European Systemic Risk Board

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MACRO-PRUDENTIAL STANCE ON ELIGIBLE COLLATERAL FOR CENTRAL COUNTERPARTIES

in response to a consultation by ESMA - based on Article 46 of the EMIR Regulation

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1. Introductory comments

The ESRB has been consulted by the European Securities and Markets Authority (ESMA) on two sets of regulatory technical standards (RTS) for the Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR), which ESMA needs to deliver to the European Commission by 30 September 2012. The specific RTS that the ESRB has been consulted on relate to (i) clearing thresholds for non-financial counterparties (Article 10(4)) and (ii) eligible collateral for CCPs (Article 46(3)). This is the response of the ESRB to the ESMA consultation on Article 46(3). The ESRB intends to make this response to the ESMA consultation public.

Regulation (EU) No 1092/2010 establishing the ESRB (the ESRB Regulation) provides the legal basis for the ESRB's responsibility for the macro-prudential oversight of the EU financial system[1]. As the ESRB Regulation defines the financial system in broad terms[2], this also includes financial system infrastructure, such as central counterparties (CCPs) and their role within the system. CCPs are crucial nodes for the financial system, and this role will grow with the progressive implementation of the G20 initiative to centrally clear all standardised over-the-counter (OTC) derivatives. The ESRB welcomes ESMA's consultation on this issue, which has important macro-prudential implications. In general, the ESRB is concerned about pro-cyclical market practices, such as the margining and haircutting behaviour of CCPs, which can contribute to negative feedback within the financial system. The ESRB acknowledges ESMA's recognition that the RTS must be drafted with macro-prudential concerns over pro-cyclicality in mind. The ESRB considers that the issue of pro-cyclicality goes beyond a narrow discussion of the immediate impact on the resilience of CCPs themselves and the impact on CCP participants, but that it also relates to the influence of CCP behaviour on the broader financial system, e.g. on the availability and quality of collateral assets in other financial market segments. The ESRB acknowledges that, while every effort should be made to limit pro-cyclicality, this should never compromise CCP resilience. The ESRB also welcomes ESMA's efforts to ensure that the RTS are consistent with the Committee on Payment and Settlement Systems

[1] See Article 3(1) of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (2010), *Official Journal of the European Union*, L331, 15 December, p 5.
[2] See Article 2 (b) of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (2010), *Official Journal of the European Union, L331,* 15 December, p. 5.

(CPSS) and International Organization of Securities Commissions (IOSCO) principles for financial market infrastructures, which consider many of these issues comprehensively.

The formal consultation request of 26 June 2012 (ESMA/2012/407) states that "*Under Article 46(3) ESMA needs to draft RTS specifying the type of collateral that could be considered highly liquid (such as cash, gold, government bonds and high quality corporate bonds and covered bonds), the haircuts and the conditions under which commercial bank guarantees should be accepted as collateral."* The ESMA consultation with the ESRB thus relates to the following three issues: (i) the type of eligible collateral that could be considered highly liquid; (ii) the haircuts to apply to asset values; and (iii) the conditions under which commercial bank guarantees may be accepted by CCPs as collateral. The following sections of this ESRB response address the macro-prudential considerations related to these three issues.

2. The type of collateral that could be considered highly liquid

This section of the ESRB response first addresses the specific criteria that have been stipulated in the ESMA discussion and consultation papers and then offers additional systemic risk considerations related to collateral eligibility criteria for CCPs that may need to be reflected in the RTS.

2.1. The criteria outlined in the ESMA discussion and consultation papers

The ESRB supports ESMA's proposal that favours a criteria-based approach over the alternative list approach and agrees with ESMA that the criteria-based approach described in the discussion paper strikes a balance between ensuring the robustness of the CCP and ensuring the availability of adequate collateral and the flexibility to adapt to changing market conditions. The ESMA discussion paper describes how the criteria-based approach envisages taking into account elements such as the depository institution used, transferability, low credit and market risk, the existence of a liquid and diversified market, the existence of an active sale or repo market, and the absence of pro-cyclicality or wrong-way risk. The ESRB supports the view that the RTS should ensure as far as possible that, for any non-cash collateral, the market is liquid in stressed as well as in normal market conditions. While, in our view, these criteria are generally appropriate, the ESRB proposes that the RTS include the following considerations related to some specific elements of the criteria-based approach:

a. **References in the low credit risk requirement to the country where the issuer is established should be removed, as this risk must normally already be considered in the issuer's credit risk assessment**. The risks arising from being established in a particular country might already be considered for an issuer's credit risk assessment. Additional country references could therefore unjustly limit the collateral availability for CCPs at times when market conditions may already be stressed in specific jurisdictions. Nevertheless, it must be noted that not every issuer's credit risk assessment need contain a country risk. These exemptions cannot lead to a framework where the country risk is not assessed at all.

b. **The RTS should include the requirement for the CCP to have a high degree of certainty that the transferability and value of collateral is (i) not encumbered by competing rights in favour of third parties, (ii) ensured via dispossession of the collateral giver, (iii) not subject to re-characterisation by securities and collateral law pending to a claim made by the collateral giver or a third party, and (iv) not voidable (by national or third country insolvency law) during insolvency proceedings against a clearing member or against any other collateral giver.**

c. **The RTS should include the requirement** – also specified in the CPSS-IOSCO principles for financial market infrastructures – **that the "*CCP should have appropriate legal and operational safeguards to ensure that it can use the cross-border collateral in a timely manner*"**.

The ESMA discussion paper points out that the proposed criteria do allow for the possibility of clearing members posting collateral that is issued by other clearing members, an option which, as ESMA concedes, provides an incentive to clearing members to engage in "cross-collateralisation", i.e. clearing members creating instruments for each other. In spite of this potential risk, ESMA has expressed the view that a CCP should be allowed to accept collateral issued by other clearing members, but that the CCP should closely monitor the wrong-way risk that the collateral could carry.

The ESRB recalls that, in principle, CCPs require collateral to limit its exposure to the counterparty credit risk of its members. It is for this reason that the pledging of own-issued instruments as collateral is not allowed (with the exception of covered bonds under certain conditions). Allowing the other members to post this collateral instead, de facto, brings back the risk exposure that was meant to be avoided in the first place. The ESRB stresses that cross-collateralisation exposes the CCP to significant risks and creates potential pro-cyclical effects[3] which also relate to wider concerns over wrong-way risk (the risks related to the negative correlation of the credit quality of the issuer of the collateral and the credit exposure of the CCP to this issuer). Moreover, the collateral eligibility of bank debt in general may raise concerns, as the default of any bank is likely to have a correlated impact on debt issued by other banks. The ESRB does, however, acknowledge that banning entirely the use of collateral issued by other clearing members to address the risks of cross-collateralisation could potentially make the range of eligible collateral too strict; this applies even more to the notion of limiting the eligibility of bank debt in general. In order to address the risks described above, the ESRB therefore proposes that:

a. **The RTS should more explicitly stipulate how the linkages in the context of cross-collateralisation of clearing members should be measured**. As a potential solution, the ESRB proposes that the CCPs' risk monitoring should, for example, focus on correlation levels between eligible financial instruments issued by clearing members and the creditworthiness of the clearing members using these instruments as collateral.

b. In addition to requiring CCPs to closely monitor the wrong-way risk that collateral could carry, **the RTS should include the additional requirement that CCPs should only be allowed to accept securities that are listed and publicly traded**, as such a requirement should act as a certain limit to cross-collateralisation.

c. The RTS could impose a limit on the use of financial instruments posted as collateral by a clearing member when they are issued by another clearing member. Alternatively, the RTS could impose higher haircuts on

[3] For example, assume clearing member 1 posts collateral issued by clearing member 2. In the event that clearing member 2 defaults, the collateral posted by clearing member 1 will significantly decrease in value, meaning that the CCP may be under-collateralised, and the surviving clearing member 1 will face a call for additional collateral.

these instruments, although this option should be carefully assessed by the competent authorities, given its potential pro-cyclical implications.

In addition to the criteria discussed in the points above, the ESMA discussion paper proposes additional currency-related criteria. The ESRB agrees with the proposed currency-related criteria. Our understanding, however, is that only CCPs that operate in different currencies are concerned. **The RTS should clarify how a CCP can demonstrate the requirement to be able to manage the currency risks.** (e.g. does ESMA consider other measures beyond the arrangements of currency swaps?)

The ESRB broadly agrees with ESMA's proposals to limit concentration risks in order to ensure that liquidation of collateral can occur without having an impact on the market and that the pool of collateral available to the CCP is less exposed to volatility and pro-cyclical effects. The ESRB, however, proposes that the RTS include the following considerations related to the concentration limits:

a. While the ESRB agrees with ESMA's proposal to aggregate and treat all financial instruments issued or guaranteed by an individual issuer as a single risk exposure, the RTS should more explicitly take into account that, in the case of a guaranteed instrument, its risk should only be computed once as an exposure either to the issuer or to the guarantor in order to avoid double counting.

b. **The proposed concentration limits must be set in alignment with the collateral pool,** as the more restricted the range of eligible collateral becomes, the harder it is to achieve diversification.

2.2. Additional systemic risk issues related to collateral eligibility criteria for CCPs

When considering eligibility criteria for CCP collateral, it is important to also consider the broader background of structural developments related to collateral at the level of the financial system as a whole. The move of OTC derivatives transactions onto CCPs does not occur in isolation, but is rather an important structural change which occurs at a time when supply and demand factors for collateral are already undergoing additional structural changes. For example, demand for liquid, safe collateral can be expected to increase further, owing to regulatory reforms such as changes to banking regulations and proposals for the margining of non-centrally-cleared OTC derivatives. In the same vein, the financial crisis has led to changing market practices, such as the decline in uncollateralised transactions, which may well persist for an extended period of time. At the same time, greater use of CCPs will also deliver netting benefits.

In this context, the ESRB notes that the International Monetary Fund's (IMF) Global Financial Stability Report of April 2012 also highlights that "*Considerable upward pressures on the demand for safe assets at a time of declining supply entails sizeable risks for global financial stability*". Safe assets that serve as collateral for OTC derivatives are explicitly cited as one of the factors putting pressure on the demand for safe assets. One of the reasons that the move to CCP clearing may increase demand for collateral is that collateral will not be re-hypothecated. The IMF's Global Financial Stability Report also notes that "*Tying up high-quality collateral in CCP guarantee funds and initial margin to improve CCP solvency profiles may reduce liquidity in OTC derivative markets and, more generally, in repo markets; as a result, various shocks could lead to price spikes and shortages of high-grade collateral*." As one of its key conclusions and policy implications, the IMF Global Financial Stability Report notes that "*The use of safe assets as collateral for CCP default funds – in the context of the anticipated move of OTC contracts to CCPs – is another area where demand pressures can be alleviated by some flexibility in the definition of acceptable safe assets. By ensuring that CCP oversight allows for a broad range of collateral (with appropriate risk-based haircuts and minimum criteria for inclusion) alongside other risk management practices, undue pressures on certain types of safe assets can be avoided without compromising the soundness of the CCP*". **The ESRB proposes that ESMA also considers for future work how structural developments impacting on the availability of safe and liquid collateral affect the stability of the financial system in the EU[4].** The ESRB stands ready to work closely with ESMA on this macro-prudential issue.

Furthermore, according to article 39(8) of EMIR, "A CCP shall have a right of use relating to the margins or default fund contributions collected via a security financial collateral arrangement provided that the use of such arrangements is provided for in its operating rules"; and article 52(1) – in the context of an interoperability arrangement – provides that " [….] CCPs shall have robust controls over the re-use of clearing members' collateral under the arrangement, if permitted by their competent authorities…". Although not directly in the

[4] ESMA could draw on work currently being undertaken in Europe (e.g. by the ESRB) and at the international level (e.g. by the committee on the Global Financial System (CGFS)).

remit of the consultation from ESMA, **the ESRB supports further clarification in the legislation on the ability of CCP to re-use or accept re-hypothecated collateral, given the strong macro-prudential implications of such a practice.**

The ESRB considers that, against the background of scarce supply and increasing demand for safe and liquid collateral (particularly if the range of eligible collateral is narrow), there is a clear incentive for a more prominent role for collateral transformation services to emerge in one form or another.[5] Some market observers have expressed views that collateral transformation services will in the future become an essential component for markets to function, particularly in a world where standardised OTC derivatives are being centrally cleared, and believe that these services will also become a new profitable business line for financial services providers[6]. Indeed, strong growth in the provision of collateral upgrade services would be the logical consequence of forthcoming structural market changes. These services[7] facilitate the transformation of CCP-ineligible collateral into CCP-eligible collateral. The use of the various collateral markets (e.g. repo, securities lending and pledges with re-use) for transformation purposes could lead to additional risks, as adverse events in those markets risk spilling over to the CCP clearing environment. The ESRB notes that the IMF's Global Financial Stability Report of April 2012[8] also highlighted that "*The potential increase in the demand for qualified collateral – given the incremental initial margin and default fund requirements associated with moving all standardised over-the-counter derivatives to CCPs – may account for shortages in the supply of cash and government bonds. Large banks that are also clearing members may offer collateral transformation services to their customers to turn less liquid assets into CCP-acceptable ones through repos and swaps. This could potentially exacerbate liquidity pressures for CCPs during market downturns, when clearing members would need to provide liquid funds for their clients at a time when they themselves are being subjected to a liquidity freeze*."

[5] There is even a mandate in the EMIR legislation to develop such services for pension funds: Recital 26 states that "the clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs".
[6] See, for example, the article in the *Financial Times* of 20 May 2012 entitled "Derivatives rules will bring new demands", which is available on its website (http://www.ft.com).
[7] To date, such services have tended to be offered by banks to their clients as part of the overall collateral management and funding services provided to clients. The bank typically uses the repo market for the transformation, i.e. securities provided to the bank are pledged as collateral in the repo market in exchange for cash. Alternatively, banks could also try to exchange the securities with other banks against other types of securities. It should be noted that some CSDs are offering collateral transformation services as well (as an additional service to their triparty collateral management service).
[8] See Annex 3.3 of the IMF's Global Financial Stability Report of April 2012 on "Collateral requirements of central counterparties for over-the-counter derivatives".

The ESRB recognises that collateral transformation services not only pose risks, but can play a constructive role in the future financial system as well. Designing collateral criteria in too lenient ways would go against the original purpose of the G20 initiative to direct more transactions via CCPs. Collateral transformation services allow lower-quality collateral to be exchanged and markets to function even in an environment of scarce supply and growing demand for safe and liquid collateral. This would involve market participants other than CCPs that may be able to hold risks that are deemed inappropriate for CCPs, but at the same time increase interconnectedness within the financial system. The systemic implications of these structural changes need to be considered. One should consider, for example, whether or not such collateral transformation services themselves would remain resilient under stressed market conditions. One should consider what the consequence would be of such services being reduced in stressed market conditions. The ESRB takes the view that such risks need to be assessed and carefully monitored.

While this may go beyond the scope of the particular RTS that the ESRB has been consulted on, **the ESRB proposes that, in its future work, ESMA also closely monitors these risks and helps find solutions for how they could be mitigated[9].** The ESRB stands ready to work closely with ESMA on this macro-prudential issue. Widespread use of collateral transformation services, in particular if such services are concentrated among a limited number of service providers, may increase pro-cyclicality as stressed markets risk the withdrawal from the market of those institutions providing the transformation services in order to protect their own positions. Also, the ESRB considers that, ultimately, there may be a direct trade-off between liquidity requirements for eligible collateral and the degree of transformation.

The issues raised under points 1 and 3 argue for having broad and flexible collateral eligibility criteria for CCPs in order to reduce the pressures on demand for the safest/most liquid collateral and also to limit incentives for strong growth in collateral transformation services that may carry systemic risks as well. On the other hand, if the criteria are too broad, this may have adverse effects on the robustness of CCPs themselves to withstand turbulence. The ESRB considers that the need to strike an appropriate balance between ensuring the resilience of an individual CCP and limiting the possible systemic impact of a collateral shortage is a key issue. The ESRB considers that the good performance of

[9] The ESRB acknowledges that the practice of collateral transformation is not restricted to centrally cleared transactions and that these risks are taken by prudentially supervised financial institutions. The monitoring and mitigation of these risks is therefore not an issue for a CCP regulation, but the responsibility of micro-prudential and macro-prudential supervisors.

CCPs during the severe stress experienced in financial markets over the past few years, e.g. managing the failure of large institutions without major difficulties, shows that the existing collateral lists are a good starting point to consider this trade-off.

Notwithstanding the above, margin calls demanded by CCPs put a cap on trading positions to the extent that market participants' access to collateral is limited. Currently open positions in the OTC derivatives sphere for which market participants have insufficient access to collateral indicate that the overall position of this particular market participant is too risky and must be reduced. It is nonetheless of importance that this adjustment process does not occur at the expense of economically worthwhile transactions.

Given the various systemic risk considerations that have been highlighted above, and in line with the IMF's policy recommendation noted under point 1, the ESRB stresses the importance of giving the market sufficient flexibility to allow for the forthcoming adjustment to the increased demand for safe and liquid collateral[10]. **The ESRB therefore calls for prudent implementation of the RTS. Frequent reviews that carefully consider the systemic risks described, as well as emerging systemic risks, will be necessary**.

The ESMA consultation paper notes that some respondents to the ESMA discussion paper have suggested that assets accepted in regular central bank operations should also be considered eligible for CCPs. Central bank collateral eligibility is a key instrument of monetary policy in crisis times and having a connection with collateral eligibility could have unintended negative repercussions. The ESRB is therefore in agreement with ESMA's decision to stick to the criteria-based approach that does not link the collateral frameworks for CCPs with those of central banks.

The ESRB does acknowledge that collateral eligibility criteria at CCPs that differ from collateral eligibility criteria elsewhere may have macro-prudential implications. For example, different eligibility criteria may have the unintended consequence that the "worst" collateral will end up concentrated in whichever framework has the loosest criteria. Also, all regulatory definitions of liquid assets create demand for the selected assets at the expense of the non-eligible ones. This asset segmentation can create market distortions, such as reducing liquidity in certain market segments, as the high-quality collateral is tied up in CCPs and can also lower the quality of assets used elsewhere with a broader collateral

[10] The CGFS working group on collateral is examining this issue from a whole-of-system perspective.

framework. **The ESRB also recommends that ESMA, in its future work, closely monitors the resulting market behaviour and risk distribution of pledged collateral and shares its finding with the ESRB. In order to enable such close monitoring, the ESRB proposes that the RTS should ensure that the transparency requirements apply to both the acceptable collateral of CCPs and the actual use of collateral by CCPs**.

3. The haircuts to apply to collateral

The ESRB supports ESMA's proposals that haircuts must be defined conservatively to protect the CCP. The ESRB also appreciates ESMA's recognition of the potential pro-cyclical effects of haircutting practices at CCPs. The ESRB focuses its response to the consultation on haircuts on two related areas of macro-prudential concern, namely pro-cyclicality and over-dependence on commercial credit ratings, and makes further proposals to be incorporated in the RTS.

3.1. Pro-cyclicality

The G20 commitment to centrally clear standardised OTC derivatives contracts will imply a significant increase in the role and systemic relevance of CCPs. CCP activities will transform systemic risk as counterparty credit risks are being mitigated but, at the same time, the increased use of CCPs in itself will also make some CCP behaviour systemically risky as they may act in a pro-cyclical manner. From a financial stability point of view, it is desirable to limit pro-cyclical movements in the acceptance criteria and haircuts for CCP collateral. The potential negative systemic implications of margining practices that were highlighted by the ESRB in its earlier response to the ESMA discussion paper also apply to the setting of haircuts for collateral. The RTS governing haircutting practices should be designed to minimise sudden and large increases in CCP haircuts in times of market stress.

The issue of pro-cyclicality in margining and haircutting practices has been addressed in detail by the Committee on the Global Financial System (CGFS) in a report[11] that

[11] "The role of margin requirements and haircuts in pro-cyclicality" (2010), *Committee on the Global Financial System*, Paper No 36. The CGFS study also argues that haircuts and initial margin requirements that are more stable across the cycle and calibrated to include periods of stressed market conditions have some desirable features for addressing financial system pro-cyclicality. It specifically recommended reducing financial system pro-cyclicality arising from margining practices in [secured lending and] derivatives transactions. To this end, regulators and authorities should (i) promote the use of properly risk-proofed central counterparties that

highlighted the potentially destabilising effects. Sudden increases in margin during times of higher market volatility draw liquidity from market participants exactly when conditions to source new liquidity in the market are most difficult. Increases in collateral requirements in times of stress risk forcing market participants to repo, swap or sell assets to meet collateral calls, and exposes the financial system to pro-cyclical and self-reinforcing spirals, as subsequent asset price declines can lead to further collateral calls, which amplify the original shock. Furthermore, as the CGFS report also highlights, trigger clauses related to ratings of counterparties have made such negative feedback loops near-automatic (which we discuss further in the next section of this response).

The framework for determining haircuts that is described in the ESMA discussion paper argues that setting haircuts sufficiently prudent and calculating haircuts in a conservative manner will limit pro-cyclical effects. The ESRB proposes that the RTS take further into consideration that:

1. In order to remain protected, CCPs should retain the flexibility to increase haircuts as necessary – and some increase in haircuts may be appropriate as market volatility increases. However, the ESRB considers it crucial that CCPs maintain policies to avoid large and sudden increases in haircuts. In a similar way to the policies for setting margins, the ESRB supports the view that this might be achieved by requiring that haircuts be set using a through-the-cycle approach, using historical data that include periods of stress (with this period of stress weighted appropriately), or stressed levels wherever such data are unavailable. Such a requirement should ensure that haircuts do not fall too far during "good times" and therefore do not require sudden increases, should market risk increase.

2. The ESRB notes that testing of haircuts is required under the CPSS-IOSCO principles for financial market infrastructures and supports the view that this should also be required in the RTS. The RTS, however, do not specify any frequency for the testing of haircuts. The ESRB considers that the frequency for the testing of haircuts should be aligned on the frequency of the other tests conducted on margins (back tests and stress tests), i.e. daily.

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mitigate counterparty risk concerns for clearing standardised derivative instruments [...], (ii) encourage supervisors and other relevant authorities to review the policies and risk management practices of central counterparties for possible pro-cyclical impacts related to haircuts and margins, and (iii) consider the prudential impacts and practical implications of imposing, through such CCPs, minimum constant through-the-cycle margins and haircuts, with a possible countercyclical add-on.

3. The ESRB has taken note of the proposal made in the CGFS' 2010 report "The role of margin requirements and haircuts in pro-cyclicality" that there may be a role for macro-prudential authorities to consider stable and through-the-cycle haircuts with a possible countercyclical add-on. The ESRB acknowledges that this has not been considered in the level 1 text of EMIR. The ESRB continues to examine how margins and haircuts, in the context of the proposal, could be applied as a macro-prudential tool and will re-consider the issue during the first scheduled review of EMIR.

4. Transparency of a CCP's policies determining haircuts is an important factor in limiting adverse pro-cyclical effects. If market participants understand the CCP's haircut framework, changes will be anticipated and the market impact may be less sudden. **The ESRB notes that the proposed RTS include a requirement that CCPs establish "transparent and predictable procedures for adjusting margin requirements in response to changing market conditions" and proposes that the RTS should explicitly contain a similar statement regarding haircuts.**

3.2. Sensitivity to commercial credit ratings

The ESRB considers it desirable for a CCP to take the credit risk of the financial instrument that is accepted as collateral and that of its issuer into account when determining haircuts. ESMA has also included the credit risk of financial instruments and/or the issuer of financial instruments as one of the considerations to determine haircuts. ESMA's RTS consider that this credit risk assessment can be performed internally or externally.

The ESRB recalls that the (over-)dependence on credit ratings of the securities used as collateral is a well-known source of pro-cyclicality[12]. Therefore, the ESRB considers that the haircuts applied to collateral values should not be highly sensitive to the commercial credit ratings of a security, issuer or country of establishment in order to avoid cliff effects and to reduce the risk of downgrades triggering a negative liquidity spiral. In this regard, the ESRB wishes to highlight the Financial Stability Board (FSB) principles for reducing reliance on credit rating agency (CRA) ratings[13], which have been endorsed by the G20.

[12] See also "The role of margin requirements and haircuts in pro-cyclicality" (2010), *Committee on the Global Financial System*, Paper No 36 **-**, which notes that "while contractual credit triggers can be seen as a prudent risk management practice to protect against deterioration in credit quality of the counterparty, market participants fail to take account of the negative externality resulting from the widespread use of similar triggers by other financial intermediaries [..] "

[13] These principles can be found on the Financial Stability Board's website at

The main intention of these principles is to reduce references to CRA ratings in standards, laws and regulations, as the "hard-wiring" of CRA ratings is considered a threat to financial stability, and to reduce market reliance on CRA ratings. The principles suggest that a mechanistic reliance on CRA ratings should be avoided and that internal credit assessments should be supported. The FSB also calls on supervisors to review the policies of CCPs (and other market participants) to guard against undue reliance on CRA ratings. Principle III.4 explicitly states with reference to CCPs that market participants and central counterparties should not use changes in the CRA ratings of counterparties or of collateral assets as automatic triggers for large, discrete collateral calls in margin agreements on derivatives and securities financing transactions.

The ESRB supports international policy-makers' intentions to move away from an over-reliance on credit ratings. In this regard, we consider that the key issue is not the use of credit ratings per se, but the cliff-edge effects that can arise when ratings are used as mechanical triggers. These effects may also arise where ratings are used to determine haircuts or collateral eligibility. The ESRB proposes that the RTS should encourage CCPs to implement policies that prevent such cliff-edge effects as much as possible. Such effects may arise from the use of credit ratings, but also from other "mechanical" triggers such as spreads. There may be a variety of methods by which this could be accomplished. **The ESRB proposes that the RTS include a requirement that a CCP "demonstrate to the competent authority the avoidance of any mechanical triggers to limit pro-cyclical effects."**

The ESRB proposes that the RTS explicitly stipulate that commercial credit ratings should not replace the risk management of CCPs, but rather should be seen as an input to their risk management. The ESRB proposes that the current wording in the RTS with respect to credit risk assessments (i.e. "based upon internal or external assessment") is amended in line with the FSB principles for reducing reliance on CRA ratings.

The ESRB understands that work is underway in the FSB, BCBS and other standard-setting bodies to consider alternatives to the use of credit ratings. **The ESRB proposes that ESMA and CCPs should follow this ongoing work closely**.

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http://www.financialstabilityboard.org.

4. The conditions under which commercial bank guarantees should be accepted as collateral

The ESRB questions the appropriateness of commercial bank guarantees as collateral and is of the view that their use should be limited. The ESRB acknowledges that the acceptance of commercial bank guarantees is already set in the level 1 text of EMIR. However, the ESRB is of the view that their use raises concerns that must be considered in the preparation of the RTS. First, commercial bank guarantees are not fungible or tradable in liquid markets, which therefore makes it difficult to manage risk and haircut effectively. Second, commercial bank guarantees are difficult to enforce unless they are backed by collateral maintained with a reliable third party.

Our reading of EMIR is that the use of commercial bank guarantees is to be limited to non-financial counterparties. The ESRB supports this limitation in use.

The ESRB notes that CPSS-IOSCO also considered commercial bank guarantees in the drafting of the principles for financial market infrastructures (e.g. whether they are reducing the risk for the financial system or simply shifting it from one part of the system to another) and concluded that “In general, guarantees are not acceptable collateral. However, in rare circumstances and subject to regulatory approval, a guarantee fully backed by collateral that is realisable on a same-day basis may serve as acceptable collateral”. The ESRB welcomes the inclusion in the RTS of requirements that commercial bank guarantees are subject to approval by the competent authority and subject to similar limitations. However, **the ESRB proposes that the use of commercial bank guarantees should be explicitly subject to a low concentration limit which is stronger than those for collateral in the form of an asset**.

The RTS have stipulated a criterion that the bank guarantees are “fully backed by collateral that is realisable on a same-day basis”. This condition may be interpreted in a variety of ways. **The ESRB proposes that the RTS clarify who is to hold this collateral** (i.e. the bank issuing the guarantee, the clearing member using the guarantee, a third party or the CCP itself).