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26 September 2012

Comments of the EAPB on the BCBS/IOSCO CP on margin requirements for non-centrally-cleared derivatives

Dear Madam or Sir,

The European Association of Public Banks, EAPB, welcomes the opportunity to comment on the consultation of the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) on margin requirements for non-centrally-cleared derivatives.

Remarks to the questions:

Q1. All financial institutions are currently working on the implementation of the obligation to centrally clear OTC derivatives deriving from various legislative proposals. Usually the people involved in the implementation project of the financial institutions are also involved in any changes on the bilateral infrastructure. The main tasks should be completed by the end of 2013, although making new products suiting for central clearing will bind resources for a longer period. Another aspect is the interaction of the new margin requirements with other topics like capital and liquidity requirements. Margin requirements strongly relate to the other requirements and all proposed changes should be carefully thought out. The implementation should be done in a two-way approach. First all financial institutions should be obliged to exchange variation margin, as this is the main source of risk associated with bilateral derivatives, and second to exchange initial margin. As additional margin requirements (in particular initial margin) could not be set in place without certain legal and operational changes like new master agreements or third party custodian accounts they should not be implemented before 2015. Coordination would be very helpful in this case,

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because the proposed margining requirements affect different jurisdictions, regulatory regimes and existing bilateral master agreements between banks. Parties included in the process should be the global banking and markets supervision authorities, market organisations like the ISDA or ICMA, market infrastructure organisations like SWIFT, central counterparties and BCBS and IOSCO themselves.

Q2. Today the collateralization of foreign exchange swaps and forwards is part of the arrangements in the ISDA Credit Support Annex and other legal margining agreements between banks. This should not be changed for variation margining. Especially PVs of FX swaps often contain huge exposures which have to be collateralized to use netting effects. Tenor periods should not be defined in relation to this product, as the biggest exposures from the mtm perspective could occur short before the settlement of the transaction and no pull to par effect can be claimed for this asset class in contrast, for example, to interest rate swaps or credit default swaps.

Q3. No.

Q4. Initial margins are useful to reduce systemic risk. Thresholds are useful to limit the liquidity impact. However, the type of margin that is eligible for the initial margin transfer is an open question with a huge impact on the proposal. Are government bonds of e. g. Germany highly liquid collateral or just EUR, USD, GBP cash collateral? The acceptance of a range of value stable securities as initial margin would limit the liquidity impact. In general there is a strong demand for highly liquid collateral in the future, which might have impacts on the pricing of bonds and not all consequences of this rising demand can be foreseen.
The BCBS/IOSCO proposal promotes central clearing, as the costs for collateral in a bilateral cleared derivative would be brought in line with the cost for a centrally cleared derivative. A robust legal and operational framework for the introduction of initial margin is missing. It is unclear whether the national insolvency law covers all aspects of your proposal. There will also be demand for third party arrangements in order to effectively protect initial margin providers, which are best safe kept by the central banks. This would be a new duty for them and implementation will take some time as.

Q5. The implementation of initial margin thresholds would be an effective way of balancing the liquidity impact of the proposal and the goal of reducing systemic risk. The use of thresholds would also help to reduce operational costs. The use of thresholds will result in regulatory arbitrage in the future, as the collateralisation of any derivative is more and more integrated in the price building of the contract. As the intention of the proposal is to reduce systemic risk a threshold of 50M EUR per portfolio would be appropriate, as lower threshold amounts would cover non-SIFIs.

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Q6. Higher thresholds should be granted to public entities, publically guaranteed entities and supranational institutions.

Q7. ---

Q8. The advantage of a fixed specification would be that it is a transparent approach to all parties involved and comparatively easy to implement.

Q9. The biggest problem in relation to two-way margining - besides the liquidity impact - is the increased settlement risk and the very high daily collateral adjustment efforts. As long as no effective payment-versus-payment mechanism exists the settlement risk associated with the exchange of universal two-way margining could offset its benefits. Is a payment-versus-payment mechanism similar to the settlement of securities or CLS workable or maybe provided in the future? From an operational perspective the daily initial margin adjustment effort could be a multiple of today's variation margin adjustment effort. This might lead to a reduction in the number of potential counterparties and could thus create systemic risk because of using only the G-SIFI as swap counterparties, having also a potential negative effect on pricing and liquidity of the products. The implementation and obligatory use of a standardized margin schedule could reduce operational adjustment efforts significantly. If swap participants do not use the same standardized margin schedule there should be very long-winding collateral adjustments and huge numbers of initial margin disputes.

Q10. ---

Q11. Yes, the scope should be extended to all sovereign, sub-sovereign and supranational entities.

Q12. ---

Q13. A serious problem with the model-based approach to initial margins is the fact that the counterparties need to agree on the amount. What happens if both parties use different models? Even if both models have been approved by the supervisory authority, the numbers may be vastly different. A similar problem exists for contracts between parties, one of whom uses a model and the other the standard schedule.

Q14. ---

Q15. The neglect of hedging and netting is inappropriate. If no further dimension is added in the calculation, the calculation raises the margin to absurd amounts and increases the liquidity impact unnecessarily, without having a clear benefit. In practice, financial institutions would usually not cover risks in case of a defaulting counterparty on a per trade

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basis, but on a risk level per maturity bucket. Multiple trades could be replaced by one with a similar risk profile. A netting element should be added in the standardised schedule.
Another aspect is the initial margin requirement for FX products. The proposed initial margin rate is not appropriate, as huge amounts of initial margin would be required especially for very short term transactions. More tenors for this product should be added or it should be exempted from any initial margin requirements at all. A clearer and more specific definition of “duration” is also needed in your table.

Q16. ---

Q17. Usually, variation margins are exchanged daily, subject to minimum transfer amounts. The collateral practice shows that this approach is the best to cover significant exposure movements on a daily basis. It also preserves the banks credit lines and capital requirements. The mtm-risks associated with the portfolios, which are covered by the variation margin, are the key elements of risk. The general standard in the collateral management should be higher than the standard in the initial margin process.

Q18. ---

Q19. A minimum transfer amount between EUR 1,000,000 and EUR 2,000,000 is adequate to mitigate operational risk and handle uncollateralized exposures. These amounts would also be adequate to protect the financial counterparties against an increase in systemic risk.

Q20. The broader eligible collateral approach with haircuts requires strict and enforceable collateral agreements between the banks related to the types of eligible collateral. In general, the proposal of BCBS/IOSCO and national supervisory institutions should be an overall standard collateral framework. It should not have the character of a margining obligation. The counterparties should still have the opportunity to bilaterally agree on a stronger framework between them.

Q21. Concentration limits are well thought out in the internal collateral policy of each institution, because only the institution itself has the ability to measure concentration risks and define appropriate levels of risks to its specific needs.

Q22. ---

Q23. A net position in initial margin is useless. The requirement could lead to concentration and legal risk, especially in case of an interaction between multiple jurisdictions. Margin payments should be made to central banks. They could be used to safekeep the margin obligations in order to protect financial institutions against a default of their counterparties.

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Q24. We support the approach of re-use but see operational difficulties. At the moment the workflow needs to be described in more detail in order to build up a final opinion.

Q25. ---

Q26. ---

Q27. ---

Should you have additional questions or comments, please do not hesitate to contact us.

Kind regards,

Julien Ernoult	Boris Bartels
EAPB	EAPB

The European Association of Public Banks (EAPB) represents the interests of 40 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

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