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25 November 2011

Dear Sirs,

BlackRock welcomes the opportunity to respond to the BCBS consultation on capitalisation of bank exposures to central counterparties. We strongly support the moves globally to increase central clearing of OTC derivatives, enhance risk mitigation of non-centrally cleared trades, and ensure position reporting to trade repositories. These are important and necessary regulatory reforms.

Who is BlackRock?

BlackRock is one of the world's preeminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world. As of 30 September 2011, BlackRock's assets under management total €2.46 trillion across equity, fixed income, cash management, alternative investment and multi-asset and advisory strategies including the industry-leading iShares® exchange traded funds (ETFs). Through BlackRock Solutions®, the firm offers risk management, strategic advisory and enterprise investment system services to a broad base of clients with portfolios totalling more than €7.35 trillion.

BlackRock is a member of European Fund and Asset Management Association ("EFAMA") and a number of national industry associations[1] reflecting our pan-European activities and reach.

Yours Sincerely,

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[1] Association of British Insurers (ABI), AFG, Assogestioni, ASF, ASIP, BVI,DUFAS, Eumedion, Financial Reporting Council (FRC), Irish Association of Fund Funds (IAPF), Irish Funds Industry Association (IFIA), Investment Management Association (IMA), Inverco, National Association of Pension Funds (NAPF), and Swiss Foreign Banks Association (SFA).

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Basel Committee on Banking Supervision (BCBS) Consultative Document on Capitalisation of Bank Exposures to Central Counterparties

Introduction

BlackRock welcomes the opportunity to respond to the BCBS consultation on capitalisation of bank exposures to central counterparties. We strongly support moves globally to increase central clearing of OTC derivatives, enhance risk mitigation of non-centrally cleared trades, and ensure position reporting to trade repositories. We manage nearly 2.5 trillion in assets under management in the form of pension funds, separate accounts, insurance contracts and mutual funds for our clients. In our response, we focus on two specific aspects of crucial relevance to individuals' long-terms savings:

- Buy-side investors will be subject to mandatory clearing. Indeed, we believe that our clients should post a substantial portion, if not the majority, of the collateral received by CCPs. For this to happen, it is of crucial importance that central clearing be incentivised through lower capital requirements in comparison to bilateral trades. The Consultative Document does not, however, incentivise the use of CCPs and thereby acknowledge the risk reducing role performed by CPPs for non-bank indirect clearing members in the OTC market. We would advocate amending the provisions to clarify that the net capital requirements of both legs of an indirectly cleared transaction are less than those incurred for the single leg of a bilateral trade.
- We request that, where temporary forbearance from central clearing has been granted by the relevant authorities and robust risk mitigation techniques exist during the transitional phase, such as verification of exposures, timely, accurate and appropriate exchange of collateral, segregation of collateral and supervision and auditing, this should be accommodated into the capital framework.

1. Indirect access

BlackRock supports the revised segregation and continuity requirements for indirect access for non-banks. In particular, we support the focus on "arrangements that prevent any losses to the client" due to the default or insolvency of the clearing member and/or the clearing member's other clients.

It seems reasonable to us that where a bank acts as a clearing member of the CCP for a client and the client is protected from losses, a risk weight of 2% be applied to the clearing bank's exposure to the CCP. Equally, it seems reasonable that a risk weight of 4% be applied where the client collateral is held in an omnibus account (which does not offer legal segregation) and the client is not protected from the default or insolvency risk of a clearing member or other client. BlackRock also believes that the revised continuity requirements offer a more viable solution than guaranteed portability.

However, the additional requirement on a clearing member to collateralise its exposure to clients as a bilateral trade, irrespective of their acting as an intermediary between the client and a CCP (paragraph 111) makes it less capital efficient to clear through a CCP. **Assuming that collateral is comparable for both centrally and bilaterally cleared trades, no clear incentive exists to clear centrally.**

In addition, the increase in hypothetical capital of a CCP, and the associated rise in capitalisation of the clearing member's default fund contribution triggered by the central clearing of a transaction, risks encouraging bilateral trading. **This is at odds with the G20 commitment to incentive the use of CCPs and does not acknowledge the risk reducing role CCPs perform in the OTC market.**

We recognise that the increased costs of the capital requirements would not apply directly to asset management but assume that they will be passed in part or in whole to the end user through increased spreads and other fees.

We therefore recommend that the requirements be amended to clarify that the net capital requirements of both legs of an indirectly cleared transaction are less than those incurred for the single leg of a bilateral trade.

2. Accommodation of the capital framework for bilateral trades that have been granted temporary forbearance and which follow robust risk mitigation techniques

BlackRock fully supports moves to increase central clearing of OTC derivatives. We see this as an important step to strengthening the resilience of our financial system. The recent financial crisis has been detrimental to the interests of the investors we serve and it is in their interests that all reasonable steps are taken to avoid a repeat of these lessons.

However, we would also emphasise that steps to strengthening the resilience of derivatives markets must not inadvertently bring new detriment to investor interests.

Individuals' long-term savings often rely on derivatives to manage the risks arising from volatility in interest rates, inflation, foreign exchange (FX) rates and equity markets; as well as to help achieve targeted investment mandates such as liability driven mandates for pension funds.

Long-term savings institutions are end-users in derivative markets, which means their net derivative positions tend to be "one way" and very large in size to reflect the long-term hedging needs of the pension scheme or retail customer. This contrasts with intermediaries/dealers whose positions typically net-out through offsetting derivative positions. Further information on long-term savings institutes use of OTC derivatives is outlined in Appendix 1.

A savings institution will typically fully invest the investment portfolio in order to achieve the best result in terms of returns and liability hedging for savers. The portfolios therefore have minimal amounts of uninvested cash available to be posted as collateral.

The need to post cash as variation margin for central clearing will lead to a significant drag in the long-term performance of pensions and equivalent long-term savings in a number of European countries due to the specific nature of the long-term savings markets in a number of European countries, as described further in Appendix 2.

European law is set to recognise this through their approval of a transitional exemption from central clearing for pension schemes arrangements. The pension schemes ability to have recourse to this exemption is tightly defined and the exemption is subject to strict bilateral risk mitigation techniques. These are set to include:

- Operational procedures and arrangements to measure, monitor and mitigate operational and credit risk;
- Daily mark-to-marking of the value of outstanding contracts;
- Risk management models as robust as those used for central clearing;
- Risk management procedures that require the timely, accurate and appropriate exchange of collateral;
- Appropriate and proportionate capital to manage risk not covered by an appropriate exchange of collateral; and
- Client account segregation (if requested before the time of execution).

Secondary rule-making will specify technical standards detailing the levels of collateral, levels of capital and risk management standards.

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The temporary exemption for pension schemes in the European Union is designed to give CCPs time to identify an operational solution to allow high quality and liquid non-cash financial instruments to be posted as variation margin to CCPs. In the interim, BlackRock believes that non-cash margining of derivatives positions should remain both operationally feasible *and* ***economically viable***. This requires that the capital framework reflect the temporary forbearance from central clearing granted to pension funds in the European Union.

We therefore propose that long-term savings institutions should not be unduly penalised under Basel III in respect of their bilaterally cleared derivatives exposures. Specifically, we recommend that where temporary forbearance from central clearing has been granted by the relevant authorities and robust risk mitigation techniques exist, such as verification of exposures, timely, accurate and appropriate exchange of collateral, segregation of collateral and supervision and auditing, their specific risk-weights should be proportionately lower than the recommended bilateral risk-weights under Basel III.

APPENDIX 1

Long-term savings' institutions use of derivatives in Europe

Individuals' long-term savings often rely on derivatives to manage the risks arising from volatility in interest rates, inflation, foreign exchange (FX) rates and equity markets; as well as to help achieve targeted investment mandates such as liability driven mandates for pension funds.

These savings are managed by investment managers and insurance companies ("savings institutions") which today represent approximately €19.4 trillion[2] of European citizens' savings. They are held in a combination of pension funds, individual savings accounts, unit / non-unit linked insurance policies and UCITS/ non-UCITS funds.

A savings institution will typically fully invest the investment portfolio in order to achieve the best result in terms of returns and liability hedging for savers. The portfolios therefore have minimal amounts of uninvested cash available to be posted as collateral.

Long-term savings institutions are end-users in derivative markets, which means their net derivative positions end up being "one way" and very large in size to reflect the long-term hedging needs of the pension scheme or retail customer. This contrasts with intermediaries/dealers whose positions typically net-out through offsetting derivative positions.

Savings institutions will generally exchange variation margin with their counterparties to mitigate the risks arising from portfolios' derivative positions[3]. The terms of such variation margining (acceptable collateral, collateral timing, haircuts and minimum transfer amounts) are broadly standardised across the industry[4] and applied by the majority of market participants today. Collateral exchanged under these arrangements include government bonds, supra-nationals, and high quality corporate bonds.

Central clearing will introduce significant changes to how savings institutions collateralise derivative positions as CCPs today typically require cash collateral (rather than high quality non-cash collateral) for variation margin purposes. This would require savings institutions to collateralise their typically large long-dated one-way derivative positions by transferring significant levels of cash to CCPs.

In order to meet such cash margin requirements, a material portion of savers' underlying investment portfolios would have to be liquidated, meaning that savers would lose the earnings on those assets. Pension funds estimate that approximately 12% of pensioners' savings would have to be allocated to cash to cover margin requirements. **The long-term nature and modest return targets of many of these products mean that the cumulative impact of these factors is likely to be significant.**

Cautious assumptions estimate a drop in overall returns for long-term savers of approximately 0.2% per annum. Many industry participants estimate the impact to be significantly higher. Most pension schemes seek returns of 1-2% per annum in excess of liabilities. In this context, losing 0.2% is significant and may lead to pension schemes moving into higher risk investments (e.g. more equities, alternatives) to compensate for the shortfall.

These impacts might be higher for insurance companies which, contrary to pension funds, tend to hold higher allocations of corporate bonds rather than government bonds, increasing the performance reduction from having to liquidate holdings into cash.

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[2] *Source: McKinsey estimation of European assets under management 2009*

[3] *An exception is FX forwards which are not typically collateralised in light of their short maturity. The predominant risk in these markets is cross-currency settlement risk, which is addressed through separate infrastructure arrangements under CLS Bank.*

[4] *Based on ISDA Master Confirmation Agreements (MCA) and related Credit Support Annex (CSA) that outlines how two counterparties agree to manage their respective credit exposures.*

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APPENDIX 2

Specificities of European Retirement Savings

Long-term savings institutions in Europe make significantly greater use of long dated OTC derivatives than in other regions due to European specificities around its ageing population and member state regulatory framework for pensions savings. Such specificities include:

- Defined benefit funds closed earlier in the US than in 'defined benefit' European countries, switching to defined contribution schemes. Hence the liabilities of defined benefit pension schemes are shorter in the USA than in these countries.
- Regulatory protection for pension beneficiaries in certain European countries which requires pension funds to hedge their liabilities (pension cash flows) against inflation and interest rate risks. Examples include the Traffic Light System in Denmark and FTK in the Netherlands.
- In addition, the almost complete indexation of UK pensions to inflation (pre- and post-retirement) compares with US corporate DB liabilities which are almost exclusively nominal. This increases the value of far-dated UK liabilities cash flows, increasing liability duration.
- Similarly, the use of largely risk-free discount rates (as opposed to corporate-based discount curves in the US) increases the duration of liabilities in both the UK and Netherlands.
- As a result, OTC derivatives in the UK are in much more demand (more duration risk to manage combined with limited inflation linked bond supply) and are more useful than in the US (interest rate and Inflation swaps are more correlated to risk-free discount rate than a corporate discount rate).
- In addition, EU regulation also encourages the hedging of liabilities and the use of long dated OTC derivatives. The IORP Directive requires pension funds to use derivatives for risk mitigation purposes only. Solvency II increases insurance companies focus on risk as measured in terms of assets relative to liabilities.