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**Comments on IOSCO's Consultation Report on Risk Mitigation
Standards on Non-centrally Cleared OTC Derivatives**

Attachement

Dear Mr Hui,

the German Banking Industry Committee (GBIC) is grateful for the
opportunity to comment on the IOSCO's consultation report on risk
mitigation standards on non-centrally cleared OTC derivatives (IOSCO
draft standards).

Please find attached our comments to your consultation paper.

Yours faithfully,
on behalf of the German Banking Industry Committee
National Association of German Cooperative Banks

by proxy



Gerhard Hofmann



Dr. Sarah Schröder

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Comments

on IOSCO's Consultation Report on Risk Mitigation Standards on Non-centrally Cleared OTC Derivatives

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.

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Comments on IOSCO's Consultation Report on Risk Mitigation Standards on Non-centrally Cleared OTC Derivatives

The German Banking Industry Committee (GBIC, die *Deutsche Kreditwirtschaft*) is grateful for the opportunity to comment IOSCO's proposed risk mitigation standards on non-centrally cleared OTC derivatives (IOSCO draft standards).

We fully support and welcome the initiative: IOSCO standards will provide a general international guidance which will help to harmonise the international regulatory frameworks. Further international harmonisation is essential to prevent inefficiencies or even incompatible regulatory regimes.

We largely concur with IOSCO's approach regarding the different aspects of risk mitigation principles with respect to non-centrally cleared OTC derivatives. The standards proposed by IOSCO seem to set out a comprehensive and consistent set of guidelines for the implementation of an effective risk mitigation regime.

We are, however, concerned that some of the IOSCO draft standards appear to be unnecessary detailed and specific and may address issues – such as the question of valuation – which are already covered by other international initiatives. Certain aspects also appear to be modelled very closely on the US standards under the Dodd-Frank Act. Because of this high degree of specificity of certain aspects addressed in some standards and of the relevant accompanying explanatory notes, there is a risk that the standards set may be interpreted in such a way that practices established under and conforming with the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (European Market Infrastructures Regulation - EMIR) of July 4th, 2012 and its implementing and delegated regulations could be seen to formally deviate from some of the IOSCO standards.

We strongly believe that the risk mitigation requirements for non-centrally cleared transactions existing in the European Union can be considered to set out a comparatively high standard which strikes the correct balance between the need to establish a comprehensive, consistent and effective framework for the mitigation of risks emanating from non-centrally cleared transactions on the one hand and the need to avoid unnecessarily formalistic and restrictive obligations on the other hand.

Against this background, we believe some of the standards and the accompanying explanatory notes should be reviewed and rephrased in a more general manner so that they are able to accommodate various manners of implementation and do not require one single approach to be pursued where others achieve the same objectives. This would ensure that the IOSCO standards can serve their purpose as general international guidance which provides for a sufficient degree of flexibility and openness to permit jurisdictions to adopt and implement them in manner best suited to the relevant regulatory and legal framework. The concerns are addressed in greater detail in our response to question (a) and (b) below.

Please find in the following our considerations regarding IOSCO's proposals:

(a) Are the proposed risk mitigation standards generally appropriate in light of the objectives? Are there any particular standards you consider to be inappropriate for inclusion? Please provide rationale.

(b) Are the key considerations appropriate and consistent with the standards? Are there elements of the key considerations that should instead be included in the standards? Are there additional or alternative key considerations that should be considered for each standard? If so, please describe them and explain why they should be included.

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As set out above we largely concur with the proposal. We particularly agree that the nine standards proposed address all key issues and encompass (together with the margin requirements addressed in the BCBS-IOSCO framework) all measures which together form an effective framework for effective risk mitigation in respect of non-cleared OTC derivatives.

In particular the following risk mitigation techniques – all of which are covered by EMIR requirements as well as generally applicable supervisory principles – are essential elements of such framework:

- contractual documentation
- trade confirmation procedures
- portfolio data reconciliation
- portfolio compression
- dispute resolution

However, some of the standards and explanatory notes appear to be unnecessarily detailed and formalistic. In addition, some of the legal concepts addressed and the terminology used and should therefore be reviewed.

- **Standard 1 – Scope of Coverage:**

We agree with the approach to limit the personal scope of the standards to “covered entities”, that is qualified counterparties which are of sufficient systemic significance: This approach ensures that the majority of corporate counterparties (“non-financial counterparties” within the meaning of EMIR) with no systemic significance is not subjected to burdensome requirements, which it is neither used to nor able to comply with. This holds particularly true for the standards proposed regarding confirmation, valuation, portfolio reconciliation and portfolio compression: For the vast majority of these non-financial counterparties it would be extremely challenging to implement the systems required to conform to all standards, in particular the requirements concerning valuation. In view of the limited systemic risks involved, this is also not necessary.

We are, however, concerned that explanatory notes under item 1.7 address issues which go beyond the subject matter of the standards: While we fully agree that the involvement of third-party services needs to be permissible (in fact their involvement is indispensable), we believe that the standards should refrain from setting out specific requirements regarding the manner in which the selection and provision of such third-party services is reviewed and monitored: The involvement of third-party services is a matter already governed by generally applicable regulatory rules (i.e. on outsourcing). There is no need for an additional layer of rules. In order to avoid inconsistencies or uncertainties, if the issue is addressed at all, it should be limited to a requirement of a more general, less specific, nature.

- **Standard 2 - Trading Relationship Documentation:**

We fully agree that adequate internal documentation of key processes in respect of OTC derivative transactions as well as the use of adequate contractual documentation as a basis for such transactions are necessary components of an effective risk management system. This is also consistent with standard practice: Transactions are generally entered on the basis of standard master agreements together with confirmations regarding the terms of the individual transactions entered thereunder or sometimes on the

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basis of stand-alone confirmations. These documents are sufficient records of all relevant legal and commercial terms. Of course, the extent and level of detail depends very much on the nature of the transaction in question and of course, also applicable law (which may already provide for rules on many aspects of transactions so that further contractual rules may not be required).

We therefore generally concur with the key considerations under items 2.1 to 2.4 and, in particular the statement under item 2.6, first sentence.

Furthermore, it should be considered to change the terminology, as "trading relationship documentation" is a term primarily associated with existing US requirements. A more neutral terminology would help to underline the international and more general nature of the IOSCO standards.

As to the explanatory notes, we believe that in particular item 2.6 should be revised. For one, we believe that all references to margin requirements should be deleted or at least limited as much as possible since margin requirements are already and comprehensively addressed in the parallel BCBS-IOSCO Margin Requirements. Documentation requirements in respect of specific aspects of the margin requirements may easily result in inconsistencies or cause uncertainties.

In addition, we would suggest refraining from attempting to set out a list of specific elements, which should generally be covered as this could be understood to constitute a definitive list or minimum standards which it cannot be: Although described as examples, the terms may be deemed to constitute the core terms to be addressed in the documentation. However, while this may be largely for standard transactions this may not be the case with less common non-standard transactions.

Furthermore, this section mentions a number of rights and obligations which in many transactions – in particular in transactions with non-financial counterparties – are of no or little practical relevance or refer to legal concepts which are not easily transferable to all jurisdictions (i.e. rehypothecation – although being addressed in a number of recent regulatory initiatives – is primarily a legal concept under common law). The explanations in this section may therefore be a cause for unnecessary confusion and can give rise to misunderstandings.

The above considerations and our comments on Standard 1 item 1.7 apply correspondingly to the explanatory notes set out in item 2.7 recommending the involvement of external auditors. These are unnecessarily specific and address issues governed by general regulatory requirements. A duplication or an added layer of requirements in this respect will only result in inconsistencies and confusion. We therefore suggest deleting the last sentence of item 2.7.

• Standard 3 – Trade Confirmation:

We note and welcome the fact that the proposal refrains from setting out specific time limits for a confirmation. Experience has shown that very demanding time limits are difficult to comply with in many situations – especially in relation to more complex transactions or transactions with less experienced and sophisticated counterparties.

Annex 1 sets out specific terms for individual asset classes deemed material which would therefore have to be covered in a confirmation. While we largely agree with the terms we also (as in the case of other list of examples or terms in this paper) believe that such a detailed list of specific terms deemed to be

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material is not necessary and may actually cause uncertainty: Such list can always only serve as examples or means for general orientation. It can neither define a strict minimum standard nor can it serve as definitive /exhaustive list of material terms. This holds particularly true since the examples mentioned are relevant for standard/plain vanilla transactions but may be less so for non-standard/bespoke transactions. To underline this exemplary/non-binding nature, it could be considered to set out more clearly, especially in the light of well-established market practices, that the terms mentioned are only examples and that it may be necessary and appropriate to address other, less or more terms in a confirmation.

- **Standard 4 – Valuation:**

Although we fully agree, that the counterparties – in order to have a clear and common understanding – need to agree in advance on the standards and methodology for determining the value of a transaction and/or the portfolio. We also fully agree (as it is current practice) that the relevant internal processes need to be documented adequately. We are, however, concerned that the standards proposed are again too detailed and formalistic: The contractual documentation governing the transactions, in particular where this is based on standard master agreements, includes standard terms regarding the calculation of the close-out amount in the case of a default or for the purposes of collateralisation which are well established and understood by market participants. There is thus no need for any further terms and documentation in addition to those agreed upon in the contractual documentation. However, the proposed requirement to agree on the methodology for determining the value (as set out in the standard and under item 4.3) could be understood to require further extensive detailed documentation in addition to such standard contractual terms. This cannot be intended. The relevant requirements should therefore be set out in more general terms or it could be clarified that this is not meant to be understood as a requirement to enter into additional agreements with more detailed terms supplementing those existing in the contractual documentation commonly used.

Moreover, it needs to be taken into account, that the requirement to agree on the process and/or the methodology for determining the value of the OTC derivatives transactions, cannot be understood to imply, that the parties to the contract have to agree on identical process and even would be required to use the same methodologies in their internal calculation for risk management purposes. This should be clarified to avoid misunderstandings. In this context, it could also be considered to distinguish more clearly between requirements concerning internal procedures (which can only apply to the counterparties individually and cannot and do not need to be agreed upon by the counterparties) and requirements concerning the contractual agreement governing the transactions.

In addition, since valuation is a central aspect of margin calculations believe that the proposal may result in unintended conflicts with or confusion over relation to the parallel BCBS-IOSCO Margin Requirements. Therefore, detailed requirements, such as those under item 4.2 concerning the manner in which valuations are to be determined or the requirements concerning the documentation on the applicable methodologies under item 4.3 should not be set forth in this paper to avoid inconsistencies, duplications and/or uncertainties.

Against this background, we believe it would be more appropriate to address any requirements concerning valuation, if at all, in general terms only. Also, any requirements regarding the documentation of contractual terms in relation to the valuation should, if at all, be exclusively addressed under standard 2 (subject to the comments above on standard 2). Likewise any requirements, including documentation

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requirements, concerning the valuation as an element of a portfolio reconciliation, should be incorporated in standard 5.

- **Standard 5 – Reconciliation, Standard 6 – Portfolio Compression:**

We agree with the proposals concerning standard 5 and 6. We particularly welcome that the proposals regarding portfolio reconciliation avoid listing detailed and specific requirements and that the proposals concerning portfolio compression recognises that the issue whether a portfolio compression is to be performed is one that can only be decided by an institution on an individual basis following internal assessments and cannot be predetermined and agreed in advance.

- **Standard 7 – Dispute Resolution:**

The dispute resolution mechanism is of course not meant to constitute a formal submission to alternative dispute resolution and precluding ordinary legal recourse. However, it could be helpful to clarify this and set out more clearly.

(c) Are there standards or key considerations that should be further expounded on (e.g. specifying the deadlines for completion of trade confirmations under key consideration 3.2; the characteristics or parameters of what constitute "economically similar transactions" under key consideration 4.2; the frequency for conducting reconciliations under key consideration 5.1)?

(d) Are there additional or alternative relevant risk mitigation techniques that should be considered and implemented to reduce the risks arising from non-centrally cleared OTC derivatives transactions? If so, please describe them and explain why they should be considered.

No: The risk mitigation techniques addressed in the proposal cover all relevant aspects and techniques and we also see no need for further specifications or details (as to our concerns over too detailed and specific requirements, see our comments above).

(e) What are the practical challenges in implementing the standards? Please substantiate the issues identified and propose solutions to these challenges.

Experience from the practical implementation of the risk mitigation techniques under EMIR has demonstrated that the requirements concerning the time limits for a timely confirmation (since August 2014 two business day following execution where one of the counterparties is a non-financial counterparty, otherwise one business day) are difficult to comply with in many situations.

In some jurisdictions, the possibility to rely on so called negative affirmation helps to reduce the difficulties. However, in certain situations and under the laws of some jurisdictions reliance on negative affirmation may not be appropriate or possible.

(f) Are the proposed risk mitigation standards compatible with obligations arising under other international standards applicable to non-centrally cleared OTC derivatives, such as the margin requirements for non-centrally cleared OTC derivatives published by IOSCO and BCBS in

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September 2013? If not, please identify the relevant standards and explain any areas of incompatibility.

See our comments on standard 4 regarding the risk that the requirements regarding valuation may conflict with the existing framework for margin requirements (BCBS-IOSCO Margin Requirements).