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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid, Spain

Dear Sir/Madam,

Re: CBA[1] Comments on BCBS – IOSCO Consultation Document - *Margin requirements for non-centrally-cleared derivatives*

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) and International Organization of Securities Commissions' (IOSCO) consultation document entitled: *Margin requirements for non-centrally-cleared derivatives* (Consultative Document).

While we are generally supportive of the Basel Committee's objective of reducing systemic risk, and while we are broadly supportive of the proposals in respect of variation margin in the Consultative Document, we believe that the Consultative Document outlines a highly conservative requirement for initial margin on OTC derivatives that will, if adopted, introduce unintended adverse consequences for OTC derivatives products and markets while not necessarily achieving the systemic risk reduction intended.

As preliminary results from the Quantitative Impact Study show, this proposal reflects a fundamental change to the OTC derivatives marketplace which could require very large increases in the net funding requirements of the financial system. The source of this funding and the impact on the underlying markets and products is unclear. The interaction of these proposed requirements, and the changes being implemented under Basel III, are far reaching complex and need to be properly understood. The current QIS exercise, although a very useful starting point, must be considered in the context of all of the regulations currently being proposed, as well as the impacts of Basel III capital and liquidity requirements. There is an inherent trade-off between

[1] The Canadian Bankers Association works on behalf of 54 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 274,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

reducing systemic credit risk in OTC derivatives activities at the expense of increasing systemic liquidity and operational risks.

In consideration of the large increases in capital for OTC derivatives already in progress under Basel III, we do not support the proposed requirement to exchange initial margin for non-centrally-cleared derivatives. The change in capital rules is already quickly leading to the movement of derivative trading into a centrally cleared environment in an orderly and effective way. We urge regulators to observe the impact of existing rules before considering the need for incremental rules on initial margin that will almost certainly prove operationally complex and costly to implement while potentially introducing new systemic liquidity and custodial risks.

We do however appreciate the complexity of the global regulatory landscape and we understand that it is likely to prove necessary to introduce some form of initial margin requirements to provide assurance that tax payer funded bailouts of financial entities are not required. We feel the following points may be used to guide a more consistent and reasonable initial margin framework:

- The initial margin framework should be based on a globally consistent formula that is risk sensitive. We believe the improvements being sought for the standardized market risk capital rules may also be applicable as a means of calculating initial margin in a consistent risk sensitive way.

- The initial margin requirements should be subject to sufficiently high thresholds to achieve the prudential and systemic risk objectives. The goal should not be to eliminate all credit risk. Banks are in the business of intermediating risk and perform an important function allowing end users to achieve risk transfer in the derivative product classes. The thresholds should be set high and allow banks to tolerate prudential credit risk up to a certain level, secured by the capital regime. Initial margin posted above the high threshold would still reduce risks of contagion due to defaults of large counterparties. High thresholds would further incentivise diversification of trades across multiple counterparties.

- Thresholds must be a function of the capital base and credit quality of specific counterparties. High maximum threshold requirements could be set by Basel Committee requirements.

- The rules for initial margin should be calibrated to ensure that margin costs are more consistent with the costs of capital underpinning a trade. The market should be price insensitive between the defaulter pay (margin) and survivor pay (capital) models.

With these underlying points in mind, we want to highlight many of the additional challenges that regulators will need to address in implementing these rules.

First, there is a very strong need for regulators to harmonize rules regarding margin requirements for non-centrally cleared derivatives. At present, regulators have adopted a ‘host country’ concept however, in view that there are two parties to a derivative contract, it is not clear which party is ‘host’ and which is a ‘visitor’. What will instead happen is that the most conservative rule will apply in any contract. This is problematic on three fronts:

- less sophisticated players will have trouble processing multiple rules associated with different regulatory regimes. Operationally, it is imperative that rules are consistent;
- regimes with more onerous or conservative rules will see transactions migrate away from their market; and
- there may be conflicting regimes even within the same jurisdiction depending on asset class.

Second, the initial margin proposal will result in a very large amount of trapped liquidity which will reduce the liquidity of the banking system as a whole. The Basel III liquidity rules will require the initial margin to be held primarily in sovereign debt, which will lead to banks carrying materially higher amounts of sovereign debt on their balance sheets. These debt positions will need to be funded with term borrowings, leading to very high carry costs of initial margin, as well as reduced capacity for lending. This will force swap participants to attempt to pass these cost on to end users, making the cost to end users significantly higher and/or motivating end users to trade with entities not under the jurisdiction of the Basel Committee or IOSCO. Such motivations may result in significant unintended consequences such as the emergence of the shadow banking system as the de facto OTC derivatives marketplace.

Thirdly, we are concerned about the adverse impact to small open economies, such as Canada, with significant trade flow. These economies are heavily dependent on currency derivatives in order to mitigate the risks of currency fluctuations. Materially higher costs of hedging this risk will form an economic tax on the economy.

Fourth, and perhaps what is most concerning is there are very few ways to implement these rules effectively. The challenge is as follows:

- To design initial margin requirements that can be widely implemented across all market participants without significant disagreements, the margin calculations must necessarily be quite simple. Complex proprietary margin calculations raise reconciliation and settlement issues.
- Simple calculations ignore important concepts such as netting and diversification.
- To ensure simple calculations work in all scenarios, they necessarily need to be quite conservative.
- Conservative calculations lead to excessive amounts of initial margin that financial systems may not be capable of supporting. Please refer to Appendix A which shows that standardized margin calculations, at a trade level, lead to costs that significantly exceed the costs of Basel III capital.
- Thresholds might reduce initial margin requirements but initial review of the QIS results suggests that to have meaningful impact, they will need to be uncomfortably high.

Given the broader implications for liquidity and the functioning of financial markets, a rush to implement these rules could have unintended adverse consequences that run counter to the objectives of policy makers. Additional analytical work is required before we can suggest a viable time line for responsible implementation of any margin framework. In the interim, we strongly recommend that regulators rely on the many regulatory reforms that have been or are in the process of being implemented and which have already resulted in very substantial reductions in systemic risk. The impact of these existing reforms should be carefully studied, data should be collected and a more nuanced and more appropriate set of margining requirements can be introduced to financial markets in a more controlled way.

Having identified the most fundamental concerns with the proposal, the remainder of this letter will focus on a number of more specific issues:

- The variation margin as proposed is on a basis which cannot be netted across asset classes. This contradicts ISDA CSA practices where variation margin can be netted across all products within the netting set per counterparty. This is a significant change which will impact market liquidity and will add an additional layer of complexity to collateral management and the reporting process.
- The introduction of initial margin requirements requires a renegotiation of all ISDA CSA or other collateral agreements which will be a time-consuming process.
- A requirement to backload existing portfolios will invalidate existing legal agreements and will create an immense operational burden on all counterparties, and necessitate a complete re-pricing of all trades to reflect the cost of the additional collateral and funding burden. This burden may be significant enough that some counterparts may elect to unwind their trades, incur very genuine costs and create open risk for their counterparts.

Rather than undertake a 'big bang' approach with the significant challenge it represents, it is likely more appropriate to start by implementing the OTC derivatives data reporting and aggregation requirements. These include mandatory central clearing and electronic trading of standardized OTC derivatives and trade reporting of all OTC derivatives contracts. This requirement would give a concrete and precise overall view of global derivatives activities and could serve as an input to calibrate the margin requirements for non-centrally-cleared derivatives. The eventual implementation of any margin rules should be rolled out cautiously by asset class. To minimize market disruption it will be important to ensure the market participants have access to central clearing for significant portions of transactions in each asset class. A phased approach with initially very high thresholds to limit impact on market liquidity should also be considered.

We stress that any initial margin requirement should be carefully balanced with the concurrent introduction of counterparty credit risk capital requirements under Basel III. In particular, careful coordination is required around the treatment of derivatives traded prior to the implementation of clearing and margining rules. Excessively conservative and simplistic initial margin requirements could overwhelm the capital rules which may prove undesirable and overly disruptive to markets.

Based on draft rules in the US, it would it appear that standard derivatives executed prior to the effective date of the new clearing rules will be exempted from mandatory clearing requirements, although back-loading such 'grandfathered' trades is, as always, an available option. Similarly, it makes sense for covered non-standard trades to be grandfathered from the margining rules provided they are not cross-margined with new positions.

We believe a delayed (i.e. at least 1 year after central clearing requirements have come into effect for the specific asset class in question) and multi-year phase-in for initial margin requirements, for new non-cleared transactions, would allow more control of the market impact and would limit shock to market liquidity with new collateral requirements for both cleared and non-cleared swaps. Please refer to appendix A which highlights that the potential cost of initial margin requirements is potentially much higher than the cost of Basel 3 capital requirements, particularly in the case of F/X transactions. These cost implications are based on current market prices. When the rules are introduced, funding costs are like to increase and the cost differential is likely to increase. Care needs to be taken to ensure that these costs do not distort financial markets.

Quantitative Impact Study (QIS)

The CBA welcomes a QIS that will accurately gauge the impact of the non-cleared margin proposals, including the amount of margin required on non-centrally-cleared derivatives as well as the amount of available collateral that could be used to satisfy these requirements. However, as explained in our introductory comments, a proper QIS cannot be done without considering the impact of all regulatory reforms. Nevertheless, our initial estimates of the potential initial margin requirements are CAD540Billion for the Canadian banks, if no counterparties are exempt from the rules (including initial margin to sovereigns and all corporates, see Appendix C for details). This means the industry, as a whole, may be unable to obtain sufficient safe assets to meet the margin requirements. This reinforces the necessity for slow and careful implementation. A second QIS may be needed to judge amended margin requirements.

Margin and capital

Counterparty credit risk of prudentially regulated firms, and the underlying systemic risk this may give rise to, can either be mitigated by margin or by capital requirements. Using initial margin to collateralise OTC derivatives exposures is a "defaulter pay" approach and is more targeted than using capital. Although it is perceived as being more effective in containing prudential and systemic risk it should be noted that using initial margin to collateralise OTC derivatives risk does not reduce the overall risk but merely transfers the risk. As OTC derivatives creditors become more senior other creditors to the defaulting counterparty become more junior. Making OTC derivatives safer by making them more senior may have cost and product liquidity implications that could deter end user access to credit and hedging products. It is our view that that prudentially regulated firms and their counterparties should have the commercial choice with respect to how they wish to mitigate risks for their institutions. It is our firm belief that variation margin together, with capital requirements, will effectively reduce risks to an acceptable level.

In the event initial margin requirements are mandated, they should translate into capital savings in the standardized and modeled approaches for counterparty credit risk capital. Otherwise, there will be a double counting of risks resulting in unnecessary capital and transaction costs. Correspondingly, initial margin posted for the purpose of mitigating the same risk that the capital requirement is said to reduce should have the effect of minimizing any such capital requirement.

Equality between 'defaulter-pay' and 'survivor-pay'

The proposals in the Consultative Document are very costly on a "defaulter-pay" basis, whereas the cost of margin (defaulter-pay) and capital (survivor-pay) should be roughly equivalent. In this regard, we stress the damages of an excessively conservative "defaulter-pay" regime which not only subordinates other creditors of the defaulter, but also significantly increases the cost of bank funding. Please refer to Appendix A which provides a variety of examples that illustrate the potentially significant cost implications of the initial margin proposals relative to the cost of Basel 3 capital. These differentials are particularly large for foreign exchange transactions and highlight the potential harm that could be done to that market if they are not better calibrated. These examples also ignore the likelihood that margin funding costs are likely to increase significantly when the rules are implemented. This will further increase the cost differential between the capital and margin approaches.

Threshold calculation

The CBA favours a flexible approach which would allow threshold adjustments to be established by bilateral negotiation and based on the credit risk capacity of each derivatives market participant. As such high grade commercial counterparties should have lower thresholds than prudentially regulated financial institutions. Ensuring that credit quality drives the size of the

threshold will fulfill the BCBS-IOSCO's objectives without placing undue stress on the market. Very high maximum threshold amounts to reduce systemic risk and contagion due to large counterparty defaults could be set by Basel Committee requirements.

Exemption of foreign exchange transactions

The CBA strongly believes that physically settled or deliverable foreign exchange transactions should be exempt from the proposed margin requirements due to the distinct characteristics of these instruments.

The argument for exempting physically settled foreign exchange transactions is based on the unique institutional nature of the foreign exchange market. Physically settled foreign exchange products, while having some derivatives characteristics, should more appropriately be viewed as money market or funding products. By definition a physically settled foreign exchange transaction is an agreement to deliver the full principal of a bank deposit in one currency in exchange for a bank deposit in another currency. For Canada in particular foreign exchange swaps and forwards are an important component in cross border borrowing and investment activities. As shown in Appendix B foreign exchange derivatives represent 22.7% of total derivatives notional for Canada compared to 8% for the global average.

The CBA recognises that replacement cost for foreign exchange derivatives while less material than settlement risk is still a significant risk when compared to other OTC derivative product classes. However, introducing mandated initial margin on physically settled foreign exchange derivatives could, by adding to the foreign exchange swap or forward cost and availability, increase funding costs and/or reduce investment yields. As a result the reduction in replacement cost risk achieved could be offset by an increase in systemic and pro cyclical liquidity risk consequences.

An additional and important argument supporting the exemption relates to the significant regulatory and infrastructure challenges facing the central clearing of deliverable foreign exchange derivatives. A central clearing solution for deliverable foreign exchange will need to avoid reintroducing settlement in to the foreign exchange market and no such solution is on the horizon. The US Treasury's proposed determination to exempt deliverable foreign exchange swaps and forwards from clearing requirements under the Dodd-Frank Act (DFA) recognizes the unique characteristics of the foreign exchange market and challenges associated with reaching an acceptable clearing solution. The imposition of initial margin on un-cleared foreign exchange products is intended by design to accelerate the move to clearing. In the event of prolonged absence of a clearing venue the initial margin requirements will impose a structural cost on both exempt and non-exempt users of foreign exchange products. Multi-lateral clearing via a central counterparty is inherently more margin efficient than a bilateral initial margin approach. In the event no central clearing venue is available it is not unreasonable to expect the foreign exchange forward and swap market to bifurcate into a two tier market with cleared non deliverable forwards and bilateral physically settled trades. The market and policy implications of such a development need to be better understood.

Given the above, we recommend that the BCBS-IOSCO consider excluding deliverable foreign exchange transactions (spot, forwards, currency swaps and cross currency basis swaps) from the proposed margin requirements. We are concerned that the absence of such an exemption will adversely impact those products and the market participants that rely on them to achieve financing, investing and risk transfer objectives.

Treatment of non-centrally-cleared derivatives between affiliates
We urge the BCBS-IOSCO not to impose the proposed margin requirements on affiliate transactions on the basis of the following considerations:

- Affiliate transactions can be differentiated from third party transactions since affiliate counterparties are better informed about one another's activities and as a result can take quick action to make a collateral call.
- In the case of initial margin, we believe that margin requirements only apply once the exposure is outside of the banking group. Otherwise there would be a double drain on liquidity with little net benefit from a prudential regulatory perspective.
- Pursuant to national laws, parent entities are often liable for the debits of a member credit institution in cases where such debts are unable to be paid using the member's own capital. This joint liability sufficiently covers the risks that may arise from transactions between affiliates.

On this basis, we believe that the imposition of margin requirements on affiliate transactions will pose an enormous burden without reducing systemic risk. If it is deemed that the exchange of initial margin is required between affiliates, sufficiently high thresholds should be imposed to reduce the burden.

Further, dependence on local supervisory judgement on initial margin requirements is problematic since participants will be subject to the differing positions of national authorities, leading to regulatory arbitrage. This is especially true for institutions with international subsidiaries since initial margin treatment could depend on the location of a subsidiary.

Scope of applicability
Because swap dealers typically run hedged portfolios, market participants that are exempted from the margining requirements, will still have to bear the cost of margining requirements that swap dealers incur when they hedge an exempt trade. Exempt counterparties may find it more economic to trade with each other rather than with a covered entity. This would shift derivatives activity into the shadow banking sector, which may not be consistent with public policy objectives. As such, we believe that a requirement for unregulated financial institutions (e.g. hedge funds) to post a standardized initial margin may have benefits, as industry participants are currently negotiating such arrangements bilaterally, with varying degrees of success.

We also do not understand why regulators would consider exemptions from margin requirements for public sector entities (including sovereigns and central banks). As the ongoing European crisis illustrates, the systemic linkages between public sector entities and regulated financial institutions are extremely strong. Typically, public sector entities can raise initial margin at lower cost than other market participants. If the key regulatory issue is systemic risk, public sector entities should be subject to the same margin requirements as other market participants with the additional constraint that they must post right way risk collateral (not their own bonds or currency). If public sector entities argue that this will prove too costly, it could give regulators pause for concern as other market participants will face still higher costs.

Impact on end-users
The Consultative Document does not appear to consider the impact of the proposed margin requirements on customers hedging their commercial activities. End users which utilize derivatives to manage and hedge cash flows, may need to expand or use existing credit lines to meet margin requirements. If imposed, we are fearful that the margin costs on instruments subject to these requirements may result in customers leaving their risks un-hedged rather than

paying the required margin. Further, regulated entities will reflect any margin costs in the price of their hedging activities, thereby making it more expensive for non- financial counterparts to hedge their risk.

In sum, we encourage the BCBS-IOSCO to achieve an adequate balance between investor protection and the proper functioning of financial markets. The proposals may be workable if the calibration of the thresholds and the end user exemptions are sufficient to allow end users and market participants to economically participate in the market. However, it seems inconceivable that a prudent and consistent calibration of these requirements can occur unless the time frame for implementation is slowed down significantly. We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Sincerely,

Attachments:

1. Appendix A – Examples illustrating the cost implications of the proposals
2. Appendix B – OTC Derivatives Market Notional Amount Outstanding as at 2010
3. Appendix C – Estimated cost of initial margin requirements on Canadian banks as at 2012
4. Detailed comments

Appendix A – Examples illustrating the cost implications of the proposals

					USD				Bps		
Product	Sector/Rating	Term	Rec	Pay	CEM Capital	IMM Capital	Std Margin	VaR Margin	CEM Capital	Std Margin	VaR Margin
FX Fwd	CORP BBB	6M	CAD	USD	1,300	2,008	59,421	99,034	0.1	5.9	9.9
			EUR	USD	1,294	2,601	59,421	99,034	0.1	5.9	9.9
			GBP	USD	1,296	2,011	59,421	99,034	0.1	5.9	9.9
	FIN A	6M	CAD	USD	553	1,010	59,421	99,034	0.1	5.9	9.9
			EUR	USD	550	1,309	59,421	99,034	0.1	5.9	9.9
			GBP	USD	552	1,011	59,421	99,034	0.1	5.9	9.9
XCCY	CORP BBB	5Y	CAD	USD	212,125	77,705	591,688	986,147	4.3	12.0	20.0
			EUR	USD	212,360	149,897	591,688	986,147	4.3	12.0	20.0
			GBP	USD	212,125	121,734	591,688	986,147	4.3	12.0	20.0
	FIN A	5Y	CAD	USD	141,067	83,203	591,688	986,147	2.9	12.0	20.0
			EUR	USD	141,228	155,394	591,688	986,147	2.9	12.0	20.0
			GBP	USD	141,067	128,136	591,688	986,147	2.9	12.0	20.0
	CORP BBB	10Y	CAD	USD	962,851	274,662	1,157,351	1,928,918	10.3	12.3	20.6
			EUR	USD	963,226	543,762	1,157,351	1,928,918	10.3	12.3	20.6
			GBP	USD	962,851	463,637	1,157,351	1,928,918	10.3	12.3	20.6
	FIN A	10Y	CAD	USD	678,934	355,576	1,157,351	1,928,918	7.2	12.3	20.6
			EUR	USD	679,206	666,154	1,157,351	1,928,918	7.2	12.3	20.6
			GBP	USD	678,934	576,295	1,157,351	1,928,918	7.2	12.3	20.6
IRS	CORP BBB	5Y	CAD	CAD	28,268	22,438	158,216	132,368	0.6	3.3	2.8
			EUR	EUR	41,288	33,541	158,216	43,404	0.8	3.2	0.9
			GBP	GBP	29,072	23,377	158,216	62,348	0.6	3.3	1.3
			USD	USD	42,897	29,629	158,216	67,958	0.9	3.2	1.4
	FIN A	5Y	CAD	CAD	18,717	19,300	158,216	132,368	0.4	3.3	2.8
			EUR	EUR	27,098	29,107	158,216	43,404	0.6	3.2	0.9
			GBP	GBP	19,191	20,539	158,216	62,348	0.4	3.3	1.3
			USD	USD	28,147	25,785	158,216	67,958	0.6	3.2	1.4
	CORP BBB	10Y	CAD	CAD	372,834	223,976	544,565	498,286	4.1	6.0	5.5
			EUR	EUR	479,839	308,855	544,565	233,118	5.2	5.9	2.5
			GBP	GBP	465,128	330,718	544,565	249,679	5.0	5.9	2.7
			USD	USD	564,816	355,164	544,565	515,824	6.0	5.8	5.5
	FIN A	10Y	CAD	CAD	261,586	223,660	544,565	498,286	2.9	6.0	5.5
			EUR	EUR	335,945	306,780	544,565	233,118	3.6	5.9	2.5
			GBP	GBP	324,774	336,236	544,565	249,679	3.5	5.9	2.7
			USD	USD	395,006	354,306	544,565	515,824	4.2	5.8	5.5

Assumptions:

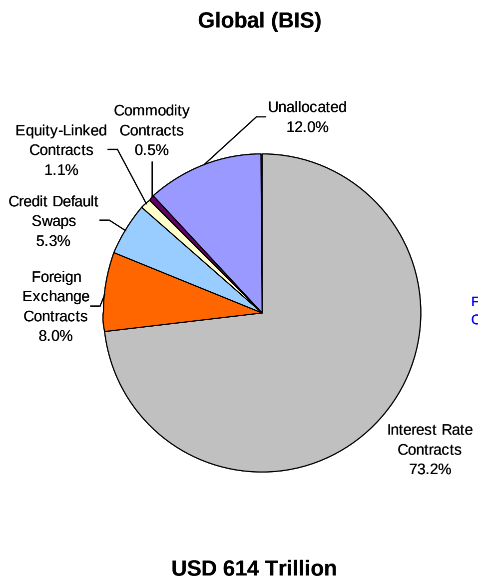
1. Each Trade has a notional value of USD 100 mm
2. Cost of Capital = 10%
3. Net Cost of Funding Initial Margin: 100 bps

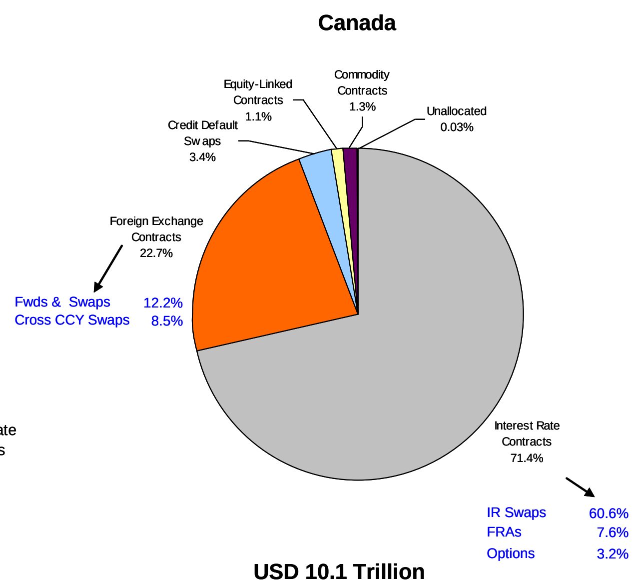
Notes:

1. Movement of FX in a stress period is about 10% at the 99th percentile level. This results in higher modelled VaR Initial Margin requirements compared to the 6% standardized IM.
2. Diversification benefits and portfolio affects across trades will not be pronounced for end users who generally enter trades in the same direction to hedge economic exposures.

Appendix B – OTC Derivatives Market Notional Amount Outstanding as at 2010

OTC Derivatives Market Notional Amount Outstanding





Sourced from OTC Derivatives Working Group Paper, "Reform of Over-the-Counter (OTC) Derivatives Markets in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group", October 26, 2010.

Appendix C – Estimated cost of initial margin requirements on Canadian banks as at 2012

Q1 2012 Notional Amounts (in thousands)

	Contracts held for trading purposes	Total Contracts	Remaining term to maturity: One year and less	Over 1 year to 5 years	Over 5 years
Interest Rate Contracts					
OTC contracts	11,962,012,727	12,815,431,107	4,678,063,627	5,850,214,607	2,287,152,875
Foreign Exchange & Gold Contracts					
OTC contracts	3,607,409,882	3,771,937,785	2,336,743,921	1,036,354,290	398,839,575
Credit Derivative Contracts					
OTC contracts	143,581,394	169,129,792	49,864,736	101,583,748	17,681,309
Equity-linked Contracts					
OTC contracts	218,974,551	243,408,474	170,816,430	64,539,182	8,052,864
Other					
OTC contracts	92,213,588	92,219,201	56,440,748	30,573,872	5,204,580
Total OTC Derivative Contracts	16,024,192,142	17,092,126,359	7,291,929,462	7,083,265,699	2,716,931,203

Q1 2012 Estimated Initial Margin Amounts

	Contracts held for trading purposes	Total Contracts	Remaining term to maturity: One year and less	Over 1 year to 5 years	Over 5 years
Interest Rate Contracts					
		255,271,043	46,780,636	117,004,292	91,486,115
Foreign Exchange & Gold Contracts					
		226,316,267	140,204,635	62,181,257	23,930,375
Credit Derivative Contracts					
		7,844,613	997,295	5,079,187	1,768,131
Equity-linked Contracts					
		36,511,271	25,622,465	9,680,877	1,207,930
Other					
		13,832,880	8,466,112	4,586,081	780,687
Total		**539,776,075**	**222,071,143**	**198,531,695**	**119,173,237**

Standardized Table

	Remaining term to maturity: One year and less	Over 1 year to 5 years	Over 5 years	**Notes**
				See 3.
Interest Rate Contracts				
	1%	2%	4%	
Foreign Exchange & Gold Contracts				**See 4.**
	6%	6%	6%	
Credit Derivative Contracts				
	2%	5%	10%	
Equity-linked Contracts				
	15%	15%	15%	
Other				
	15%	15%	15%	
				See 2.

Notes:

1. Source: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=554
2. The numbers provided include OTC trading with sovereigns CPs. Current IM proposals exclude sovereigns from requirements. The estimate presented here are thus an overstatement of the total IM required under the rules.
3. OSFI provides numbers for maturity 0-1y, 1-5y, 5+y while the standardized table applies to 0-2y, 2-5y, 5+ years terms.
4. Gold is included with FX in the above. In the BCBS proposed standardized table, Gold requires a higher margin of 15% compared to the 6% for FX.

CBA comments on BCBS Consultative Document – Margin requirements for non-centrally-cleared derivatives

CBA Members' Comments and Requests for Clarification
Overall comments
Please refer to our cover letter which identifies the most fundamental challenges with the proposal. Additionally: ▪ A regulated firm could decide to loan its counterparty the collateral that gets posted and incur the same exposure indirectly. ▪ Having both parties post collateral for potential future exposure is a very high test; market practice is based on the weaker party posting initial margin. ▪ We question whether mechanisms (such as third party custodians) exist to hold collateral from both parties to a transaction. ▪ It is difficult to design an effective market based calculation for initial margin that is easy to administer and properly recognizes diversification across asset classes. Thus, regulators should avoid introducing standardized calculations that are excessively conservative.
Implementation and timing of margin requirements
Q1: 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? Please refer to our cover letter.
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? Please refer to our cover letter. ***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?*** Primarily, we expect that the proposed rules apply only to newly booked deals post introduction of the initial margin requirements (i.e. that all pre trades will be grandfathered) and seek the Basel Committee's confirmation in this regard. In the alternative, a reasonable and appropriate back loading window should be given if no grandfathering is allowed for clearable products. Initial and variation exemptions should also be considered for certain transactions that are structured to eliminate credit risk. One example is a fully collateralized derivative where the obligations owed on maturity have been posted by each party to the other. Another example is a transaction where the obligation is prepaid up front. As they already fully collateralized or prepaid, with each party protected from the other's default risk, such trades should not

CBA Members' Comments and Requests for Clarification
be subject to either initial or variation margin, including those situations where the collateral has been re-hypothecated or re-used. Transactions with affiliates should also be exempted from the margining requirements (please refer to our cover letter).
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? Observations and notes on the proposal are below: • **The proposal duplicates efforts of Basel III:** Further to our cover letter, a stated objective of the proposed margin framework is the promotion of central clearing in the OTC derivatives market. New capital rules aimed at strengthening banks and the banking system have introduced a number of specific requirements that greatly raise the costs of non-cleared OTC derivatives. These include, but are not limited to, CVA Capital, increased AVC parameter for capital calculations on exposures between financial institutions and increased margin period of risk. As a result of these new capital rules, there is already significant incentive for banks to port as many trades as possible to CCPs. The newly proposed margin rules, and in particular the initial margin requirements, therefore appear to unnecessarily target non-standard trades. New capital rules are such that banks would clear such trades if possible. Layering on further costs will not push a bank that executes a non-standard trade towards a CCP if there are no CCPs that offer clearing for such trades. • **Decreased market participation and increased interdependence:** Extending credit is a core function of banks. Mandating bilateral posting of initial margin eliminates the ability of banks to take any credit risk on any covered OTC derivatives and ignores that a bank may be willing to extend credit on such trades, especially since such exposures give rise to substantial capital requirements. Simultaneously, the new margin rules may in fact increase the need for affected firms to take credit so that they can meet the requirements to post initial margin. While pushing it out of the OTC derivatives market, the net result may in fact increase inter-bank lending. • **Increased systemic risk:** Another concern is that the requirement to post initial margin to third parties may create concentration risks with a small number of custodial banks. This will create a new systemic risk that to some extent merely displaces the systemic risk that bilateral initial margin requirements are intended to mitigate. • **Costs will be market dependent and will be passed to non-financial entities:** Most swap dealers run relatively matched positions. When a swap dealer executes a trade with an end user exempt from IM requirements, they will still need to hedge with a financial counterparty that is non exempt. The cost of IM requirements on the hedge must be passed on to the exempt user. These costs will be most severe in F/X markets which lack CCP venues. In this sense, no entity is exempt from the costs of high IM requirements. The costs will have the greatest impact in small open economies such as Canada and Australia which are most dependent on F/X markets. High IM requirements with low thresholds for systemically important end users will provide disincentives for hedging of exposures and heighten systemic risks.

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- **Clearing is not the ideal option for all markets**: The US Treasury has articulated why certain F/X transactions should be exempt from centralized clearing. To the extent these exempt F/X transactions are subject to excessively conservative margin requirements, the market will have no choice but to develop and use centralized clearing venues. Regulators need to make sure in their coordination efforts that certain F/X transactions are not inadvertently forced into centralized clearing.

- **Increased participation of unregulated entities:** It is important to note that by introducing margin requirements that only apply to prudentially regulated entities, the combined effect will be to push end users away from transacting with regulated firms in favour of non-regulated entities that can meet their needs at a lesser cost, thereby encouraging transactions outside of the regulated community.

- **Decrease in efficient and competitive markets:** In the event that margins are mandated, we believe that it is important that the Basel Committee afford regulated firms with the commercial choice to set thresholds on the basis of a risk based measure instead of dictating pre-determined amounts. To do so would more appropriately balance the policy objectives of the consultation document.

- **Loss of transparency in pricing:** These new requirements will be operationally complex as counterparts will ask each other for initial margin, each based on their own approved internal models. Allowing the traders to anticipate in real time the costs of these requirements given a specific counterpart will be extremely challenging. Liquidity of non-cleared derivatives will be reduced. Elimination of cross-margining between asset classes creates additional liquidity impact without corresponding reduction of systemic risk. Since cash cannot be segregated, the requirement of segregation will require third party custody which in turn will introduce new credit risk. Furthermore, should the access to assets held by 3rd party custodian be difficult in times of crisis, this can exacerbate systemic risks.

Q5: Are the 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 CBA would welcome flexibility in terms of adjusting any threshold according to the derivatives market participant. Thresholds should be risk based and as such, high grade commercial counterparties should have lower thresholds than prudentially regulated, high rated financial institutions. Ensuring that credit quality and the size of the entity drives the size of the threshold will fulfil the Basel Committee's objectives without placing undue stress on the market. We should not expect the exact same threshold for every A rated financial client. Also, a larger swap dealer should be able to tolerate higher thresholds than a smaller swap dealer.

It is most important that thresholds are set high enough to limit the operational burden, risks and impact on market liquidity.

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

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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?

Please refer to our cover letter and our response to question 4.

As a counterparty to a regulated counterparty is less exposed to risks relating to the insolvency of that regulated firm, the initial margin requirement of the regulated counterparty should inherently be less extensive that that for a non-financial counterparty. The current proposal introduces a large differential treatment for high risk vs. low risk non-financials through thresholds: Systemically important non-financials have low thresholds with medium to high margin requirements whereas low risk non-financials are exempt completely. A large differential with a sharp cut-off definition for systemic importance could be problematic and introduce an unlevel playing field. A solution removing margin requirements for non-financial end users would be preferred.

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?

With the introduction of additional capital requirements in Basel III, prudentially regulated entities are required to hold substantial capital against non-cleared OTC derivatives credit exposures as compared to non-regulated entities. By introducing incremental margin requirements that only apply to prudentially regulated entities, the disparity in costs between regulated and non-regulated entities only grows. There is a concern that the combined effect will be to <u>push end users away from transacting with regulated firms in favour of non-regulated entities</u> that can meet their unique hedging needs at less cost. Such an outcome runs entirely counter to the stated objective of bringing additional transparency to the OTC derivatives market. We therefore believe that a requirement for unregulated financial institutions (e.g. hedge funds) to post a standardized initial margin may have benefits as industry participants are currently negotiating such arrangements bilaterally (with varying degrees of success). A provision for higher margins could also be appropriate for entities that are under similar tighter regulations such as pension funds, sovereign owned enterprises (e.g. crown corporations).

We further note that the current rationales for thresholds are opposite of requirements under the Dodd Frank Act, where high-risk financials (e.g. prudentially regulated banks) attract zero thresholds.

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?

Thresholds allow introduction of a measure separate from initial margin amounts (e.g. consideration of credit quality and prudential regulated capital requirements). As such, thresholds should <u>not</u> be based on IM amounts/models but rather should be independent. Any methodology used for threshold calculations should be simple and transparent and allow for judgement since it is essentially an adjudication decision.

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Q 9: ***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 introduction of two-way segregated margining will significantly alter market convention and the separation of exposures by asset classes will increase the effect. Collateral posting requirements on a gross basis will also move away from current segregation practice where net posting of cash collateral is possible

There will be significant liquidity impacts, operational and compliance costs associated with the requirements of universal two-way margining for all market participants. In particular non-dealer participants, which have little existing infrastructure for setting, taking and managing initial margin than dealers (including coming to an agreement on a valid figure given internal models and ensuring that traders can see costs/gains of a prospective trade on the initial margin required from a counterpart in a timely manner), will have to undertake significant investments in IT and modeling infrastructure.

By proposing initial margin at 99% confidence, it seems that the requirements are very conservative. Ultimately, it is important that regulators achieve an adequate balance between reducing systemic risk and the cost of doing so. This initiative requires additional research beyond the QIS (which is a static exercise) to ensure that undue harm does not come to market participants and financial systems.

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?

Primarily, initial margin requirements should not apply to non-financial entities. Institutions already calculate their credit risk exposure and allocate capital accordingly. Variation margin further improves risk mitigation and we believe this to be sufficient.

To require regulated entities to post IM to unregulated counterparties will create a new source of systemic risk as non-financial counterparts may not be in a position to segregate collateral and operationally manage margin. Therefore, the regulation will most likely require third-party services thus introducing new credit and operational risk.

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

Given their systemic importance, we question the rationale for exempting public sector entities, sovereigns and central banks and would appreciate reasoning from the Basel Committee in this regard. In particular, we note that one of the most pressing global concerns right now is the financial stability of a number of sovereign states and the public sector entities, including central banks, within those states. If systemic risk is the concern, it is in these precise instances where initial margin may be most warranted. Thresholds should either be risk based or high thresholds should be mandated. The Basel Committee could also consider the exclusion of all non-financial end users. IM requirements for end users could provide disincentives for hedging of exposures.

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Collectively, the CBA membership has met with many public sector entities. We consistently find public sector entities are concerned about the cost and liquidity issues around posting substantial amounts of both variation margin and initial margin; yet these public sector entities inevitably have greater ability to raise and fund large amounts of initial margin than other financial market participants. In many cases, some of the most resistant public sector entities are most actively lobbying for the margin requirements. This is inconsistent.

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?

In order to promote the goal of reducing systemic risk and promoting central clearing in a manner that does not create unintended negative consequences to the market, any exemptions should be risk based and determined after careful consideration on the basis of research led initiatives.

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?

The proposed calculation of initial margin to a 99^{th} percentile confidence interval over a 10-day horizon is similar (if not more conservative than) to the approach used for initial margin by CCPs. CCPs, however, do not have the same diversified balance sheets nor the same level of regulatory oversight as prudentially regulated banks. Without initial margin, CCPs have significantly less loss absorbing capacity than banks. It is therefore extremely conservative to require banks to collect initial margin in similar quantities to CCPs. Excessive conservatism creates additional risks and costs to the financial system. The goal of the regulations is to improve the stability of the financial system but excessive conservatism risks, on the contrary, destabalization and a further constraint to global and sustainable economic recovery.

There are also practical issues around the use of internal models to calculate initial margin. It is not clear how a bank is to be comfortable with the initial margin calculation of a counterparty that is using an internal model, especially if that counterparty is regulated in a different jurisdiction and its model is therefore approved by a different supervisor using its own criteria. The consultation document states that "*parties to derivatives contracts should have rigorous and robust resolution procedures in place"* to deal with disagreements on initial margin, but no template exists for handling such disputes. It is unclear how such a dispute could be settled without the collecting bank sharing substantial details of its calculation methodology, perhaps including features that are proprietary.
Nevertheless, any internal measure should be simple and transparent, and should also consider existing risk mitigation techniques such as netting. More specifically:

- <u>Transparency</u>: The current calculation using proprietary calibration is not sufficiently transparent to the counterparty. Additional issues persist in being able to disclose IM requirements intraday upon inception of a deal.
- <u>Consistency</u>: Calibration to historic period may vary from institution, which affects initial margin requirements. We expect 20-100% variation in the current IM approach. An approach where there is an agreed upon model in use by all participants would be ideal; something analogous but

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perhaps more sophisticated than SPAN methodologies.

- Stress period: A clarification of calibration requirements is needed, e.g. should the stress period be defined separately for each major asset class or use an overall stress period for calibration.
- Initial margin calculation with different VM horizon introduces unnecessary complications.
- A consistent application of an internal model to all derivatives within one asset class may be difficult to achieve in reality. This is particularly true given the need for operational standardization amongst many financial end users. The more conservative standardized approach should be allowed to serve as a fall-back option for derivatives where inclusion into the modeled approach is not immediately possible. Given the number of financial end users who might need to rely on this fall back option, it is important that the standardized approach is not excessively conservative.
- Further guidance concerning the criteria to be applied in approving internal models should be given. With an extremely punitive standardized approach, we also note the importance of having transparent and efficient regulatory approval of internal initial margin models.

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?***

Removing diversification benefits between major asset classes appears to be an extremely conservative and punitive approach to calculating initial margin on a portfolio of trades and stress that overcollateralization of derivatives can cause significant harm to the market. We further note that the proposed methodology of using a 99^{th} percentile, 10-day closeout calculation already introduces substantial conservatism.

On the one hand, justifying restriction of diversification benefits because "*relationships are prone to instability may be more likely to break down in a period of financial stress*" is simply not a credible argument given internal model calculations are to be based on a stressed historical period. However, we acknowledge that separation between asset classes does have the benefit of simplified margin calculations, allowing separate models for each asset class with separate stress calibrations. This would also allow initial margin model standardization to take place for each asset class separately.

We are therefore of the view that categories of diversification should be risk based and prudentially allowing diversification should be encouraged.

Q15: ***With respect to the standardized schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardized 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?***

At present we are not in a position to comment fully on the appropriateness of the calibration of the initial margin levels prescribed in the proposed standardized schedule due to a lack of information in this regard. We would appreciate more information from the Basel Committee with respect to how the standardized schedule was determined.

However, we remain concerned that the initial proposals appear excessively conservative and we note that:

- the recognition of netting benefits is essential to create a level playing field between the internal model and the standardized approach;
- the recognition of offsetting transactions or basis trades is required;
- an inclusion of counterparty credit rating in the assessment of minimum margin requirements would be preferable (possibly through introduction of

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thresholds that dependent on credit-rating or capital adequacy?).

- these requirements do not take in the account volatility or quality of the assets. While such requirement maybe justifiable for single name/commodity, it is non justifiable for index based products;
- an extra dimension should be added for basis risk. (e.g. a 10-year 1month libor / 3 month libor basis swap should have a lower margin than 10 year vanilla swap);
- an extra dimension should be added for option risk. (e.g. an out-of-the money option on 100mm 10-year swap should initially have a lower scheduled margin than a vanilla swap); and
- simulations should be done to determine if the 99% 1-tail risk over 10 days comes close to the proposed calibration.

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?

Yes, they are appropriate.

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 firmly believe that banks should have the flexibility and commercial ability to set the frequency of variation margin payments. In the alternative, the frequency of variation margin payments should be daily at a minimum.

More research has to be done on the frequency of initial margin payments and particular consideration needs to be given to the administration limitations of being able to effect initial margin movements.

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?

We are unable to comment until we know how the proposed framework for variation margin is calibrated. We seek clarification from the Basel Committee in this regard. At a minimum, it is mandatory that Variation Margin is not segregated and can be rehypothecated.

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

The minimum MTA is typically $250,000 in existing market contracts. This is likely suitable for swap dealers; however, this threshold may prove operationally burdensome for many financial end users. It seems likely that there will be a need to phase in relatively low MTA's.

Eligible collateral for margin

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Q20: Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why? Primarily we seek confirmation from the Basel Committee that, on the basis of a pre-determined list of eligible collateral, parties can bilaterally agree to accept some (and not all) types of eligible collateral. The BCBS requirement should serve as a conservative baseline without requiring national supervisors to develop their own list of eligible collateral/haircuts. The inclusion of a broader set of assets classes (other than cash and high quality sovereign debt) in the scope of the proposed eligible collateral will reduce the liquidity impacts of the proposals. However, national supervisors should be afforded the discretion and flexibility to establish their own list of eligible collateral assets considering their own markets and infrastructures. In this regard it would be important that national supervisors establish a consistent framework at an international level based on common principles in order to ensure a level playing field and reduce the risks of regulatory arbitrage. Given the scope of these collateral requirements, it will be important for regulators to avoid a tendency to excessive conservatism. Further and as it stands, the proposed standardized haircut schedule is not internally consistent. In general it appears that cash in a different currency attracts an unusually high hair cut. This is particularly punitive to market participants in countries that do not use a reserve currency (collateral is most frequently posted in reserve currencies). If we consider including Sovereigns, Super Sovereigns and public sector entities in the scope, these entities should be prohibited from posting wrong way collateral such as their own currency or their own bonds. ***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 standardized 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 standardized haircuts?*** We firmly believe that the decision to include concrete diversification requirements as a condition of collateral eligibility should be a commercial matter that is freely negotiated between parties. With respect to the standardized haircut proposed in the schedule, we note the following: • gold receives the same haircut as equity (15%) and is treated differently from FX (8%). We note that gold is generally considered a less-risky collateral than FX. We refer to the World Gold Council's arguments that gold is a highly liquid asset and an effective contributor to liquidity buffers; • cash FX haircuts are problematic and can potentially increase risk taking. Also, cash FX haircuts are not currently a standard. Instead, consideration could be given to currency-separated collateral as in recent ISDA proposals; and • complex haircuts and collateral categories introduce a complex cheapest to deliver optionality which creates an unlevel playing field for smaller market participants. Further and while the consultative document contemplates concentration and wrong-way risks, there is no mention made of right-way risk collateral. It is not uncommon for certain types of transactions to be collateralized with right-way risk securities. Equity swaps, for example, where the party paying the

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return on equity posts the underlying stock as collateral creates right-way risk for the receiving party. Collateral posted in such situations should be exempt from haircuts. We ask the Basel Committee to consider the standardized CSA proposals and encourage the requirements in the consultation document to be aligned with these industry efforts. Moreover, the requirement for the stock to belong to a main equity index should not apply. (We call this same-way risk of the collateral and swap as opposed to right way).
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? To fulfill the key objectives of the consultation document, the collateral received should not be reduced through re-hypothecation. However, it would be beneficial for market stability that the recipient of collateral be allowed to borrow securities from the pool as long as replacement collateral be given to the custodian. We are therefore in favour of strict conditions on IM re-hypothecation where such conditions are commercially determined. For example, Dodd Frank only requires strict segregation for interdealer transactions. Also, some foreign jurisdictions still allow reuse of collateral based on a strict reinvestment principle. We note that further details on segregation of cash are needed. Collateral pledge should be available to borrow as long as collateral of equal quality is pledged. Otherwise the availability of securities for SBL will be significantly reduced. ***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?*** Collateral posting requirements on a gross basis will move away from current segregation practice where net posting of cash collateral is possible. It will also result in significant increase of concentration risk given large amounts of initial margin will be held by a reduced number of custodian banks. In order to limit concentration risk associated with custodians, it could be relevant to ensure that these custodian banks have the capacity to handle these large volumes of initial margin exchanges in order to ensure that operational risks are mitigated in terms of infrastructure. In addition, BCBS-IOSCO could issue specific requirements to custodian banks in order to mitigate the undesired concentration risk that the proposed margin requirements will create. Furthermore, considerations to payment netting should be given to reduce settlement risk and funding implications caused by exchange of margin on a gross basis. ***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?***

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It is important to make a distinction between initial and variation margin: • Variation margin: re-hypothecation of collateral is common practice as the liability is extinguished. With the concern of market liquidity constraints, disallowing re-hypothecation could introduce significant systemic risk and reduction in liquidity as collateral assets are tied up and precluded from use. We therefore believe that variation margin collateral should be allowed to be re-hypothecated or re-used by the collecting party. • Initial margin: although re-hypothecation of collateral is not common practice, we favour IM re-hypothecation on the basis of strict commercially agreed conditions.
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? Please refer to our cover letter. ***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?*** Exchange of initial or variation margin between affiliates should not be required.
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? The proposed approach with respect to the interaction of national regimes in cross-border transactions is appropriate since it will avoid conflicting and double counting requirements. The BCBS-IOSCO could issue specific principles that would guide both home and host regulators in determining the equivalence of margin requirements. This would enhance the transparency of the criteria that would have to be fulfilled in order to be granted the requirement equivalence of home and host regulators. This would also reduce uncertainties with respect to the set of rules that would be applied across border transactions with different jurisdictions.