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28 September 2012

Dear Sirs,

AIMA's response to the joint BCBS-IOSCO consultative document, "Margin Requirements for non centrally cleared derivatives"

The Alternative Investment Management Association Limited (AIMA) appreciates the opportunity to comment on the BCBS-IOSCO consultative document, 'Margin requirements for non-centrally-cleared derivatives' (the Consultative Document).

AIMA is the trade body for the hedge fund industry globally. Our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in more than 40 countries.

Our members are active participants in derivatives markets in all regions of the globe and it is fundamental to their interests and those of their end investors that the markets in which they trade are efficient and safe. This is why we strongly supported the design and implementation of an appropriate framework for central clearing of derivatives and why we continue to work with regulators and market participants to ensure that buy side concerns are properly taken into account.

To this end, AIMA welcomes the role of BCBS-IOSCO in examining what are the most appropriate requirements for margining of non-centrally cleared derivatives (NCCDs), which we consider supplements the significant work already done in the area of clearing obligations for derivatives.

We believe that, given the global nature of the financial markets, the optimal regulatory result can only be achieved through rules and obligations that are functional in a cross-border setting. It is, therefore, extremely important to ensure that the new regulatory framework for non-cleared derivatives is coordinated internationally in order to avoid market distortions, inefficiencies and regulatory arbitrage. We therefore commend the efforts of both organisations to work towards a consistent set of principles governing this extremely important part of the financial market.

Summary of AIMA's key issues

We set out in Annexes 1 and 2 below our detailed replies to the questions which BCBS-IOSCO poses in the Consultative Document and our comments in respect of portfolio margining. But we would highlight, in particular, the following points:

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Portfolio margining

Portfolio margining is a time-tested market practice which brings with it a number of significant. As the process of developing margining regimes for cleared and non-centrally cleared OTC derivatives goes forward, it is critical not to overlook the relationship between the two, since market participants typically maintain portfolios that include both types of instruments, as well as other correlated financial instruments.

Therefore, AIMA believes that, in its final policy proposals, BCBS-IOSCO should ensure that it remains possible to comply with margin requirements on a cross-product basis. As more OTC derivative products are moved to central clearing, care should be taken not to inhibit efficient portfolio margining arrangements. The consequences of doing so include (a) discouraging customers from transacting in cleared swaps on a voluntary basis and (b) once clearing becomes mandatory, making the costs of participating in the swaps market prohibitive, leading to a loss in market depth and liquidity.

Re-hypothecation/segregation

AIMA agrees with the principle of re-hypothecation for variation margin (VM) on the basis that assets are classified as customer assets and must accordingly be protected in the event of a default. However, we firmly believe that initial margin (IM) should be segregated and not re-hypothecated unless agreement has been specifically given.

Impact assessment

It is vital that an impact assessment is undertaken before implementation as there is a risk of requiring enormous amounts of IM, way in excess of any measure of actual risk, which could severely reduce liquidity in the OTC markets, reducing the ability of market participants to properly hedge risk and thereby increasing systemic risk.

The impact assessment should include information from dealers as to the likely impact on overall margin levels were all standardised trades centrally cleared, when a dealer would be required to post only one margin on its net risk to the CCP rather than multiples of margins on gross risk to clients.

Initial margin model

AIMA supports allowing market participants to choose a standardised model such as the one proposed by BCBS-IOSCO. However, as proposed, the BCBS-IOSCO model is insufficiently granular to be appropriately risk-sensitive. For example, buyers and sellers of products such as options present significantly different risks, and such positions should be subject to margin requirements that reflect these distinctions. AIMA would support providing market participants with a choice between using BCBS-IOSCO's Proposed Standardised Initial Margin Schedule (at Appendix A of the Consultative Document) or more nuanced quantitative models developed by dealers or third parties.

Two-way margining

AIMA agrees with the principle of two-way margining, provided that it is proportionate to the risk entailed in the relevant transaction. We would, though, highlight the risk that the BCBS-IOSCO proposals may lead to both a requirement for too much IM being posted and also to increased operational complexities, in turn resulting in increased costs - potentially to the extent that NCCDs might become commercially non-viable.

Timing of implementation

AIMA's strong preference would be for the implementation of a regime for NCCDs not to proceed until the latter is adequately known and available in key jurisdictions. This would not require all necessary steps for all financial instruments to be cleared to have been finalised but, as a minimum, the secondary rulemaking and/or guidance phase needs to have been completed and market participants need to have adequate certainty about the set of instruments which are likely to be mandated for clearing.

Conclusion

AIMA sees BCBS-IOSCO's work on margin requirements for NCCDs as crucial in achieving an inter-jurisdictional framework which is workable, coherent and consistent. Such a framework is critical if the markets on which our

members trade are to be efficient and safe and if our members, as market participants are to manage appropriately the risks which are an inevitable part of the investment process.

We believe that the proposals put forward by BCBS-IOSCO in the Consultative Document are, in general, sound and sensible and we give them our strong support. Where we feel that specific issues need to be taken into consideration by BCBS-IOSCO, or where we disagree with certain aspects of BCBS-IOSCO's initial thinking, we have sought to highlight these in a constructive manner in our detailed responses, which can be found in Annex 1 below.

We hope that our comments will assist BCBS-IOSCO in developing a rigorous and effective framework and we stand ready to offer any help which BCBS-IOSCO feels would be useful as this process goes ahead.

Yours faithfully,

Jiří Król
Director of Government and Regulatory Affairs

<u>Annex 1</u>

AIMA's detailed comments

on questions posed by BCBS-IOSCO in the joint consultative document

"Margin Requirements for non centrally cleared derivatives"

Q1 What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

Ideally, the timetable for phasing in implementation of margin requirements for non-centrally cleared derivatives (NCCD) should reflect the implementation of the clearing obligations in key jurisdictions which are already advanced in implementing central clearing solutions for derivatives. This would help avoid both regulatory arbitrage and imposing higher margin requirements on the non-cleared market before a cleared alternative is available.

However, there are many challenges to timely implementation given both (a) existing industry demands for preparing appropriate internal systems and controls in time for clearing; and (b) the lack of a universally available 'quantitative initial margin model' which has been approved by the 'appropriate supervisory authority' (as referred to at page 17 of the Consultative Document).

AIMA's strong preference, therefore, would be for the implementation of a regime for NCCDs not to proceed until the latter is adequately known and available in key jurisdictions. By this, we mean not that all necessary steps for all financial instruments to be cleared have been finalised but that, as a minimum, the secondary rulemaking and/or guidance phase is complete and there is adequate certainty about the set of instruments which are likely to be mandated for clearing. Industry requires a certain level of clarity about the new clearing regime and its legal requirements before it can meaningfully start to prepare its systems for NCCDs. Thus, we would support a coordinated approach which is global in scope, covering all market participants by product class, once clearing is made available for that class. In the absence of such coordination, however, there will exist opportunities for regulatory arbitrage, which AIMA is keen to see minimised.

Element 1: Scope of coverage – instruments subject to the requirements

Q2 Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

We agree with BCBS-IOSCO that short-term FX swaps and forwards are distinct from the broader non-cleared OTC derivatives market in terms of market structure and liquidity. However, we believe that FX forwards should be included within the scope of the margin requirements regime for NCCDs. It should be noted that current market practice is such that the large majority of AIMA's members who enter into bilateral trades in the FX space are already required to post margin (both IM and VM).

However, any eventual margin requirement imposed on such instruments should be tailored to the nature of risk they present to the financial system and developed apart from those for the other non-cleared derivatives. Specifically, a 99%, 10-day liquidation horizon would be inappropriate and excessive for highly liquid, short-dated FX swaps and forwards. We recommend that BCBS-IOSCO permit a significantly lower time horizon for short-dated FX swaps and forwards, such as 5 days (as has been widely proposed for cleared swaps) or 1 day (as is standard for cleared futures) as appropriate.

Q3 Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

Following on from our response to Q2 above, it is hard to see what exemptions should be provided since all derivatives transactions, to a greater or lesser degree, entail some degree of risk. We accept that a risk-free transaction should, rightly, require no margin to be posted against it.

As a general rule, therefore, we argue that IM should be commensurate with the risk associated with the relevant type of transaction and, as such, it should be required unless a trade is essentially risk-free.

Element 2: Scope of coverage – scope of applicability

Q4 Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

AIMA agrees with the principle of two-way margining, provided that it is proportionate to the risk entailed in the relevant transaction. We would, though, highlight the risk that the BCBS-IOSCO proposals may lead to (a) a requirement for too much IM being posted and (b) increases in operational complexities, which would in turn result in increased costs, potentially to the extent that NCCDs might become commercially impossible to trade.

We accept that the introduction of two-way margining would involve certain operational issues – how will novation of derivatives contracts work, for example? Where, and under what rules will IM be held? These challenges can certainly be overcome, but this may need some consideration in respect of the specificities of different instruments and product ranges. For instance, should the same margin be posted when one buys CDS protection as when one sells it?

We also recognise that there are significant operational costs associated with negotiating, establishing and maintaining segregated tri-party accounts with thousands of counterparties, as would be required of each dealer under the universal two way posting. These operational complexities could result in dealers shutting smaller market participants out of the market, thereby further straining liquidity. The additional costs will likely be passed on to customers, and these additional costs also need to be considered in any impact study.

Overall, therefore, we see benefits to having two-way margin exchange but the key issues, those of (a) ensuring that the requisite IM is proportionate to the risk and (b) the impact of such exchanges on liquidity must, AIMA feels, be the subject of a rigorous impact study conducted by BCBS-IOSCO in order to establish how and where the parameters of any such regime should properly be set. It is very important that any such impact assessment be on the basis of realistic, risk-sensitive models for initial margin requirements – such as the in-house risk models currently in use at every bank and dealer - rather than standardised tables, as it is only such risk-sensitive models that give a true picture of the likely impact.

The study should also take account of dynamic effects on overall margin levels that will be produced by the introduction of central clearing.

Q5 Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

Q6 Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

Q7 Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

Q8 How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

Taking Q5 to Q8 (inclusive) together, AIMA believes that allowing thresholds could, to some greater or lesser degree, undermine the rationale for the margin regime by allowing certain important institutions not to post margin at all, thereby increasing systemic risk.

If thresholds were allowed, then AIMA would strongly suggest that they be based on each party's assessment of the credit worthiness of its counterparty rather than its regulatory status. As recent experience has shown, not all prudentially regulated institutions pose low credit risk; neither do all non-prudentially regulated intuitions.

Use of thresholds can be seen as identical to unsecured lending and so should be treated in the same prudential manner.

Therefore, if thresholds were to be used, AIMA strongly recommends that:
- they do not distort the market and are not discriminatory;
- they are equivalent to unsecured lending from the perspective of capital requirements; and
- regulated and non-regulated entities are treated in the same manner in the setting of thresholds.

Q9 What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

Q10 What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

As mentioned in our response to Q4, we encourage BCBS-IOSCO to consider the impact of its proposals in respect of two-way margin in its impact study to ensure that the potential adverse effects (referred to below) which arise from the proposed margin requirements do not counteract the systemic benefits of universal two-way margin posting.

While mandatory two-way exchange of segregated IM is an effective mitigant of systemic risk, as we have argued in response to Q4 above, we are concerned that it will also likely require many prudentially regulated participants to commit significantly more collateral to their trades than they have historically in the absence of any requirement. To the extent that these requirements precipitate a shortfall of eligible collateral, or make it prohibitively expensive for participants in derivatives markets to manage risk with non-cleared swaps, universal two-way margin may have the effect of exacerbating systemic risk rather than reducing it.

There are also operational cost implications to universal two-way margining. The opening and ongoing operation of tri-party accounts will likely present a material cost to the posting counterparty. Current documentation is non-standardised and legal negotiations cost time and resources. Accordingly, it may not be necessary or appropriate in all cases for a participant in non-cleared derivatives markets to make

use of tri-party segregation if that participant's swap exposure is not systemically significant, and the costs of tri-party segregation outweigh the benefits. However non-"key" or non-prudentially regulated participants should be afforded the legal right to elect tri-party segregation for their IM under commercially reasonable terms at their choosing. We note that, in the current environment, several buy side firms have opted to bear these costs voluntarily in exchange for the added protection of segregation.

Q11 Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

See our response to Q9 and Q10 above. In the current environment, in particular, it is not necessarily the case that all sovereign entities could be regarded as being risk-free and we would favour a robust analysis as to which may be so regarded and which may not.

In addition, we consider that it would be difficult for a firm to determine in every instance, and at every moment, whether its counterparty is, or is not, systemically risky.

Q12 Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?

We make no specific comment in respect of this question.

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

Q13 Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

Q14 Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

AIMA supports there being a choice between using a model based on BCBS-IOSCO's proposals or quantitative IM models developed by dealers or third parties.

We would see a great benefit for market participants, and especially for smaller buy side firms, in having the ability to use independent models, which we see as being likely to be more nuanced than a universal IM model, and we would not wish BCBS-IOSCO to remove the ability of individual dealers to use their own approved models in future.

We also consider it critically important that buy side firms be able to replicate IM models so that they can anticipate changes in margin through the life of the relevant derivative contract. Therefore, regulators should take step to empower buy side firms to have an appropriate degree of transparency into dealers' approval quantitative IM models, so they can reasonably predict and anticipate IM requirements going forward, rather than being handed a black box.

Q15 With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

We support allowing market participants to choose a standardised model similar to the one proposed. However, as proposed, the model is insufficiently granular to be appropriately risk-sensitive. For example, buyers and sellers of products such as options (in any market) and CDS present significantly different risks, and such positions should be subject to margin requirements that reflect these distinctions. In addition, more granular maturity buckets should be specified.

If the standardised model were improperly calibrated, so that it produced excessive levels of required margin and if it were costly, or otherwise not convenient, for a large number of market participants to calculate margin on the basis of calibrated risk models, there is a danger that the use of the standardised model would lead to significant draining of liquidity in the market.

For example, LCH Swapclear currently has an outstanding cleared notional in interest rate swaps of approximately $300 trillion, and holds total IM of approximately $100 billion (margin which has been posted by both parties to the trade). Therefore, the average margin requirement per side at LCH is 1.5 basis points of notional (100 billion / 300 trillion / 2 = 0.015%). The requirement proposed in the standardised schedule is that interest rate swaps should have an initial margin requirement of 1%, 2% or 4% depending on whether their "duration" (presumably meaning remaining maturity) is under 2 years, 2-5 years or over 5 years. According to BCBS statistics for outstanding derivative notional, the weighted average initial margin requirement would be 2.1% of notional – a figure which is 140 times higher than LCH.

Q16 Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?

The VM methodology does not take into account the complexity of valuing certain structured trades. Daily valuation statements are not available for more esoteric products, which rely on model valuations as the underlying inputs may not be available. In the absence of daily pricing, the valuation statements would remain unchanged.

Q17 With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?

VM payments should be exchanged on a daily basis.

Q18 Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?

IM should not increase, but VM calls should be at least daily in times of market stress. In general, risk models provide for increased margin gradually in periods of market stress. Whilst it is accepted that this may entail a mild degree of procyclicity, this tends to remain, in our view, at an appropriate level and is clearly preferable to the procyclical effects which result when there is an absence of, or insufficient, margin.

Q19 What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?

We would recommend that the minimum transfer amount should be the equivalent of US$250K in the base currency of the CSA.

Element 4: Eligible collateral for margin

Q20 Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

The proposed standardised haircut schedule needs to be clarified. For example, does 'cash in different currency' mean different from the base currency of the CSA or different from the trade currency?

AIMA also believes there should also be a sliding scale of haircuts depending on trade currency and that the haircut schedule should be bilaterally agreed on the CSA.

The haircut schedule as a whole is too vague – for instance, how is a 'High Quality Corporate Bond' defined?

Q21 Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

See our answer to Q 20 above.

Element 5: Treatment of provided margin

Q22 Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

The proposed requirements for provided margin are too vague. If tri-party accounts are required, then market standard documentation would be beneficial in reducing legal costs.

Q23 Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

AIMA is happy with the proposal to exchange gross IM and agrees that the exchange of IM will likely lead to a larger concentration risk at custodians.

Q24 Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

AIMA agrees with the principle of re-hypothecation for VM on the basis that assets are classified as customer assets and must accordingly be protected in the event of a default. However, AIMA would like a limit prescribed at the point of trade or CSA negotiation.

AIMA's strongly held view is that:

- IM should be segregated and not re-hypothecated unless agreement has been specifically given; and
- VM should not be segregated but should be free to be re-hypothecated.

Element 6: Treatment of transactions with affiliates

Q25 Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?

We make no specific comment in respect of this question.

Q26 Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

We make no specific comment in respect of this question.

Element 7: Interaction of national regimes in cross-border transactions

Q27 Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

AIMA fully supports BCBS-IOSCO's comments regarding the desirability of avoiding regulatory arbitrage, ensuring a level playing field and avoiding duplication of regimes. We agree that the aim should be to achieve as full a harmonisation of principles as possible at a global level in order for margining regimes in different jurisdictions to be properly regarded as equivalent.

Whilst we support the general thinking behind BCBS-IOSCO's proposals regarding home/host supervision, we believe that some further clarity is needed. For example, what is the position with regard to non bank entities (since the examples given in the Consultative document reference banks)?

In general, it may not be easy to determine who a 'home' or 'host' supervisor may be in each situation. It would therefore, be advisable that, provided both relevant jurisdictions have recognised and implemented the BCBS-IOSCO regime, the parties should have the ability to choose the home jurisdiction at the time of the trade.

In order to avoid major differences emerging between regimes upon implementation, it is important that, when a jurisdiction adopts the BCBS-IOSCO framework, equal attention is paid to operational aspects as to issues around risk. By way of example, segregation rules, and rules concerning client asset protection generally, should be as uniform as possible across jurisdictions so that these do not, of themselves, determine whether market participants are prepared to enter into NCCD transactions in that jurisdiction.

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Annex 2

AIMA's comments on portfolio margining

BCBS-ISOCO invites comments on all aspects of its consultation, not merely in respect of the issues specifically raised in the questions which are posed.

One key area on which we would comment is that of portfolio margining. We endorse BCBS-IOSCO's recognition of the importance of this issue and strongly support the concept that quantitative IM models may account for risk on a portfolio basis.

Portfolio margining is a beneficial, time-tested market practice which is underpinned by sound economic, risk and legal bases. As margining regimes are developed in parallel for cleared OTC derivatives and non-centrally cleared OTC derivatives, it is essential that the relationship between the two is not overlooked, since market participants typically maintain portfolios that include both types of instruments, as well as other correlated financial instruments.

Therefore, BCBS-IOSCO should ensure in its final policy proposals that the importance of cross-product margining is acknowledged and that statements are not made that would inadvertently stymie these arrangements going forward. Sound portfolio margining arrangements that exist today often encompass derivatives, both cleared and non-cleared, as well as repos and cash products, among others. Examples of cross-product risk offsets include:

- Treasury futures vs. Interest Rate Swaps (IRS);
- IRS vs. swaptions;
- single-name CDS vs. CDS indices;
- IRS vs. Repos vs. Government Bonds.

As more OTC derivative products are moved to central clearing, care should be taken not to inhibit efficient portfolio margining arrangements, subject to the following provisos:

- CCP margin is always fully satisfied and rights to it are never abrogated;
- arrangements do not increase risk to the counterparties or the financial system as a whole;
- only offsets "that can be reliably quantified" are accounted for;
- margin model approval is received by relevant supervisory authorities;
- legal opinions verifying the validity and enforceability of the arrangements under applicable law of the relevant jurisdictions are obtained.

In practice, cross-product margining arrangements enable a dealer (and its affiliates, as the case may be) to look at a client's entire portfolio across cleared and non-centrally cleared products and - to the extent that products are negatively correlated or offset each other - afford concurrent reductions in non-centrally cleared margin obligations, while always ensuring that:

- cleared positions are always fully margined; and
- if a client defaults, the dealer and its affiliates can liquidate the client's portfolio and will be made whole (gains on cleared positions will offset losses on uncleared positions, or vice versa) given ample IM for the portfolio as a whole.

Cross-product margining arrangements, while not increasing risk in the marketplace:

- remove excess interconnectedness from the marketplace by optimising IM payments and collateral balances;
- facilitate the transition to central clearing;
- encourage market demand for clearing;
- address the scarcity of eligible collateral issue;
- incentivise risk reduction through hedging and the maintenance of balanced portfolios; and
- allow capital to be deployed most efficiently, yielding better returns for the investing public.

The unintended consequences of inhibiting cross-product margining are that:

- customers would be discouraged from transacting in cleared swaps on a voluntary basis;
- once clearing is mandatory, customers could find participating in the swaps market to be cost prohibitive, with a resultant loss in market depth and liquidity;
- market participants are discouraged from hedging risks; and
- returns that buy-side firms are able to deliver to their investors would be diminished due to posting excessive collateral.

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