# ING response to draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories

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**IV.1 Collateral and capital requirements**
**Q1. What would be the effect of the proposals outlined in this discussion paper on the risk management of insurers and institutions for occupational retirement provision (IORPs)?**
Response not applicable to ING

**IV.2 Options for initial margins**
**Option 1: The posting of IM by all counterparties**
**Q2. What are your views regarding option 1 (general initial margin requirement)?**
Making it mandatory for both sides of a trade to post initial margin would generate a drain on liquidity. It could have a significant economical impact on Non Financial Counterparties (NFC) to develop or acquire systems and/or to set up a back office organization to comply with the regulation in the short term.
Given that option 1 is misaligned with the Initial Margin requirements from Dodd Frank, this may lead to the possibility of regulatory arbitrage.

**Q3. Could PRFCs adequately protect against default without collecting initial margins?**
In principle they could. The available risk coverage capital should be sufficient at all times to cover the risks taken.

**Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.**
There is a cost implication for any derivatives market participant in having to deposit IM. This cost in the long run will be borne by participants paying higher margins/fees to market makers. This situation differs to settling Variation Margin; payment of VM can be priced in or priced out by market makers and as such does not increase overall costs for participants – for clearable transactions end users will be able to choose to transact through execution brokers and clear through CCPs and obtain interbank prices, with IM, clearing and custodial fees as an add on to the savings in transactional fees.
Major Trading FCs are likely to clear through CCPs for clearable transactions between major trading FCs – which increases costs as both parties place IM. However, there should be regulatory capital savings in terms of counterparty and CVA Var to compensate for the increase costs due to IM.
If FCs are required to receive and post IM with NFCs then this will increase costs further. It may lead to an incentive to clear through CCPs even when the NFC is not mandated to clear through CCP as this will lead to a regulatory gain for the FC and reduce operational cost for the FC. This will lead to some of the increased costs payable by NFCs in terms of custodial fees.

**Option 2: The collection of IM by PRFCs only**
**Q5. What are your views regarding option 2?**
Option 2 reduces the mismatch between EMIR and Dodd Frank Proposed Rules, which consequently reduces the potential regulatory arbitrage.

**Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?**
Generally speaking it assumes that the parties in scope will have the financial means and organizations to cater for this which is difficult for ING to comment on.

**Option 3: PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold**
**Q7. What is the current practice in this respect, e.g.**
**- If a threshold is currently in place, for which contracts and counterparties is it used?**
Currently, we do not use a threshold on PFE to determine whether we request for initial margin (or Independent Amount). For a small subset of counterparties (typically hedge funds), we do collect Independent Amounts on a trade-by-trade level.

**- Which criteria are currently the bases for the calculation of the threshold?**
ING does not apply a threshold,but for hedgefund counterparties the risk profile is one of the determinants.

**Q8. For which types of counterparties should a threshold be applicable?**
For all counterparties.

**Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?**
Ideally, it be linked to certain criteria the counterparty should meet; however, in order to be less complex to apply, but still sufficiently tailored, it is our view that a fixed amount as a function of the counterparty's internal rating could be considered. The threshold calculated based on the internal ratings could be limited by a cap provided by ESA provided that such threshold is set at sufficiently high level.

**Q10. How – in your opinion - would a threshold change transactions and business models?**
As noted before, IM creates an overall cost to the market which will be paid for by market end users. If regulators recognise that systemic risk is only posed by major market participants, and therefore exclude the more minor end user participants from a mandatory requirement to place IM, then this will reduce the overall cost to those end users. Using a PFE threshold as a determinant of minor end users would seem a sensible way of differentiation. Allowing minor end users to be exempt from these requirements will not change the fact that the market will have to bear materially increased costs imposed by the new regulations; costs that will be borne ultimately by end users.

**On all options:**
**Q11. Are there any further options that the ESAs should consider?**
No further comments

**Q12. Are there any particular areas where regulatory arbitrage is of concern?**
Our concerns are mainly:

- On the misalignment of counterparty classification and its margin requirements between Dodd Frank Proposed Rules and all options proposed in this consultation paper.

- If Financial Counterparties (FC) freedom to set the thresholds, as per option 3, and a potential conflict of interest could be solved by providing for a cap which is sufficiently high to allow flexibility in credit decision making.

**Q13. What impacts on markets, transactions and business models do you expect from the proposals?**
These proposals are going to have the following impacts, all of which will increase the costs of market makers, who will pass these costs on to end users;

1. The increase usage if IM will increase costs
2. The increased requirement for FCs to operate in the new environment will require IT investment to support an IM collateralised infrastructure
3. The requirement to collateralise with all counterparties will increase the size of collateral management operations support
4. The front office of FC dealing rooms will have to become more sophisticated in managing collateral which will become a business in itself. Collateral transformation will become a stand alone business line. This will require IT/OPS investment and increase in front office HC – all of which will be paid for by end users.
5. Global custody/brokerage services will extend into derivatives with increased costs to end users.

It is noted that for end users, transaction pricing for CCP cleared transactions will become more transparent and there is the possible outcome that these savings for end users will offset the increased costs mentioned above.

The absolute size of the market or any impact on transactional sizes is not expected to be material.

Those trading organisations that decide not to offer a client clearing service as their organisations do not offer global custody/prime brokerage/exchange traded future broking services will be disadvantaged against those organisations that offer these services, as "captive" OTC clients of these smaller trading organisations will use global trading organisations for their "OTC derivative" clearing. Although these clearing services should be ring fenced from an informational perspective from the trading activities of the same organisation, it is not envisaged that this segregation will be "water tight". Thus trading organisations with large derivative clearing businesses will obtain competitive advantage and access to end users over those organisations that do not offer OTC derivative clearing.

### IV.3 Variation margin

**Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?**

In our view, a less frequent exchange of collateral could be applied for NFCs+. This is because, given a proposed low clearing threshold, we expect that some NFCs+ would likely be limited by operational constraints in meeting the daily requirements.

**Q15. What would be the cost implications of a daily exchange of collateral?**
This would increase the execution cost of transactions.

**IV.4 Initial margin**

**Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?**
The MTM method is basically equal to the Current Exposure Method (CEM) and is unreasonable because of the fact that it is not risk sensitive enough. A similar argument can be used for the standardized method. In addition, the standardized method may also not be conservative enough. ING considers investing in a sophisticated Initial Margin calculation tool for uncleared OTC derivatives, rather then investing in methods that only give rough approximations. It is very likely that ING will need additional time beyond the current implementation date.

**Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?**
A HVAR approach is the best, with a second best-approach a simulation approach.

**Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?**
Other than for hedge funds (where ING is using a percentage of the notional), ING does not calculate IM at the moment.

**Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?**
Yes, as DNB approval of the model, but without a capital framework (under which the use of bad models are punished by higher capital requirements), does not seem to make much sense.

**Q20. Do you think that the "Internal Model Method" as set out in the CRD is a reasonable internal approach for the calculation of initial margin requirements?**
Yes, under some further conditions. IMM is basically a simulation method and a risk sensitive approach. However, correlation assumptions with regard to different asset types may need to be setup more conservatively. Also the model testing should be focusing more on the short term performance, then on the longer term performance for which the IMM was originally meant. So short term volatilities should be more key then long term or average ones, due to the fact that the calculation will be done under a 5d to 10D close out period.

**Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?**
Not relevant for ING Bank

**Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?**
This is difficult to quantify at the moment, but this will not be immaterial.

**Q23. To what extent would the „mark-to-market method‟ or the „standardised method‟ change market practices?**
These methods are currently not used.

**Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.**

For VM, in case of MTM disputes a third party (calculation agent) can be used. For IM there is a similar risk that two counterparties might not agree on each others assumptions. This also should be addressed in the bilateral agreements in terms of agreed dispute management provisions.

**Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?**
If bilaterally agreed that one counterparty is the calculation agent for IM, that is very well possible.

**Q26. Do you see other options for treating such differences?**
No third party arbitrage seems to be the only solution.

**Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?**

Collateral Segregation should be possible in a segregated account or with independent third party custodian.
Advantages:

- Extra default protection

Disadvantages:

- Funding implications; re use of collateral no longer possible

**Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?**

Although we generally believe that segregated initial margin should be held by an independent third party custodian, we also point out that cash cannot effectively be segregated as it will get ultimately commingled with the assets of custodian, i.e. it will become a contractual claim ranking *pari passu* with other non-secured liabilities of custodian. Therefore additional transparency and mitigation techniques could be considered such as (a) definition of *independent* ensuring that such custodian will not be a member of the same corporate group[1], (b) that the identity of such independent third party custodian is disclosed to a counterparty, so that the counterparty can assess and aggregate risks it runs with the independent third party custodian with any other exposures arising from other relationships with such third party custodian and (c) that such independent third custodian is of certain credit quality.

**Q29. What are the practical problems with Tri-Party transactions?**

ING does not currently engage in Tri-Party collateral transactions with OTC Derivative counterparties so no practical problems currently exist for the firm.

**Q30. What are current practices regarding the re-use of received collateral?**

All collateral, legally agreed for rehypothecation, is re-used..

**Q31. What will be the impact if re-use of collateral was no longer possible?**

Currently ING hold a non material amount of Initial margin for OTCD transactions. Post EMIR implementation this can definitely be a material amount and hence will have funding implications if this cannot be re-used

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[1] Similar rule can be found for example in Chapter 7 of FSA Handbook on Client Money Rules

## IV.5 Eligible collateral

### Q32. What are, in your view, the advantages and disadvantages of the two options?

<u>Option 1</u>
Advantages

- Limiting the collateral to the same criteria as the CCPs will not encourage entities to avoid central clearing in order to allocate their less liquid collateral which may be allowed under the Bilateral CSA, although we assume that most of the current CSA's signed in the market focus on cash and high grade government bonds.
- Entities can re-use the received collateral under the Bilateral Agreements to post as collateral in a CCP. This alternative ensures most of the times, there will be a use for the collateral received under the bilateral agreements, even though there is no market for it at a specific moment in time.

Disadvantages

- Allows for collateral that is not normally accepted under the CSA such as commercial bank guarantees. Physical gold we do not view at the moment as an instrument that will be easily used by parties

<u>Option 2</u>
Advantages:

- symmetry with eligible collateral accepted under law which enacted CRD
- Acceptable criteria mostly limited only to cash or tradeable financial securities

Disadvantages

- Some collateral types under CRD may not really find acceptance in the market or will have liquidity concerns or costly procedures to post/and receive (eg gold) May encourage entities to avoid central clearing in order to post other acceptable collateral bilaterally.

### Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

No, as it is already general market practice to collateralize with financial assets. Certain types of counterparties will restrict themselves to instruments they only have available, but in ING's view no formal need to make restrictions.

### Q34. What consequences would changing the range of eligible collateral have for market practices?

Impact may be insignificant. Firms have already developed a standard collateral list included in Collateral Agreements (eligible collateral under the CSA) to ensure that the collateral assets are of sufficient quality and sufficiently liquid (with haircuts) to mitigate exposure. In general, the standard market eligible collateral is covered under the scope of both options.

### Q35. What other criteria and factors could be used to determine eligible collateral?

The range of collateral allowed under EMIR should be flexible but also should ensure that collateral is very liquid and have low credit and market risks. We consider eligible collateral as defined by ESMA consultation in paragraph 120 to be a good indication. Furthermore parties should be able to transfer it easily. (Cash could be by far the easiest instrument)

### IV.6 Collateral valuation / Haircuts

**Q36. What is the current practice regarding the frequency of collateral valuation?**

Collateral should be valued daily.

**Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?**

Regardless of types of transactions/counterparties, daily collateral valuation should be mandatory.

**Q38. What are the cost implications of a more frequent valuation of collateral?**

For financial institutions operating in liquid security markets the cost of frequent collateral valuation should be minimal as this is already market process.

**Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?**

If counterparties have a sufficient/robust credit risk management function to ascertain the appropriate haircuts for collateral, they should be allowed the use of own estimates of haircuts otherwise they should have to use standardised haircuts. Therefore we believe that only PRFCs should be allowed to use own estimates of haircuts.

**Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?**

PRFCs have a sufficient/robust credit risk management function to ascertain the appropriate haircuts for collateral and they should be allowed the use of own estimates of haircuts.

### IV.8 Risk management procedures, operational process for the exchange of collateral and minimum transfer amount

**Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?**

To ensure counterparties have robust operational processes ING suggests that their operational process be inline with the ISDA's "Best Practices for the OTC Derivatives Collateral Process[2]".

**Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?**

In order for the operational process to continue being robust given the pending regulation (identifying of different customer classification (NPRFC, PRFC and NFC); initial and variation margin calculation and collateral management; segregation of IM collateral) significant system infrastructure redesign is necessary, which will necessitate substantial investments in systems. As vendor solutions are not ready for this yet, costs are difficult to quantify yet.

As an additional point, we believe that ESA should clarify that in computation of variation margin, netting effects can be granted to whole netting set as per CRD IV regardless of time in which transaction was entered into. Although this is ING's understanding that this is the only possible correct interpretation, it would be useful to have it expressly confirmed. This would help ensuring correct implementation in the operational processes.

**Q43. What are your views regarding setting a cap for the minimum transfer amount? How should such cap be set?**

[2] **Best Practices for the OTC Derivatives Collateral Process** ISDA Collateral Steering Committee - June 30, 2010

ING believes that any minimum transfer amounts are bi-lateral agreements between OTC derivatives participants and as such regulators/authorities should **not** be setting caps. However, it is a regulators responsibility to encourage a robust and efficient market with reduced systemic risk and as such regulators have a mandate to establish capital rules. In determining CVA VAR capital requirements, credit mitigants will be a natural offset to credit risk and therefore the valuation volatility arising from counterparty credit and market volatility. Therefore ING would see it as a role of regulators to determine scales of credit mitigation in OTC derivative collateral agreements that would include the size of minimum threshold amounts in collateral agreements that allow reduction in CVA VAR and therefore CVA VAR Capital. ING sees this as a much better driver of market practice than legal caps.

**Q44. How would setting a cap impact markets, transactions and business models?**
Credit exposure is a relative factor. Sensitivity to changes in credit exposure between ING and Deutsche Bank for example are very different than between ING and a Mid-Corp client experiencing liquidity problems. It therefore follows that having a "one-size" fits all cap on minimum transfer amount could never possibly address these two credit sensitivity situations. As such any legal cap will be a limitation which in some cases will fit the situation but in many cases will be totally inappropriate. If the cap is set at more of the ING/Deutsche end of the scale, it will be meaningless at the ING/Mid-Corp end and Banks will go below the minimum for the weaker credits, if the cap is set at the ING/Mid-Corp level then this will increase the number of collateral transfers between better credits which have an immaterial relativity to the commercial exposure, thus increasing costs and inefficiency for market participants without reducing systemic risk.

**IV.9 Intra-group exemptions**

**Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?**
Practical or legal *impediments* to the prompt transfer of own funds or repayment of liabilities should be defined in a narrow manner and should be deemed mitigated in case there is an enforceable documentation in place (regardless of enforceability of netting or collateral). Impediments could include any capital, foreign exchange or other ring-fencing restrictions imposed by authorities of a country of incorporation or head office of affiliates.

**Q46. What is the current practice regarding the collateralisation of intragroup derivative transactions?**

Although for the larger intragroup ING entities we collateralize intra-group derivative exposures on a daily basis, it is crucial that we will be able to remain flexible in deciding correct mix of collateral and liquidity arrangements between affiliates. We stress the importance of intra-affiliate exemption for transfer of collateral.

**IV.10 Cost-benefit analysis**

**Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?**

Regarding the span of time, ING foresees major issues with the targeted implementation date of 1 January 2013. Rather ING would suggest having a more phased in implementation of the new rules, in close conjunction with the relevant supervisor. On the impact of presented options, the expected implications for funding are perceived to be rather negative as the re-use of collateral will be subject to considerable limitations.