Eurex Clearing
Response to
ESMA’s discussion paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Frankfurt am Main, March 19th, 2012
A. Introduction

Eurex Clearing is a globally leading central counterparty clearinghouse (CCP) and the largest clearinghouse in Europe. Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure as well as with industry leading risk management services for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

Eurex Clearing AG is a company incorporated in Germany and licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für 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 welcomes the opportunity to comment on the ESMA Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories issued in February 2012.

In our response, we have focused on topics related to clearing and CCPs. The first part of the document contains general remarks we have on specific aspects of the discussion paper. The second part provides detailed answers to the questions posed by ESMA.
B. Comments

B 1: General remarks

Recalling the goals of the G20, it was envisaged to strengthen the international financial regulatory system through improving over-the-counter (OTC) derivatives markets. In particular, it was agreed to implement clearing for all standardized OTC derivative contracts through central counterparties by the end of 2012. Eurex Clearing appreciates ESMA’s Discussion Paper as an important step towards achieving the G20 goals and towards defining technical standards as required in the forthcoming final Regulation on OTC Derivative Transactions, Central Counterparties and Trade Repositories (EMIR).

Before turning to the specific responses to the questions raised in the Discussion Paper, in section B 2, Eurex Clearing would like to make some general remarks for ESMA to consider on major aspects of significant importance in drafting the technical standards.

• **ESMA should avoid an overly prescriptive approach and leave flexibility to the CCPs in their Risk Management responsibility**

  As pointed out in more detail below, Eurex Clearing believes that the Technical Standards in particular on CCP requirements tend to be very prescriptive and too inflexible. CCPs already today have a very strong incentive to follow a robust and prudent risk management and operational approach since they are directly exposed to counterparty risk, while being neutral institutions not conflicted from taking market risk.

  In drafting the Technical Standards, ESMA should define principles that still allow sufficient room for CCPs to drive innovation in risk management as evidenced in the past. In addition, CCPs are closest to the actual business and have the highest degree of expertise, when defining the right risk management approach in consultation with their risk committee. A principle-driven approach ensures best, that CCPs can contribute their own expertise and experience. In the past, CCPs have proven their strength during the financial crises and performed well over the years.

  The goal rather has to be to establish a harmonized framework in Europe, in which CCPs can manoeuver based on guidelines and criteria, rather than a prescriptive approach.

• **Information requirements for the clearing obligation are disproportionate and tend to be backward-looking**

  With respect to the clearing obligation we recognize the challenge ESMA is facing to try striking the right balance in defining the classes of derivatives eligible for a clearing obligation. A definition that is too narrow might lead to circumvention of the clearing obligation by market participants; a definition too wide might leave too much ambiguity to be implementable and enforceable.

  The current set of information requirements is too ambitious to be collected. Due to the nature of current OTC market practices, information such as bid-ask spreads will not be readily available for a significant number of OTC contracts. Eurex Clearing therefore suggests to regard the list of information requirements not as minimum standard but as guideline that should leave room for discretion by ESMA.
All in all, Eurex Clearing believes that a reasonable definition of classes of derivatives for the clearing obligation should also consider CCP risk management approaches for pricing, liquidation and standardization instead of largely focusing on historical data.

- **Clearing obligation should set the right incentives for further standardization and transparency in OTC derivatives**

  In general, it would be preferable to provide economic incentives to market participants for standardized OTC contracts to be centrally cleared rather than maintaining a mandatory list of OTC derivative classes. The clearing mandate raises the topic of enforceability which has to be considered by ESMA. As an alternative, we would propose to ESMA to follow a target-based approach. Instead of market intervening measures in regards to enforcing a clearing obligation, we would advocate setting goals for central clearing to be achieved in the various classes of OTC derivatives, whereas the path of implementation can be kept flexible, in order to promote innovation and responsibility.

  In order to achieve the goals set by the G20 and to lead EMIR to success, a large majority of OTC derivatives should be CCP cleared considering the potential for OTC standardization. For this reason, it is important to apply significant economic incentives for instance in capital requirements to facilitate a smooth migration while steal leaving flexibility to market participants to conduct bilateral transactions if required.

- **ESMA should ensure global consistency of the clearing and CCPs requirements and not exceed CPSS-IOSCO standards**

  In order to limit competition between CCPs on risk management grounds, it is important to adopt and enforce consistent standards on a global basis. Otherwise, it will not be possible to eliminate the risk of competition from CCPs outside the EU on risk management grounds. It is the intention of CPSS-IOSCO to set out principles for CCPs globally. EMIR might compromise global consistency of risk management standards by going beyond these principles.

  An example thereof is that the EMIR Level 1 text requires 99% minimum for margin requirements, which is consistent with the proposed CPSS-IOSCO principles. Stipulating margin confidence levels above 99% would limit the flexibility of CCPs with respect to their risk management capabilities on the one hand, and will lead to disadvantages for European CCPs on a global level.
B 2: Detailed answers to the questions

Clearing obligation and clearing obligation procedure (Articles 3 and 4)

Response to Questions 1 to 9:

**Q1:** In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

**Answer:**
While it is challenging to define specific requirements on a detailed level, Eurex Clearing would suggest to consider that the following criteria are of relevance for specifying classes of OTC contracts with a direct effect within the EU:

1) The underlying of the OTC contract is a European underlying, e.g. interest rates; index benchmarks, etc.; or
2) The currency of the OTC contract is the Euro or a currency of a EU member state; or
3) A counterparty of the OTC transaction is based within the EU.

In order to determine a substantial and foreseeable effect, ESMA could consider to set specific thresholds for gross nominal outstanding exposure and for nominal payment flows as applied by other regulators.

**Q2:** In your views, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

**Answer:**
Eurex Clearing believes it is difficult to provide general cases. Based on the definition of classes of OTC derivatives that have a direct, substantial and foreseeable effect within the EU, ESMA shall rather apply an ongoing monitoring of those contracts and determine required actions on a case-by-case basis.

**Q3:** In your views, what should be the characteristics of these indirect contractual arrangements?

**Answer:**
Eurex Clearing recognizes the need for market participants to comply with the clearing obligation and to maintain either a direct or indirect relationship with a CCP. Already today CCPs maintain a principle-to-principle relationship with their direct clearing participants who act as risk intermediaries to indirect participants, i.e. non-clearing participants (clients of clearing members). We believe the current model with different risk management roles for the CCPs and their clearing members has proven to work very well.

Eurex Clearing welcomes choices of different models of client asset protection as laid out in EMIR Article 37 for indirect participants to protect themselves from the default of their clearing members. Eurex Clearing supports that the choice of segregation models should include full individual client segregation on a CCP level, being the only
model to provide both full insolvency protection and immediate portability of positions and assets – highlighted again in the MF Global default. Incentives for indirect participants should favor the choice of full individual segregation from instance in terms of regulatory capital requirements.

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

Answer:
Eurex Clearing considers the required information as outlined in paragraphs 12 to 19 as far too detailed. A too narrow description of requirements for a clearing obligation will be counterproductive and will lead to induce significant delays for new classes to be included in the clearing obligation. In addition, details like e.g. tightness of spreads, or open interest as requested in paragraph 17 might not be available at all for a contract. Therefore the information requirements should not be seen as minimum requirements but as examples leaving discretion for ESMA decision making. Furthermore historical information will only be accessible from Trade Repositories over time, once databases are developed and maintained and data is published. For the described bottom-up approach, ESMA may recognize that CCPs will only ask for clearing obligations of products or classes of derivatives if they are able to ensure adequate risk management. Therefore the focus should be much less on backward looking empirical data, but rather on CCPs approaches to e.g. pricing of contracts and liquidation.

Thus, Eurex Clearing believes that a reasonably broad definition of classes of derivatives for the clearing obligation should be defined with justified exemptions e.g. based on liquidity or other aspects. As a starting point we propose that ESMA follows the International Swaps and Derivatives Association (ISDA) classifications of asset classes as the highest level of classification. These include:

- Credit Derivatives / Credit Default Swaps;
- Equity Derivatives;
- Interest Rates Derivatives;
- FX Derivatives;
- Energy, Commodities, Developing Products; and
- Structured Products and Other.

Within each asset class the standardized OTC products can be further broadly determined. For example, OTC interest rate derivatives may include single or cross currency swaps, basis, overnight indexed swap and forward rate agreements; and equity derivatives may include single name, index, dividend and volatility derivatives amongst others. Given the various and detailed requirements currently discussed by ESMA we would like to question how the clearing obligation can be enforced by ESMA on an ongoing bases for economically equivalent contracts falling into under one of the classes of derivatives published in the ESMA register.
Q5: For a reasonable assessment by ESMA on the basis of the information provided in the notification, what period of time should historical data cover?

Answer:
Historical data is only of limited relevance. For example, new products or recently standardized products might not have a long history available that could be used. From a CCP perspective this is not a barrier, since alternatively higher margins could be calculated for these products. For further details on margin calculation please refer to our responses to Q 34 and 35.

Q6: What are your views on the review process following a negative assessment?

Answer:
The proposed process appears reasonable. However it should be clarified that CCPs will nevertheless be able to offer such contracts for clearing regardless of whether ESMA adds these to their public register.

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, and availability of pricing information?

Answer:
The specifications for assessing standardization, volume and liquidity, and availability of pricing information seem to be appropriate. However, as outlined already in our answer to Question 4 Eurex Clearing believes that a reasonably broad definition of classes of derivatives for the clearing obligation should be defined with justified exemptions e.g. based on liquidity or other aspects. This also applies to the associated criteria of legal and operational process standardization. An excessively narrow description of legal frameworks and operational processes would encourage an evasion of the clearing obligation.

Q8: What are your views, regarding the details to be included in ESMA register of classes of derivatives subject to the clearing obligation?

Answer:
Eurex Clearing considers the requirements as outlined in paragraph 24 as too detailed for a clearing obligation. Too many details might encourage an evasion of the clearing obligation. In addition, ESMA should outline the procedure how the clearing obligation can be enforced to contracts that are currently traded and clearing bilaterally but are economically equivalent to a class of derivatives falling under the clearing obligation.

Q9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

Answer:
Please refer to our answer to Question 4.
Non-financial counterparties (Articles 5 and 7)
Response to Questions 10 and 11:

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

Answer:
Eurex Clearing recognizes the treatment of OTC derivatives transactions of non-financials. However, the proposed range of reasons for hedging purposes with respect to commercial activities as outlined in paragraph 29 is quite broad. It is imperative that ESMA clearly defines rules and definitions to proof that the respective “commercial” reasons are only used for those activities only.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

Answer
The above criteria deem valuable to define the clearing threshold(s). The favored approach should be setting low threshold levels for activities of non-financials not related to activities directly reducing commercial risks or treasury financing.

Risk mitigation for non-CCP cleared contracts (Articles 6 and 8)
Response to Questions 12 to 22:

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

Answer:
We believe the objective has to be that all transactions are electronically confirmed. A transaction that is electronically handled should be confirmed far more quickly than manually processed transactions.

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

Answer:
The period for reporting unconfirmed trades should be on trade date. In the evening of the trade day there should be an overview of what is confirmed or not confirmed, but
nonetheless, the whole portfolio should be reported.

Q14: In your views, is the definition of market conditions preventing marking-to-market complete? How should European accounting rules be used for this purpose?

Answer:
We leave the detailed answer to this question for other market participants.

Q15: Do you think additional criteria for marking-to-model should be added?

Answer:
We leave the detailed answer to this question for other market participants.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

Answer:
We leave the detailed answer to this question for other market participants.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

Answer:
We leave the detailed answer to this question for other market participants.

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

Answer:
We leave the detailed answer to this question for other market participants.

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

Answer:
We leave the detailed answer to this question for other market participants.

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

Answer:
We leave the detailed answer to this question for other market participants.
Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

Answer:
We leave the detailed answer to this question for other market participants.

Q22: In your views what details of the intragroup transactions should be included in the information to be publicly disclosed by counterparty of exempted intragroup transactions?

Answer:
Exemptions should be carefully calibrated because usually companies are limited in their liabilities and there is no obligation for parent companies to cover potential losses. All intragroup transactions should at least be reported to Trade Repositories.

Access to venues of execution (Article 8a)

Response to Question 23:

Q23: What are your views on the notion of liquidity fragmentation?

Answer:
With multiple trading venues being served by multiple CCPs, same products would be fragmented on trading and clearing layer. Being concerned with performance and efficiency, the costs or economies directly attributable to fragmentation are still obscure and there is no consensus on a figure.

In general, it is important to point out that there are different motivations and interests, when it comes to intransparency, liquidity and availability of customer flow in regards to open markets. Those market participants which benefit from obscure and intransparent markets and reduced liquidity are rather inclined to internalize customer flow, instead of providing the flow to open and transparent markets. These market participants are also the ones who benefit from fragmentation, to the expense of the overall market. Since fragmentation reduces liquidity, internalization becomes more profitable.

There are several adverse effects to the market associated to fragmentation in derivatives markets:

- Fragmentation has negative oversight effects
  - E.g. regulators are concerned that fragmentation makes it harder to conduct effective market surveillance against market manipulation and abuse

- Fragmentation has negative risk implications
  - E.g. multiple interfaces between independent entities will put end-to-end operational stability at risk
  - In order to further attract flow, CCPs could start a race to the bottom in regards to risk management. If it would be mandated to have same risk management
measures and models, in order to correct the race to the bottom, a monoculture would arise, transmitting undesirable effects throughout the whole European network.

Fragmentation is negative for investors due to worsened price discovery

- E.g. Institutional investors consider that fragmentation makes it harder to find liquidity

Fragmentation demands inter-linkage/ interoperaibility

- To make a model with two or more clearing houses serving one market economically efficient, requires some form of interoperability

- Interoperability in derivatives is highly problematic, as it tends to destabilize markets by creating additional systemic risk and reducing market efficiency, e.g. open risk positions could be linked across multiple jurisdictions with different bankruptcy laws and regulators with unpredictable consequences in case of market default.

- Title V on interoperability for CCPs for transferable securities does not impose an obligation but rather defines the conditions under which interoperability can be allowed. It would be illogical that interoperability for transferable securities is treated with caution whereas a right for interoperability for derivatives would be a result that is implied

**Recognition of a CCP and organizational requirements (Articles 23 and 24)**

**Response to Questions 24 to 29:**

**Q24:** What are your views on the possible requirements that CCP governance arrangements should specify? In particular, what is your view on the need to clearly name a chief risk officer, a chief technology officer and a chief compliance officer?

**Answer:**

A CCP should be free to define its organizational structure. This structure should be reviewed by the relevant regulatory authorities. We do not believe that a definition of particular roles will add value.

**Q25:** Are potential conflicts of interests inherent to the organisation of CCPs appropriately addressed?

**Answer:**

Yes, the proposal appears adequate.
Q26: Do the reporting lines – as required – appropriately complement the organisation of the CCP so as to promote its sound and prudent management?

**Answer:**
In principle, all requirements as outlined in 70 to 72 can promote sound and prudent management of a CCP. However, as these requirements are very detailed we would like to highlight, that the final technical standards need to provide a level of flexibility to cater for national characteristics (e.g. a two tier board structure).

In addition, we interpret the wording of 71. last sentence “subject to independent audits” in conjunction with 72. first sentence “CCPs should, therefore, establish and maintain an internal audit function...” to be equivalent, i.e. the internal audit function can be seen as independent.

Q27: Do the criteria to be applied in the CCP remuneration policy promote sound and prudent risk management? Which additional criteria should be applied, in particular for risk managers, senior management and board members?

**Answer:**
It is of critical importance that ESMA align approaches with EBA as EBA outlines analogous technical standards for CRD IV (or with the European Commission if the Commission is to include these in legislative proposals directly). A CCP should only be subject to a single set of regulations / single regulatory policy on remuneration.

The criteria applied are sufficient to serve the goal to achieve a prudent and sound (risk) management.

Generally, there should not be an incentive to take inappropriate risk in order to achieve individual goals. The balance between fixed and variable remuneration should be balanced (i.e. variable proportion not above certain percentage of total). The variable remuneration should be linked to targets in line with the CCPs strategic targets.

A selection of elements likely to be included in a remuneration policy for risk managers and senior managers:
- Annual review requirement
- Consistency with business strategy, e.g. incorporating target achievements defined in accordance with business strategy
- Appropriateness of remuneration, e.g. appropriate ratio between fixed and variable remuneration for staff versus for management, guaranteed variable remuneration in exceptional cases only and just for the first year of employment, link to measurement of performance
- Avoiding high risk positions, e.g. through not having significant dependency on variable remuneration and not having significant contractual severance entitlements
which are not diminished by individual negative performance contribution

- Prohibition of personal hedging strategies, e.g. management should not undertake personal hedging strategies or other countermeasures (such as insurances) that confine or neutralize the risk alignment effects of their remuneration

- Ensuring appropriate capital bases, e.g. variable remuneration must not limit the companies ability to sustainable maintain or recover an appropriate capital base

In most countries, remuneration of members of boards of publicly listed companies are regulated under separate policies.

Q28: What are your views on the possible organisational requirements described above? What are the potential costs involved for implementing such requirements?

Answer:
We would like to highlight that in the current setting organizational requirements functioned well. CCPs are subject to national laws and supervision. We believe there is no value add in further detailing requirements.

Q29: Should a principle of full disclosure to the public of all information necessary to be able to understand whether and how the CCP meets its legal obligations be included in the RTS? If yes, which should be the exceptions of such disclosure requirements? Has the information CCP should disclose to clearing members been appropriately identified? Should clients, when known by the CCP, receive the same level of information?

Answer:
To clearing members
- Daily settlement/valuation prices
- Daily and Intra-Day margin requirements and margin breakdown
- Required clearing fund contribution
- Risk methodology (margining, collateral valuation)
- Benefits and risks of different segregation solutions
- Governance arrangements with customers
- Default waterfall and liquidation process outline

To clients known to the clearinghouse, e.g. through individually segregated clients
- Daily settlement/valuation prices
- Daily and Intra-Day margin requirements and margin breakdown
- Required clearing fund contribution
- Risk methodology (margining, collateral valuation)
- Benefits and risks of different segregation solutions
- Governance arrangements with customers
- Default waterfall and liquidation process outline

To clients not known to the clearinghouse
- Aggregate volume information by product
- Daily settlement/valuation prices on next working day
- Governance arrangements with customers
- Default waterfall and liquidation process outline

To the public
- Aggregate volume information by product
- Daily settlement/valuation prices on next working day
- Governance arrangements with customers
- Default waterfall and liquidation process outline

**Record Keeping (Article 27)**

Response to Questions 30 and 31:

**Q30: What are your views on the possible records CCPs might be required to maintain?**

*Answer:*

The list of proposed records a CCP might be required to maintain is extensive and very detailed. In particular, the requirement under 81 b, to explain the content of up to 10 year old reports without delay, might proof challenging.

We propose to start record keeping forward looking after EMIR approval of the CCP.

**Q31: What are your view on the modality for maintaining and making available the above records? How does the modality of maintaining and making available the records impact the costs of record keeping?**

*Answer:*

Maintaining and making the extensive and detailed proposed records available can be a huge cost driver for a CCP. For electronically available data electronic means for reporting of records might be considered. For all reporting of kept records the costs and benefits of the request should be carefully balanced to avoid too much of a burden for CCPs.

In addition, to ease the burden of record keeping we propose to start the record keeping forward looking (e.g. entry into force of EMIR, when applying as CCP under EMIR or with approval as EMIR complaint CCP). A backdated approach should be avoided.
Business Continuity (Article 32)

Response to Questions 32 and 33:

Q32: What are your views on the possible requirements for the business continuity and disaster recovery plan and in particular on the requirements for the secondary site? Would it be appropriate to mandate the establishment of a third processing site, at least when the conditions described above apply? What are the potential costs and time necessary for the establishment of a third processing site and for immediate access to a secondary business site?

Answer:

The possible requirements outlined in Article 32 appear generally appropriate, although we have comments on some aspects (see further below).

The requirement 88.b) for the secondary site seems adequate. Whilst there is an intuitive understanding, the requirement may benefit from further clarification regarding the term “geographically distinct risk profile”. We believe it should be a distinct location taking operational limitations into account.

With regard to 88.c) and a third site, if the requirement as per 88.b) cannot be met, than it makes more logical and economic sense to move either the primary or secondary site, rather than to establish a third site. In addition, operating a third site would cause material additional costs.

Additional comments:

With regard to terminology, a clear distinction should be made between “policy” and “plan”. The policy typically does not contain implementation or operational details, however, the plan does. The policy should set high-level objectives and regulate roles and responsibilities to provide clear direction for the development, implementation, validation and maintenance of business continuity plans. Also only the term “business continuity” should be used instead of “disaster recovery” to avoid confusion.

With regard to the structure of Article 32, the requirements of the business continuity plan should be summarized under 87.b). 87 c) and d) should therefore be merged into there, and also as partially repetitive with regard to b).

With regard to 87.a) it would be beneficial to clarify the terms “board” and “extreme scenarios”.

With regard to 88.d) and “immediate access”, here also the recovery time objective should be applied.

With regard to 89., the requirement on the CCP to include clearing members and external dependencies in tests is challenging, unless they are obliged contractually or by regulation. Other practical challenges include finding common dates for the different tests stipulated. 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 the regulator or a market association, as it happens in some jurisdictions.
In addition, customers are included in tests, if material changes are to be considered at their side.

**Q33: Is the 2 hours maximum recovery time for critical functions a proportionate requirement? What are the potential costs associated with that requirement?**

**Answer:**
The requirement of a 2 hours recovery time objective appears to be generally proportionate. The requirement should be phrased as an objective. Therefore we suggest to use the term “recovery time objective” instead of “recovery time” in 88.b), like it is used in 88.c). It should not be excluded that there might be circumstances, notably in “extreme” or “large scale” scenarios, which could perhaps lead to a protracted recovery time.

**Margins (Article 39)**

**Response to Questions 34 to 37:**

**Q34: Are the criteria outlined above appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP’s margin models? Should a criteria based approach be complemented by an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?**

**Answer:**
In general, no prescriptive approach should be implemented to increase the margin related interval beyond 99%.

The above criteria should be complemented to mention the appropriate confidence levels and criteria for the method structure, due to the fact that fixed percentages are not comparable between the methods that differ structurally. The percentages should reference the out-of-sample back testing performance of the model rather than the in-sample historical look back view. Out of sample back testing performance is also able to address the criteria mentioned under paragraph 95 to a large extent.

Structurally it is possible to construct models with large discrepancy between the two confidence levels: in-sample historical view at 99,5% could produce an effective out-of-sample back testing performance of as low as 94% or less during stressful periods. In such case the comparison of 99,5% and 99% of the following two methods lead to counterintuitive results: 99,5% n-day full revaluation scenario based VaR with 4 year historical scenarios (method 1) may be effectively less adequate than 99% n-day full revaluation scenario based VaR with 250 stress scenarios, 3 year volatility scaled historical scenarios including countercyclical component (method 2). Reason here is
the poor out-of-sample backtesting performance of the method 1.

On the magnitude of the percentage: ECAG point of view is that increase of percentages beyond 99% lead to a decrease of the Guaranty Fund requirement and thus disincentivise the involvement of Clearing Members in Default Management Process. Especially the default management process is the core element of a CCP and therefore we would consider that the right incentive mechanisms here a crucial for the stability of a CCP. In addition one could think of very straight forwards concepts to address procyclicality, moral hazard, portability and short history other than just a higher confidence level. The very high confidence level close to 100% makes clearing very expensive and would lead to large concentrations to a much reduced number of clearing members, which is neither intended nor desired. An out of sample back testing performance of 99% can be seen as valid trade off between a defaulter pays model and the right incentives for loss mutualization. This can also be concluded from historical defaults, were margins proofed to be sufficient to cover the losses out of a clearing member default.

Furthermore, the general ECAG view on margin methodology selection is outlined below.

Risk scenarios evaluated have to be adequate, methodologically sound and of sufficient quantity to estimate 99% appropriately. Out of the sample backtesting is the core element here. When balancing between model stability and accuracy, the priority should be given to the stability of margining model, also countercyclicality ideas should be taken into account when calculating margins. Definition at an instrument level is not feasible, as this would disagree with the portfolio approach.

**Considerations for margin methodology selection**

Out of many existing risk calculation approaches spanning a wide range from simple and rough approaches to sophisticated approaches, only a narrow subset is applicable for the purposes of a CCP. Furthermore, some adjustments outlined below are required to adequately reflect the CCP specifics, e.g. the chosen margin methodology is consistent with its default management process. The set of methods assessed here in respect to applicability for margining and ranked by the level of sophistication is comprised of:

- Current Exposure Method/Standardized Method (very low sophistication),
- SPAN/TIMS/RBM (low sophistication),
- Simulation based historical VaR methods (medium sophistication) and
- Simulation based Monte Carlo VaR methods (high sophistication).

Ultimate purpose of the margin is driven by the business model of the CCP: cover the losses that may arise during the resolution of a clearing member default. Further
desired properties beyond the (1) consistency with the default management process are (2) transparency, (3) risk adequacy, (4) stability and (5) capital efficiency.

(1) Consistency with Default Management Process
The fact that margining is done for the purposes of default management requires a strong alignment between the risk calculation and the mechanics of the default management process. This implies restrictions on i.e. risk period, risk netting, confidence level

Risk period: The assumed duration of the default management process should correspond to the assumed period of risk in the calculations. The risk period expresses the expected time needed to liquidate without unduly stressing markets. This may include set-up time, hedging, direct sales or auctions, and must include a buffer period to remain guarded against unforeseen situations. This time period should be set by each CCP based on its operational procedures for liquidation, and validated to as high a degree as possible in regular simulations. Based on the past experience, a 3-5 day risk period seems to be appropriate. However the CCP has to ensure that these periods are kept.

Risk netting: Portfolio margining should only be granted for such portfolios which can be liquidated at the same point in time in case of a clearing member default. This is firstly to avoid any risk of margin shortfalls during the liquidation procedure due to previously granted margin offsets and secondly to ensure that cross-product offsets are not out-weighted by additional liquidity margins.

If the portfolio of the defaulting member is liquidated product-wise, then product-wise margining should be performed. However liquidating portfolios on position level is very high time and resource consuming with negative market impact and therefore not sufficient for large portfolios. In contrast, if the portfolio is liquidated as a whole (e.g. via auction process) then portfolio margining is adequate. If the portfolio is split into parts that are liquidated separately, then risk netting should respect the structure of the portfolio split. Similarly, if parts of the portfolio are segregated (e.g. segregated member account) then risk netting should be restricted to respect the economic structure of the segregation.

Confidence level: Collateralization at 100% confidence is in general neither feasible nor economically reasonable. Therefore it is common that margining reflects the risk at almost 100% confidence level, leaving the tail risk to be mitigated by further layers in the Lines of Defense (e.g. Default Fund). Given the rare occurrence of extreme events, the tail risk is to be tested separately against the sufficiency of the Lines of Defense in hypothetical what-if stress scenarios.

The exact value for confidence level is a matter of standardization, currently the values
are scattered across CCPs e.g. 99%, 99.7%, 100%. However, there are limitations for the comparability of the claimed confidence levels shown on the examples below. Confidence level information is only meaningful together with the information on method structure (e.g. 99% full revaluation scenario based VaR with stress scenarios, volatility scaled historical scenarios including countercyclical component)

- Distribution assumption: 99.7% with a normal distribution assumption is not the same as 99.7% with fat-tailed distribution
- Pro cyclical vs. counter-cyclical margins: 99% confidence based on weighted scenarios is (especially in calm periods) not comparable with 99% based on scenario framework containing countercyclical component
- 99% at a single product level does not translate into 99% at a portfolio level which can get substantially different depending on the structure of risk netting
- Claimed 100% is not true 100% risk coverage. The percentages should reference the out-of-sample back testing performance of the model rather than the in-sample historical lookback view.

Methods of medium and high sophistication can be adjusted to deal with all the topics named above. Although the methods with very low and low sophistication can be adjusted to incorporate the adequate risk period, they have difficulties to adequately deal with risk netting and provide resilient statement on the targeted confidence level. A 99% confidence level based on the (fat-tailed) real distribution proved to be an appropriate measure.

(2) Transparency

Members usually require understanding and possibility to replicate the margin numbers calculated by the CCP. The CCPs should provide measures. From this perspective the margining methodology should strike the balance in respect to sophistication vs. transparency.

(3) Risk adequacy

Suitability for the type of portfolios and products: The margining should reflect the economic risks arising from the potential necessity to manage portfolios of defaulted clearing members. All risk methods make assumptions and approximations that result in some imprecision of margin numbers when measured against economic risk. Overall, by increasing the sophistication of the method, the imprecision can be reduced. And vice versa, reducing the sophistication of the method more and more implicit assumptions come into play and the field of the model reasonable applicability gets very narrow. For example Current Exposure method may compute risk adequate figures for small directional portfolios, but disconnects from economic risk when
dealing with large diversified portfolios, due to the inability to adequately deal with risk offsetting.

**Coverage of relevant risk drivers:** The models employed should cover all the material risk drivers for the products and portfolios in question. For example in options portfolios, the modeling of implied volatility dynamics, in Interest Rate Swaps portfolios the modeling of tenor spreads, in bond portfolios, the coverage of credit and default risk is essential.

**Liquidity and concentrations:** In addition to market, credit and default risk considerations, the liquidity and concentration aspects are important from the CCP perspective. Large concentrated portfolios are common and in case of liquidation which has to be conducted during a limited short time frame it cannot be assumed any more, that losses will be attributed to market moves only. The applied risk model should quantify the discounts due to illiquidity and concentrations (i.e. large positions relative to the market capacity). Where default management procedures avoid the line-by-line liquidation of positions, the duality between liquidation discount and hedging cost should be taken into account in the risk model.

**Offsetting, correlations:** Depending on the risk model, the offsets in portfolio context are modeled either explicitly (very low to low sophistication but also Monte Carlo) or implicitly (historical VaR). Any model should account for the fact that offset structure, being a key driver for risk numbers for diversified portfolios is not stable over time and forms a very vulnerable assumption for the overall risk model. So, adjustment for the variation in the offsetting structure should be quantified in the risk model.

Models with medium or high level of sophistication can include the corrections to account for variability of correlations e.g. Monte Carlo when using VCV matrices estimated from different time periods, or historical VaR using scenarios from different time periods. Models with low and very low level of sophistication are very limited in the ability to calibrate and use the reasonable alternatives for offsetting structure.

**Good forward looking properties:** The ultimate goal of the margining model is to adequately project the potential future losses during default management. The common technique to improve the forward looking properties of the risk models is the usage of dynamic volatility models. Here, the level of margins dynamically increases when the market volatility increases. The downside of such approach is that the models exhibit pro-cyclical behavior, exacerbating the negative effects by pulling the liquidity out of the financial system during crises. So further adjustments for margin stability should be included (see section on stability)

**Ongoing validation:** For any type of model, there should be robust model supervision and validation processes in place including but not limited to backtesting of how the model would have performed in the past but also during real default situations.
Overall, rather diversified type of portfolios, anticipated growth of the product spectrum, portfolio size and concentration within a CCP suggest that models with very low to low level of sophistication should not be considered.

(4) Stability
The pro-cyclical behavior is not a desired property for margining model. But it can arise in any model: for example when using the dynamic volatility modeling in mid- and highly- sophisticated models, but also in the models with very low or low sophistication if the inputs are calibrated based on weighted scheme or based on the historical data from the calm market period.

There are ways to introduce the counter-cyclicality in the model of any sophistication e.g. by using volatility floors and/or including stress periods into scenarios. Such measures stabilize margins both in long term through the economic cycle respectively and also in short term i.e. significant jumps for unchanged portfolios are avoided over a few weeks.

(5) Capital efficiency
The effects of the central clearing from the market participant’s point of view is twofold: first, it creates “positive” effects mitigating counterparty risk, second it creates “negative” effects while pulling the liquidity in form of margin and Default Fund collateral out of the market. To preserve the economic reasonability for central clearing, the margining computation should account for capital efficiency considerations i.e. accounting for portfolio effects as long as this does not contradict with segregation and default management mechanics.

Q35: Taking into account both the avoidance of procyclicality effects and the need to ensure a balance distribution of the financial resources at the CCP disposal, what it is in your view the preferred option for the calculation of the look-back period.

Answer:
ECAG point of view is that a combination of stress scenarios and around 3 years of recent historical scenarios – so alternative c) - is the most appropriate. Additionally, historical scenarios should undergo the dynamic volatility modelling scheme in order to improve the out of sample back testing performance of the model.

The main reason for c) this is that increase of the look back period beyond 2-3 years does not translate to the increase of the model quality as directly (or at all, given that weighting scheme by construction reduces the effective look back period), as structural improvement of the model, provided by explicit inclusion of unweighted stress periods, does.

Driving considerations for the look back period is a right balance between the responsiveness and stability (countercyclicality) of the model. The lack of
responsiveness of the model leads to very poor and undesired out of sample back testing properties - typical behaviour for unweighted historical simulation models, so incorporation of the weighting scheme is the way to address. At the same time, introduction of weighting leads to the fact that effective look-back period decreases. Even if the model's input is 5, 10 or more years of historical data, older data is effectively marginally contributing to the output. Given this, there is little improvement if more than 2-3 years of history are used within the weighting scheme. In addition to their questionable contribution to the improvement of the model, too long look back periods restrict the transparency and replicability of the model.

Now, the remaining problem is that look-back period of one/two years does not guarantee the coverage of the stress phases. To address this, a hybrid model using weighting scheme for few recent years with explicitly selected stress periods prolonging the effective memory and avoiding the procyclicality of the model should be used. Furthermore, please see our answer to question 34 (Stability section).

Q36: Is in your view the approach described above for the calculation of the liquidation period the appropriate one? Should a table with the exact number of days be included in the technical standards? Should other criteria for determining the liquidation period be considered?

Answer:
Please see comment to Q34:

The assumed duration of the default management process (here defined as the liquidation period) should correspond with the expected time needed to execute the predefined default management strategy without unduly stressing markets and the longest period possible between the last margin call and the declaration of default by the CCP. The latter is particularly important in case the CCP does not calculate and call for margins intra-day.

This time period should be set by each CCP based on its operational procedures for liquidation, and validated to as high a degree as possible in regular simulations. Based on the past experience, a 3-5 day risk period seems to be appropriate. However the CCP has to ensure that these periods are kept, therefore exact numbers shall not be included in the technical standards.

Q37: Is procyclicality duly taken into account in the definition of the margin requirements?

Answer:
Please see our answer to Question 34 (Stability section) and Question 35.
**Default Fund (Article 40)**

Response to Question 38:

Q38: What is your view of the elements to be included in the framework for the definition of extreme but plausible market conditions?

**Answer:**

Scenarios that were observed during the stress periods in the past at a confidence level of 99.9%. In addition, hypothetical scenarios should be applied. The elements mentioned under the paragraphs 103 – 105 sound reasonable. In respect to Political events, Natural disasters; Economic developments and Regulatory events one could assume that they are already covered in the historical or hypothetical scenarios implicitly.

**Liquidity Risk Controls (Article 41a)**

Response to Questions 39 to 41:

Q39: Do you believe that the elements outlined above would rightly outline the framework for managing CCPs’ liquidity risk?

**Answer:**

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 suggested in 110 ii) is therefore not expected to add value.

In case of a stress situation, liquidity is not used to cover losses of the clearing house, but rather to interim finance the settlement of securities transactions. The used funds will be available again within a short time frame according to the liquidation procedures. Replenishment as suggested by 110. v) should therefore happen automatically within the liquidation period.

Concentration risk is an important risk component. Limits should be based on the liquidity requirement rather than the available liquidity. To better explain this statement, following example is provided:

Assuming following parameters:

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity requirement</td>
<td>EUR 4bn</td>
</tr>
<tr>
<td>Available liquidity</td>
<td>EUR 12bn</td>
</tr>
<tr>
<td>Concentration limit</td>
<td>25%</td>
</tr>
</tbody>
</table>
Liquidity provision:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A</td>
<td>EUR 1bn</td>
</tr>
<tr>
<td>Bank B</td>
<td>EUR 1bn</td>
</tr>
<tr>
<td>Bank C</td>
<td>EUR 1bn</td>
</tr>
<tr>
<td>Bank D</td>
<td>EUR 9bn</td>
</tr>
</tbody>
</table>

Hence, with a concentration limit of 25% the liquidity requirement of EUR 4bn is covered by four banks with 25% contribution each. The higher provision of Bank D is not an issue, as the "excess" liquidity is not required. In turn, if the limit were calculated on the available liquidity, four banks with each contributing EUR 3bn would be required.

Q40: Do you consider that the liquid financial resources have been rightly identified? Should ESMA consider other type of assets, such as time deposits or money market funds? If so, please provide evidences of their liquidity and minimum market and credit risk.

Answer:

Liquid high quality securities (e.g. Government or agency bonds) can be used to generate same day liquidity through repo arrangements or pledge to Central Banks and should therefore be considered as liquid financial resources.

Q41: Should the CCP maintain a minimum amount of liquid assets in cash? If so, how this minimum should be calculated?

Answer:

A CCP must have sufficient liquidity to fulfill its contractual obligations. The required liquidity depends on the products cleared and the settlement mechanisms used. The CCP should have liquidity available in an amount that is at least equal to the (stressed) daily cash outflows experienced.

Default waterfall (Article 42)

Response to Questions 42 and 43:

Q42: What is your preferred option for the determination of the quantum of dedicated own resources of CCPs in the default waterfall? What is the appropriate percentage for the chosen option? Should in option a, the margins or the default fund have a different weight, if so how? Should different criteria or a combination of the above criteria be considered?
Answer:
In general, clearing fund contribution is determined on the risk, i.e. margin a clearing member has with the CCP. The CCP contribution must be according to risk and margins and therefore Eurex Clearing strongly prefers alternative a), but would have certain suggestions to amend it.

If the intention is to maintain CCP reserves in proportion to the risk it runs, then it must scale according to the Margins and Clearing Fund. The utilization of total collateral held at the CCP in the formula has the advantage, as noted in the commentary, of some neutrality towards broad (multiple members with a lower Clearing Fund to margin ratio) or narrow (smaller membership with a higher Clearing Fund to Margin Ratio) CCPs.

The setting of a particular percentage into the formula is complicated by what the perceived necessity of CCP skin in the game is, which may vary depending on the quality of the CCP, the markets it clears, and its (largest) members. It is crucial to have at least a minimum, irrespective of the percentage, which we propose to set at the minimum Clearing Member Clearing Fund contribution. This ensures that the CCP at least matches the minimal member requirement.

A general metric to consider that the CCP is providing enough own collateral is to compare it to the membership, and a proposal is to compute the own reserves as the average Clearing Fund contribution of the largest 10 members. This has the advantage of ensuring the CCP’s contribution also (smoothly) reflects any concentration in the markets. As the default contributions of the 10 largest members are based on their margins this metric is risk related.

The relative weighting to margin to clearing fund in the formula should be equal. This is to prevent a CCP having incentives to alter the balance of margin to clearing fund to match its desired own contribution.

Since the purpose of the CCP own contribution is to ensure CCP participation in covering losses in proportion to the risk it faces, any interoperable CCP’s should be considered in the computation to the degree that they pose counterparty credit risk to the CCP.

Q43: What should be the appropriate frequency of calculation and adaptation of the skin in the game?

Answer:
The recalculation frequency should be annually, to ensure the CCPs' contributions match their typical activity. Additionally, regulators may consider on a case by case basis whether CCP’s should re-evaluate sooner if they experience a sudden and prolonged change in funds held.
Collateral Requirements (Article 43)

Response to Questions 44 to 50:

Q44: Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

Answer:

In general, CCPs should be entitled but not obliged to accept all collaterals which are accepted as collateral by their national central bank. It should be distinguished between general criteria for collaterals and specific / individual limitations to the eligible collateral pool. In general, eligible security collaterals should show low credit risk, low market risk, no constraints to transferability and valuation possibilities. In case no current market prices are available, prudent pricing of collaterals should be performed through accepted theoretical pricing models. Specific limitations should be in place to mitigate wrong way risk effectively. To effectively limit the eligible collateral pool, sufficient and reliable information about the affiliation between collateral provider and the issuer of securities has to be available. Mitigating wrong way risk, excluding clearing members’ own issues as well as securities issued by closely affiliated companies (majority owned) is strongly advised. However, it should be at the discretion of the CCP to define the acceptable collateral pool. As the clearinghouse cannot observe the business relationships of the Clearing Members and therefore an reliable information pool is not available, securities issued by an entity who has significant business relations with the collateral provider should not be excluded by definition.

Collateral should be available for the purpose of securing clearing member positions based on prudent risk calculations, thus collateral needs to be stable in value, also in extreme situations and easy to liquidate in case of a clearing member default. CCPs should not be obliged to accept all possible collaterals; it is in the CCPs discretion to set up their own eligible collateral pool. This applies especially for commercial bank guarantees or physical gold. In this respect higher operational efforts need to be taken into account.

Q45: In respect of the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member seeking to lodge those financial instruments, is it appropriate to accept covered bonds as collateral issued by the clearing member?

Answer:

Key element for accepted collateral is that the collateral value remains stable also in
extreme situations and remains stable in the event of the collateral provider default. In case of own issues or close link securities this is not ensured because of pro-cyclical effects of the collateral provider default on the value of the provided collateral. For this reason, we strongly advise to exclude those securities to be eligible as collateral (individual limitations of the collateral pool). Covered Bonds need to be clearly defined, different legislations might provide different protection, and in consequence single securities need to be checked in regards to their protection mechanism.

Q46: Do you consider that the proposed criteria regarding the currency of cash, financial instruments or bank guarantees accepted by a CCP have been rightly identified in the context of defining highly liquid collateral? Should ESMA consider other elements in defining the currency of cash, financial instruments or bank guarantees accepted by a CCP as collateral? Please justify your answer.

Answer:
Cash collateral is regarded as the preferred collateral in regards to liquidity. Though, it is important to permit foreign currencies as cash collateral only where the CCP has established reliant connection with selective payment banks to hold / receive cash collateral in foreign currencies and as pointed out the CCP is able to manage the risk on the specific foreign currency.

Due to the fact that cash collateral is highly liquid, certain restrictions in regards to the acceptance of foreign currencies should not be imposed, referring to the currency of the jurisdiction of the CCP or the CCPs exposure in specific currencies. It should be up to the discretion of the CCP to accept cash collateral in specific foreign denominations and specify the relevant amounts.

Q47: Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements? accepted by a CCP as collateral? Please justify your answer.

Answer:
Accurate collateral valuation is essential for assessing the CCPs current risk exposure generated by the individual positions of the participant by the appliance of appropriate methods and "haircuts" and collateral specific valuation factors. Thus, prudent haircuts have to be set by the CCP in order to have a realistic / conservative judgment on the value of the collateral. The collateral value needs to encounter for uncertainties, thus should reflect the most likely valuation in case of liquidation needs.

Therefore, haircuts should be as conservative as necessary to take market risk as well as liquidity risk into consideration. In order to value collateral adequately and protect the clearinghouse sufficiently, also in stressed market situations, it is necessary to combine dynamic components with minimum components that stay at reasonable levels even in calm times when setting haircuts.

The appliance of prudent haircuts should be at the discretion of the Collateral Taker (CCP), in particular taking into consideration liquidation periods of the specific
collateral. Liquidation periods for margin and liquidation periods for collateral are different. A CCP should be much more restrictive in respect to accepted collateral than in products it clears. Hence, collateral should be more liquid and therefore a shorter liquidation period is more than realistic and should be applied respectively. Driving considerations for the look back period is a right balance between the responsiveness and stability (counter cyclical) of the model. The lack of responsiveness of the model leads to very poor and undesired out of sample back testing properties, this is a typical behavior for un-weighted historical simulation models, and thus weighting schemes should be incorporated into the models and appropriately addressed. At the same time, introduction of weighting leads to the fact that effective look back period decrease, older data is effectively only marginally contributing to the output (5, 10 or more years of historical data). Given this, there is little improvement if more than 2-3 years of history are used within the weighting scheme. In addition to their questionable contribution to the improvement of the model, too long look back periods restrict the transparency and replicability of the model.

Q48: Do you believe that the elements outlined above would rightly outline the framework for assessing the adequacy of its haircuts? Should ESMA consider other elements?

Answer:
The proposal put forward appears adequate.

Q49: Do you consider that the elements outlined above would rightly outline the framework for determining concentration limits? Should ESMA consider other elements?

Answer:
The key aspect in regards to concentration limits is that CCPs should not encounter certain market risks in regards to price risks in the case of liquidating collateral. It is essential that sufficient market liquidity is available to absorb held collateral without negative impact on their prices.

ESMA should require CCPs to set own concentration limits according to their individual financial resources and the risk of the cleared products. A concentration limit could take the form of: if the issuer of a security defaults, then the effect (estimated Loss given default) should not lead to collateral shortfall versus margins of more than a certain percentage of the margin requirement.

Concentration risks in the collateral management context are managed by Eurex Clearing affecting the composition of the Clearing House’s collateral portfolio. Eurex Clearing undertakes several measures to manage risk exposure and to fulfill all settlement or repayment obligations resulting from CCP trades in case of a participant’s default. Therefore, the implementation of concentration limits to individual obligors or securities is considered as reasonable.
Q50: Should a CCP require that a minimum percentage of collateral received from a clearing member is provided in the form of cash? If yes, what factors should ESMA take into account in defining that minimum percentage? What would be the potential costs of that requirement?

Answer:
From a liquidity perspective, cash collateral is the preferred means of collateral provided to a CCP. CCPs should be allowed to impose such a minimum cash proportion on clearing members (minimum percentage of collateral received from a CM to be provided in cash), but it should not be a mandatory rule enforced by ESMA.

CCPs should consider other measures to incentivize members to provide cash to the CCP. This can be by paying adequate returns on cash collateral, or by discouraging the use of securities collateral by imposing a fee on securities collateral. Only when flexible incentives do not achieve the required proportion of cash collateral vs. securities collateral, a CCP may consider a mandatory cash proportion.

The introduction of a mandatory cash proportion imposes operational and most likely legal issues. It needs to be ensured that the mandatory cash proportion is recalculated frequently throughout the day and in case sufficient security collateralization exists, automatic release need to be most likely implemented.

Investment Policy (Article 44)
Response to Questions 51 to 56:

Q51: Do you consider that financial instruments and cash equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?

Answer:
The definition of highly liquid financial instruments is too restrictive. It may impair the CCPs placement possibilities in “normal” times. Bear in mind that the more restrictive the placement criteria, the more likely it is that a CCP may be unable to place all its cash under these criteria. Ultimately, non-invested cash may end up in the CCPs accounts with commercial banks, thus representing an unsecured counterparty risk (if the CCP does not have access to a Central Bank account, which currently is the case at least for other currencies than the CCPs home currency).

The same is true for the definition of a maximum duration. Although desirable, it does reduce the number of eligible instruments and increases the risk that the CCP is unable to place available funds secured. To avoid a potential inability to place funds according to prudent standards, we suggest not to establish a maximum duration.
Q52: Do you think there should be limits on the amount of cash placed on an unsecured basis?

Answer:
In principle, it makes sense to limit unsecured exposures. However, as the CCPs balances are influenced by securities settlements and margin inflows, which cannot be fully controlled at all times, the amounts remaining in correspondent bank accounts, may exceed any limits.

Q53: Do you consider that CCP should be allowed to invest in derivatives for hedging purposes? If so, under which conditions and limitations.

Answer:
If a CCP incurs currency or interest rate risk, it must be allowed to use derivative instruments to manage that risk. A prohibition to hedge existing market risk may destabilize the CCP.

Q54: Do you consider that the proposed criteria regarding the currency of financial instruments in which a CCP invests has been rightly identified in the context of defining highly liquid financial instruments with minimal market and credit risk? Should ESMA consider other elements in defining the currency of highly liquid financial instruments with minimal market and credit risk? Please justify your answer.

Answer:
Why should (as suggested by 138 iii) financial instruments in a currency in which the CCP clears business, not be considered highly liquid, if they exceed collateral in that currency?

Q55: Do you consider that the elements outlined above would rightly outline the framework for determining the highly secured arrangements in respect of which financial instruments lodged by clearing members should be deposited? Should ESMA consider other elements? Please justify your answer.

Answer:
Yes, the elements above rightly outline the framework for determining the highly secured arrangements

Q56: Do you consider that the elements outlined above would rightly outline the appropriate framework for determining concentration limits? Should ESMA consider other elements? Please justify your answer.

Answer:
There is a conflict between requiring the highest possible credit quality of financial instruments and the limitation of concentrations. As an example, ECAGs current placements show a high concentration in instruments issued by the Federal Republic
of Germany, German regional governments and German agencies (e.g. KfW). Despite the high concentration, we consider this as appropriate, as the alternative would be to invest in lesser quality EUR bonds or foreign currencies, which would introduce an FX risk. A requirement to diversify would necessarily impact the credit quality of the portfolio.

Review of models, stress testing and back testing (Article 46)
Response to Questions 57 to 68:

Q57: What are your views on the definitions of back and stress testing?

Answer:
In general paragraph 145 addresses back testing and stress testing in the right way. The testing of the models and the calibrations of the risk parameters that determine the financial resources should be done by the CCP. The testing results, the model monitoring and validation reports have to be presented to the Risk Committee on a regular basis.

The time periods taken for back testing should include at least one year of history. In case the historical data is not available, back tests for similar products (i.e. with proxy data) should be conducted. If there are no similar products, rigorous analysis of the product structure should be conducted to check that implicit model assumptions are compatible with this given product type. In both cases model conservativeness should be increased by applying additional model components accounting for higher uncertainty.

Transparency of the risk management models is important for CCP. Therefore the members should be able to replicate margin numbers and also their contribution to the clearing fund. The details of the risk management models should not be made publicly available beyond the full information that is provided to clients and regulators. Furthermore, infrastructure to conduct test calculations should be provided to the clients.

Q58: What are your views on the possible requirements for a CCP’s validation process?

Answer:
We agree with the statements in 146-150.

Q59: What are your views on the possible back testing requirements?

Answer:
Back testing should provide statistical evidence of the correctness of the margining method as indicated in 151 e. Therefore it makes sense to require the use of a clear
statistical test as stated in 151 b. Which test is chosen in the end should be left to the CCP’s Risk Management. Back testing should indeed recognize both member and client portfolios as stated in 151 a, so that certain findings which do not appear on Clearer level do not get lost. For transparency reasons back testing results should be available to members and clients as stated in 151 d. In order to understand the results relevant policies should be disclosed to members and clients, who should be advised to familiarize themselves with these policies. Or in short: We agree with 151.

**Q60: Would it be appropriate to mandate the disclosure of back testing results and analysis to clients if they request to see such information?**

**Answer:**
Yes, it makes sense to present the anonymized back testing results to the Risk Committee. Additionally, the individual reports should be available for each client.

**Q61: Should the time horizons for back tests specified under 144(e) be more granular? If so, what should the minimum time horizon be? Should this be different for different classes of financial instruments?**

**Answer:**
The time horizon for back testing should be compatible with the statistical methods used, i.e. it should allow statistically significant results. Therefore, a sensible time horizon may vary depending on the margining method and it does not make sense to give further specifications.

**Q62: What are your views on the possible stress testing requirements?**

**Answer:**
The requirements for stress tests stated under paragraphs 153 – 156 are considered to be reasonable.

**Q63: Would it be appropriate to mandate the disclosure of stress testing results and analysis to clients if they request to see such information?**

**Answer:**
The disclosure of the results and the magnitude of stress scenarios is reasonable, however confidentiality issues referred to in 154 have to be considered. It should not be possible to derive any information on the portfolio of particular clearing members or their clients from the disclosed stress results. The public disclosure of detailed information on stress scenarios should not be mandatory since this might allow members to structure their portfolios to minimize the
It is considered reasonable to disclose information on the detailed stress scenarios to regulators in order to independently validate the stress approach and ensure that every CCP applies reasonable stress tests. By limiting the obligation to reporting detailed information on stress scenarios to the disclosure towards regulators ensures a plain and efficient reporting and validation structure.

**Q64: What are your views on the possible requirements for reverse stress tests? And what impact do you think such requirements would have on industry?**

**Answer:**

Reverse stress test can give additional information on possible worst case market moves. However, there are unlimited possibilities to construct market moves in the different assets and asset classes that cause a participant to default. The definition of these scenarios relies on assumptions and the definition of these scenarios is very subjective. It depends on the current exposures to the different assets and asset classes to figure out which scenarios are reasonable and consistent as well as likely and grave enough to cause a market participant to default. In the end reverse stress tests will be based on comparable scenarios like standard stress tests. The results of these Reverse Stress Tests only indicate possible market moves to the management. However, it does not give any hints on how likely such a scenario would be.

**Q65: Should there be any other parties involved in the definition and review of tests? - Please justify your answer and explain the extent to which suggested parties should be involved?**

**Answer:**

It is reasonable to involve the Risk Committee in the definition of stress and back tests. The Risk Committee is expected to be able to provide valuable input due to their expertise in risk management. However, gathering the advice of the risk committee should not entail the disclosure of detailed stress scenarios to the market. Regulators should also be involved in the definition and validation of stress and back tests in order to ensure and independent validation of the tests applied by each CCP without disclosing detailed information to the entire market. Regulators should ensure that each CCP comply with minimum standards in stress and back tests. Further parties should not be involved in the definition and validation of stress and back tests in order to ensure a plain and efficient reporting and validation structure.

**Q66: Should the testing of default procedures involve a simulation process?**

**Answer:**

Yes, the default simulation is an important measure to ensure the best practicable level of preparation for any actual default situation among CCP users. In particular,
components where clearing members, clients and other relevant parties are involved should be simulated regularly.

Q67: Are the frequencies specified above appropriate? If no, please justify your answer.

Answer:
Yes, the frequencies specified above are appropriate.

Q68: In your view what key information regarding CCP risk management models and assumptions adopted to perform stress tests should be publicly disclosed?

Answer:
A CCP should publish all information necessary to replicate the margin requirement including information on the margin methodology, theoretical prices and scenarios used for determining the margin requirement as well as the relevant liquidation period.

In respect to the default procedures referred to in 162 it is reasonable that the CCP publishes information on the circumstances and responsibilities of the actions and mechanisms that are applied to address the obligations of the CCP to the towards the non-defaulting clearing members and the defaulting clearing member towards its clients respectively as outlined 162 i) -v). However, publication of the information should not imply that the mentioned actions and mechanisms are entirely prescriptive. A reasonable and sufficient leeway should remain with the CCP in order to enable it to have flexibility to react to changing market conditions and the characteristics and specialties that each default brings.

Besides the above mentioned basis for stress scenarios it is reasonable to publish the magnitude of the stress scenarios, however disclosing the detailed scenarios can be seen problematic since this is competition-relevant information.
C. 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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