Response to the BCBS-IOSCO consultative document “Margin requirements for non-centrally-cleared derivatives”

28 September 2012

Introduction

ABI welcomes the BCBS-IOSCO consultative document on “Margin requirements for non-centrally cleared derivatives”. In general terms, ABI shares and supports the two main objectives of a regulation regarding margin requirements, i.e. the reduction of systemic risk and the promotion of central clearing. Secondly, collateral management should be promoted as one of the techniques to manage the counterparty risk, and be considered among the mitigation techniques as a tool available for supervised entities to hedge this risk.

Prior to entering into the details of the answers provided to the consultation paper questions, ABI feels it is important to highlight that the Basel III regulations have already incentivised the use of centralised clearing by requiring higher capital requirements for OTC derivatives transactions and by providing incentives to the development of internal models and processes. Within this framework, ABI is of the opinion that bilateral transactions in OTC derivatives would be excessively penalised by the mandatory introduction of the Initial Margin (IM) requirement. The goal of reducing systemic risk should instead be pursued through alternative means, as described further below.

We believe that mandatory exchange of IM posted by Prudentially Regulated Entities (PREs) should not be introduced as it could increase systemic risk. The reasons for this view are listed below:

1. **Liquidity shock**. By applying the regulation as proposed, the liquidity needs of the covered entities to match IM requirements would be enormous and would lead to a significant liquidity shock.

2. **Funding the real economy**. A very high percentage of the collateral pool currently available in the market would have to be pledged as IM: if segregated, it would reduce the liquidity available for lending and affect the ability of financial institutions to fund themselves at competitive levels and to lend money to the real economy. As a consequence, the monetary base provided by ECB will be partially drained from the private sector to be immobilised as IM.

3. **Unhedged economic risks**. The higher funding cost faced by OTC derivatives providers for posting IM will result in less competitive prices for derivatives offered to clients. In some cases, the very expensive hedging costs could discourage some OTC derivatives users to hedge their risks. Specific risks would, therefore, remain unhedged, and will thus pose a potential systemic risk.

4. **Concentration Risk**. The higher funding cost faced by OTC derivatives providers for posting IM would inevitably lead to wider bid/offer spreads for derivatives offered to clients in order to balance the costs related to IM posting: this spread would be highly dependent on the funding cost of each institution. This could lead to a concentration of the OTC derivatives business in the hands of a few players, which can offer these products with tighter bid/offer spread thanks to their lower funding cost. The systemic risk could be exacerbated by this kind of concentration which will be highly related to future developments in the funding structure of each player. Please note that PREs are already subject to prudential capital requirements, and to specific capital charges which cover current and potential counterparty risk: the introduction of a mandatory IM exchange seems to overlap with capital requirements. In addition, a level playing field is not warranted if mandatory rules can be applied in a different way to covered entities which are active in the same business (SIFIs vs. not SIFIs for instance).

5. **Risk transfer.** The goal of reducing or minimising the counterparty risk could not be achieved. Indeed, under this new framework, every entity must fund itself before dealing an OTC derivative: it would borrow the IM on the funding market, as the IM needs to be posted to the OTC derivative counterparty. This would mean that every entity would be likely to transfer some risk from the counterparty's side to the credit one. We do not believe that this kind of risk transfer, instead of a genuine "de-risking", should be targeted if the goal is to reduce the systemic risk. The counterparty risk is often a <u>potential</u> risk which is likely to materialise <u>only</u> in the close-out process (i.e. when the entity has to simultaneously manage the counterparty's default and the increased positive exposure provided by the derivative MTM), whereas the credit risk implies a "full risk" represented by the instantaneous and effective exposure.

6. **Disincentives to manage counterparty risk.** As already said, the main effect of this proposal is the reduction of counterparty risk by transferring this risk to other areas (concentration, liquidity, credit, unhedging of market risk). The banking industry is currently:

   - investing in and developing internal models and control processes;
   - upgrading collateral management tools and processes;
   - reviewing contractual agreements;
   - developing CVA desks to manage the counterparty risk according to the upcoming Basel III framework.

   This process is driven by the potential saving in terms of capital requirements that justifies the costs. Within a framework which requires the mandatory elimination of counterparty risk through IM posting, all these developments will be reduced or cease. This is in contrast with the aim of the Basel III regulations and represents a potential source of

systemic risk because it does not provide significant incentives to manage the residual counterparty risk. In addition, this proposal could make Basel III counterparty rules obsolete or even not applicable.

Given the considerations above, systemic risk could be reduced by promoting the following risk mitigation techniques (as an alternative to the provision of mandatory IM) aimed at reducing counterparty risk:

1. **Collateral Management**. As collateral management represents a risk mitigation technique, we suggest strengthening the provision of variation margins by widening the type of counterparties subject to the obligation and by increasing the frequency of their exchange. In our opinion, this would substantially contribute to the reduction of counterparty risk, without causing any side-effects as the mandatory initial margining would do. IM exchange should be provided only on a voluntary basis;

2. **CVA desk**. Active management and hedging of CVA exposure is something banks have invested in to comply with the provisions of the Basel agreements. Mandatory IM would render these investments worthless;

3. **Contractual agreements**. Reinforcing of legal documentation on collateral management so as to ensure better protection;

4. **Reporting of counterparty exposure**. Reporting to regulators and supervisory authorities about the main counterparty exposure.

Answers to the questions presented in the consultation paper, assuming that the initial margin requirement would be set as mandatory

Please acknowledge that the answers provided below should be considered only in the event that our proposal against the mandatory provision of initial margins is not taken into consideration. The proposal represents our position and is our preferred solution.

Implementation and timing of margin requirements.

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?

A phase-in period of at least 6-12 months would be appropriate. This should only be for the variation margin exchange requirements; there is no need to modify or implement the ISDA and its Credit Support Annex (CSA) which regulate the issue, assuming that the new legislation takes priority over the aforementioned agreements and that its validity is extended to all involved counterparties. By now, the concept of the variation margin exchange is a relatively entrenched one. A general requirement for an exchange with zero (or very low) thresholds which takes place on a daily basis would achieve a notable result in a short space of time. It would also leave enough time to handle the most delicate phase of making the exchange of the initial margin obligatory, which is the most significant new proposal outlined in the consultation document.

Finally, it is worth pointing out that the implementation period should be carefully coordinated in line with Basel III and CRD IV capital requirements, but this step must only be taken when the phase-in period is over.

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?

There is indeed a chance to establish a margin requirement for FX swaps and forwards, with a maturity of over one month. However, for the purposes of calculating the initial margin, exempting these products from the initial margin exchange requirements would be a good move, at least during an introductory phrase. Thisisbecause:

- the product duration is relatively short;
- there is a (by now entrenched) habit of also including forex products in CSA agreements which are already involved in variation margin exchanges;
- the CCPs are already working to include these products on the list of products suitable for clearing, which we feel is the best solution;
- their use as alternative instruments to money market deposits (a market already hit hard by the current crisis) would reduce their liquidity and the liquidity of the deposits as well.

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?

PREs subject to proper capital requirements– and, specifically, capital charges covering current and potential counterparty risk–should be granted a full exemption from posting initial margins. The adoption of initial margins should be on a voluntary base.

In addition, exemptions from margining requirements should be permitted in the event that the operation concerns derivatives used to hedge risk. This aim of such a provision would be to stop financial and non-financial companies from being scared off in terms of making transactions whose purpose is to efficiently manage financial risks related to the instruments they hold. Secondly, a provision for a one-way CSA could also be considered. Under this document, the margining requirements would imposed on the counterparty dealing the derivative used to hedge risk (see also answer to Q6). Exemption from margining requirements could be also permitted in derivative dealing in the area of securitisation, as long as the derivatives are used to regulate cash flows.

In conclusion, Regulation (EU) No. 648/2012 (EMIR), Articles 3, 4 and 10 (respectively on “intragroup transactions”, “clearing obligation” and “non-financial counterparties”), should not be overlooked when trying to identify

the best solution in this specific area. The overall goal is to outline clear, intelligible measures which can be readily incorporated into the everyday operations of financial and non-financial counterparties.

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?

Although we agree with the principle, the information set out in Basel II (with regards to this specific scope) and the percentages provided in the consultation document don't appear to add up. The latter result higher than those provided in the Bank of Italy's «Circolare n. 263» adopting the Basel II prudential requirements. In order to quantify the initial margins, we suggest applying percentages that take the duration and type of derivative into account at the same time. Furthermore, greater clarification should be given as to the ability of a creditor to accept financial instruments they have issued themselves in order to set margins for their credit position.

The use of initial margin thresholds is a feasible method of limiting liquidity impact. We agree with the proposed framework in which the thresholds vary according to the type of counterparty. However, it appears to be limited in one sense: counterparty categorisation is not something that can ever be monitored in real time, so risk is inevitable whenever there is a delay in updating the list/classification. Applying simple and uniform rules, on the other hand, would be beneficial in that it would significantly reduce the possibility of regulatory arbitrage.

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?

The initial margin threshold is an appropriate tool primarily for mitigating the liquidity risk of larger entities as it is usually tied to ratings or assets. Therefore, we suggest introducing a "size" criterion which would also remove any discretion given to the parties involved.

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, eg G-SIFIs, or by the level of an entity’s non-centrally-cleared derivatives activities? Could data on an entity’s derivative activities (eg notional amounts outstanding) be used to effectively determine an entity’s systemic risk level?

The extent of the initial margin should depend on the purpose of the derivative (i.e. if they are intended for trading or for hedging. See answer to Q3). The use of thresholds is a step in the right direction but it must be accompanied by more extensive and more thorough standardisation of the regulatory framework concerning capital requirements.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie 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?

We feel that it is appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated

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?

As far as the method for calculating the initial margins is concerned, a simple calculation model that gives the parties involved the option to use more complex models would be the best solution. Requirements should also vary depending on the type of asset class. In any event, a standard computational model/standard computational criteria must be guaranteed. Moreover, the option of outsourcing these activities should be considered, as external service providers would guarantee impartiality in the event of a conflict of interest.

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?

The main impacts are summarized in the first part of this paper. In addition, the potential practical effect may be related to the liquidity position of the market participant in relation to what amount will eventually be the initial margin and the level of the threshold. The current practice is related to the CSA in such a way that the two-way margin exchange affects actual market practice but is more consistent with the goal of risk mitigation. On the other hand, the two-way margin requirement goes against the size principle, i.e. the size of the entities involved in the transaction. Please refer to the possible solutions put forward in the answers to Q3 and Q11.

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?

We believe requiring regulated entities to post initial margin to unregulated counterparties does exacerbate systemic risk, as described in the first part of this paper. For these counterparties,systemic risk could partly be balanced by an ad hoc threshold level.

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

As mentioned above, PREs subject to proper capital requirements – and, specifically, capital charges covering current and potential counterparty risk – should be fully exempted from posting Initial Margins. The adoption of Initial Margins should be left to a voluntary basis.In any case, it should be considered that the exemption of some catagories of counterparties from posting margins would inevitably influence the prices offered to them.

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?

Having considered our position, reported above, on the appropriateness of not providing for the obligation to posting initial margins, ABI regards that as per article 3 (2)(b) of the EMIR Regulation, intragroup transactions should be exempted from the margin requirements. More specifically, counterparties which are members of the same institutional protection scheme should also be exempted from margin requirements, as per article 80(8) of Directive 2006/48/EC. Margin requirements should also be extended to financial counterparties that are not systemically important, applying a generally recognized principle of proportionality. If this were not done, margining costs incurred by small banks in particular would proportionally increase. As such, setting a threshold in line with the regulated assets of the entity concluding the operation would be advisable.

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

General considerations

The proposal outlined in the document related to calculating the initial margin seems appropriate in theory, but may be less so in practice, given that it concerns two-way contracts. Internal models are undoubtedly needed to reduce the amount of liquidity employed, but a problem would arise in the event that two counterparties were to have different internal models (or if one counterparty did not have such a model at all), as it would be difficult to decide which calculation method to use.Hence, it would be sensible and advisable to use the same calculation method since the portfolio of operations is the same. Therefore, we recommend settling on a

sufficiently prudential standard model to be invariably applied to all counterparties, with the ultimate aim of achieving the uniformity of treatment that regulated markets demand and actually exercise. Finally, we also recommend to leave to the parties to a transaction the opportunity to decide whether to use internal models, as long as these would be compliant to the provisions details in the specific guidelines adopted for the standard approach /calculation method.

In terms of the variation margin, we support the proposal outlined in the document; in fact, it is already the norm for CSA agreements. A different minimum transfer amount (MTA) could be chosen for the initial and variation margins, opting for a higher amount for the former and a lower amount for the latter. For the initial margin, the likelihood that securities are used should be taken into account, while cash is a more distinct probability for the variation margin (cash is already used on regulated markets).

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?

There is concernon different entities using different methods, ending in different initial margin amounts. Given the fact that there are bilateral trades, when the party aren’t able to agree on a methodology, the Proposed Standardised Margin Schedule could be a solution. A standardized approach seems the preferable compromise in case counterparty would not agree on the methodology to calculate initial margin.

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?

In general terms, standardised approachesseem preferable as internal models may differ between market participants unless they agree on a common methodology.

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 suggest to include a measure of the leverage component, typical of exotic products. The level of the initial margin should be compared with the internal model calculated ones.

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 suggested methodologies seem appropriate, preference remains for standardised approach(es) when counterparty would not agree on initial margin methodologies.

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?

We suggest to set the frequency for variation margin to 'daily'.

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?

The proposed framework is acceptable. However, standardised approach(es)would likely rule out the need for additional margining in particularly stressed margin condition.

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

The level of the MTA depends on the size/extent of the trading run bya counterparty, so it would be difficult to find a unique amount valid for every counterparty.Perhaps, an indicative amount could be set at around EUR 500.000,00,or equivalent in other currencies.

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?

We feel that national supervisors must be consulted in order to establish the eligible collateral, although the goal of standardisation at European level must be kept in mind at all times. Additionally, as broad a list of collateral as possible should be drafted.

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?

The same haircuts as the ones applied by the ECB should be used. In terms of margins not in the form of cash, the assets used instead should be diversified to avoid concentration risk. Once again, it is imperative that the haircuts and the list of usable collateral be the same for everyone affected by the legislation.

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 initial margins must be able to be used and reused throughout the various international institutions so that bank liquidity can be managed as effectively as possible. Removing the option to post margin to a third-party custodian (in line with the standard practice of euro area market operators) is recommended.

In addition, the use of a limited number of custodians to preserve the initial margins could lead to concentration risk, even though that is built into the logic of the two-way initial margin exchange.

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?

We believe that the initial margin should be exchanged on a net basis due to liquidity requirements.

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?

Please, refer to our answer to Q.22.

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?

It would be appropriate to clarify this aspect when the Basel III requirements will be finalised.Meanwhile, please, see answer to Q12.

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?

Our feeling is that only the variation margins should be exchanged in transactions between entities belonging to the same group.

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?

This question addresses an absolutely crucial part of the issue, i.e. the lack of uniformly-applied regulations and the subsequent risk of damaging conflicts. However, the expectation is that the final measures resulting from it will be adopted across the board by everyone involved and no country-to-country differences will be allowed. The cross-border approach will help prevent an uneven playing field.