

**Communication of the Association of Global Custodians' European Focus Committee  
Subject to Supplemental Commentary**

10<sup>th</sup> July 2015

European Securities and Markets Authority  
European Banking Authority  
European Insurance and Occupational Pensions Authority  
Joint Committee of the European Supervisory Authorities

Dear Sir/Madam:

The members of the Association of Global Custodians' (the "**AGC**") European Focus Committee (the "Committee")<sup>1</sup> are grateful for the opportunity to provide comments in response to the second consultation paper issued by the European Supervisory Authorities ("ESAs") on their Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (the "draft RTS").

The member banks of the Committee support efforts to reduce systemic risk in the OTC derivatives markets, including the ESAs' initiative to adopt risk-mitigation techniques for OTC-derivative contracts that are not cleared by a CCP. However, we have noted the draft RTS proposals on treatment of cash collateral and wish to call to your attention our very significant concerns about them.

We understand that the ESA's draft RTS were revised to permit cash collateral to be reinvested in other eligible collateral as agreed between two swap counterparties, however, the draft RTS require further revision to ensure cash collateral remains viable in the context third-party custodian arrangements.

**The importance of cash accounts in third-party custody arrangements**

The final Basel/IOSCO agreement on margin for uncleared derivatives pointed out,<sup>2</sup> "the use of third-party custodians is generally considered to offer the most robust protection" for collateral posted in uncleared derivatives transactions. While not mandated by the ESAs draft RTS, we agree with the industry consensus that third-party custodians are likely to be the preferred alternative for protecting collateral posted by counterparties under the final RTS. We also regrettably agree with the emerging consensus that the draft RTS will make these third-party custody arrangements impractical if not impossible in practice.

Eligible collateral includes both cash and non-cash: third-party custody arrangements must be able to accept both types, as agreed by the counterparties. Furthermore, a critically important inherent attribute of non-cash collateral is that it, too, generates cash: dividends and income, proceeds from

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<sup>1</sup> The members of the Association of Global Custodians are: BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and trust Company.

<sup>2</sup> <http://www.bis.org/publ/bcbs261.pdf>

repayment of principal from maturing bonds, proceeds of repurchase agreements and proceeds of sale all are received into linked cash accounts held with the custodian. A custody arrangement inherently must be able to maintain holdings of both securities and cash, even in cases where “cash” collateral is not “delivered” by the collateral poster.

Securities held in custody are held “off balance sheet” in bankruptcy-remote custodial accounts. Cash, in contrast, is held either *in specie* or as a claim on a bank as a deposit: banks reflect deposit obligations as liabilities on their balance sheets. This cash can of course be invested as the swap counterparties agree, in which case the investment is removed from the balance sheet of the bank (no liability of the bank exists). This treatment of cash is common to all custody arrangements, including mutual funds, pension funds, etc., and is not limited to the swaps margin accounts that are the subject of the draft RTS.

Cash is held on deposit with a bank naturally equates to credit exposure to that bank. As suggested above, cash and other collateral placed with a custodian bank acting under a tri-party custody agreement provides additional protection because the custody bank will only move assets (including the cash) on receipt of proper instructions as agreed between the counterparties, rather than at the discretion of just one counter-party. These arrangements are widely used in the financial markets and among all kinds of participants in the industry: a key factor is the creditworthiness of the custodian bank, the integrity of its records and controls and the prudential regulation and supervisory framework to which it is subject. Custodian banks tend to be subject to the highest prudential standards, including those relating to leverage capital, risk-weighted capital, liquidity, large exposures/credit concentration limits, stress testing, living wills, and resolution planning.

In addition, institutional customers generally minimise cash left on deposit with the custody bank in order to manage credit exposure to the custody bank and to generate higher yields than is available on custody deposits. Custody banks have an interest in minimizing such deposits as well, due to the negative impact of such deposits on the bank’s leverage ratio and other regulatory limitations.<sup>3</sup>

The broader context is that a third-party custodian, who is not a party to the trade, has no economic interest in the derivative contract. The custodian’s sole purpose is to provide safekeeping of posted collateral. The custodian’s actions are dictated solely by the direction of the counterparties subject to the rules prescribed in the custody agreement, and it has no discretion over the collateral. Assets held by the custodian under a tri-party custody agreement, whether in cash or securities, are bankruptcy-remote from both the posting and collecting counterparties – the parties in interest to the transaction. The ability of custodian to protect the interests of both counterparties under the contractual custody agreement is one of the key factors in making third-party custody the preferred option for many collateral posters.

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<sup>3</sup> A longstanding tool used to manage credit exposure to bank custodians is commonly referred to as “sweep”: end-of-day cash balances are “swept” for short-term investment in “off-balance sheet” investments such as money market funds and repo or in “on-balance sheet” investments such as interest-paying deposits maintained with other banks (i.e., banks other than the third-party custodian bank). We emphasise that, due to the inherent nature of cash arising in connection with securities accounts (as discussed above), it is not possible to “sweep” all cash to banks other than the third-party custodian bank.

## Concerns with draft RTS and recommendations

The members of the Committee are concerned that the draft RTS do not properly accommodate the third-party custody business model: they seem to assume that conditions imposed on segregation by collecting counterparties can be applied without adjustment to third-party custodians. The draft RTS should take account of the important differences between cash and non-cash posted to third-party custodians so that cash remains viable as posted collateral and complications with no-cash collateral are prevented (since non-cash collateral generates cash, as discussed above).

In particular, the Members of the Committee urge the ESAs to clarify that cash posted with third-party custodians may be placed on deposit with the custody bank. Since such deposits necessarily result in credit risk to custodians, we also recommend that the ESAs require the collateral poster and the collecting counterparty to manage such credit risk by, for example, availing themselves of the option under 1 REU (2) to reinvest cash collateral in other eligible assets.<sup>4</sup>

Our specific concerns and recommendations on these issues, as well as several suggested technical corrections, follow below.

### 1) Clarify that cash accounts will hold all cash flows connected to posted collateral

Article 2 LEC (g) of the draft RTS requires risk management procedures of the collecting counterparty to ensure that cash accounts are maintained to accept “collateral collected as initial margin and for crediting the proceeds of repurchase agreements on the collateral.”

As noted above, cash flows connected to posted collateral could result from numerous sources in addition to the two referenced in Article 2 LEC (g), including dividends paid on held securities, payouts of principal on maturity of bonds, or other sources. The cash account established pursuant to a collateral arrangement must be able to accept cash from any of these sources. As a result, we recommend Article 2 LEG (g) be amended as follows:

*(d) cash accounts in all the acceptable currencies are maintained with a party other than the collateral provider for depositing cash collateral collected as initial margin **and cash arising from non-cash collateral collected as initial margin.** ~~and for crediting the proceeds of repurchase agreements on the collateral;~~*

### 2) Require the swaps counterparties to manage credit risk resulting from a bank holding cash collateral

The Members of the Committee acknowledge that the credit exposure resulting from placing cash collateral on deposit with a custodian should be managed by swaps counterparties. Generally, the management of such credit risk will be accomplished by reinvestment of cash collateral in other eligible collateral, as is common practice today, and is permitted by the

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<sup>4</sup> Some cash, as noted in footnote 3, can be “swept” to third-party banks: similar to other EU legislation (such as UCITS) intending to protect investor or customer interests, therefore, provision should be made to permit deposits to be allocated to banks other than the third-party custodian bank as “eligible collateral”.

revision of Article 1 REU proposed by the ESAs in the second consultation on the draft RTS. We suggest such risk management be addressed in the final RTS in a new section added to Article 2 LEC, as follows:

**(new) Credit exposure resulting from cash collateral collected as initial margin, and from cash arising from non-cash collateral collected as initial margin, held on deposit with a third party custodian shall be managed appropriately, including through reinvestment of such cash in other eligible assets as permitted under 1 REU (2)**<sup>5</sup>.

### 3) Clarify that cash maintained by third-party custodians may be placed on deposit

As described above, cash, whether posted margin or operational cash flows, held in third-party custody arrangements is placed on deposit with the custody bank. The draft RTS does not clearly reflect this practice, and fails to distinguish between the treatment of cash held by a collecting counterparty and cash held by a custodian. As a result, we suggest Article 1 SEG (3) be amended as follows:

3) Where initial margin is collected in cash **and maintained by the counterparties**, it shall be segregated individually, unless the collecting counterparty has legally binding arrangements in place to segregate it from proprietary assets. **Where initial margin is collected in cash and maintained by a third party custodian, it shall be placed on deposit with the custodian.**

### 4) Clarify that cash may only be reinvested by the custodian at the direction of the counterparties

New Section 2 of Article 1 REU helpfully permits cash collateral to be reinvested in other eligible assets upon agreement of the counterparties. This provision is consistent with current market practice, and will allow counterparties to minimize their credit risk to the custodian or collecting counterparty.

For a custodian, such reinvestment would involve facilitating the reinvestment of cash on deposit into other eligible securities. A custodian, however, would only do so at the direction of the swap counterparties, and not at its own discretion. We suggest clarification of the directed nature of the custodian's duties, as follows:

2) initial margin posted as cash can be re-invested by the collecting counterparty ~~or custodian~~ **(or the custodian, at the direction of the collecting counterparty)** only for purposes of protecting the collateral poster, and subject to an agreement between the counterparties. The re-invested collateral shall be treated in accordance with Articles 1 LEC and 1 SEG [segregation and eligibility].

### 5) Clarify differences between cash and non-cash collateral

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<sup>5</sup> We reiterate that provision should be made to permit deposits to be allocated to banks other than the third-party custodian bank as "eligible collateral".

As described above, the treatment of cash and non-cash collateral differs considerably under traditional custodial arrangements. In several instances, the draft RTS applies concepts suitable to non-cash collateral (i.e. securities) to all collateral, including cash. We suggest the draft RTS be amended to correct these inappropriate references, as follows:

A) Article 2 LEC (g) –

Section (g) of Article 2 LEC requires collateral to be transferable without regulatory, legal, or third-party constraints. This concept is entirely appropriate for securities collateral, but not consistent with cash placed on deposit, where the collateral holder is a general unsecured creditor of the bank. As mentioned above, the presence of such credit risk has led the Members of the Committee to recommend a specific provision in the RTS requiring counterparties to manage such risk. The requirement of Section (g), though, should be limited solely to securities collateral, as follows:

*(g) **All securities** collateral should be transferable without any regulatory or legal constraints or third party claims, including those of the liquidator of the collecting counterparty or third party custodian.*

B) Article 1 SEG (1) –

Similarly, Section (1) of Article 1 SEG would require all collateral to be held in a manner which protects the collateral from default or insolvency of the custodian. As described above, cash held in third-party custody arrangements necessarily creates credit exposure to the custodian. Such exposures should be managed by the counterparties, but cash (either margin or operational) cannot be accepted by the custodian if no such credit exposure is permitted. Article 1 SEG (1) should be amended to read:

*1) **Securities c**ollateral collected as initial margin shall be segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty, third party holder or custodian.*

### Custodial liens

In both the direct model and the alternative model, a third party custodian or holder is likely to be involved in the arrangement (as described above). Such custodians will need to be adequately protected and incentivised to offer services in relation to IM arrangements and will need to charge fees for their services. A custodian would normally be secured by a custodial lien. Article 2 LEC (1)(g) (p. 40) and the Recitals should therefore permit custodial or third party liens and security interests. If all such liens or security interests are prohibited, there may be reluctance on the part of the custodians to provide the necessary custodial services to facilitate the posting of IM.

The members of the Committee are grateful for the opportunity to provide these comments and would welcome subsequent dialogue if the ESAs wish.

Sincerely,

John Siena  
Chair, European Focus Committee  
Association of Global Custodians