these products can already be subject to or clearing house requirements (cleared derivatives, listed options, futures) or their own regulatory minimums (for instance, cash positions at a U.S. registered broker-dealer).

4.2 Segregation of initial margin

(a) The Draft RTS mandates segregation of initial margin collected from uncleared derivatives transactions. We recommend that it would be more beneficial to all parties to offer optional segregation instead, such that if counterparties opted for segregation they would provide the relevant operation processes and procedures to enable this to take place. We propose that if a counterparty chose not to have its initial margin segregated, there would be no further restrictions such as on the reuse of that margin.

(b) We believe that this is in line with the current US Dodd-Frank margin segregation rules (17 CFR Part 23, Subpart L), and thus would offer a level playing field for European and US firms. Without an optional approach, it is likely that counterparties would look to move their business to non-European firms that are not impacted by this mandatory segregation and thus this would have a wider impact for firms in the European market as they would not only lose access to these clients' initial margin but their entire business.

4.3 Reuse and rehypothecation of collateral collected as initial margin

The Draft RTS proposes to introduce a full ban on rehypothecation. Whilst we agree that firms and regulators will face many challenges in implementing the measures set out in the BCBS-IOSCO Paper, AFME strongly recommends that a full or effective ban is not appropriate, especially because: (i) it was not the intention of the BCBS-IOSCO Paper to ban the activity; and (ii) it will have broad unintended consequences, whereby prime brokers will not be able to undertake any rehypothecation activity, which will have a significant impact on prime brokerage clients.

(a) A full or effective ban is not in line with the intention of BCBS/IOSCO

(i) The Draft RTS explains the reason for the proposal of an outright ban: the conditions recommended by BCBS-IOSCO Paper leads to "multiple legal and technical difficulties, such as the requested degree of insolvency protection of the initial posting counterparty taking into account the diversity of insolvency laws, the return of the collateral from the third counterparty to the initial posting counterparty in case the collecting party defaults, or the one-time re-use of cash collateral".

(ii) The objective of the BCBS-IOSCO Paper was to reduce systemic risk and promote central clearing. More specifically, BCBS-IOSCO intended to mitigate risk in the case the counterparty to which it has posted initial margin defaults. The BCBS-IOSCO Paper proposes twelve requirements for reuse of initial margin but, notably, it neither introduces an explicit ban nor states that it intends to introduce an effective ban. Whilst we

agree with the Draft RTS that there are many difficulties with the IOSCO/BCBS regime, we do not believe that an outright or effective ban is appropriate or intended. Therefore, we strongly recommend that the ESAs should set out to develop a workable regime in line with the objectives of BCBS/IOSCO.

(b) A ban or a restrictive approach will introduce an unlevel playing field between European and US prime brokers and as such the ESAs should take a pragmatic approach.

(i) It is apparent that the primary objective of the rehypothecation provisions in the BCBS-IOSCO Paper is to enhance protection of and client recourse to initial margin. However, if the provisions, as currently drafted, are introduced into implementing legislation, there will be significant legal, economic and operational challenges. We are concerned that these challenges will result in local regulators taking different approaches and, as such, inconsistent rehypothecation regimes could be produced globally. The US already has an extensive client asset protection regime within its bankruptcy rules for securities and cash held at broker-dealers and also has recently finalised its regulatory regime for uncleared derivatives (under Dodd-Frank); as such, it is likely that the US will take a pragmatic approach to the BCBS-IOSCO provisions and implement a regime that is workable within its existing and recently finalised legal framework.

(ii) We strongly recommend for the ESAs to adopt a globally consistent regime and to ensure that an unlevel playing field between the US and European markets is not introduced (whereby Europe would be at a disadvantage). If the same economic position is not adopted on a global basis, the inconsistency may give rise to significant arbitrage opportunities when trading derivatives, which are not able to be cleared with a CCP, to the detriment of firms established in, and trading under the laws of, EU Member States.

(iii) It should be noted that, unlike the other provisions in the BCBS-IOSCO Paper, BCBS/IOSCO never published any formal consultation on rehypothecation and thus did not receive industry views or expertise. Further, the BCBS-IOSCO Paper appears to not have taken into account the significant legal, economic and operational challenges the provisions pose to implementation in the EU as opposed to the US. We believe it is odd for BCBS/IOSCO to produce recommendations that are deemed unworkable by the ESAs because of implementation challenges.

(iv) We strongly urge the ESAs to use the European process as an opportunity to obtain the industry expertise that was not obtained in the BCBS process, and to thereby produce a workable and pragmatic solution in line with the higher-level intentions of BCBS/IOSCO. As a means of doing this and ensuring a globally consistent approach, we recommend the ESAs propose a rehypothecation regime only after the US have clarified their intended approach.

(c) There will be unintended consequences to end-clients.

(i) The purpose of rehypothecation is to provide prime brokerage clients with access to cost effective financing. Specifically, the prime broker will be able to select assets to rehypothecate in order to generate funding at a reduced financing cost for the client. Some of the factors that determine the level of rehypothecation include: the prime broker's clients' funding needs, portfolio of assets and liabilities in aggregate and pricing considerations. For example, as stated above, rehypothecation is used as a method of securing cash or securities for the prime brokerage client by using the re-hypothecated asset as collateral in a repo or securities lending transaction. Specifically, rehypothecation enables this benefit for the client by transferring ownership of the underlying asset to the prime broker; if ownership were not transferred to the prime broker, the prime broker could not use the asset in financing transactions such as repo or securities lending transactions with third parties because it could not transfer title to the third party.

(ii) By introducing a full or effective ban on rehypothecation of margin posted in relation to uncleared derivative exposures, the rehypothecation activities for prime brokers could be restricted more broadly, impacting financing provided to clients, especially if cross-margining is not permitted. We stress that such a wide ban goes beyond the intent of BCBS-IOSCO and is in direct conflict with the approach of other European regulations.

(iii) Generally, prime brokers undertake various types of transactions, including: cash transactions, cleared derivatives and uncleared derivatives. Currently, there is no proposed ban on rehypothecation for cleared derivative or cash transactions. In fact, the opposite is true. In January 2014, the European Commission proposed to introduce transaction requirements for rehypothecation of collateral in the context of cash transactions but no ban was proposed. However, a ban on rehypothecation for uncleared derivatives could result in restricting prime rehypothecation across all types of transactions. The reason is that currently, prime brokerage business is undertaken at portfolio-level and margin called is not directly linked to specific uncleared derivative exposures.

(iv) To elaborate, in the prime brokerage business, the initial margin is calculated based on the uncleared derivatives exposures within each individual client portfolio. However, to determine whether margin will be called or not from the counterparty, the initial margin is compared to the total value of the client's entire portfolio, which is the value of the cash credit balances plus the value of the long securities plus the value of the uncleared derivatives (if positive) minus the value of the debit balances minus the value of the short securities minus the value of the uncleared derivatives (if negative). If the value of the initial margin is greater than the market value of the whole portfolio, margin will be called. If the initial margin is less than the market value of the whole portfolio, margin will

not be required (because the portfolio is over-collateralised). Therefore, the margin is calculated based on entire portfolio and is not linked one-to-one with the uncleared derivative exposures.

(v) Under the new regime, as described above, the initial margin for uncleared derivatives would be calculated separately (in addition to the portfolio level margin). If there were a ban on rehypothecation for uncleared derivatives margin, the margin that prime brokers could rehypothecate would be the portfolio margin less the uncleared derivatives margin. For example, if portfolio level margin was EUR 100 and the uncleared derivatives margin was EUR 20, the remaining EUR 80 would be the amount of margin that the prime broker could rehypothecate. This could have significant cost implications (i) if cross margining could not be applied to uncleared derivatives initial margin as described above; and (ii) if the client had significant uncleared derivative exposures.

(vi) Further, prime brokers will be restricted from providing client intermediation (i.e. a client “gives up” derivatives undertaken with a counterparties to the prime broker – the prime broker will in turn enter into an equal and opposite derivative with those counterparties), which means the client neither needs to maintain a credit lines with the counterparties nor does it need to have formal documentation in place with them. Client intermediation is an essential part of a prime broker service offering, which effectively enables clients to access the markets at a lower cost and greater efficiency. A restriction on rehypothecation would materially impact intermediation (particularly with respect to transactions that are not or do not become eligible for clearing).

4.4 Collection of variation margin via prime brokerage accounts

We recommend that the variation margin requirements should permit prime brokerage clients subject to the margining requirements (i.e. AIFs with EU authorised AIFMs, who are therefore “Financial Counterparties” for EMIR) to collect variation margin from a prime broker counterparty via a prime brokerage account, if the required amount of variation margin is credited by the prime broker as “account equity” in the prime brokerage account. This mechanism is frequently used within prime brokerage account arrangements, and provides significant operational and cost benefits to the clients, enabling them to choose to transfer relevant amounts from the prime brokerage account, to borrow against such amounts, or to apply such amounts to meet their own margin requirement for that account. In these circumstances, AIFs with prime brokerage accounts would “collect” required variation margin if the required amount is reflected by the prime broker in the AIF’s account equity for its prime brokerage account.

5. Key Issues for Securitisation Swaps

5.1 The key issue of concern with the Draft RTS for Securitisation Swaps is the lack of special provisions exempting a securitisation issuer ("**Issuer**") from the requirement to post collateral similar to those which apply for covered bond swaps, and the lack of recognition of the existing structural features which are already a standard feature of securitisation transactions (including collateral posting requirements imposed on swap counterparties) and which provide effective risk mitigation for both Issuers and swap counterparties (each a "**Swap Counterparty**").

5.2 Other issues include:

- (a) the fact that *all* Issuers established outside the EU would be required to post collateral, even where they would be classified as a "NFC-" if established in the EU;
- (b) the impact of the phase-in of the initial margin requirements;
- (c) lack of certainty in the provisions providing for intragroup transactions;
- (d) the impact of the Draft RTS on existing transactions;
- (e) the requirements for initial margin to be segregated; and
- (f) the requirement for express agreement between the parties to disapply various requirements in the Draft RTS.

5.3 Each of these issues is discussed in more detail below.

6. Technical description of how Securitisation Swaps are already structured

6.1 Before analysing the impact of the Draft RTS on Securitisation Swaps, it is helpful to summarise briefly the key features of a securitisation and how Securitisation Swaps are usually structured.

6.2 Securitisation is the aggregation of cash-generating assets, such as mortgages, auto loans or SME loans, created (or "originated") typically by a bank (the "**Originator**") and initially funded on the balance sheet of the Originator, and then funding these assets instead by issuing bonds in the capital markets. The bonds are "non-recourse" to the Originator. This means that payment of interest and repayment of principal on the bonds is dependent on, and limited to, the cashflows from the underlying securitised assets (and not the general assets of the Originator). Because of this, the interest and principal payments on the bonds need to mirror very closely the cashflows received from the securitised assets.

6.3 Where, as is usually the case, there is some form of mismatch between the cashflows generated by the assets which are the subject of a securitisation and the payments to be made to noteholders, it is common for the Issuer to enter into one or more Securitisation Swaps to transform the cashflows from the asset pool into the payment flows to be made to noteholders. The most common types of swaps

utilised for this purpose are interest rate swaps (including basis swaps) and currency swaps.

6.4 The parties to a Securitisation Swap will be the Issuer and a financial institution, which would in almost all cases be either a financial counterparty or an entity that would be a financial counterparty if it were established in the EU. In most, but not all, cases, the Issuer will be a non-financial counterparty (or an entity which would be a non-financial counterparty if it were established in the EU).

6.5 Because, in order to isolate the cashflows of the securitized assets from the risk of bankruptcy of the Originator, the Issuer is a special purpose entity, whose activities will be limited to engaging in securitisation transactions (either as a one-off transaction or as part of a programme structure), it will generally be a bankruptcy-remote "orphan" entity. The Securitisation Swaps themselves will in almost all cases be transactions which are "objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty" for the purposes of Article 10(3) of EMIR. Accordingly, viewed on a standalone basis, the Issuer would expect to be a "NFC-" (that is, a non-financial counterparty other than a non-financial counterparty referred to in Article 10 of EMIR). However, because of difficulties which can arise in interpreting the definition of "group" in Article 1(16) of EMIR it is not always possible for the Issuer (or the financial counterparty) to determine conclusively that it is in fact a NFC-. Further, because the composition of a group may change over time, including as a result of factors over which the Issuer itself may have no control, it is possible that even if the Issuer is a NFC- on the date it enters into the Securitisation Swap, it may subsequently become a NFC+ (that is, a non-financial counterparty referred to in Article 10 of EMIR).

Protecting the Swap Counterparty against the risk of default by the Issuer

6.6 Securitisation Swaps contain risk mitigation features to protect the Swap Counterparty against the counterparty credit risk which it faces in relation to the Issuer. Many of these features have their origins in rating agency criteria with which the Issuer and Swap Counterparty are obliged to comply where the securitisation notes are being rated by one or more credit rating agencies. However, such features are also found in most unrated securitisations precisely because of the risk mitigation features which they provide for the Swap Counterparty. In particular, these features will typically include:

(a) The Swap Counterparty will be a secured creditor of the Issuer, and will rank at least pari passu with or senior to the noteholders in the Issuer's payment waterfall. As such, Swap Counterparties will assume higher recovery rates upon Issuer default even though they have uncollateralized positions. Given that the size of the asset pool will generally be much larger than the Swap Counterparty's exposure, swaps ranking senior to notes will benefit from very high recovery rates.

(b) Any collateral which is posted by the Swap Counterparty is held in a separate collateral account. If the swap is terminated, any surplus collateral remaining after settlement of the swap is returned directly to the Swap

Counterparty. As such, Swap Counterparties benefit from ring-fenced collateral arrangements which protect them against collateral being commingled with the Issuer's other assets.

6.7 It is common for the Swap Counterparty to be subordinated below noteholders in the event of a Swap Counterparty default (including where the Swap Counterparty has failed to take remedial action following it being downgraded below a particular rating threshold, as described below). However, the subordination of a defaulting Swap Counterparty is less disadvantageous to the Swap Counterparty than it may initially appear for the following reasons.

(a) First, where the Swap Counterparty has posted collateral to the Issuer, this will generally indicate that the Swap Counterparty is out-of-the-money and so would actually be required to pay the net mark-to-market value to the Issuer (and so have no credit exposure at that juncture) upon a termination. Accordingly, the only collateral which would remain to be returned to the Swap Counterparty is any excess above that mark-to-market (that is, the volatility buffer, which corresponds to initial margin), and that is the portion of the collateral which is effectively still returned directly to the Swap Counterparty notwithstanding its default in the manner described in Paragraph 6.6(b).

(b) Secondly, where the Swap Counterparty is in-the-money, the Issuer has little incentive to terminate the swap (as without the swap the cashflows will become unmatched), and in many cases will be restricted from terminating the swap, as a result of a default by the Swap Counterparty unless or until it has received an offer from a replacement Swap Counterparty to enter into a replacement swap. In those circumstances, the replacement Swap Counterparty would be paying an upfront premium to the Issuer to enter into a swap that is in-the-money for the replacement Swap Counterparty from the outset, and that upfront premium will correspond to the mark-to-market amount which the Issuer will owe to the defaulting Swap Counterparty. As with the return of collateral described in Paragraph 6.6(b), such replacement swap premium will generally be paid to the defaulting Swap Counterparty notwithstanding that it is in default.

Protecting the Issuer against the risk of default by the Swap Counterparty

6.8 Securitisation Swaps also contain provisions to protect the Issuer against the counterparty credit risk which it faces in relation to the Swap Counterparty. These provisions will generally include:

(a) Prescribing a minimum rating requirement for the Swap Counterparty. This is usually done through a "two step" process involving two ratings which act as triggers which, if breached, require certain risk mitigation actions to be taken by the Swap Counterparty.

(b) First, if the Swap Counterparty does not have the first trigger rating, it is obliged to post collateral. The amount of collateral to be posted is determined pursuant to a formula or model prescribed by the rating agency, which

includes both a mark-to-market (or variation margin component) and a volatility buffer (or initial margin component). What constitutes eligible collateral is also prescribed by the rating agencies, and limited to highly-rated liquid collateral (generally cash and government securities).

(c) Secondly, if the Swap Counterparty does not have the second trigger rating, it is required, within a relatively short time-frame, either to transfer the swap to a replacement Swap Counterparty which does have the required rating, or else to procure a guarantee from a third party which does have the required rating.

These rating-linked provisions protect the Issuer against the counterparty risk by ensuring that unless the Swap Counterparty has a sufficiently high credit rating, it is either posting collateral or taking other steps to ensure that the Issuer remains exposed only to another highly-rated entity.

6.9 The features of Securitisation Swaps described above, including the risk mitigation techniques generally adopted, are identical to those which apply to swaps entered into in connection with covered bond transactions in all material respects.

7. Application of the Draft RTS to Securitisation Swaps

7.1 The Draft RTS do not contain any special provisions in relation Securitisation Swaps. Thus, if the Issuer is a NFC+ (which is very possible – see Paragraph 6.4) or a third country entity, unless the exemptions in Article 2 GEN are applicable (which currently will never be the case where the Issuer is a third country entity), both the Issuer and the Swap Counterparty will be required to post margin.

7.2 It is sometimes the case that the Issuer forms part of the same group as a potential Swap Counterparty. Articles 11(5)–(11) of EMIR provide that the requirement to exchange collateral prescribed in Article 11(3) of EMIR shall not apply to intragroup transactions subject to certain conditions. While these exemptions may provide some relief for an Issuer where it does form part of the same group as the Swap Counterparty, there remain a number of issues with these exemptions.

(a) Even if the Issuer does form part of a larger group, it is not necessarily the case that a Swap Counterparty can be found that is also a member of the same group. This is particularly so given that in many securitisations, the Originator does not have a sufficiently high credit rating to act as the Swap Counterparty if the notes issued by the Issuer are to obtain the desired rating from the credit rating agencies (usually AAA/Aaa).

(b) The intragroup exemptions only apply where there is no practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the parties. In relation to legal impediments, paragraph 1 of Article 3 IGT identifies certain factors which are "deemed" to constitute a legal impediment. However, it does not appear that this is an exclusive list, meaning there remains a significant degree of uncertainty. In relation to practical

impediments, paragraph 2 of Article 3 IGT provides that a practical impediment shall be "deemed" to exist where sufficient assets of the counterparties are or may not be freely available to the counterparty in the necessary form. Again, it is not clear what this constitutes. Where a positive or negative decision of a competent authority is applicable, it appears from paragraphs 1 and 2 of Article 1 IGT that determining the existence of legal or practical impediments forms part of that decision by the competent authority. However, where the Issuer and the Swap Counterparty are established in the same Member State, no decision of the competent authority is required for the intragroup exemption to apply (see Article 11(5) of EMIR). This means that the determination of whether or not any legal or practical impediments exist would need to be determined by the parties, which may be difficult in light of the uncertainties described in this paragraph.

(c) In many cases, a positive decision from the competent authority is required before the parties can take advantage of the intragroup exemptions. It is clear from Article 1 IGT that obtaining this positive decision could be a lengthy process. Conversely, in other cases where the exemption may not be available if the competent authority makes a negative decision, the competent authorities have up to three months to make such decision. In the case of securitisation transactions, where the Issuer is often a newly-formed special purpose entity, it is not clear whether this decision-making process can commence prior to the formation of the Issuer. Indeed, given the difficulties with the application of the "group" definition in Article 1(16) of EMIR, it may be the case that the Issuer does not even form part of the same group as the Swap Counterparty until after the securitisation closes, the notes are issued and the Securitisation Swap has been entered into, thereby making it impossible for the Issuer to obtain any necessary positive or negative decision from the competent authorities until after it has had to agree the required risk mitigation techniques with the Swap Counterparty.

(d) Unless the Issuer and the Swap Counterparty are established in the same Member State, the exemption may only be partial. However, there is no guidance in either Article 11 of EMIR or the Draft RTS as to what partial exemptions may entail. Thus, if partial limitations are imposed, the intragroup exemption may be of limited utility.

(e) Even if the Swap Counterparty is in the same group as the Issuer, if the Swap Counterparty is downgraded or defaults and is required to be replaced, the replacement Swap Counterparty is unlikely to be in the same group as the Issuer and original Swap Counterparty. This means the Issuer would no longer be able to take advantage of the intragroup exemptions. However, it would also not be in a position to effect the restructuring of the securitisation as a whole to enable it to post collateral for the reasons outlined elsewhere in this letter.

(f) Articles 1 IGT, 2 IGT and 3 IGT use the terms "counterparty" and "counterparties" when describing the conditions which apply to the these exemptions. However, for the reasons set out in Paragraph 13.3 below, this would appear to mean the intragroup exemptions are not available where one

of the parties is not an EU entity. This is inconsistent with Articles 11(8) and (9) of EMIR which expressly contemplate that the intragroup exemptions may be available in relation to entities which are not established in the EU. Accordingly, for the reasons discussed in Paragraphs 13.3 to 13.5 below, AFME members are of the view that these references to a "counterparty" or "counterparties" should be interpreted as including entities which are not established in the EU.

7.3 Accordingly, unless the parties can clearly determine that the Issuer is a NFC-, it would be subject to the requirements to exchange variation margin and initial margin in accordance with the Draft RTS. In this regard, however, AFME members note that many of the difficulties with the Draft RTS in the context of Securitisation Swaps, at least where the Issuer is an EU entity, could be overcome if the scope of the definition of "group" in Article 1(16) of EMIR was clarified so that it is clear that an "orphan" and "bankruptcy-remote" special purpose entity does not form part of the same group as any other entity. This could be achieved if the references to "dominant influence" and "control" in Article 22(1) of Directive 2013/34/EU (the "**Accounting Directive**") (which is cross-referenced in Article 1(16) of EMIR) were given their ordinary legal meaning rather than potentially being given an accounting meaning given that the Accounting Directive is primarily concerned with the preparation of financial statements and consolidated accounts.

8. Special treatment for Securitisation Swaps – Posting by Issuers

8.1 The Issuer does not have any assets other than the asset pool which is the subject of the securitisation and its rights under the various transaction documents, meaning it does not have any excess assets available to post as collateral under the Securitisation Swaps. Accordingly, if the Issuer was required to post collateral, it would need to implement some form of "collateral provider" solution along the lines of that described in relation to covered bonds as "Alternative 2: collateral provider" in paragraphs 32 to 35 of the Draft Impact Statement set out in the Draft RTS. However, AFME members consider that such a solution would create significant difficulties.

(a) Until there is clarity on the actual structure of such a collateral provider solution, what requirements the rating agencies would impose and the capital and accounting rules which would apply to such structures, it is not possible accurately to quantify what the end costs of such a solution would be, or to ascertain whether any third parties would actually be prepared to fill this rule.

(b) Implementing such a solution would have significant cost implications for the structure, as the collateral provider would charge fees and the legal complexity of the transactions would increase. These arrangements and associated modeling would also need to be factored into the analysis by the credit rating agencies. The impact on existing noteholders would also need to be confirmed. It is generally assumed that swaps against notes are pari passu with those notes, and anything that gave swap counterparties a claim senior to the note could have implications for the note rating and spread at which investors were prepared to invest.

(c) Further, whether a collateral provider solution would actually provide any meaningful additional protection to the Swap Counterparty over and above the existing protections already described above is by no means obvious. While it may result in the Swap Counterparty having a reduced credit exposure to the Issuer, that credit exposure is already minimal because of the Swap Counterparty's position as a secured creditor ranking either senior to or *pari passu* with the most senior class of noteholders. In addition, unless the collateral is capable of rehypothecation (which would not be permitted in relation to initial margin under the Draft RTS), it would have no impact on the Swap Counterparty's funding costs, which is typically a more significant cost driver than credit. Even though the collateral may reduce the Swap Counterparty's risk weighted assets for regulatory capital purposes, it will not reduce the leverage ratio, which has a greater impact on the capital requirements for Securitisation Swaps. Against these marginal benefits must be considered the significant economic, structural and legal challenges to implementing such a solution discussed above.

(d) Ultimately, the additional cost burden would increase the cost of funding for originators, and would be likely to be passed on to borrowers, thereby reducing access to credit. It is the view of AFME members that these additional costs are unwarranted in light of the structural protections for swap counterparties which are already found in most Securitisation Swaps, as discussed above.

8.2 However, there is scope within the EMIR framework to provide for special rules for posting collateral in relation to Securitisation Swaps, without undermining the underlying objective of the risk mitigation techniques.

8.3 The risk mitigation techniques are primarily contained in Article 11 of EMIR as follows:

(a) Article 11(1) outlines the basic policy objective of the risk mitigation techniques, which is that "Financial counterparties and non-financial counterparties that enter into an OTC derivative contract not cleared by a CCP, shall ensure, exercising due diligence, that *appropriate procedures and arrangements are in place to measure, monitor and mitigate* operational risk and *counterparty credit risk*" (emphasis added). Paragraph 11(1) goes on to mandate that these techniques must "at least" include provisions for the timely confirmation of transactions and procedures for reconciling portfolios and identifying and resolving any disputes between the parties in relation to such transactions. These two specific requirements are primarily directed at measuring and monitoring counterparty credit risk rather than mitigating it. This suggests that the other provisions of Article 11 should be interpreted in the context of this general aim to "measure, monitor and *mitigate* counterparty credit risk" (emphasis added).

(b) These basic requirements are then supplemented by Article 11(3), which provides that "Financial counterparties shall have risk-management procedures that require the timely, accurate and *appropriately segregated exchange of collateral* with respect to OTC derivative contracts that are

entered into on or after 16 August 2012. Non-financial counterparties referred to in Article 10 shall have risk-management procedures that require the timely, accurate and *appropriately segregated exchange of collateral* with respect to OTC derivative contracts that are *entered into on or after the clearing threshold is exceeded*" (emphasis added).

(c) Article 15(a) then delegates to the ESAs responsibility for implementing regulatory technical standards specifying "the risk-management procedures, including the *levels and type of collateral and segregation arrangements*, required for compliance with paragraph 3" (emphasis added).

8.4 Importantly, Article 11(3) does not specify what constitutes "collateral", nor does it specify how such collateral is to be exchanged or what constitutes appropriate segregation arrangements. On the contrary, responsibility for determining these matters is delegated to the ESAs in Article 11(15)(1). Article 11(3) also does not specify the amount of collateral that is required to be "exchanged". The requirements of Article 11(3) must, therefore, be interpreted in light of the more general principle in Article 11(1) that parties are required to have "*appropriate procedures ... to ... mitigate ... counterparty credit risk*" (emphasis added).

8.5 While large sections of the OTC market operate on the basis that "collateral" primarily refers to liquid assets such as cash and securities, and that the amount of collateral required to be posted is determined by reference to the mark-to-market value and associated volatility of transactions, there is also a very large segment of the OTC market which does not operate on that basis but is still classified as secured (or collateralised) by the parties to those swaps. In particular, the very significant market for interest rate and currency swaps hedging loan obligations, as well as Securitisation Swaps and covered bond swaps, do not require the borrower/issuer to post collateral to the Swap Counterparty. Rather, as discussed above, the Swap Counterparty shares along with the borrower/issuer's other creditors in a security package. The Swap Counterparty generally ranks either senior to or *pari passu* with the senior debt-holders, ensuring that it is unlikely to suffer a loss as a result of the default of the borrower/issuer.

8.6 AFME members submit that there is nothing in the text of Article 11 of EMIR (or, indeed, in the rest of EMIR) which prescribes that the only way to satisfy the requirements of Articles 11(1) and (3) is by the exchange of liquid collateral on a daily basis by reference to the mark-to-market value and associated volatility of transactions. Nor is there anything in those articles which prescribes that all types of swaps must be subject to the same basic collateralisation requirements as, indeed, is implicitly recognised by the special treatment afforded to certain types of currency swaps in paragraphs 1 and 2 of Article 2 GEN. Indeed, other than in the context of transactions subject to the clearing obligation and certain transitional provisions relating to pension funds, the only reference to "margin" in EMIR is in Article 11(13) in relation to EMSA conducting reviews to guard against systemic risk which may arise in connection with arbitrage between cleared and uncleared transactions. Given that most Securitisation Swaps or loan hedging swaps contain features which are likely to mean they do not fall within the scope of the clearing

obligation, AFME members submit that such arbitrage is unlikely to pose a significant issue at this time.

8.7 The distinction between the many references to margin in the context of CCPs and transactions subject to the clearing obligation, and the more general reference to "collateral" in the context of uncleared transactions indicates that the references to collateral should not be interpreted as referring only to collateral arrangements based on the posting of initial margin and variation margin. Rather, provided that the collateral arrangements provide *effective* mitigation of counterparty risk, then they can fall within the scope of the requirements laid down in Articles 11(1) and (3) of EMIR. This broader discretion in relation to what may constitute appropriate collateral measures in relation to uncleared swaps is also consistent with the fact that the scope and variation found in uncleared swaps is generally much broader than that found in swaps to which the clearing obligation applies, thus justifying drawing distinctions between what constitutes appropriate collateral arrangements for different types of uncleared swap transactions.

8.8 The foregoing interpretation of the requirements of Articles 11(1) and (3) of EMIR is presumably the foundation of the special treatment provided for swaps connected with covered bond transactions which are set out in Article 3 GEN of the Draft RTS. Article 3 GEN provides that, where a swap connected with a covered bond transaction meets the conditions set out in that article, the covered bond issuer or cover pool is not required to post initial or variation margin. These conditions include features that are similar to the protections which apply for swap counterparties in Securitisation Swaps as discussed above, namely: that the derivative counterparty ranks at least *pari-passu* with the covered bond holders (paragraph 1(b) of Article 3 GEN). Although it does not expressly say so, the implication here is that where the covered bond holders are themselves secured creditors of the covered bond issuer or cover pool, the derivative counterparty would also be required to be a secured creditor in order to achieve that *pari passu* ranking.

8.9 No express reference is made to the application of the risk mitigation techniques to covered bond swaps in Article 11 of EMIR, or elsewhere in the operative provisions of the regulation. Although there are acknowledgements in Recitals (16) and (24) of EMIR that ESMA should take into account the special features of covered bond swaps and impediments which may be faced by covered bond issuers or cover pools in providing collateral, as well as the alternative protection given to the derivative counterparty as a result of its priority claim against the cover pool assets, these Recitals do not form part of the operative provisions of the Regulation. Accordingly, it is the discretion which the ESAs have in formulating the collateral requirements along the lines outlined above which permits special treatment for covered bond swaps.

8.10 As noted above, the features of covered bond swaps which justify the special treatment for those swaps contained in Article 3 GEN are features which are also present in most Securitisation Swaps. It is also the case that both covered bonds and securitisation serve a similar economic purpose in providing funding for bank lending. However, the special treatment provided for covered bond swaps, without corresponding treatment for Securitisation Swaps which are structurally very

similar and serve a similar economic purpose results in favourable treatment for those jurisdictions in which covered bonds are a widely used asset financing technique compared with those jurisdictions where traditional securitisation is more common and is not consistent with the general policy objective of achieving a "level playing field".

8.11 Proposal: AFME members therefore propose that Securitisation Swaps should be treated in a similar way to swaps connected with covered bond transactions for the purposes of the Draft RTS. Members submit that, for the reasons outlined above, such treatment is both consistent with the underlying policy objective of mitigating counterparty credit risk, and with the requirements of Article 11 of EMIR.

8.12 Members recognise that such an exemption would require an appropriate definition of what constitutes a Securitisation Swap. For covered bonds, Article 1(e) of Article 3 GEN requires that the covered bond programme is required to meet the requirements of Article 129 of Regulation (EU) No 574/2013. In the case of Securitisation Swaps, reference can be made to the definition of "securitisation" and "securitisation special purpose entity" found in Articles 4(1)(61) and (66) of Regulation (EU) No 575/2013 ("CRR"). Article 41(1)(66) defines a "securitisation special purpose entity" as follows:

'securitisation special purpose entity' or 'SSPE' means a corporation trust or other entity, other than an institution, organised for carrying out a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator institution, and in which the holders of the beneficial interests have the right to pledge or exchange those interests without restriction.

8.13 In turn, a "securitisation" is defined in Article 4(1)(61) as follows:

'securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having both of the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

8.14 It is therefore proposed that an exemption for Securitisation Swaps be based on the above definition, as well as incorporating some of the conditions which apply to the exemption for covered bond swaps set out in Article 3 GEN as follows:

"Counterparties' risk management procedures may include the agreement in writing or through other equivalent permanent electronic means² that initial and variation margins are not posted by securitisation special purpose entities if all of the following conditions are met:

² Note discussion in Section 16, below, in relation to the requirement for parties to agree in order to take advantage of exemptions.

(a) the derivative counterparty is a secured creditor of the securitisation special purpose entity and ranks at least pari-passu with the securitisation bondholders (other than in respect of payments due to the derivative counterparty (other than the return of collateral) where an event of default has occurred in respect of that derivative counterparty or the derivative counterparty has been downgraded below a particular rating threshold);

(b) the derivative is used only for hedging purposes; and

(c) the netting set does not include derivatives unrelated to the securitisation."

9. Special Treatment for Securitisation Swaps – Posting by Swap Counterparties

9.1 As discussed in Paragraph 6.9, in the case of securitisations rated by a credit rating agency, Securitisation Swaps contain risk mitigation techniques designed to protect the Issuer from the counterparty credit risk of the Swap Counterparty. These protections take the form of requiring the Swap Counterparty to have a specified minimum credit rating and a requirement for the Swap Counterparty to post collateral where it does not have a even higher "first trigger" credit rating. Even in the case of unrated securitisation transactions, it is common for very similar risk mitigation techniques to be employed specifically for the purpose of mitigating the risk to the Issuer of a Swap Counterparty default.

9.2 Although in some ways these rating agency-driven requirements are less onerous than those contained in the Draft RTS, on the basis that the Swap Counterparty is not required to post collateral while it has the "first trigger" rating, in other ways these requirements are actually more onerous to the extent that, if the Swap Counterparty ceases to have the "second trigger" rating, it is required either to replace itself or procure that its obligations are guaranteed by a third party which does have the required rating. For the reasons discussed below, AFME members submit that these collateral requirements provide better risk mitigation in the context of the structure of securitisation transactions than the collateral requirements set out in the Draft RTS.

9.3 In particular, the fact that if the Swap Counterparty does not have the "second trigger" required rating, it is required to replace itself or procure a third party to guarantee its obligations under the Securitisation Swap is more consistent with the Issuer's need to ensure that it will not be left facing a defaulting Swap Counterparty than the Draft RTS requirements which go no further than requiring Swap Counterparty to post collateral. Unlike an operating company, an Issuer has very little flexibility or ability to obtain a replacement swap should the Swap Counterparty actually default. In almost all cases where the Swap Counterparty for a securitisation has been replaced, that replacement process has been largely driven by the outgoing Swap Counterparty in order to comply with its requirements as a consequence of a rating downgrade. It is unlikely that such co-operation by the outgoing Swap Counterparty would be available if replacement did not occur until after that Swap Counterparty had defaulted. Because the Issuer is a special purpose entity, with no active management, this means that the Issuer would essentially be

relying on a third party with no contractual relationship with the securitisation stepping in to procure a replacement swap in these circumstances. In these circumstances, the fact that the outgoing Swap Counterparty had provided collateral is less significant than the fact that if the Issuer is unable to obtain a replacement swap quickly it is likely that the entire securitisation transaction will collapse.

9.4 Further, there is considerable evidence from the past few years that this replacement mechanism does work effectively. Since 2008, many swap counterparties have been downgraded, in many cases below the "second trigger" ratings, therefore requiring them to find a replacement Swap Counterparty. An active market has developed in response, and market participants are now familiar with the process involved in executing such replacements. This evidence indicates that these risk mitigation techniques do provide an effective means of mitigating counterparty credit risk.

9.5 It is also important to recognise that the rating agency-driven risk mitigation techniques found in Securitisation Swaps do not mean that swap counterparties would not be required to post collateral, merely that the requirement to post collateral only applies once the Swap Counterparty is downgraded below the "first trigger" rating which is generally relatively high compared to the credit rating of most parties to OTC derivatives (and which may, of course, be the case from the date of entry into the Securitisation Swap). Thus, by the time that the creditworthiness of the Swap Counterparty may come into question, it will already be posting collateral, as well as being subject to the additional replacement or guarantee requirements outlined above. Further, while the Draft RTS would not require initial margin to be exchanged where one of the parties is below the EUR 8 billion threshold (or higher before December 2019), the rating-agency driven criteria will generally oblige the Swap Counterparty to post a volatility buffer which, in many cases, may be greater than the initial margin amount which would be required under the Draft RTS. The size of these volatility buffers also increases as the Swap Counterparty suffers further downgrades, thus providing yet further risk mitigation for the Issuer. In other ways too, the rating agency-driven criteria provide a higher level of protection for the Issuer than the Draft RTS. For example, they will require posting on a daily or weekly basis, rather than fortnightly as required by the Draft RTS. They will usually impose a minimum transfer amount of EUR 100,000 against EUR 500,000 for the Draft RTS and the list of eligible collateral is generally more restrictive than that which applies under the Draft RTS.³

9.6 For the reasons outlined in Paragraphs 8.3 to 8.7 (above), the ESAs have discretion to specify different types of collateral arrangements for different types of OTC transactions, provided that those arrangements provide effective mitigation of counterparty credit risk. For the reasons outlined in this Section 9, AFME members submit that the rating-agency driven risk mitigation techniques which apply to most Securitisation Swaps do provide effective mitigation of counterparty risk for the

³ The current criteria of the four major credit rating agencies are as follows: (i) **S&P**: *Counterparty Risk Framework Methodology and Assumptions* (June 15, 2013) and *Global Derivative Agreement Criteria* (June 24, 2013); (ii) **Moody's**: *Approach to Assessing Swap Counterparties in Structured Finance Cash Flow Transactions* (November 12, 2013); (iii) **Fitch**: *Counterparty Criteria for Structured Finance and Covered Bonds* (14 May 2013); and (iv) **DBRS**: *Swap Criteria for European Structured Finance Transactions* (June 2011).

Issuer, in a way which is particularly well-suited to the practical and structural realities of securitisations.

9.7 Proposal: AFME members therefore submit that where the securitisation contains certain structural features which provide for effective risk mitigation along the lines described above, the circumstances in which the Swap Counterparty is required to post collateral, and the amount of collateral which the Swap Counterparty is required to post, should be modified as follows:

"By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, where a securitisation special purpose enters into a derivative with a financial counterparty in connection with a securitisation, the securitisation special purpose entity may agree with the derivative counterparty that the requirements set out in paragraph 3 of Article 1 GEN shall not apply and may instead agree alternative risk management procedures if the following conditions are met:

(a) the derivative counterparty is required at all times to have a credit rating from at least one specifically identified credit rating agency (each a "specified credit rating agency") which is at or above a particular threshold (the "minimum required rating");

(b) the derivative counterparty is required to post initial and variation margin to the securitisation special purpose entity if its credit rating from any specified credit rating agency falls below a threshold which is not lower than the minimum required rating (the "collateral threshold rating"). For the avoidance of doubt, this condition does not require that the amount, frequency and types of initial and variation margin to be posted by the derivative counterparty shall be determined in accordance with these Regulations;

(c) if the derivative counterparty ceases at any time to have a credit rating from any specified credit rating agency which is at or above the minimum required rating, the derivative counterparty is obliged, within a specified period of time, either to take steps to:

(i) procure that a third party which does have the minimum required rating from each specified credit rating agency provides a guarantee of all of the derivative counterparty's derivative obligations to the securitisation special purpose entity; or

(ii) transfer all of its rights and obligations under all its derivatives with the securitisation special purpose entity to one or more replacement derivative counterparties each of which has a credit rating which is at or above the minimum required rating from each specified credit rating agency; and

(d) the transaction documentation governing the derivative provides that, if the securitisation special purpose entity exercises any right which it has to terminate the derivative as a result of the failure of the derivative counterparty either to:

(i) procure a guarantee of all of its obligations to the securitisation special purpose entity from a third party which has the minimum required rating from each specified credit rating agency; or

(ii) transfer all of its rights and obligations under all its derivatives with the securitisation special purpose entity to one or more replacement derivative counterparties each of which has a credit rating which is at or above the minimum required rating from each specified credit rating agency,

then, to the extent permitted by any applicable law, any termination payment which may be payable to the derivative counterparty in connection with such termination shall be subordinated to the obligations of the securitisation special purpose entity to the bondholders in the securitisation, except to the extent that such termination payment can be met from the initial and variation margin previously posted by the derivative counterparty to the securitisation special purpose entity or from any premium paid by a replacement derivative counterparty which enters into a replacement derivative with the securitisation special purpose entity."

10. Valuation Models and Eligible Collateral

10.1 As noted in Paragraph 6.8, above, in the case of securitisations rated by a credit rating agency, the rating agency will prescribe what constitutes eligible collateral, the amount of collateral which is required to be posted by the Swap Counterparty and the haircuts applicable to such collateral.

10.2 These criteria are not developed or designed by either the Swap Counterparty or the Issuer and, accordingly, do not necessarily comply with the requirements laid down in the Draft RTS (for example, in relation to confidence intervals, risk horizons, etc.). However, according to the explanatory information published by the rating agencies, the volatility buffers which are required to be posted by the Swap Counterparty are sized to cover the gap risk following default by a Swap Counterparty and are based on an assumed replacement time period which is considerably longer than a 10 day close-out assumption, in keeping with the reality that it is likely to take a lot longer than 10 days for an Issuer to find a replacement Swap Counterparty for a Securitisation Swap.

10.3 AFME Members are proceeding on the assumption that to the extent that the provisions of the Draft RTS establish the *minimum* collateral requirements with which parties are required to comply. That is, to the extent that any applicable rating agency criteria would require *more* collateral to be posted than the Draft RTS requirements, or would apply more restrictive requirements for what constitutes eligible collateral, the parties would be free to continue to apply those rating agency requirements. This would need to be determined on an ongoing basis, such that the parties would need to comply with the more onerous requirements at a given point in time.

11. Third Country Entities

11.1 The exemptions set out in paragraphs 3 and 4 of Article 2 GEN only apply provide for agreements between "financial counterparties" and "non-financial counterparties" in various circumstances. In the case of non-financial counterparties, these are defined in Article 2 of EMIR as undertakings established in the EU. The effect of this is that FCs and NFC+s which enter into derivatives with third country entities will always be required to collect margin from that third country entity, regardless of whether or not that entity would be classified as a NFC+ if it were established in the EU.

11.2 This inconsistent treatment of entities established within the EU from those established outside the EU is also inconsistent with the international standards laid down in the BCBS-IOSCO framework.

11.3 It is not uncommon for Issuers to be incorporated or established in jurisdictions outside the EU. This presents a significant problem for such securitisations, as it would mean that none of the exemptions from the requirement to post collateral that do apply where the Issuer is a NFC- would be available.

11.4 There is nothing in the text of EMIR which would prohibit the Draft RTS applying to third country entities in the same way that they apply to EU entities. Indeed, this would be consistent with the approach taken in Article 4(1) of EMIR for the purpose of determining when transactions may be subject the clearing obligation. In that article, in relation to transactions involving one or more non-EU entities, whether or not the transaction would be subject to the clearing obligation is determined by whether or not the non-EU entities *would* be subject to the clearing obligation if they were established in the EU.

11.5 The provisions in Article 11(3) of EMIR are not as detailed or prescriptive as those in Article 4(1) of EMIR. However, there is nothing in Article 11 which requires that the collateral requirements apply to all third country entities. Indeed, there is actually nothing in Article 11(3) which expressly exempts NFC-s or entities referred to in Articles 1(4) and (5) of EMIR from the collateral requirements. Rather, this exemption is presumably derived from the fact that Article 11(3) only requires financial counterparties and NFC+s to have procedures for the exchange of collateral. It is therefore implied from the fact that NFC-s and entities referred to in Articles 1(4) and (5) of EMIR are not obliged by Article 11(3) to exchange collateral that financial counterparties and NFC+s may agree not to exchange collateral with those entities. The same rationale should apply to third country entities, which, as with NFC-s and entities referred to in Articles 1(4) and (5) of EMIR, are not themselves subject to the requirement to exchange collateral under Article 11(3) of EMIR.

11.6 While on this basis it would be within the scope of Article 11(3) for transactions involving third country entities to be completely excluded from the collateral requirements, it is also within the scope of the discretion given to ESAs by Articles 11(3) and (15)(a) for the ESAs to draw a distinction along the same lines as that which applies to the clearing obligation, namely that financial counterparties and NFC+s would be required to exchange collateral with third country entities

which would have been financial counterparties or NFC+s if they were established in the EU. This approach would be consistent with the international standards established in the BCBS-IOSCO framework.

11.7 Proposal: AFME members therefore propose that the requirements to exchange both initial and variation margin should apply to swaps entered into with third country entities in the same way as they would apply to such third country entities if they were established in the EU.

12. Time for Determining Applicable Risk Management Procedures

12.1 Paragraph 6 of Article 1 FP provides that the risk management procedures shall apply throughout the life of the contract, should the contract be subject to the requirements when entered. AFME Members interpret this provision as meaning that whatever risk management procedures are required to be implemented at the time a Securitisation Swap is entered into shall remain the applicable risk management procedures throughout the life of that transaction. That is, should any exemptions or special treatment apply to the transaction at the time it is entered into, that relief would continue to apply even if there is subsequently a change in the status of the parties that would mean that such relief would not be available in respect of subsequent transactions entered into between the parties.

12.2 In the case of a non-financial counterparty, this interpretation is consistent with Article 11(3) of EMIR, which provides that a non-financial counterparty is only required to have procedures for the exchange of collateral in relation to transactions entered into on or after the clearing threshold is exceeded. It is also consistent with the determination of whether or not a transaction is subject to the clearing obligation in Article 10(1)(b) of EMIR, which provides that the clearing obligation only applies to future transactions entered into after the rolling average position over 30 working days exceeds the relevant threshold.

12.3 This interpretation is particularly important in the case of Securitisation Swaps because the securitisation will have been structured on the basis that there either would or would not be a requirement to post margin. In most securitisations, the Issuer has little or no flexibility to amend the terms of the Securitisation Swaps during the life of the transaction, and even if it did have that flexibility, it would have no access to the resources necessary to post collateral as required by the Draft RTS. Accordingly, the only way for the Issuer to ensure that it would be able to comply with the requirement to post collateral should any relevant exemptions cease to apply is for the Issuer to assume at the outset that such posting would be required. This has significant cost and structuring implications for securitisation transaction.

12.4 Proposal: Accordingly, to avoid any uncertainty on this point, AFME Members propose that paragraph 6 of Article 1 FP be amended to clarify that the risk management procedures which counterparties are required to comply with throughout the life of a transaction shall be those risk management procedures which the counterparties were required to comply with on the date the relevant transaction was entered into.

13. Timing of Implementation and Application of Thresholds

13.1 Paragraph 3 of Article 1 FP provides that counterparties may agree not to collect initial margin where at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-cleared derivatives is below a specified threshold. This threshold reduces in steps from EUR 3 trillion in 1 December 2015 to EUR 8 billion from 1 December 2019.

13.2 In order to determine whether this exemption applies, parties will need to know the aggregate month-end average notional amount of non-cleared derivatives in respect of both themselves and their counterparty. As discussed in Paragraph 6.5 above, in the case of securitisation issuers, it can be difficult to determine definitively the composition of the group to which it belongs. Further, in the case of either party, whether or not it belongs to a group with an aggregate month-end average notional amount of non-cleared derivatives may change as a result of matters beyond its control (for example, following a merger), with adverse implications for the other party.

13.3 The current drafting of paragraph 3 of Article 1 FP also makes it unclear whether it is intended that these thresholds apply where one of the parties is a third country entity. In the explanatory material on page 7 of the Draft RTS, it is stated that "EU entities would have to collect margin from all third-country entities, unless explicitly exempted by the EMIR *or under the EUR 8 billion threshold ...*" (emphasis added). However, paragraph 3 of Article 1 FP provides that "Counterparties' risk management procedures may include the agreement in writing", and the various thresholds apply where "at least one of the *counterparties*" (emphasis added) is below the relevant threshold. "Counterparties" is defined in paragraph 1(a) of Article 1 DEF as meaning financial counterparties or NFC+s — that is, it only refers to EU entities. As paragraph 3 of Article 1 FP requires an "agreement" between "counterparties" this would appear to indicate that an EU entity cannot agree with a third country entity to take advantage of the exemption from the requirement to collect initial margins where one of the parties is below the applicable threshold. This is inconsistent with the express statement in the explanatory material, and it is submitted that this is an unintended consequence of the restrictive definition of "counterparties".

13.4 This conclusion is supported by other references to "counterparties" in the Draft RTS where it would appear that the term is intended to include third country entities. For example, in paragraph 2 of Article 1 EIM, "two counterparties" are required to agree the method "each counterparty" uses for calculating initial margin. Paragraph 4 of Article 1 EIM then refers to the initial margin requirement being recalculated and collected "by a counterparty from another counterparty" at least when entering into a new contract with "that counterparty" or when an existing contract with "that counterparty" expires. Further, paragraph 1(a) of Article 1 MRM refers to an initial margin model being developed "by one of the two counterparties or jointly by the two counterparties". In all these examples, the reference to the counterparties presumably includes both EU and non-EU entities, as otherwise large parts of the Draft RTS would not be applicable where one of the parties was a third country entity.

13.5 A distinction should also be drawn between reference to agreement between "counterparties" in paragraph 3 of Article 1 FP and the references to agreement between "financial counterparties" and "non-financial counterparties" in the various exemptions set out in Article 2 GEN. Unlike the reference to "counterparties" in paragraph 1 of Article 1 FP, in the latter case, the reference to "financial counterparties" and "non-financial counterparties" is consistent with the statement on page 7 of the explanatory material that EU entities would have to collect margin from third country entities even if they would be classified as NFC-s if they were established in the EU (although this observation is made without prejudice to the submissions and proposals outlined in Paragraph 11 in relation to third country entities).

13.6 Proposal: AFME Members make two proposals in this regard.

(a) First, the definition of "Counterparties" should be amended, at least for the purpose of paragraph 3 of Article 1 FP, so that it includes entities established in both the EU and outside the EU.

(b) Secondly, that each party should be responsible for determining its own aggregate month-end average notional amount for the purposes of the application of the thresholds. Each party should be entitled to rely on information provided by its counterparty for the purpose of determining that counterparty's aggregate month-end average notional amount.

14. Application to Future Transactions Only

14.1 In both Recital (18) to the Draft RTS and the explanatory note on pages 24-5 of the Draft RTS, it states that the margin requirements would only apply to transactions entered into from the entry into force of the RTS. This does not, however, appear to be reflected in the actual text of the Draft RTS. Although paragraph 2 of Article 1 FP of the Draft RTS provides that the RTS apply from 12 December 2015, paragraph 1 of Article 1 FP states that the RTS will enter into force on the 20th day following its publication in the Official Journal of the European Union. Further, paragraphs 3 and 4 of Article 1 FP which provide for phased-in application from 1 December 2015 to 1 December 2019 only apply to initial margin, not variation margin.

14.2 It should also be clarified that where a transaction is amended after it has been entered into, such amendment shall not constitute entry into a new transaction for the purposes of determining the application of the RTS.

14.3 Similarly, where a Securitisation Swap is novated to a replacement Swap Counterparty in accordance with a predetermined contractual arrangement set out in the Securitisation Swap (for example, following a downgrade of the Swap Counterparty as discussed in Paragraph 6.8 above), it should also be clarified that this does not constitute entry into a new transaction. This is particularly important in the context of a securitisation where the Issuer would not be able to agree to new collateral posting obligations in connection with such a novation within the framework of the existing transaction documentation.

14.4 Proposal: It is proposed that the Draft RTS should be amended to reflect the intention expressed in Recital (18) and the explanatory notes on pages 24–5 of the Draft RTS that they do not apply to transactions which are first entered into prior to the date on which the RTS enter into force.

15. Segregation of Initial Margin

15.1 Article 1 SEG requires that initial margin be segregated from the proprietary assets of the collateral taker. The collecting counterparty must also offer the posting counterparty the option to segregate initial margin posted by one counterparty from collateral posted by other counterparties. The initial margin must be segregated in a manner which provides that it will be "immediately available" to the collecting entity where the posting counterparty defaults, and that the posting entity is "sufficiently protected" in the insolvency of the collecting counterparty. Paragraph 5 of Article 1 SEG provides that these arrangements must be supported by legal opinions which are updated annually.

15.2 These requirements raise a number of issues. These are divided into issues arising in respect of collateral posted *to* the Issuer, and collateral posted *by* the Issuer. These comments are also made without prejudice to the proposals outlined above for special treatment to apply to the requirements for Issuers and swap counterparties to post collateral.

15.3 Collateral posted *to* the Issuer:

(a) It is not clear precisely what is meant by "segregation". The market convention for collateral posted by swap counterparties in Securitisation Swaps is to use "title transfer", whereby title to the collateral is passed to the Issuer and would form part of the insolvent estate of the Issuer. This would not constitute segregation of the collateral. However, at the same time, and as described in Paragraph 6.6, the Issuer grants security over all of its assets, including the swap collateral. In particular, the Swap Counterparty has first priority in respect of the security granted by the Issuer over the collateral posted by the Swap Counterparty. Further, where, as is almost always the case, the Issuer is a bankruptcy-remote vehicle, the risk to the Swap Counterparty that it would not be protected as a consequence of the Issuer's insolvency is remote. Accordingly, it is submitted that these arrangements taken as a whole do constitute effective segregation of all of the collateral (not just initial margin) posted by the Swap Counterparty, even though the Swap Counterparty itself is not in a position unilaterally to cause the initial margin to be returned to it following an Issuer default.

(b) If the above arrangements were not considered effective segregation, then it would be necessary for the Swap Counterparty to post initial margin by way of a security interest. In many jurisdictions, the ability to enforce a security interest may be subject to a stay or moratorium in the insolvency of the security provider. It is not clear whether the possibility of such a stay or moratorium is consistent with the requirement that the initial margin be immediately available to the collecting entity where the posting entity defaults. While some relief from a stay or moratorium is provided within the

EU where the collateral arrangement is a security financial collateral arrangement, it is not always possible to structure a collateral arrangement in a way that does constitute a security financial collateral arrangement.

(c) Notwithstanding the above analysis, in the absence of more detailed guidance in the Draft RTS as to what constitutes segregation, or exactly what is required to satisfy the conditions in paragraph 4(a) of Article 1 SEG, it may be difficult to obtain clean legal opinions that the collateral arrangements do in fact meet these requirements.

15.4 Collateral posted *by* the Issuer:

(a) If, contrary to the proposals outlined in Section 8, the Issuer was required to post initial margin to the Swap Counterparty, in order to meet the segregation requirements, it is likely that an Issuer would need to post collateral by means of a security interest (as opposed to a title transfer arrangement). In the case of cash collateral, this would require the issuer to open an account with a third party bank and grant security over that account in favour of the Swap Counterparty. In the case of securities collateral, the Issuer would need to open a custody account and grant security over that account in favour of the Swap Counterparty.

(b) As described above, it is a feature of most securitisations that the Issuer grants security over all its assets in favour of a trustee for the benefit of all its creditors (including the Swap Counterparty). It is unusual for separate security interests to be granted in favour of individual creditors. Rather, the priority in which the proceeds of enforcement of various assets are applied to meet the claims of the various creditors is governed through the use of payment waterfalls (such as those described in Paragraphs 6.6 and 15.3 above in relation to collateral posted by the Swap Counterparty). This means, however, that no individual creditor (other than the trustee) is actually in a position unilaterally to enforce the security over any individual asset on its own behalf. Rather, the transaction documentation prescribes the circumstances and method by which the security would be enforced and the proceeds applied. Thus, even though these arrangements are well-established and accepted by all market participants as an effective means of taking security, it is difficult to see how these arrangements could be said to result in the collateral being "immediately available" to the Swap Counterparty.

15.5 It is therefore important that the segregation requirements are interpreted in a manner which allows sufficient flexibility to take into account the various structural features of a securitisation transaction which already protect the parties from the insolvency or other default of the other party but which may require certain procedures to be followed in order to enforce security or obtain the return of collateral.

16. Requirement expressly to agree exemptions

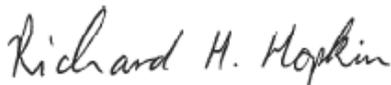
16.1 The Draft RTS provide for various exemptions from the requirement for parties to post collateral (see, eg, Article 2 GEN and paragraph 3 of Article 1 FP). Most of these exemptions require, however, the parties to agree "in writing or through other equivalent permanent electronic means" that the relevant requirements either do not apply or are apply in a less onerous manner. It is submitted that this requirement for positive agreement to disapply the requirements is unnecessary and adds administrative burden without providing any significant benefit from a risk management perspective.

16.2 AFME Members would urge the ESAs to be mindful to avoid excessive documentation requirements that are burdensome and costly and which are not necessary in order to give effect to the requirements of Article 11(3) of EMIR.

16.3 Proposal: It is therefore proposed that the parties should be free to determine which requirements apply to swaps entered into between them and that the documentation should only be required to reflect those requirements which do actually apply.

AFME very much appreciates the opportunity to provide this letter to the ESAs. We would welcome the opportunity to assist the ESAs in their efforts to revise the Draft RTS and implement the rules therein. Please feel free to contact Richard Hopkin with any questions relating to Securitisation Swaps or Sidika Ulker with any questions relating to prime brokerage, at your convenience.

Yours faithfully,



Richard Hopkin, Managing Director
Securitisation



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