4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

The Hong Kong Monetary Authority
55th Floor
Two International Finance Centre
8 Finance Street
Central
Hong Kong

Submitted via hkma_mail@hkma.gov.hk

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Consultative Report on Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards

Dear Sirs,

Markit is pleased to submit the following comments to the HKMA in response to its Consultative Report on *Non-centrally cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards* (the "***Consultative Report***").

Markit[1] is a leading global diversified provider of financial information services.[2] Founded in 2003, we employ over 4,000 people in 11 countries and our shares are listed on Nasdaq (ticker: MRKT). Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 140 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

Introduction

Many of Markit's services have been designed to reduce the risk and increase efficiencies in the OTC derivatives markets and facilitate firms' compliance with various regulatory requirements. Examples of services of ours that that are most relevant in the context of this Consultative Report are:

- Markit's derivatives processing platforms[3] are widely used by participants in the OTC derivatives markets and are recognised as tools to increase operational efficiency, reduce cost, and secure legal certainty. Specifically, our derivatives processing services facilitate the electronic confirmation of a significant portion of OTC derivatives transactions worldwide, submit them for clearing to 16 CCPs globally, and, for many counterparties,[4] report their details to Trade Repositories in several jurisdictions including Europe, the United States, and Hong Kong.

[1] See www.markit.com for more details.
[2] We provide products and services that enhance transparency, reduce risk and improve operational efficiency of financial market activities. Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. By setting common standards and facilitating market participants' compliance with various regulatory requirements, many of our services help level the playing field between small and large firms and foster a competitive marketplace.
[3] See http://www.markit.com/product/markitserv for more details
[4] Globally, we currently report transactions to Trade Repositories for over 100 firms and more than 1,000 entities, including most of the large, globally active dealers.

- Markit provides participants in global financial markets with state-of-the-art analytical services[5] across asset classes, often in conjunction with our pricing and valuation services. These services support, for example, banks (including those that have received or are expecting to receive IMM approval) with the calculation of their regulatory capital requirements, including measures such as PFE, IMM EAD, IRC, CRM, and the CVA Capital VaR charge.[6] Based on our expertise in these areas, both buy-side and sell-side institutions have approached us to help them with the calculation of initial and variation margin for their portfolios of cleared and uncleared derivatives transactions.

Comments

We welcome the publication of the Consultative Report and we appreciate the opportunity to provide the HKMA with our comments. Based on our experience in providing trade processing, analytical and valuation services to firms around the globe we recommend the HKMA:

- Require the confirmation of all terms of a transaction (rather than just the material terms);
- Clarify that it allows for the use of different methods to achieve trade confirmation as long as it is legally binding;
- Limit the use of "negative affirmation" to only those transactions where no central infrastructure is available to achieve confirmation by matching or by affirmation and where one of the counterparties is a non-financial firm;
- Set deadlines for the timing of confirmation that take into account the nature of the product and the degree of its electronification;
- Require sufficient independence in the valuation process and encourage the use of third party providers to achieve this objective;
- Allow the use of third party methodologies for the computation of initial and variation margin to ensure consistency in margin calculation and reduce the potential for disputes; and
- Encourage the use of third party providers to help AIs manage their trading relationship documentation.

1. Trade Confirmation

The HKMA suggests specific requirements for the format and the timing of confirmations for OTC derivatives transactions.[7] We generally welcome these requirements and believe they are broadly consistent with current market practice. However, based on our experience in providing processing and confirmation services, we suggest the following improvements to more closely reflect market realities and reduce risk:

a) Definitions

The HKMA has set out confirmation requirements that differentiate between asset classes and product types.[8] However, we believe that the definitions of these product types are not clear. For example, the term "credit default swaps" does not seem to be defined in the proposals. It is thus unclear as to which credit derivative products would qualify as "credit default swaps" and which ones would be regarded as "other product types". While "interest rate swaps" are defined[9] in the reporting rules there are also references to interest rate derivatives[10] in the HKMA's proposals to expand the reporting requirements. Since the application of the HKMA's confirmation requirements is dependent on the meaning of these definitions, we encourage the HKMA to set out precise definitions of the terms "interest rate swaps" and "interest rate derivatives" respectively.

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[5] See https://www.markit.com/product/analytics
[6] CVA = Counterparty Value Adjustment, PFE = Potential Future Exposure, IMM EAD = Internal Model Method Exposure At Default, IRC = Incremental Risk Charge, and CRM = Comprehensive Risk Measure
[7] Pg 13
[8] Pg 31-32, Para 4.2.3
[9] See Pg 45 of *http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=14CP8*
[10] *http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2015/20150930e7a1.pdf*

b) Format of confirmation

We welcome the HKMA's acknowledgement that different formats of confirmation, broadly classified into electronic and paper confirmation, are appropriate for transactions in OTC derivatives depending on the type of product.[11] We support the HKMA's approach to allow for paper confirmation for certain types of bespoke products.[12] However, we believe there would be benefits if the HKMA emphasized the need for confirmations to be executed electronically where possible and appropriate to ensure the timely confirmation of transactions while reducing potential risks. We further recommend the HKMA clarify the following issues:

- The HKMA states that, "to promote legal certainty to the transaction"[13] the confirmation of material terms of the transaction should be sufficient. However, the confirmation of just the material terms would *not* be sufficient to achieve a legally binding contract as this will require an agreement on *all* the details of the transaction. We therefore recommend that the HKMA require confirmation of all terms of the transaction. The HKMA should note that such approach would be in line with current market practice for the majority of OTC derivatives transactions. Furthermore, it would be consistent with the HKMA's own approach in relation to the acknowledgment of the transaction, which it defined as "a written or electronic record of *all* of the terms of an OTC derivative transaction".

- We note that the HKMA requires "two-way confirmation"[14] of trades. In this context the HKMA should note that various methods of reaching an agreement on the transaction details between counterparties and producing a confirmation are currently employed in the marketplace, depending on the asset class and product type. We therefore recommend the HKMA explicitly allow for the use of different confirmation techniques by covered entities, including "confirmation by affirmation"[15] or "confirmation by matching",[16] as long as they result in a legally binding confirmation of all terms of the transaction.

- For transactions with a non-financial counterparty the HKMA proposes that an AI "should provide an acknowledgement within the relevant timeframe [as stated in the proposals] and give a deadline for the counterparty to object".[17] We believe that the HKMA here refers to an approach to confirming a transaction that is called "negative affirmation" in industry parlance. While the provision of an acknowledgement is an essential and obvious step in a confirmation process, the practice of negative affirmation is a less sound approach to achieving confirmation as this process is riddled with risks due to a lack of a positive feedback loop. Specifically, without the use of a centralized confirmation platform the acknowledgement recipient may not receive the trade acknowledgement[18] or, even if it does, the acknowledgment sender may not receive feedback on a possible correction of the trade acknowledgement. As a consequence, counterparties might not become aware of any disparities between their views of the trade until trade reconciliation, a margin dispute or at the time of settlement which, for some products, may be years after the date of execution of the transaction. To increase the certainty of confirmations for OTC derivatives transactions, the HKMA should allow for the use of negative affirmation only in specific, clearly defined situations, namely where a centralized platform to achieve electronic confirmation is not available and if one of the parties to the trade is a non-financial counterparty. Also, in cases where negative affirmation is

[11] In Para 4.2.2 the HKMA notes that confirmation could be "via non-rewritable, non-erasable automated methods where it is reasonably practicable for the relevant counterparties to the transaction to do so" or confirmations could be "given in writing via manual means (e.g. fax) or other non-rewritable, non-erasable electronic methods (e.g. email)".

[12] This is because bespoke products have non-standard documentation and are generally not executed or processed electronically.

[13] Pg 31, Para 4.2.1

[14] Pg 31, Para 4.2.3

[15] Trade affirmation is a process by which two counterparties verify that they agree the primary economics of a trade. The affirmation process may be done by telephone, voice recording, email or on an electronic checkout platform.

[16] Trade matching is a process of reconciling the terms of a transaction as confirmed by each counterparty, either manually or on an electronic platform.

[17] The HKMA defines an "acknowledgement" as "a written or electronic record of all of the terms of an OTC derivative transaction, signed and sent by one counterparty to the other". Pg 31, Para 4.2.3

[18] This is particularly problematic if the recipient of the acknowledgment does not even know the transaction.

permitted the HKMA should require the existence of an agreed, robust, legally binding and enforceable framework.

c) Timeliness of confirmation

The HKMA also provided requirements specifying the timeliness of confirmation with the proposed deadlines depending solely on the asset class.[19]

However, our experience has shown that the time needed to confirm OTC derivatives transaction mostly depends on the degree of electronification of the transaction which tends to be closely related to the level of legal standardization of the product. We therefore recommend that timing requirements for confirmations set by the HKMA should not depend only on the asset class. Specifically, where electronic means of execution and confirmation are available for the product and used, the confirmation of these OTC derivatives transactions can be achieved within the deadlines proposed by the HKMA. However, the HKMA should provide counterparties with longer timeframes for more customized product types that are executed over-the-counter and typically confirmed on paper. The HKMA should promote electronic means of confirmation wherever possible.

The HKMA further requires that AIs "should maintain records of transactions that remain unconfirmed after 5 business days from the execution date of the transactions".[20] We recommend the HKMA clarify if this requirement is valid only in cases where one of the parties to the trade is a non-financial counterparty. This is because, once the timing requirements are in place from March 2017, all transactions between AIs would have to be confirmed within 1 or 2 days in any case. Furthermore, the HKMA should clarify whether AIs, before the the confirmation requirement for "other product types" comes into place, would need to record transactions that remain unconfirmed after 5 business days, irrespective of whether those transactions are with AIs or with non-financial counterparties.

2. Valuation with counterparties

We agree with the HKMA that, from a risk perspective, it is important to ensure the consistent and effective valuation of OTC derivative contracts between counterparties. Specifically, the HKMA's proposals would require counterparties to OTC derivatives transactions to agree on the process of valuation, the key parameters, data sources, dispute resolution mechanisms and the valuation review process.[21] We believe that, in addition, the HKMA should encourage the use of third parties for each of these processes as it will help provide sufficient independence and transparency to the process.

We welcome that the HKMA also included a provision for the valuation to be provided by third parties.[22] To allow for a smooth and effective implementation of the valuation procedures, we encourage the HKMA to provide further guidance to allow counterparties to also rely on input data and methodologies provided by qualified independent third parties. We believe that such approach would also be helpful to reduce the potential for valuation disputes between counterparties.

Finally, we would recommend that, irrespective of whether valuations are "computed internally or provided by third parties" the HKMA should issue guidance to ensure that the process is sufficiently independent. For example, where valuations are generated by a firm internally, this could be achieved by ensuring that valuations are provided by Independent Price Verification (IPV) teams that are separate from the teams responsible for making the trading decision.

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[19] For interest rate swaps and credit default swaps by T+1 from and after 1 September 2016; for other product types by T+2 from 1 March 2017 to 31 August 2017; and by T+1 from and after 1 September 2017.
[20] Pg 32, Para 4.2.6
[21] Pg 33, Para 4.3.3-6
[22] Pg 31, Para 4.3.2

The HKMA also recognizes the need for "an alternative process or approach by which an AI and its counterparty will determine the value of a non-centrally cleared derivative in the event of the unavailability, or other failure, of any inputs required to value the transaction".[23] We believe that third party valuation services are well placed to provide independent opinions and valuations in the event of stressed markets. The HKMA should therefore explicitly allow for or encourage AIs to use an independent third party provider in any of the aforementioned events.

3. Margin standards

a) Variation margin

The HKMA calls for a consistent application of variation margin rules for the various entities that are covered by its margin provisions.[24] It highlights that the models used by firms for the margin calculation can vary which would complicate the process of supervision. We believe that, to ensure a uniform application of margin rules, the HKMA should therefore encourage the use of third party services that can provide independent margin calculation which would result in an increased standardization of such calculations across the marketplace.

The HKMA rightfully recognizes the complexities surrounding the valuation of derivatives which form the basis for the determination of variation margin amounts. We agree with its observation that non-centrally cleared derivatives are likely to be relatively illiquid and "the associated lack of price transparency further complicates the process of agreeing on current exposure amounts for VM purposes".[25] We recommend that, to reduce the potential for disputes in the process of agreeing variation margin, the HKMA consider issuing guidance that allows covered entities to use third party methodologies for the valuation of a derivative's current exposure and for calculating "current exposure amounts for VM purposes".[26]

The HKMA also proposes for VM to be calculated daily and collected "at the earliest time possible after the trade date but no later than the end of the following Hong Kong business day ("T+1")".[27] We believe that such approach represents sound risk management practice to protect market participants from the risk of a counterparty default in stressed market scenarios.

b) Initial margin

We recommend that, consistent with the HKMA's approach in relation to variation margin calculations, to achieve the HKMA's stated objective that "margin collected from a covered entity should [..] be consistent across entities covered by the margin provisions",[28] HKMA issue guidance to encourage the use of third parties. Third party calculation of IM, in addition to ensuring uniform initial margin calculation across market participants, will reduce the potential for IM disputes between counterparties.

The HKMA lists the conditions under which a call to exchange initial margin should be triggered.[29] We generally agree with the HKMA's proposal and believe it is broadly aligned with requirements proposed in other jurisdictions.[30] However, we recommend that a recalculation of IM is also required in the event of a major change in market conditions. This is because major market moves are likely to affect the risk considerations as well as historical models, and can consequently result in a significant change in IM amounts which can only be

[23] Pg 33, Para 4.3.6
[24] Pg 20, Para 3.1.2
[25] Pg 20-21, Para 3.1.6
[26] Markit's Analytics business helps clients compute margin for OTC derivatives transactions, both cleared and uncleared.
[27] Pg 26, Para 3.7.2
[28] Pg 21, Para 3.2.3
[29] Pg 26, Para 3.7.4
[30] See European Supervisory Authorities' *Second Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP (EBA/JC/CP/2015/002:* *https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf*

reflected through a recalculation. The HKMA should therefore encourage firms, as part of their internal risk management policies, to also determine the threshold and materiality of changes in market levels/conditions that would trigger an IM recalculation.

4. Trading relationship documentation

The HKMA requires that trading relationship documentation should be established between AIs and their counterparties to, inter alia, provide “legal certainty for non-centrally cleared derivatives”.[31]

We welcome the HKMA’s proposals for firms to establish trade relationship documentation that would satisfy certain conditions and contain relevant information. However, considering the number of trade relationships that many AIs maintain, the HKMA should note that establishing and updating trading relationship documentation between thousands of counterparties can be logistically challenging. We therefore recommend the HKMA explicitly allow for and encourage AIs to use third party platforms that help them establish, update and manage such documentation in an efficient, reliable and auditable manner.

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We hope that our above comments are helpful to the HKMA. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,

Marcus Schüler
Head of Regulatory Affairs
Markit
marcus.schueler@markit.com

[31] Pg 30, Para 4.1.3