Dubai Financial
Services Authority

1 October 2012

Basel Committee on Banking Supervision
Bank for International Settlements
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CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/Oquendo 2
28006 Madrid
Spain

By E-mail and post: baselcommittee@bis.org / wgmr@iosco.org

Dear Sir/Madam,

Re: DFSA's feedback on Consultative Document - Margin requirements for non-centrally-cleared derivatives.

The DFSA welcomes and appreciates the opportunity to provide feedback on the consultative document regarding the margin requirements for non-centrally cleared derivatives. We provide with our submission some general feedback as well as responses to a selection of the questions posed in the consultative document. We hope you find these comments useful and constructive.

Please note that the DFSA has no objection to the publication of its comments.

Yours sincerely,

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General Comments

Margin and capital

The consultative paper (CP) includes a discussion of the relative merits of margin and capital as two avenues of addressing counterparty credit risk in non-centrally cleared derivatives, thus achieving the specified objectives. But, the proposals do not address situations in which some of the financial institutions are already subject to capital requirements (under Basel II requirements (Basel II)) to address counterparty credit risk, including that in respect of non-centrally cleared derivative trades. In such cases, imposition of margin requirements will seemingly result in duplication of risk mitigants and result in undue regulatory burden for such institutions as well as resulting in competitive disadvantage for such institutions.

Alternatively, banks and financial institutions facing capital requirements for counterparty credit risk exposures from non-centrally cleared derivative trades can be given an exemption from relevant capital charges as long as they are subject to the proposed uniform margining requirements. Such an approach would support a consistent approach to all financial firms exposed to the same underlying risk.

The necessity for an OTC market

Under the presumption that (i) OTC contracts that can be cleared centrally, should be cleared through a central counterparty (CCP), and (ii) there is need for the flexibility of an OTC market to exist, the imposition of higher margin requirements on OTC positions to force positions to a CCP may not achieve the desired effect: the contracts that are not eligible or accepted by a CCP for clearing, may then be faced with conditions that may prove to be uneconomical whilst not addressing additional risk per se. As a secondary effect, but to the same point, the reduced activity in OTC markets could cause reduced liquidity in the market leading to the widening of spreads and consequential increases in financing costs for smaller businesses and financial institutions, and damage to emerging markets as a whole.

DFSA believes that the impact of the increase in collateral demands, the impact on the structure of the OTC market is not yet well understood. A comprehensive impact analysis should precede the introduction of the proposed regulation. Of specific focus in this study should be the impact on the occasional user of the OTC market vis-à-vis the systemically important and more frequent users. The impact on the fully hedged user is an additional key issue that need to be

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better understood. "Hold-to-delivery" or "hold-to-maturity" positions should not be subjected to mandatory margin requirements.

Gross two-way margin

The proposal mandates the collection of gross two-way margin. Specifically for initial margin, this appears to be an inefficient mechanism to reduce the systemic risk it aims to achieve for entities that may already fall under capital requirements. Variation margin could be required to be collected to address risks related to (increased) market volatility. The margin collection in this model should be done on a timely basis and could efficiently follow on-exchange market practice of T+1.

Netting is a widely accepted industry practice and should be allowed for jurisdictions that have enacted netting legislation as part of its insolvency framework. Although there is merit in the threshold approach for initial margin as described in the paper, the transfer of daily variation margin from counterparty to counterparty may be a burdensome and costly process.

The proposal should also provide more specific guidance to the timing of the collection of initial margin. We believe that the collection and payment of variation margin should be on a T+1 basis at the latest.

Scope of applicability

The proposed margin requirements should be made applicable to all parties except non-financial market participants who trade for their own use, particularly in energy and commodity derivative markets. Failure of such participants in these markets are not likely to have the potential to aggravate systemic risk and the cost implications of imposing margin requirements are likely to affect the cost of provision of the commodity in which they trade. A further fine-tuning of the definition of systemic risk may therefore be useful and far-reaching hedging exemptions for commercial users should be introduced.

However, margin requirements should be applied to all financial entities which are involved in the market for non-centrally cleared derivatives if the intended objectives as set out in the CP are to be achieved effectively. This is essential to ensure a level playing field as margins involve a specific and material cost and may distort competition, including potential adverse effects to the end-clients in terms of quality and price of the service involved.

We agree with the view expressed in the CP that it is important to ensure consistency between entities that are subject to the central clearing obligation for standardised derivatives and those

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entities that are subject to margin requirements for non-centrally-cleared derivatives because any inconsistency may create various market distortions (e.g. by creating preferred counterparties) and could permit regulatory arbitrage.

In the same way, DFSA believes that varying margin requirements for different types of derivative market participants is not desirable as it would lead to unfavourable positions for some institutions and potential regulatory arbitrage. This can potentially drive out some players from specific market segments and possibly lead to lower liquidity.

Responses to specific queries posed in the CP

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

DFSA response:

A reasonably long phase-in time is required for effective implementation of the proposed margining requirements, because the implications of such margin requirements are likely to materially alter the cost and profitability aspects of trading in non-centrally cleared derivatives. So, firms, particularly banks which are likely to face simultaneous implications on liquidity rules from the Basel Committee, would need time to review and decide on the options available to them including the viability of continuing with this business. Also, firms would need time to shore up liquid assets for posting as margin, which includes collecting from their clients, in case of flow business. DFSA notes that the larger banks are already under liquidity pressures from Basel III requirements.

Implementation timelines must not be set independently and must be set considering not only other regulatory initiatives in the market infrastructure domain but also regulatory initiatives in the pipeline, across the wider banking and financial services domain. As pointed out earlier in this CP, the proposed margining requirements are likely to have material implications in relation to the liquidity proposals for banks and impact on the overall demand for highly liquid assets considering the key principle 4 above.

A Quantitative Impact Study (QIS) on the proposed margining should be combined with a QIS on liquidity proposals for banks from the Basel Committee to measure and assess the cumulative impact on banks which are significant players on markets involving non-centrally

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cleared derivatives.

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?

DFSA response: DFSA believes that short-dated foreign exchange swaps and forwards with a maturity of less than a year must be exempted from margining requirements for the very reasons mentioned in the consultative paper. The other reasons which would support such an exemption include the fact that such short-dated forex swaps are largely used to support underlying commercial and investment transactions and are very rarely used for speculative purposes. Because of their nature and their normal usage, short-dated forex swaps and forwards were not seen as material contributors to accumulation of risk concentrations. They are self-liquidating positions and imposition of margins on such transactions would increase the overall cost of financing for the underlying trade and investment transactions they support. A similar reasoning could be applied to an exemption for *inter alia* interest rate swaps as long as they do not form part of a speculative position.

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?

DFSA response: The margin requirements proposed should allow for appropriate commercial exemptions for OTC derivatives. For instance exemptions should apply where derivatives position are held by firms on a commercial basis, are governed by accepted master agreements, are not part of a trading book and meet a complete hedging requirement. If bilateral contract parties envisage requiring initial and variation margin from each other then this would be a separate consideration.

The overarching principle governing these inclusions should be that these hedged derivatives position do not pose a systemic risk or induce regulatory arbitrage.

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This exemption should not only apply to commodity derivatives participants and products, but consideration should be given to extend this to other financial (full) hedging purposes as well, i.e. a pension hedging its duration. We would encourage the feedback statement to elaborate on this point.

Q8: (a) How should thresholds be evaluated and specified?

DFSA response: The threshold method requires an assessment of the counterparty risk as well as a conclusion to some of the specifics of the contract (e.g. liquidity, size) to determine the appropriate threshold.

Q10: What are the practical effects of requiring regulated entities (such as securities firms and bank) to post initial margin to unregulated counterparties in a non-centrally cleared derivative transaction?

DFSA response: DFSA has made the point in its General comments above that the imposition of initial margin to (unregulated) counterparties on top of the Basel capital requirements would not be covering additional risk and likely make the services to these entities uneconomical.

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?

DFSA response: The margin calculation methodologies should recognise the volatility in respective market segments and the recent historical experience. Given the limitations of the VaR models, particularly in days of high stress in financial markets, the utility of the proposed margins to achieve the intended objectives can be ensured only by going in for a shorter frequency of volatility observation in calculating VaR. So, DFSA would support a more sensitive model with a 1-day VaR at 99% confidence level for calculation of the proposed margins. Although the DFSA has not prepared a detailed comparison the standardised margin schedule proposed would likely lead to requiring more collateral than necessary if a risk-based approach would be adopted.

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