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28 September 2012

Re: Consultative document on margin requirements for non centrally cleared derivatives

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to provide comments on the BCBS-IOSCO consultative document on margin requirements for non-centrally cleared derivatives.

We fully agree that the proposal to require all financial firms and systemically important non financial entities that engage in non-centrally cleared derivatives to exchange initial and variation margin on a 'universal two-way' basis would, as acknowledged by the consultation paper, incur the most substantial liquidity costs of all possible proposals in this area. We do not however, agree that it would best achieve the policy goal of reducing systemic risk and promoting central clearing.

The systemic risk benefits of margining may be undermined by the 'universal two way principle'. Under this proposal, for example, prudentially regulated financial institutions would be required to post collateral to non-prudentially regulated, indeed potentially unregulated, counterparties. Increased interconnectedness between prudentially regulated institutions and the shadow banking system may generate additional risks, potentially running counter to other international work in this regard. Furthermore, a number of those counterparties may only be able to use the proposed standardised approach to calculating initial margin – this may lead to some institutions posting higher margins than they are required to collect.

We would anticipate that, as a result of the considerable complexity and costs involved in setting up individual collateral accounts and maintaining collateral processes for each bilateral counterparty relationship, many market participants may choose only to trade centrally cleared OTC and exchange traded derivatives in the future. Depending on the

counterparty, this may in itself not be a desirable outcome from both a systemic and idiosyncratic risk perspective, given that the cleared instrument may not fully hedge the specific risk concerns of the counterparty. Reduced participation in the market for non-centrally cleared OTC derivatives would also reduce liquidity in these markets, which in turn would further increase margin levels and reduce liquidity in non-centrally cleared OTC derivatives. In a worst case scenario, market participants seeking customised derivatives to hedge their specific risk concerns may not be able to find a market for such products and will be left with insufficiently hedged risks that can build up over time.

Any requirements to segregate collateral with third party custodians and not allow the conservative re-use of collateral will further exacerbate both the liquidity demands of the proposals and concentration risks in the financial system via the reliance on a small number of third party custodians.

As a result of the potential effects above, the proposals are likely to increase the procyclicality of the financial system and leave market makers less willing to provide liquidity in non-centrally cleared derivatives when demand is greatest.

We are furthermore not convinced that it is necessary to implement such a comprehensive approach to encourage central clearing. There are already incentives to do so and in future clearing will be mandatory for many products. Users of non-centrally cleared derivatives are generally those with a genuine need for a product that cannot be centrally cleared. These proposals thus risk penalising those many genuine users.

We understand the desire to include within the scope all financial institutions and systemically relevant non financial institutions, however a blanket approach in terms of calibration does not take account of both the fact that some systemic financial institutions are already prudentially regulated, and that some financial institutions are not systemic. If the primary goal of the regulation is to reduce systemic risk, it is not necessary to require all participants to both post and collect initial margin.

We caution against the imposition of a requirement for the universal exchange of initial margin without more extensive analysis of the impact on global liquidity and of the potential procyclical effects. During such consideration other more limited proposals could be examined. If reducing systemic risk is the key objective, it might be possible to propose that only systemically important market participants should be required to collect IM. If two systemically important market participants trade with each other, they would both have to collect IM (i.e. collect and post), thereby effectively preventing spill-over and contagion. However the proposal might strike a more appropriate balance between impact and reducing systemic risk by ensuring that:

- systemically important market participants would not have to post collateral to end-users of OTC derivatives, who are not systemically important; and

- non systemically important end-users (whether financial counterparties or otherwise) would not have to implement margin models and manage IM collection processes.

BCBS and IOSCO should develop guidance as to the definition of ‘systemic relevance’ in this specific context to avoid inconsistencies across jurisdictions. Such a definition could include: whether the entity is a market maker, the size of the outstanding portfolio of OTC derivatives and the frequency of trading in OTC derivatives, and would clearly include within its scope major swap participants, swap dealers and other systemically important financial and non financial institutions.

In addition to the risks outlined above, the pace of change combined with the scale of the challenge on many thousands of counterparties to establish operational and legal arrangements – more complex and challenging in some respects than the equivalent transition to central clearing – to implement such rules potentially introduces new operational risks into the global financial system. With the proposal above, many of the operational costs and challenges (implement margin model, set-up IM processes, manage segregated accounts) that threaten to discourage many non-systemically important entities from participating in the market would be avoided. At the same time, this framework would contribute to reducing systemic risk while preserving the functioning of the marketplace.

Given these uncertainties and risks, alongside the scale of the potential impact, depending on the outcome of the final rules, we would therefore recommend an appropriate period of phasing by counterparties and products, commencing at least after central clearing is operational and taking place over a number of years, consistent with other measures of comparable potential impact such as the four year observation period for the liquidity coverage ratio. Implementation would be significantly simpler after CCPs have fully developed their product offerings and services.

We trust you find these comments helpful. Please let us know if we can provide further information.

Yours sincerely,

Andrew Procter
Global Head of Government and
Regulatory Affairs

Annex

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? If coordination is desirable, how should this be achieved? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

When considering the appropriate phase in period, a number of factors should be considered:

- The operational changes that will need to be put in place for thousands of counterparties, many of which cannot be implemented until the rules are clear;
- The need to avoid competitive distortions associated with different regulatory approval processes globally and the ordering in which they are granted;
- The risk that many counterparties may choose not to use non-centrally cleared derivatives following the changes and the corresponding need to ensure they are operationally able to gain access to central clearing before these rules come into effect;
- The need to design an appropriate transitional or grandfathering regime to deal with existing non cleared derivatives; and
- Consideration of whether requirements should be phased by counterparty type.

In our covering letter, we suggest that a sufficiently long transitional period should be considered to ensure the introduction of margin requirements for non centrally cleared derivatives is implemented in an orderly way without introducing new operational risks. The operational and implementation challenges include:

- the need to develop and obtain approval for models consistent with the ultimate requirements for initial margin and collateral haircuts;
- the need to secure separate regulatory approval for each entity within each jurisdiction;
- the need for thousands of existing contractual and operational agreements, including negotiation of new CSAs or amendments to current CSAs to comply with the new regulatory requirements;
- bifurcation of the collateral margining process (between legacy and new regulatory CSAs) leading to a significant increase in margin call volumes;
- an increase in settlement activity with the potential for two way initial margin and variation margin to three distinct accounts; and

- the risk of an increase in dispute activity arising from differing initial margin calculations between firms.

The length of the phase-in period should therefore be cogniscent of these challenges and should be sufficiently long to ensure any reduction in counterparty risk is not initially replaced by an increase in other risks. In addition, margin requirements for non-centrally cleared OTC derivatives should only be required after CCPs have fully developed their OTC clearing offerings and clearing members and their clients have been able to set up the infrastructure required to gain access to the CCPs, (and establish the daily collateral process required by the CCPs). Similarly, the requirements should also allow the time for the market to develop standardised products that may be clearable as a partial replacement for non-cleared contracts.

Furthermore, appropriate provisions should be introduced globally to ensure consistent grandfathering of existing OTC derivative portfolios, with flexibility for counterparties to bilaterally agree whether to migrate a portion or all of their grandfathered trades over to the new regulatory CSA structure.

Phase in periods for non-cleared margining by firm type should be considered, according to a universal and globally harmonised counterparty classification methodology, taking into account size of firms' OTC derivative portfolio. In this regard, it might also be desirable to differentiate the length of the phase-in period by the systemic importance of various counterparties to the overall OTC derivative market.

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?

As noted in the consultative document, FX swaps and forwards do not generally represent significant counterparty risks: they are typically short dated, a large proportion being less than 30 days, and are highly liquid. There are other mitigants that address risks arising from the absence of margin rules including the existence of settlement arrangements and the application of capital requirements to uncollateralised exposure.

Therefore margining of FX swaps and forwards should not be mandatory. Market participants should however retain the option to include them into their margin processes where appropriate.

As a result of the short dated nature of FX swaps and forwards, the costs of the proposal to apply margin to transactions according to tenor in terms of market disruption and operational implementation costs would likely exceed the benefits. Furthermore, it could

have potential unintended consequences and create market distortions as a result of a market that has been bifurcated due to tenor.

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?

If a specific margin methodology is determined at international level (as described under element 3 of the consultative paper), it is unlikely to be appropriate for all products. For example, delta-one total return swaps (where for every percentage change in the value of the underlying asset, there is an equivalent percentage change in the notional of the swap) on asset classes that are cleared and publicly traded (such as certain equities and bonds). It follows that certain products would be better suited to be subject to a margin methodology customised to the underlying asset classes.

Such an approach will reduce the possibility of regulatory arbitrage between the cash and derivatives markets without increasing systemic risk, since the swaps are often hedged by the establishment of cash positions in the underlying asset. Imposing a specific margin methodology that is uncorrelated to the risk of the underlying asset class is likely to unnecessarily trap liquidity.

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?

As expressed elsewhere in this letter we have doubts about the advisability of mandatory exchange of initial margin, due to concerns about the impact of such a requirement on global liquidity, the potential procyclical effects and the concern that certain market participants will choose not to hedge risk because of the expense and difficulty of complying with such a requirement. It might be more effective to focus on requirements for the exchange of variation margin among appropriate counterparties, and to defer requirements for initial margin pending a more extensive study on the quantitative impacts.

If following such study it were considered absolutely necessary to impose mandatory requirements with respect to initial margin, the following might represent an alternative approach for consideration. Market participants who are considered as systemically important should not be required to post initial margin on a mandatory basis; only collect.

Financial firms not considered to be systemically important should be exempted from the requirements.

In order to enhance the systemic stability of the market for non centrally cleared OTC derivatives, the amount of counterparty risk that systemically important market participants could take to other market participants should be limited, in particular to other systemically important market participants. To achieve this, it is sufficient to require that systemically important market participants are obliged to *collect* initial margin from their counterparties above certain thresholds. This would effectively address the following challenges:

- participation in the market would not be unduly restricted as thresholds could be defined such that market participants who are not systemically important would not need to implement margin processes; and
- since non-systemically important participants would not be required to collect margin, they maintain access to competitive pricing and liquidity.

Transaction between:	SYSTEMICALLY IMPORTANT MARKET PARTICIPANTS
SYSTEMICALLY IMPORTANT MARKET PARTICIPANTS	Both sides post & collect IM - higher thresholds may be applied to prudentially regulated entities
NON-SYSTEMICALLY IMPORTANT FINANCIAL ENTITIES	Systemically important market participant collects IM only above applicable thresholds
NON-SYSTEMICALLY IMPORTANT NON-FINANCIAL ENTITIES	No mandatory exchange of IM

If such an approach were implemented we would further recommend the establishment of thresholds in terms of size and number of transactions such that financial entities who fall below should be exempted on the basis that:

- they are unlikely to represent a source of contagion;
- they may not have experience in the management of collateral;

- operational implementation challenges are somewhat proportional to the number of counterparties covered as much the size of portfolios and so operational risks and phase in periods could be reduced; and
- market makers tend to have a large population of counterparties that enter into a low number of transactions every year.

In addition, special rules should apply to special purpose vehicles. Exchanging collateral with a special purpose vehicle is not strictly necessary from a risk perspective as derivative transactions with them typically rank most senior in the waterfall, i.e. they are effectively collateralised by the entire set of assets that the special purpose vehicle owns. In addition, they typically do not have the staff and/or resources in order to support the periodic exchange of margin.

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?

Subject to an appropriate regulatory backstop, for prudentially regulated institutions, where counterparty limit setting and risk-taking processes are already regularly reviewed, it would be appropriate to allow more reliance on internal limit methodologies when such entities are establishing thresholds. Prudentially regulated institutions should be free to set appropriate thresholds for collecting IM by reference to counterparty type, trade and asset type, available capital, liquidity and risk limits.

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?

Such decisions should be left to individual parties involved, taking into account creditworthiness, and the type of transaction. Deutsche Bank has well-established credit risk management processes, subject to regulatory review. These procedures are able to

determine the level of threshold that should be applied to different counterparties. The correct use of thresholds, based on risk-management processes, would not result in an uneven playing field among market participants.

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 believe that thresholds should be based on internal risk assessments that are considerate of a broader context of requirements than regulation alone. Deutsche Bank has well-established internal processes for this kind of evaluation.

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?

The threshold should be calculated based on an evaluation of the counterparty risk of the parties involved, the specifics of the transaction involved and the commercial judgment of the firms concerned. Thresholds represent credit lines to counterparties, and they should be treated accordingly.

Thresholds should be evaluated against the ability to withstand any potential losses due to the counterparty defaulting.

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?

As set out in our covering letter, we are concerned that universal two-way initial margin will generate the most substantial liquidity costs of all possible proposals in this area, and that it would not necessarily best achieve the policy goal of reducing systemic risk and promoting clearing. Many of the perceived reductions in systemic risk may be offset by the two way nature of the requirements increasing risks to prudentially regulated institutions, reductions in market liquidity, increased concentration risk potentially

following from segregation requirements and increased operational risks resulting from too rapid a phase in period.

Universal two-way margining would represent a large alteration of current market practices:

- at present, key market participants would likely collect IM when trading with high-risk counterparties but be less likely to do with low-risk counterparties, such as pension funds, who may not operationally be able to comply with frequent margin calls or validate the initial margin calculation they are being required to post; and
- for many counterparties it may be practically challenging to develop IM methodologies and have to rely on the standardised method for collecting IM, which is insufficiently risk sensitive and will increase the risk that participants using model based approaches may not want to trade with them.

Universal application of two way margining would have a considerable operational impact on the volumes of collateral movements in the market through:

- Potential bifurcation of margining processes, meaning two margin calls between parties for each legal relationship (due to the fact that there will be a legacy uncleared OTC portfolio that will remain on the current CSA, with newly executed eligible OTCs being migrated to a regulatory compliant CSA);
- Potential for two way transfer of initial margin to segregated accounts at a 3rd party custodian will lead to at least 3 collateral movements per margin call (two IM and one VM amount);
- Significant increase in disputes due to varying initial margin calculation models between firms.

By way of an example, for Dodd-Frank eligible firms alone, based on Deutsche Bank's own data we would expect to see significant increases in margin call activity, settlements and disputes. Furthermore, according to the current margining models for non centrally cleared trades, where margin is called by currency and product type, we would expect that over a period of 3-5 years there is the potential for a greater than fivefold increase in margin calls and tenfold increase in collateral movements.

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

As highlighted in the covering letter to this response, requiring regulated entities to post IM to non-regulated counterparties may not be desirable from a regulatory perspective as it is likely to increase interconnectedness between the prudentially regulated sector and

the shadow banking sector. It would also increase the pressure on liquidity at a time when it is scarce. The result would be a mitigation of credit risk at the cost of an increase in liquidity risk and operational risks related for example to ensuring appropriate management of fraud risk, ensuring collateral is properly segregated and ongoing monitoring.

In addition, it is important to note that posting initial margin in segregated accounts, if required, to non-prudentially regulated, or even non regulated, institutions will also increase the risk that it is not possible to access that collateral at the time of counterparty stress due to the legal risks associated with having collateral held at a third party and the potential for resulting litigation.

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

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

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?

The treatment of OTC derivatives entered into by special purpose vehicles or equivalent structured finance entities used in securitisations and as structured note issuance vehicles require clarification for reasons we have identified in our response to Question 4.

<u>Element 3: Baseline minimum amounts and methodologies for initial and variation margin</u>

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?

It is not necessary to require the holding period of 10 days and confidence interval of 99 per cent for each individual bilateral pool of non centrally cleared OTC derivatives to exceed the relevant requirements that might be demanded by a clearing house in order to promote central clearing. There are multiple pools of non centrally cleared derivatives where there is no netting benefit which means the aggregate amount of capital required for margin will be much more than required for central clearing even when using a lower holding periods and confidence intervals. Additionally, such a proposal would not be reflective of the liquidity of the underlying instrument. It would make more sense to begin by requiring a lower confidence interval and holding period and gradually phase in higher

requirements while monitoring the effect on liquidity and progress towards central clearing.

The 10-day horizon is too long, especially if compared with actual practices used by CCPs. Usually, non-centrally cleared transactions can be closed out quicker than those managed by CCPs. The period should be adjustable, depending on the product characteristics.

As a further consideration, if all counterparties are required to collect initial margin, there is a risk that some end users of non-cleared OTC derivatives, who do not have the capabilities to develop their own models or implement third party models, will not be able to obtain competitive prices from market makers for non-cleared OTC derivatives. In order to prevent this, the Proposed Standardised Initial Margin Schedule would have to be refined, which should – for reasons of international consistency – be co-ordinated with the work conducted by the Risk Modelling Group on refining standardised methods for market and counterparty risk for banks.

In more vanilla products (such as FX) dealers have developed intraday margin processes where the close-out period is less than 1 day. In many other cases margin delivery is rapid, grace periods eliminated and the dealer has the operational and trading ability to close out risk rapidly. Counterparties that negotiate and operate high quality collateralised risk management processes should be allowed to compute margin on shorter periods otherwise incentives for counterparties to invest time and effort in these processes will be reduced, which will not be consistent with reducing systemic risk and maintaining liquidity.

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?

Netting should be allowed between different asset classes, where there are well-understood risk diversification benefits. Diversification benefits recognised on a conservative basis would smooth the margining process and increase efficiencies. Inter-relationships between derivatives in distinct asset classes do exist and correlations in these instances are widely accepted and used across the industry. In addition to observable correlations, the proposal should reflect the fact that derivatives over different asset classes may net the same risk – for example an equity swap can have interest rate risk that might be hedged by an interest rate swap.

Operationally it may be difficult for bilateral counterparties to achieve the same asset-class allocation of their trades due to system constraints and internal classifications. For many it would be simpler to include all covered trades in a single initial margin calculation. This could be facilitated by requiring a higher confidence interval where

counterparties choose to margin across asset classes, compared to where they margin within asset class.

The consultative document states that asset classes may be differentiated for the purposes of building a model to calculate IM. However it is unclear how those asset classes should break down and clarification in this regard would be welcome. For example, on page 7, five major asset classes are noted, on page 18 it groups currency/rates as distinct from credit, commodities etc, and on page 32 the paper makes a further (broader) differentiation between Credit, Commodity, Equity, FX, Rates and Other.

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 would suggest that a more granular Initial Margin schedule is needed to more accurately reflect the risks. Many financial entities would not be able to develop internal models, and the current schedule is insufficiently granular to be workable: enhancing the standardised schedule would avoid the disruption for smaller financial entities.

As an example, under the proposed schedule, a 5yr CDS on an obligor trading at 50bp versus one trading at 500bp (both for buying protection and selling protection) where clearly the risk is different, would be margined the same, which does not appear to be a risk-sensitive outcome.

Furthermore, we believe that there should be a breakdown of each category of asset class to reach an appropriate level of granularity and a distinction between long and short positions, (in order to allow netting of positions); and for positions that do not represent a credit risk (such as a sold option).

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 calculation methodology for variation margin is well established. There may however be some counterparties in scope that would need time to develop proper internal processes for this calculation.

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?

The appropriate frequency will depend on the idiosyncratic quality of the counterparty. Many counterparties do not post variation margin on a daily basis at present because they are of sufficiently high credit quality and the benefits are outweighed by the operational burden of doing so. Allowing some entities to post margin less frequently is desirable but should be balanced by recognition that the residual risk (or need for initial margin) would increase because the margin posting frequency is longer.

Although not raised in the consultative document, the introduction of appropriate thresholds for VM as well as IM would merit further consideration. This would reduce the operational burden of the margin process for low users of non centrally cleared OTC derivatives without materially increasing risks. Since counterparty exposure is the sum of current exposure and potential future exposure, the rules could provide for a combined "VM+IM" threshold allowing counterparties to define their tolerance levels for uncollateralised current vs potential future exposure.

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?

There is a significant risk that the rules as proposed will exacerbate procyclicality: the requirements around IM and VM would put pressure on the marketplace at a time of heightened market stress. Firms should have the ability to alter margin levels in response to market conditions and observed levels of volatility in specific instruments or asset classes without generating procyclical effects.

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

We agree that a de-minimis Minimum Transfer Amount (MTA), is necessary to avoid the cost of small movements of collateral that convey no appreciable risk protection and as suggested in the consultative document, $100,000 or equivalent seems appropriate.

Element 4: Eligible collateral for margin

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

The proposal that jurisdictions should be free to set their own list of eligible assets will inherently encourage regulatory arbitrage.

As regards the proposed requirements, a few adjustments may be necessary following further analysis. For example, in many cases certain types of collateral may be more appropriate than others. For example, in general, physical commodities would not be

considered as acceptable collateral. However, there can be no better collateral against the sale of a commodity than the commodity itself. Margin requirements should allow for the underlying commodity to be posted as collateral against the sale of that commodity (with appropriate haircuts to reflect any additional costs or risks to ultimately accessing that commodity for delivery under the contract).

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?

Financial institutions should be allowed to use their internal risk methodologies to determine eligible collateral. Furthermore they should be able to revalue collateral in the Initial Margin calculation along with the collateralised positions. In this way, wrong way risk associated with the collateral is better captured along with diversification benefits where these can be prudently recognised.

Concentration limits may be appropriate in some cases, but this decision seems more appropriately based on the nature of the margin collector, counterparty, and relevant portfolio for which the collateral is intended to collateralise. For example, it may be entirely appropriate to accept as collateral a less liquid emerging market currency to support a portfolio of interest rate swaps in that currency.

While Annex B does seem to provide a reasonable differentiation by risk, there are a number of practical considerations in the implementation which require further consideration. The distinction between “Cash in same currency” and “Cash in different currency” will be impractical to implement. For example, is it intended that an entity trading a non deliverable forward would need to post half of the variation margin in each of the two relevant currencies with any mismatch requiring the 8% haircut?

Annex B would be improved by incorporating also FX risk for non-cash securities, which would carry similar FX risk as the relevant cash itself.

It may also be worth considering defining a small number of liquid currencies for which a 0% or small haircut could be applied, regardless of the currency of the exposure, and additionally applying the appropriate FX add-on onto bond collateral.

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?

Segregation should be possible, but not mandatory. We would agree with the suggestion in the consultation paper that requiring segregation would create material incremental liquidity demands. Furthermore, if such segregation were required to be with third party custodians, this would also increase concentration risks and deadweight costs. There would need to be an examination of third party custodians' preparedness as well as the relevant insolvency and customer protection regimes applicable to such third party custodians, where such a proposal adopted. Furthermore, there would also need to be an industry standard agreement for control accounts, to cover third party custodian relationships that can be quickly executed with minimal risk for counterparties.

The requirement to segregate margin for non-cleared transactions would also have a direct impact on the ability of prudentially regulated institutions to manage their implementation of the liquidity coverage ratio (LCR) under Basel III. The BCBS estimated in its April quantitative impact assessment on Basel III implementation that group 1 and 2 banks faced a €1.76tn shortfall meeting the LCR. The mandatory segregation of margin for non-cleared transactions would add significantly to that shortfall.

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?

It is important to avoid an asymmetry of calculation between counterparties and avoid the creation of imbalances. To this end, exchange on a net basis may be more appropriate. We would note that this problem only exists as a direct result of the requirement for two way exchange of margin. The risks and deadweight costs associated with concentrating segregated IM at a small number of custodians would be significant; the market and the financial system will be vulnerable to the operational /technological/insolvency risks of a small number of institutions.

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?

We assume that this question addresses initial margin, even though it is not specified. Rehypothecation of variation margin is an essential aspect of current market practice without which the market could simply not function due to the large amounts of required liquidity. Reuse of variation margin does not per se increase systemic risk, as the obligation of the receiver of variation margin to return it will, in the case of default, be offset by its swap receivable from the defaulting party.

Requiring segregation as suggested would effectively prevent rehypothecation. Such an approach would be a significant change to current market practice and, as such, would contribute to the significantly increased liquidity requirements contemplated by the overall proposal.

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?

Affiliates should be able to be fully or partially exempted from the requirements to exchange both variation and initial margin where their risk management procedures are adequately sound, robust and consistent with the level of complexity of the derivative transaction and where there is no current or forseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the affiliates.

Furthermore, a harmonised global approach to determining initial and variation margin requirements for intra group transactions should be sought. Principles for exempting transactions between affiliates should be agreed globally and then implemented by local supervisors.

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?

As noted by the consultation paper, to the extent that there are no practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties, entities within the group share the same centralised risk evaluation, measurement and control procedures, the exchange of variation margin between affiliates within the same jurisdiction should not be required.

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?

We are supportive of the key principle proposed. We would note however that more work is needed to ensure a harmonised regulatory framework with regard to the treatment of collateral in transactions with third-country counterparties, especially in jurisdictions where netting and the risk mitigation benefit of collateral might not recognised at present. In such jurisdictions, the posting of additional collateral can increase, rather than decrease, risk.