September 28, 2012

RESPONSE TO THE BCBS-IOSCO CONSULTATIVE DOCUMENT ENTITLED "MARGIN REQUIREMENTS FOR NON-CENTRALLY-CLEARED DERIVATIVES"

Overview

EACH, the European Association of Central Counterparty Clearing Houses, welcomes the opportunity to respond to the Consultative Document produced by the Working Group on Margining Requirements ("WGMR") on margin requirements for non-centrally-cleared derivatives ("the Consultative Document").

The proposals for margin requirements set out in the Consultative Document are in some cases less prescriptive and onerous than equivalent requirements for centrally cleared derivatives that will come into effect in the EU under EMIR. We note that the authors of the Consultative Document are careful to balance the benefits of margin requirements with the potential negative liquidity impact which would result from the requirements being overly onerous. This concern is clearly a major factor in the proposals put forward. We support such a balanced consideration, but believe that such balance was not taken into account to the same extent in the EU in consideration of margin requirements for centrally cleared derivatives. The consequence is that in many cases, the proposals put forward in the Consultative Document will lead to more flexible and less onerous margin arrangements for non-centrally-cleared derivatives than for centrally cleared derivatives.

<u>As a result the objective set out by the G20 and by BCBS of promoting central clearing may not be met unless the capital requirements for uncleared trades are sufficiently penalising compared with the requirements for cleared ones.</u>

This is especially true for CCPs based in Europe, for which the proposals set out in the most recent ESMA consultation paper relating to CCP clearing are substantially more onerous and prescriptive than those set out in WGMR's Consultative Document relating to non-centrally-cleared derivatives.

Specific details of this imbalance are set out in the next section of this paper, but the following specific examples give an illustration of the scale of the imbalance:

- The Consultative Document proposes a more liberal approach to the quality of collateral than that proposed for CCPs.
- The prescribed haircut levels for collateral set out in Appendix B are substantially lower than would be considered appropriate under proposals for CCPs.
- The requirements relating to segregation arrangements set out in EMIR and implied in Basel III for centrally cleared derivatives are more onerous than those contained in the Consultative Document for non-centrally cleared derivatives.
- The system of thresholds for initial margin exemptions set out in the Consultative Document would not be available to CCPs.
- The Consultative Document puts forward minimum 99% confidence intervals for margin calculation. This compares with a minimum confidence interval of 99.5% proposed by ESMA for European CCPs.
- The Consultative Document puts forward a consideration of a separate phase-in schedule from central clearing mandates. This could in the short to medium term amplify the imbalances between centrally cleared and non-centrally-cleared derivatives.

Specific imbalances between proposals for non-centrally-cleared and centrally cleared derivatives

As set out above, considerable importance is attached in the Consultative Document to minimising the liquidity impact of the proposals. This consideration is repeated throughout the document and influences all the specific proposals. In addition an impact study (QIS) is proposed to address this concern. The degree of importance attached to this factor in the Consultative Document is substantially greater than the evident consideration given to this factor for equivalent proposals for non-centrally cleared derivatives.

As a result the proposals put forward in the Consultative Document will lead to less onerous and more flexible margin arrangements for non-centrally-cleared derivatives than for centrally cleared derivatives. The consequence is that the objective clearly expressed by the G20 and by the Basel Committee to provide incentives for banks to increase their use of central counterparties may not be met[1]. This objective is referenced on P.2 of the Consultative Document, pointing out that such incentivisation would in turn contribute to the

[1] Extract of the BCBS Consultative Document on the capitalisation of bank exposures to central counterparties, dated November 2011: '*The G20 Leaders, at their Pittsburgh summit in September 2009, agreed to a number of measures to improve the over-the-counter (OTC) derivatives markets, including creating incentives for banks to increase their use of central counterparties (CCPs). The Basel Committee has been working to give effect to the G20 statements, and has developed proposals that require banks to more appropriately capitalise their exposures to OTC derivatives, while creating incentives for banks to increase their use of CCPs'.*

reduction of systemic risk. In actuality the reverse is the case: the imbalance between the proposals will dis-incentivise central clearing, resulting in the reduction of systemic risk not being achieved.

This imbalance is particularly extreme in relation to proposed European regulation for centrally-cleared derivatives[2].

Specific instances of imbalances between proposals for non-centrally cleared derivatives and centrally-cleared derivatives which will actively dis-incentivise the central clearing of derivatives are set out below:

1. Overall level of prescription and flexibility
   The level of detailed prescription of margin requirements in the Consultative Document is substantially lower than for centrally-cleared derivatives, particularly for European CCPs. The principles-based proposals indicated in the Consultative Document will provide considerably greater flexibility and adaptability than equivalent proposals for CCPs.

2. Quality of collateral
   EMIR specifies that 'A CCP shall accept highly liquid collateral with minimal credit and market risk to cover its initial and on-going exposure to its clearing members[3]. Conversely in the Consultative Document BCBS and IOSCO specifically propose permitting a broader range of eligible collateral for non-centrally cleared derivatives, with appropriate haircuts.

3. Proposed levels of haircuts for collateral
   The Consultative Document sets out in Appendix B a set of standardised collateral haircuts that can be used in lieu of model-based haircuts. It is explained in the document that such standardised collateral haircuts provide a conservative alternative, and '*should be sufficiently stringent so that firms have an incentive to develop internal models*'.

   However, even these levels of haircuts are substantially lower than CCPs will be required to have in place as a result of the requirements set out in the CPSS-IOSCO Principles for FMIs, EMIR Level 1, and ESMA's proposals for EMIR Level 2. Together these provisions will require haircuts at CCPs to take into account the historical and hypothetical future price volatility of the asset in stressed market conditions, the liquidity of the underlying market, including bid/ask spreads, and the liquidity risk following the default of a market participant. CCPs will also need to ensure avoidance

[2] Reference Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012, on OTC derivatives, central counterparties and trade repositories ("EMIR"), and ESMA's Consultation Paper of 25 June 2012 entitled 'Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories'.

of pro-cyclicality, wrong-way risk and concentration risk, carry out independent validations of haircut methodologies at least annually, and demonstrate to the competent authority that haircuts are calculated in a conservative manner. As a consequence of these requirements we estimate that CCP haircut levels will need to be in certain cases over 3 times higher than the levels proposed in Appendix B of the Consultative Document.

The proposed intention of the Consultative Document is to allow haircut levels used in internal models to be significantly lower than the standardised levels, resulting in an even greater contrast between the centrally cleared business at CCPs and non-centrally cleared derivatives.

4. Segregation, custody and liquidity arrangements
   In element 5 of the Consultative Document consideration is given to the treatment of margin provided. Issues such as the netting of margins, segregation and re-hypothecation are discussed, with different options considered.

   Even if the most onerous option is followed on every issue considered, the standards for non-centrally-cleared business will still be substantially less onerous than the protections required at CCPs as a result of the requirements set out in the CPSS-IOSCO Principles for FMIs, EMIR Level 1, and ESMA's proposals for EMIR Level 2. Together these provisions include strict controls over the investment of assets of clearing members / customers, full protection of collateral, a minimum of 98% collateralisation of all cash, controls over investment counterparties, custodians, settlement banks and payment systems, onerous segregation and portability requirements, establishment of a framework for measuring, monitoring and managing liquidity risks, settlement and funding flows relating to margins, a range of stress testing requirements incorporating theoretical and historical scenarios over at least a 30 year period including daily testing of liquidity of financial resources, independent review and validation of all models, and disclosure of testing results.

5. Initial margin thresholds
   In element 2 of the Consultative Document consideration is given to the use of thresholds, below which initial margin would not be required. The stated intention is to manage the liquidity impact associated with margin requirements. The use of such thresholds at CCPs cannot be envisaged as it would not be consistent with either the CPSS-IOSCO Principles for FMIs or EMIR. For organisations operating at margin levels below their assigned thresholds, this measure alone may provide a substantial incentive to use non-centrally-cleared derivatives rather than centrally cleared derivatives.

6. Confidence intervals for initial margin calculation
   In element 3 of the Consultative Document it is proposed that a confidence interval of 99% should be used in the calculation of initial margin levels for non-centrally-cleared derivatives. In contrast, ESMA is proposing that CCPs must use a minimum

confidence interval of 99.5% for OTC derivatives[4]. In addition ESMA proposes that for CCPs the confidence interval be applied to pricing data equally weighted between the last 6 months and the worst 6 months in the past 30 years[5]. This is of course in addition to an extensive range of stringent requirements relating to default fund backing for centrally cleared derivatives to accommodate circumstances where such initial margins are insufficient.

Element 1: Scope of Coverage - instruments subject to the requirements

Question 2 of the consultation asks whether Foreign Exchange Swaps and Forwards with a maturity of less than that a specific tenor such as one month or one year should be exempted from margining requirements due to their risk profile. We believe that the prudent course would be to only exclude margining for very short tenors, probably less than 1 month. First, the volatility in the Foreign Exchange markets implies market risk which margins would mitigate. Second, if market participants were only required to clear Foreign Exchange Swaps and Forwards with a maturity below one year, they would adapt their trading behaviours to get around the obligation as the cost of rolling a contract would not be as high as the cost of clearing.

Conclusion

The cumulative effect of the imbalances set out above will be to substantially dis-incentivise the use of central clearing. This is direct contrast to the objective expressed by the G20 and by BCBS to promote central clearing. As identified by BCBS this in turn will serve to increase the systemic risk.

EACH is of the opinion that requirements relating to non-centrally cleared derivatives should be at minimum as prescriptive as for centrally cleared derivatives.

EACH favours a market driven approach of incentivizing central clearing instead a clearing obligation. Therefore a holistic view of total costs of clearing derivatives by all types of market participants is urgently needed. This has to be taken into account by margin requirements and capital requirements for centrally cleared and non-centrally cleared derivatives. Only this ensures the intended objective of promoting central clearing.

[4] ESMA Consultation Paper of 25 June 2012 entitled 'Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories', Chapter VII Article 1 MAR.

[5] ESMA Consultation Paper of 25 June 2012 entitled 'Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories', Chapter VII Article 2 MAR.

About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1991. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 23 members:

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CSD and CH of Serbia

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This document does not bind in any manner either the association or its members.

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