



Eurex Clearing

Response to

ESMA Consultation Paper on Draft Technical
Standards for the Regulation on OTC
Derivatives, CCPs and Trade Repositories

Frankfurt am Main, August 3rd, 2012

A. Introduction

Eurex Clearing is a globally leading central counterparty (CCP). We offer fully automated and straight-through post trade services for derivatives, equities, repo, energy and fixed income transactions. As a central counterparty, our focus is to increase market integrity.

Eurex Clearing is a subsidiary of Deutsche Börse Group and acts as the central counterparty for Eurex, Eurex Bonds, Eurex Repo, European Energy Exchange (EEX) the FWB® Frankfurter Wertpapierbörse (the Frankfurt Stock Exchange) - both Xetra® and floor - and the Irish Stock Exchange.

Eurex Clearing AG is a company incorporated in Germany and licensed and regulated as a credit institution under supervision of the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin) pursuant to the German Banking Act (Gesetz über das Kreditwesen). The Financial Services Authority (FSA) has granted Eurex Clearing status as a Recognised Overseas Clearing House (ROCH) in the United Kingdom.

Eurex Clearing has contributed to the consultation on ESMA's Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories issued in February 2012. We welcome the additional opportunity to comment on ESMA's Draft Regulatory Technical Standards which already deliver a first draft legal text based on the discussion paper issued in February.

The next part, section B, of the document contains general remarks we have on the consultation paper. Finally, section C of this document contains detailed remarks on the proposed text.

B. General remarks

The G20 agreement envisaged to strengthen the international financial system by improving the functioning of over-the-counter (OTC) derivatives markets through legislative and regulatory reforms to be implemented by end of 2012. In particular, the mandate was to promote the attractiveness of CCP clearing and thereby increase its use to mitigate counterparty risk and increase market integrity.

As a result on July 27th, 2012 the Regulation on OTC derivative transactions, central counterparties and trade repositories ("EMIR") has been published in the Official Journal of the European Union. While the legislative process took significantly longer than expected, the remaining time for defining and implementing the regulatory standards is very tight and puts both ESMA and the financial industry under significant pressure in order to adhere to the milestones set. ESMA has made great efforts to deliver on this crucial piece of Level 2 regulation on time and in close dialogue with the industry despite complex topics. Eurex Clearing in particular welcomes the consultations undertaken by ESMA in February 2012, and the current one published in June 2012.

To further contribute to ESMA's work, we would like to draw attention to some important aspects of the Draft Technical Standards, which we identified in the consultation paper. We are concerned, that some of the requirements will significantly increase the cost of CCP clearing in Europe beyond the points stipulated in EMIR.

This particularly holds true if the proposed ESMA Draft Technical Standards are neither aligned with recommendations set forth by EBA, or also the recently published CPSS-IOSCO Principles for Financial Market Infrastructures (FMIs), for example. The latter principles will become the global standards for CCPs and other post trade FMIs.

- **ESMA should orientate on comparable international standards**

Mandating requirements for the European financial markets should never ignore the fact that financial markets are global and market participants acting internationally will evaluate their clearing choice based on integrity and safety, but also equally strong on efficiency criteria. Given that the requirements of CPSS-IOSCO Principles as well as the mandate under the Dodd-Frank Act will be deemed as prudent and safe, the final decision of market participants to select a CCP clearing location might then culminate on one factor, namely on costs – legal, operational, administrative or other.

We therefore would like to emphasise that the proposed requirements go beyond the CPSS-IOSCO principles or comparable rulemaking in the US and will put European CCPs in a competitive disadvantage compared to CCPs adhering to those accepted global standards. As example we would name the prescriptive proposals in the areas on margining, collateral, investment policy or liquidity risk control.

To preclude such outcome we urge ESMA to align its orientation with comparable global standards and to perform a detailed cost-benefit analysis and not take a too prescriptive approach when finalizing the technical standards but provide for principle based flexibility

- **Too prescriptive requirements for portfolio margining and compulsory confidence levels**

The deviation from international standards becomes most evident in Annex III, Chapter VII on Margins. Whereas CPSS-IOSCO in its Principles for Financial Market Infrastructures (FMIs) as well as Dodd-Frank (via CFTC regulation 39.9 (g)) set harmonized global standards at 99.0 per cent in confidence levels for both OTC derivatives as well as non-OTC derivatives ESMA has set higher confidence levels for OTC derivatives at 99.5 per cent.

In addition, we would like to refer to the latest Basel III ruling for capital requirement for bank exposures to CCPs as well as the current CRD IV proposal on that topic. OTC derivatives and non-OTC derivatives are treated equally with respect to capital requirements. This might be an indication to not distinguish between OTC and non-OTC derivatives for risk management purposes.

We clearly see the necessity for ESMA to detail relevant EMIR articles and to set certain benchmarks in that respect. However, the entire margins section is overly detailed and prescriptive in its regulation. This prescriptive approach will lead to substantially higher cost for the financial industry and also the real economy without stipulating a safer or more prudent framework. Also we are concerned about reducing the relevance of mutual lines of defense such as the clearing fund and the resulting moral hazard of lower incentive to support the default management process.

Many proposals throughout the entire margins section would fit only in the context of a risk model with a rule-based single-product approach. Such approaches may work for simplest products, but are not applicable for some products cleared already and more complex OTC products subject to mandatory clearing in the future.

A clearing member's default may lead to systemic market disruption if the clearing member's portfolio is too large or not balanced. A balanced portfolio structure is best incentivised by risk sensitive portfolio margining. However, these incentives are violated if margining is not risk sensitive and especially the requirements in Art. 2 MAR and Art. 4 MAR would lead to risk insensitive margins.

The taken approach by ESMA will therefore hinder innovative, state-of the art portfolio margining concepts which to our knowledge are promoted by regulators.

We fully support the idea that the risk method should adequately account for product specifics and special treatment may be required in some cases (e.g. complex or illiquid products). Though, the segmentation into OTC/non-OTC is arbitrary; the segmentation based on inherent product characteristics is far more adequate.

Therefore, addressing such product specifics via a higher confidence level across-the-board is misleading. Instead, specific model add-ons should be included to best reflect the structure of product specifics (e.g. liquidity add-on to account for illiquidity). We will elaborate on details in the respective section of the document.

C. Detailed comments on the consultation paper

Annex II

Chapter II, Indirect clearing relationships (page 66 -67)

Eurex Clearing comments:

Art 39 (3) EMIR requires *“CCPs to open, upon request from a clearing member, more than one account in their own name or for the account of their client”*.

Art. 4 (9) ICA (page 67) requires that:

*“A client that provides indirect clearing services shall request the clearing member **to open a segregated account at the CCP**. The account shall be for the exclusive purpose of holding the assets and positions of its indirect clients.”*

We propose to clarify that individual client segregation as stated in Art. 39 (3) EMIR is required.

In addition, Art. 4 (4) ICA (page 67) requires: *“These procedures shall be supported by the CCP and shall allow the transfer of assets ...”*

We propose to clarify what kind of support is expected from a CCP.

Chapter VI, Liquidity Fragmentation (pages 71/72)

Eurex Clearing comments:

Art. 8 (4) EMIR stipulates that *“access of the CCP to the trading venue shall be granted only where such access would not require interoperability [...]”*

The article is backed by recital 34 of EMIR where *“the right of access of a CCP to a trading venue should allow for arrangements whereby multiple CCPs use trade feeds of the same trading venue. However, this should not lead to interoperability for derivatives clearing or create liquidity fragmentation.”*

Additionally, recital 73 EMIR requires ESMA to first produce a report by 30 September 2014, before an extension of interoperability arrangements can be considered for asset classes other than transferable instruments.

Based on the above, recital 53 of the CP *“that interoperability arrangements should not be excluded”* as well as Art. 1 LF (6) to *“take the form of interoperability arrangements”* for OTC derivatives are in direct contradiction with the level 1 text EMIR.

We believe that before interoperability arrangements for derivatives are authorized a detailed assessment of the implications on systemic risk for the financial markets in Europe is required and minimum standards for Europe should be defined.

Therefore, Art. 1 LF (3) – (6) should be deleted.

Art. 8 (5) EMIR requires ESMA to draft technical standards specifying the notion of liquidity fragmentation. Article 1 (2) LF outlines a definition of liquidity fragmentation. We

believe that this description is too narrow and disregards the aspect that there are different liquidity pools on each level of the value chain.

ESMA, in regards to the task of finding a definition of liquidity fragmentation, should consider these aspects. An alternative specification for the notion of liquidity fragmentation also considering clearing liquidity pools should replace Article 1 LF (2):

“As there are liquidity pools on the clearing and trading layer, it needs to be differentiated between clearing liquidity fragmentation and trading liquidity fragmentation. Clearing liquidity pool fragmentation is a situation where the connectivity between CCPs would create additional systemic risk (resulting from the split of liquidity between the CCPs).

The case would arise where the connectivity of CCPs would end up in a net long position of one CCP and a net short position of the other CCP, and where the CCPs do not provide margins for cross CCP risk positions. It is required, that Inter-CCP risk positions need to be collateralized (i.e. secured by margins) at a third party. In addition, the trading venue needs to ensure the availability of an orderly post-trade process.”

Annex III

Chapter I, General

Eurex Clearing comments (additions in bold / italic):

We would recommend having a clarification added with respect to the confidence level definition in Article 2 (4), i.e. making it clear that the confidence level is the confidence level actually achieved and not the targeted level. Therefore we propose to add a second sentence to the definition: ***"The confidence level is determined via ex-post backtesting as defined in paragraph (1) and reflect the actually achieved percentage of exposure movements"***.

Chapter III, Recognition of third country CCPs (pages 91/92)

Eurex Clearing comments:

We fully support the requirements for the recognition of 3rd country CCPs as outlined in Art. 25 EMIR. We also agree with the statement in Annex III recital 13 that it is “important to ensure that recognised third country CCPs do not disrupt the orderly functioning of European markets or have competitive advantage to authorised CCPs.”

We read with concern that ESMA has chosen policy option 2 relying only on the equivalence assessment by the European Commission for the following reasons:

- Art. 25 (6) EMIR states that European Commission may adopt an implementing act (equivalence assessment) to ensure compliance with EMIR requirements as laid down in Title IV of EMIR.

- This obviously excludes certain EMIR articles of Title II and III e.g. Article 7 (Access to a CCP), Article 8 (Access to a trading venue), Article 9 (Reporting obligations) and Art. 16 (Capital requirements) from the equivalence assessment.

We would urge ESMA to require additional detailed information on the above mentioned areas for the application process according to Art. 1 3C (1) to ensure a level playing field. This could be achieved via inclusion of information in the list of Art. 1 3c (1).

Also, as this is not explicitly itemized, details on the segregation and portability services (customer protection arrangements) of the third country CCP as well as the proof of the legal soundness of those services should be requested, e. g. as a letter (k) on the list of Art. 1 3C (1).

Chapter IV, Organizational Requirements (pages 92 - 99)

Eurex Clearing comments:

In general, with respect to all requirements as set out in Art. 1 ORG et seq., we would ask ESMA to refer to potential outsourcing arrangements pursuant to EMIR Art. 35 which clearly stipulates the outsourcing requirements. We do not see the necessity or mandate for ESMA to restrict outsourcing arrangements by way of regulatory technical standards under EMIR Art. 26. In particular, Art. 35 (1) EMIR even allows for the outsourcing of major activities linked to risk management provided that the approval from the competent authority has been obtained.

According to Art. 1 ORG (2) "a CCP shall define its organisational structure as well as the policies, procedures and processes by which its board and senior management operate." Art. 1 ORG (6) acknowledges that "where a CCP maintains a two-tiered board system, the role and responsibilities of the board and senior management shall be allocated to the supervisory board and the management board as appropriate."

In the final technical standards ESMA should clarify that Art. 1 (6) can be applied to all provisions under Chapter IV (ORG), or, as the case may be, under all ESMA standards.

This is necessary to determine in each case, in accordance with national corporate law, whether reference is made to the management board or the supervisory board.

We would therefore suggest amending Art. 1 ORG Nr. 6 as follows (additions in bold / italic):

"Where a CCP maintains a two-tiered board system, the role and responsibilities of the board and the senior management shall be allocated to the supervisory board and the management board as appropriate. ***For the avoidance of doubt, this provision shall apply to all provisions under these standards imposing responsibilities to the board or the senior management and not only to provisions under this Chapter IV Art. 1 ORG.***"

More detailed aspects are:

In Art. 2 (10) ESMA stipulates conformity with international standards. While we agree that adherence to those standards in general is necessary we however question the legal mandate from ESMA to determine the accounting standards. We see several conflicts with national law especially in regards to the bank accounts directive and the missing opportunity to use it as exempting financial statement.

In Art. 3 (2) ORG the requirement that the CCP's activities and operations have to be "legally sound" should be replaced by the requirement that the operations have to be "*in compliance with EMIR, including regulatory technical standards adopted by the EU Commission.*"

The requirements under Art. 5 ORG should not apply to the CCP's staff in general but should be limited to the board and certain core functions, e.g. the functions as provided for in Art. 5 (4) ORG. This is in line with the purpose of Art. 5 ORG to promote the soundness and effectiveness of the CCP's risk management (cf. Art. 5 (1) ORG).

Chapter VI, Business Continuity (pages 102 – 104)

Eurex Clearing comments:

1) Terminology

- a) "board": again it is not clear which board is meant in a two-tier system: the executive board or the supervisory board. It should be made clear, as it makes a difference for the required board approval according to national corporate law.
- b) "policy" and "plan": the two terms are used in a confusing way. A clear distinction should be made between policy and plan, in terms of content. Alternatively the ESMA technical standards should be worded more flexibly so that this definition issue is avoided.

A policy typically does not contain implementation or operational details. A plan does. The paper is not clear in this respect, respectively suggests that the policy should include information which is normally in the plan. Such as the identification of critical functions and systems, that is normally either in the plan, in the risk analysis or impact analysis.

- 2) Article 1 BC (6): The recovery time of 2 hours should be understood as an objective, as it cannot be excluded that there might be circumstances not under the control of the CCP, notably in "extreme" or "large scale" scenarios, which could perhaps lead to a protracted recovery time.
- 3) Article 2 BC (1): The assessment of the criticality of the CCP functions to other institutions cannot only be the analysed from the CCP itself.
- 4) Article 3 BC (2): Geographically distinct risk profile: it would be useful to repeat the explanation given in recital (32) also in Article 3 BC (2): "should be located sufficiently distant and in a sufficiently geographically distinct location from the primary site so that it would not be subject to the same disaster which may cause the unavailability of the primary site".

- 5) Article 4 BC (2) b: Testing with clearing members, external providers and relevant institutions: this might be challenging, unless external parties are obliged contractually or by regulation. Practical challenges include finding common dates for the tests. In order to address the concern of interdependencies, it would appear to be more practical, if for example industry-wide tests would be organized by regulators or a market association, as it happens in some jurisdictions. ESMA might consider such an approach.
- 6) Article 5 BC (1) & (2): Notwithstanding previous comments on terminology regarding the use of "policy" and "plan", the two articles seem to want to say the same. Consequently, Article 5 BC (1) should be deleted.
- 7) Article 6 BC: The crisis management function shall be "overseen" by the board: Again it is not clear which board is meant and what "overseen" means in practice? Does it mean an operational oversight role? Or should the board just ensure that there is such a function?
- 8) Article 7 BC: The paragraph on crisis communication should be moved under article 6 BC on crisis management, as there is already a sentence there on that topic. For reasons of clarity the article's title could be changed to "Reporting". In addition, it is again unclear which board is meant.

Chapter VII, Margins (pages 105 – 107)

Eurex Clearing comments:

- We would like to note that with regards to the entire margins section, ESMA is overly detailed and prescriptive in its regulation. This prescriptive approach will lead to tremendously higher cost for the financial industry and also real economy without stipulating a safer or more prudent framework. In addition, we see the threat of increased possibility for moral hazard whereby CCPs just follow the rules without attempting to find the adequate risk model. Also we are concerned about reducing the relevance of mutual lines of defense such as the clearing fund and the resulting moral hazard of lower incentive to support the default management process.
- Many proposals throughout entire margins section would fit only in the context of a risk model with a rule-based single-product approach. Such approaches may work for simplest products, but are not applicable for some cleared products already and more complex OTC products subject to mandatory clearing in the future.
- The clearing member's default may lead to systemic market disruption if the clearing member's portfolio is too large or not balanced. Instead, for not too large and balanced portfolios the disruption is much less probable, as such portfolios can be much easier digested by remaining community. The balanced portfolio structure is best incentivised by risk sensitive portfolio margining. The incentives are violated if margining is not risk sensitive. Especially Articles 2 and 4 would lead to risk insensitive margins.

- The taken approach will also be detrimental to innovative, state-of the art portfolio margining concepts which to our knowledge are promoted by regulators.

To efficiently address these major critical areas of concern, we propose to extend or introduce an escape clause in relevant articles to allow the usage of other adequate procedures if it can be shown that comparable level of safety is achieved. In detail we propose the following changes.

Art. 4 MAR Portfolio Margining

Paragraphs 1, 2, 3, 4, 6 unchanged

We would recommend changing paragraph 5 as proposed (additions in bold / italic, deletions in strikethrough):

"A CCP may use any other procedure for the calculation of the adequate offset between different sets of products ~~periods~~, provided that the margin requirements are at least as conservative as those defined in this Article, it is **to satisfy the articles 1 and 3, when applied in a portfolio context and verified according to Chapter XIII Article 3 SBT. The CCP should be** able to demonstrate a clear convergence with the parameters specified in ~~paragraph 2 and~~ **Articles 1-3**, the approach used is **must be** based on a sound theoretical framework and subject to ongoing review **and testing program as defined in Chapter XIII Articles 1 and 3 SBT. In case a scenario-based portfolio margining approach is used, CCP shall instead of applying Art. 4. MAR 2 demonstrate that correlation structure reflects correlation regimes observed over at least two years and during stressed historical or hypothetical scenarios.**"

Art. 1 MAR Percentage

Paragraphs 1, 2, 4 unchanged

We would recommend changing paragraph 3 as proposed (additions in bold / italic):

"The CCP shall inform its competent authority on the criteria considered to determine the percentage applied to the calculation of the margins for each class of financial instruments and shall justify appropriately any departure of the above framework.

In case portfolio margining between OTC and non-OTC derivatives is used, a CCP may use other procedure for calculation of harmonized confidence intervals provided that the margin requirements respect at least confidence interval as defined in Art. 1 MAR 1. b. and account for the factors described in Art. 1 MAR 2. based on a sound theoretical framework and subject to ongoing review and testing programs as defined in Chapter XIII Art. 1 and 3 SBT."

Art 2. MAR Time horizon and other factors for the calculation of historical volatility

1, 3, 4 unchanged

We would recommend changing paragraph 2 as proposed (additions in bold / italic, deletions in strikethrough):

"A CCP may use any other time horizon **and other factors** for the calculation of historical volatility periods provided that the use of such time periods **and other factors** results in margin requirements **that are based on a sound theoretical framework and subject to ongoing review and are consistently verified by testing programs as defined in Chapter XIII Article 3 SBT with the result that margins demonstrate to be** at least as conservative as ~~those obtained with the time periods defined in the paragraph 1~~ **suggested by confidence interval definition in Article 1 MAR and liquidation period definition in Article 3 MAR when applied in a portfolio context.**

The details on the rationale behind the proposed changes are provided below.

With respect to Art. 1 MAR and Article 3 MAR (pp. 105 -106) we have the following remarks:

We fully support the idea that the risk method should adequately account for product specifics and special treatment may be required in some cases (e.g. complex or illiquid products). Though, the segmentation into "OTC" and "financial instrument other than OTC derivatives" seems arbitrary; the segmentation based on inherent product characteristics is more adequate. Therefore, addressing such product specifics via a higher confidence level across-the-board seems inadequate. Instead, specific model add-ons should be included to best reflect the structure of product specifics (e.g. liquidity add-on to account for illiquidity).

Concrete points on confidence level and liquidation period definition:

- The confidence level should be set at a sufficiently high level to guarantee that margins cover relevant portfolio risks in "almost all" cases but should still be at a level which allows for a robust and statistically sound computation of margin figures and statistically reasonable backtesting analyses (i.e. the higher the confidence level, the longer backtesting period would be required to backtest)
- The given confidence level definition is misleading since it motivates the confidence interval in a purely backward-looking way. Instead, the effective confidence level based on out of sample backtesting should be a relevant measure to conclude on model confidence level (see attached presentation with illustrative calculation)
- Instrument-dependent quantiles do not seem reasonable, since the margin requirement in portfolio context should cover losses with a specific statistical confidence, which should be the same over all products in the given portfolio. Quantile requirements should furthermore be in line with other regulatory requirements to ensure globally unified standards (e. g. CFTC/SEC 99%).
- The economic disadvantages for very large confidence levels are listed on page 30 of the consultation paper. In addition, reliable backtesting gets increasingly difficult (even for a one day risk horizon, a quantile of 99.5% expects about one outlier per year). The latter point is important as backtesting is at the core of the margin model

validation process. Also in that context, high confidence levels do not fit together with the envisaged time horizon for backtesting of 250 days, which would require overlapping backtesting for a risk horizon larger than one day, which leads to a further reduction of backtesting significance (page 42, point 233).

- It should furthermore be considered that margin requirements are only one part of the lines of defence, which are supposed to ensure the sufficiency of capital available in the case of member defaults. Risks beyond the levels margin levels are addressed by stresstesting. Too high margin requirements would mean a too small Clearing Fund; therefore members would have little incentives to participate in the Default Management process.
- It was noticed during Lehman that some exchange products had lower liquidity and longer holding period than OTC and vice versa.
- We also would like to question the argument as outlined in recital 163 (CP page 30): ESMA argues that margins will receive a better capital treatment than default fund contributions and hence incentivises clearing member to provide more margins. This argument however falls short of recognizing that the Basel framework as well as the current CRD IV proposal treats OTC derivatives and non-OTC derivatives equally with respect to capital requirements. This is a clear indication to not distinguish between OTC and non-OTC derivatives for risk management purposes.
- As a consequence liquidity (and thus the reliability of the price) should be the criteria for differentiating between derivatives and that those differences should result in different liquidation periods rather than different confidence intervals.

With respect to Art. 2 MAR we have the following arguments why the approach will lead into the wrong direction:

The proposed definition of volatility is ambiguous and has to be clarified:

- a. One possible interpretation: a product-specific volatility should be derived based on equally weighted returns from both periods, whereas most stressed market conditions may differ from product to product.
 - Here, the PnL dynamics in portfolio context is implicitly violated, since volatilities are determined in a scenario-inconsistent way. It seems again to be motivated by single-product rule-based thinking
- b. Another possible interpretation: the scenario set on which margin requirements are based consists of equally weighted stress and latest scenarios:
 - In this case, the margin requirement becomes almost totally insensitive to changes in the market regime. An increase in market volatilities would be shadowed by the worst historical crisis and no immediate awareness to such a change in market conditions would be provided.

To our opinion, both interpretations do not lead to a desirable model feature or are even incompatible with a portfolio margining approach. Counter-cyclical model properties are best provided by preserving a reasonable degree of responsiveness incl. flooring of

margin requirements on different levels (e. g. stressed period floor on portfolio level with additional risk-factor-specific volatility flooring).

Arguments why we are convinced that the approach in Art. 4 MAR (pp. 106) would lead to undesired instabilities for CCP, clearing members and financial system level:

The disallowance of offsets between products where no fundamental rationale for stable correlation can be expected (i.e. equities vs. commodities) is reasonable. Further far reaching prescription for a rule based approach based on pair-wise instrument correlation thresholds would introduce strong imbalance between “conservatism” and “risk sensitivity” of margins, i.e. in most cases the margins would be conservative but not risk sensitive. This disincentives proper risks management both at a clearinghouse and clearing participant level, as same margin amounts may be required for portfolios with completely different risk profiles.

The arguments on the far reaching side effects of the push for risk insensitive approaches and on the limitations of the variants of “pairwise correlation approaches” are known to the industry and to the regulatory world. As a result the proposed approach would be not compatible with portfolio based approaches as they are used by leading CCPs.

The statement on p 33. Art 175. (“ESMA has, therefore, analysed the current practices among European CCPs and on the basis of that developed the requirements included in Annex III”) is misleading, as the analysis might have been restricted to simple products i.e. futures, whereas for complex products like Swaps already now CCPs use risk factor based approaches.

Specifically on the regulatory view this approach would be not compatible with other regulations both in “cleared” context

- Principles for FMI, CPSS/IOSCO/BIS, Apr 2012, cpss101a.pdf
“[...] *An FMI should also provide appropriate incentives [...] for its participants and other entities to manage and contain their risks vis-à-vis the FMI [...]*”)

and “non-cleared” context

- CPSS/IOSCO/BIS consultative paper on Margin requirements for non-centrally-cleared derivatives, July 2012, bcbs226.pdf,
“[...] *Non-centrally-cleared derivatives will often be exposed to a number of complex and interrelated risks. Internal or third-party quantitative models that assess these risks in a granular form can be useful for ensuring that the relevant initial margin amounts are calculated in an appropriately risk-sensitive manner. Moreover, current practice among a number of large and active CCPs is to use internal quantitative models when determining initial margin amounts. [...]*”)

We believe that to best achieve the ultimate goal of the regulation one should impose a guiding principle for a conservative and at the same time risk sensitive margining method where adequacy should be validated by means of robust backtesting process.

In detail, the deficiencies of the “pairwise correlation thresholds approach” are mainly attributable to

- 1) the ambiguities around how the correlation is defined,
- 2) the ambiguities around granularity of instrument definition (vs. risk factor definition), therefore meaninglessness of the “instrument correlation” for complex instruments and
- 3) non-desirable quantitative aspects where restrictions on correlations may counter-intuitively increase or decrease risk estimate depending on the portfolio structure.

add 1)

Correlation itself is a vulnerable starting point to build rule-based framework on it, as pair-wise correlation can be strongly affected by the choice of time windows or weighting schemes, the values may be meaningless as input time series may deviate strongly from normal distribution assumption.

add 2)

Historical “correlation between instruments” implies that instrument is an entity which may be identified, clearly separated from other instruments and observed over time. This may be meaningful for some simple products e.g. futures. But this approach quickly gets meaningless for instruments where more dimensions and granularity in parameter space are possible (e.g. strike and expiry for options, parameters in term sheet for swaps), for instruments depending on many risk factors, exhibiting changing risk profiles over time (e.g. options, bonds, swaps). Here, risk factor approach as opposed to instrument approach is a proven building block for risk models.

Add 3)

Capping of correlations may increase or decrease margins depending on the portfolio setup. Splitting portfolios with more than two instruments based on correlation thresholds may be non-deterministic. In general, manipulating correlations in multivariate context may lead to non-desirable results (negative initial margins for some portfolios).

Example on instrument correlation vs. risk factor correlation:

In the case of IRS, what would it actually mean that two instruments are anti-correlated?

It is impossible to check correlations for all swap rates and maturities; since usually one does not have the same products available in the past to check correlations directly etc.

The risk factor based approach would mean identification of the risk factors in IRS context (e.g. many tenors of the discount curve and forward curve). Attempts to combine the granular risk factor approach with “pairwise-correlation thresholds approach” would result in highly impractical computation scheme (in our curve example the correlations for nearby tenors is very high, short-to-mid is sufficient, mid-to-long is sufficient, but long-to-short is not sufficient to be taken into the same portfolio).

There is no practical example known to us yet of such models employed in real life.

Known examples for simplified rule-based models typically use drastic reduction of risk factor granularity (e.g. only parallel shift is assumed for interest rate curves and implied volatility surfaces) where very rough outcomes are produced and material risks remain not covered.

In our view the solution is an approach where a granular set of risk factors run through a set of scenarios (historical, stress period) furthermore approach is extended with adjustments for known limitations (e.g. correlation breaks and backward looking scenarios). This avoids the above named problems using a consistent risk-factor view by which offsetting is naturally built in without explicitly dealing with a vulnerable correlation numbers. As a consequence, no complicated pair-wise instrument logic employing a strict long-short perspective is needed, which demands for ad-hoc / expert definitions of thresholds (why 70% and not 50%).

This is only one reason, why self-consistent portfolio risk models based on sophisticated historical scenario sampling approaches have manifested themselves as state of the art risk models and are considered best practice by market participants and regulators.

Art. 5 MAR on procyclicality

We view that excessive procyclicality can be best avoided by the inclusion of flooring of margin requirements on different levels (e. g. stressed period floor on portfolio level with additional risk-factor-specific volatility flooring). At the same time the margining should preserve a reasonable degree of responsiveness for CCP to be able to adapt to the change in market phase and ensure the integrity of the markets.

Chapter VIII, Default fund (pages 107/108)

Eurex Clearing comments:

- A review of stress testing scenarios by the Risk Committee every 3 months as outlined in article 3 DF is not useful if there have been no changes in current market conditions.

Chapter IX, - Liquidity risk controls (pages 108 - 110)

Eurex Clearing comments:

Art. 1 LIQ (3) b requires the monitoring of liquidity needs *"across a range of market scenarios"*.

In respect to Art. 1 LIQ (3) it needs to be distinguished between liquidity requirements arising in the normal course of business and liquidity requirements caused by a clearing member default. In the normal course of business, liquidity should be sufficient to cover events that have occurred in the past. In addition, scenarios should be used to stress the historical occurrences.

Liquidity requirements are not materially influenced by market movements but rather by

settlement processes and timely payments by clearing members. Monitoring of needs "across a range of market scenarios" as required in Art. 1 LIQ will not add value and the term "across a range of market scenarios" should be deleted to avoid confusion.

Art. 2 LIQ requires "A CCP shall maintain, in each relevant currency, liquid resources commensurate with its liquidity requirements, defined in accordance with Article 44 of [EMIR] and Article 1 of this Regulation."

We would request that this Article includes a clarification that "liquidity should be measured across all currencies and not for currencies. For major currencies an intraday FX conversion is possible."

Art. 2 (4) LIQ requires a "rigorous due diligence" at liquidity providers. We interpret this as "providing process descriptions to ensure adequate due diligence of liquidity providers". We would ask ESMA to clarify this.

Chapter X – Default Waterfall (page 111)

Eurex Clearing comments:

Art. 1 (1) DW stipulates that "A CCP shall keep, and indicate separately in its balance sheet, an amount of dedicated own resources for the purpose set out in Article 45(4) of Regulation (EU) No xx/xxxx [EMIR]. This amount shall be at least equal to the 50 per cent of the capital, including retained earnings and reserves, held in accordance with Article 16(2) of Regulation (EU) No xx/xxxx [EMIR]."

We are of the opinion that the minimum amount of 50% is too high, is not properly justified in the impact assessment and might lead to a situation where CCPs are encouraged to hold as less own capital as possible. On the contrary, CCPs with higher amounts of capital will be sanctioned.

In defining the dedicated amount of CCP's own resources to be used in the default waterfall ESMA may consider the outcome of the current EBA consultation on CCPs own capital and more importantly the potential detrimental effects on the default procedure of CCPs.

With respect to the default procedure ESMA needs to carefully balance mainly two factors: The amount of the CCP's own resources as well as the contribution of clearing members to the default fund. The amount of the latter is an incentive for clearing members to participate in close-out actions, particularly when it might be most appropriate.

The current ESMA proposal clearly puts a high weight on the CCP (through high own contribution in the default waterfall - "skin in the game"). This will lead to the situation that clearing members are less incentivized to participate in a close out auction (moral hazard).

To avoid such moral hazard we believe a better balanced weighting between the CCP's own contribution and clearing members contributions will help to keep the incentives for both CCPs and clearing members. We propose to split CCP's own resources for the default fund into a minimum 10% portion of "skin in the game" as first step from the CCP

in the default process and to use the remaining 40% portion in the second step on a pro-rata basis together with non-defaulting clearing members.

Such a step wise approach has the additional advantage to not compromise CCPs due to the requirement to immediately recapitalize under stressed conditions.

Also, with respect to the first sentence of Art. 1 DW we would like to highlight that the requirement "separately in its balance sheet" is in conflict with national accounting regulation. We therefore would ask ESMA to change the wording into „*as to be clearly and separately shown in the statutory accounts either in the balance sheet or the notes.*”

Chapter XIII, Review of models, stress testing and back testing (page 119 – 126)

Eurex Clearing comments:

We fully support the need for robust backtesting and stresstesting programmes. Backtesting is the essential mechanism to verify the adequacy and risk sensitivity of the margining model.

In detail we have the following comments:

- 250 day backtesting period in combination with confidence level 99,5% and risk period of 5 days would be not statistically sound (backtest based on overlapping samples or 1-day PnL is questionable). (see also our comments on confidence levels in margining)

Art 3 SBT (1): clarification needed: on what “time horizons” are meant? PnL horizon of e.g. 1_2 or 5 days or historical backtesting period of 1,2 or 5 years?

ANNEX V - Draft regulatory technical standards on trade repositories

Article 6 Reporting of collateral (page 140)

Eurex Clearing comments:

Eurex Clearing margins transactions and positions using a portfolio margin approach, hence, the margin requirements are for a given portfolio and not broken down to individual positions.

Eurex Clearing will call for margin on an aggregate basis across the different portfolios; hence, the collateral posted per margin call or without a margin call does not have a one-to-one relationship with the margin required by Eurex Clearing.

Eurex Clearing assumes, based on Article 6 Number 2, that reporting of collaterals will be done for business that is covered by the CM's proprietary collateral and separately per segregated client. For each of the proprietary and segregated clients the types of collateral will be reported along the value of the collateral and the corresponding currency.

Therefore, the data in Table 2 does not appear to be a suitable format to submit the collateral values. Eurex Clearing therefore proposes the following format for reporting collateral:

Item	Field	Format
1	Clearing member ID	LEI, interim-LEI, BIC.
2	Collateral Type	G=Government Bonds / E=Equity / X=Xetra Gold / C=Cash / B=Corporate Bonds / ...
3	Collateral amount	Up to 10 numerical digits (xxxx,yy)
4	Currency of collateral amount	ISO Currency Code
5	Interoperable CCP maintaining the collateral	LEI, interim-LEI, BIC.

D. Closing

We hope that you have found our comments useful and remain at your disposal for further discussion. If you have any questions please do not hesitate to contact:

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