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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF comments on BCBS- IOSCO consultation on "*Margin requirements for non-centrally cleared derivatives*"

Key Points

- The European Banking Federation (EBF) would like to welcome the objective of harmonizing margin requirements globally in order to create a level playing field between different jurisdictions. It also wishes to stress that OTC derivatives are vital to the economy.

- The proposal would fundamentally change the landscape of collateral management. The EBF therefore welcomes the proposed quantitative impact study. Together with the impact of other regulatory reforms around the world, collateral would become scarcer and thus more expensive. Market participants will need time to make adjustments to existing collateral management systems and procedures or to implement new ones.

- Any mandated bilateral exchange of Variation Margin by financial institutions in combination with capital requirements should be sufficient to satisfy the G20's key objective of minimizing credit risk and mitigating systemic spill-over risk.

- Mandating mandatory Initial Margin requirements would introduce liquidity risk and interfere with the normal course of credit underwriting, particularly for unsecured credit and credit collateralized by physical collateral.

- The credit risk of prudentially regulated financial institutions can be managed in a variety of ways. Such institutions are already subject to comprehensive regulatory requirements and supervision. Accordingly, they should be permitted to individually negotiate the terms of margin, collateral, and price within this regulatory framework.

- The FX markets should not be subject to punitive margin requirements that might interfere with a market that is already transparent, liquid, and has a well-functioning settlement process.

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?

Coordination and alignment with central clearing mandates is essential if the BCBS-IOSCO margining requirements are to be consistently implemented. Given the significant global regulatory activity in this area, with Europe, the US and now several Asia-Pacific jurisdictions at various stages of implementing their G20 central clearing commitments, significant uncertainties will exist into the medium term about how these regulations will ultimately function. Accordingly, the EBF believes it would be most practical to introduce a clear and sufficiently lengthy multi-year phase-in period in order to properly assess the efficacy of these multiple regulatory initiatives.

From a practical point of view, regulators should also be mindful that the industry has to overcome sizeable challenges including:

- Building and adapting the infrastructure for collateral management, including automated processes, and developing standards for segregation and customer protection.
- Updating documentation for netting and collateral in accordance with revised ISDA or other agreements. – Large banks have thousands of counterparties, all of which would need updated netting and collateral agreements. There is little chance of timely implementation without revised ISDA or other streamlined agreements.
- Working with regulators to review and gain approval for margining models covering a majority of non-cleared exposures.
- Adjustment of bankruptcy laws in some jurisdictions to make sure custody arrangements are really bankruptcy remote.

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?

The scope of applicability should not encompass foreign exchange (FX) swaps and forwards. FX forwards and swaps are important risk management tools for hedging foreign exchange risks arising in the course of ordinary business activities. As noted by the U.S. Department of the Treasury in its proposed determination to exempt FX swaps and forwards from mandatory clearing, risk profile of these instruments is quite different from other derivatives classes because of existing market price transparency, liquidity, and well-functioning settlement processes. They are an essential part of the FX market as they provide a critical source of liquidity and funding. The FX market is a *global payment system* that underpins the global economy by facilitating and supporting international trade and all forms of cross-border activity.

Subjecting these products to a mandatory margin regime may create perverse incentives that could harm the well-functioning market structure. A mandatory margin regime raises the costs of trading these products bilaterally, even when end-user exemptions exist due to the interbank margining required and could have these undesirable effects:

- Incentivize central clearing when there is no approved robust and safe solution for these products,
- Jeopardize the use and role of CLS (which is not mandatory) in reducing systemic risk as costs may move the focus away from settlement risk reduction, and
- Discourage trading in these products, which might affect global trade and cross-border activity.

Small open economies - more dependent on FX markets than larger economies - will suffer a more profound cost impact relative to the size of their economy than larger ones, especially when one considers their smaller systemic risk threat. In regards to emerging markets - where there are comparatively few CCPs and those that do generally offer more restricted product clearing services - firms may have few if any options for clearing. This is doubly so where a US or EU CCPs will not clear a trade from an emerging market counterparty as a matter of operational policy. Imposing higher margin requirements for uncleared FX derivatives in these markets is punitive and would have a disproportionate impact.

Also, to ensure a level playing field and foster international trade and competition, exemptions for FX swaps and forwards should be aligned across jurisdictions and harmonized to a maximum extent.

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?

The EBF believes that margining requirements should not be indiscriminately imposed on all products alike. Rather they should be considered as a tool among others to manage counterparty risk appropriately.

For example, there are some types of OTC derivatives that may not be viewed as sufficiently liquid to be deemed eligible for clearing, but where the risks associated with these products are not of systemic importance. It is therefore important not to base the margin/collateral requirement on solely what is cleared or uncleared. This could, for example, unnecessarily penalise and interfere with smaller markets that are not liquid enough to be eligible or available for clearing.

Furthermore the EBF requests clarification that any new margin requirement would only be applied prospectively and not retroactively to existing transactions. At a minimum, imposing the requirements retroactively would require the renegotiation of pricing for all existing transactions.

Accordingly, imposing any requirements retroactively would be unreasonably burdensome and there would be no legal basis for such alteration of existing contractual arrangements.
Additionally, the EBF does believe that there should be specific reference made to an exemption for special purpose vehicles ("SPVs") used in structured financing, as well as state and municipal governmental entities and central banks.

Q.4 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?

The EBF strongly urges the BCBS-IOSCO to find an appropriate balance between investor protection and the proper functioning of financial markets. Credit risk faced by prudentially regulated financial institutions can be managed in ways other than margin, such as with other types of collateral. In addition, such institutions are already subject to capital and other regulatory requirements as well as prudential supervision. Accordingly, derivative counterparties should be permitted to individually negotiate the terms of margin, collateral, and price within this regulatory framework.

Any mandated bilateral exchange of VM in combination with increased capital requirements should be sufficient to satisfy the G20's key objective of mitigating and minimizing credit risk and systemic spill-over risk.

In order to efficiently balance the envisaged policy goals, the EBF is of the opinion that the following should be considered:

1) Exchange of Variation Margin ("VM"): There is currently no mandated or uniform practice on exchange of VM even between financial institutions. While many financial institutions now require bilateral exchange of VM, this has been a recent development designed to address regulatory concerns about systemic risk and interconnectedness of financial institutions.

2) Exchange of Initial Margin ("IM"): Any new mandatory bilateral exchange of VM should be sufficient to address concerns not only about changes in market risk but also future exposure. Mandating IM introduces liquidity risk and interferes with the normal course of credit underwriting. Financial institutions and their counterparties assess and manage derivative exposure at the time that they enter into a transaction as part of a credit relationship. The transaction price reflects each counterparty's estimate of their risk and VM covers future changes in that exposure. Mandating IM would interfere with loans and derivatives collateralized by, among other things, real property, equipment, inventory, or accounts receivable. It would also make hedging an unsecured loan with a customized derivative impossible, which would be most detrimental to small borrowers and new businesses. Mandating bilateral exchange of IM would compound this problem. It would also increase funding costs and affect credit availability, particularly long-term and fixed rate financing. It

is noteworthy that the Dodd-Frank Act adopted in the United States only mandates margin requirements for swap dealers and major swap participants. Therefore, the EBF believes that banks and their counterparties should have the option to choose the most appropriate form of counterparty risk protection.

Mandating IM would also give rise to a number of unintended consequences and consequently shift risk to other areas in the financial system:

1) Economic risk: as the cost of OTC transactions will increase significantly, end-users could turn away from hedging their commercial risk with tailor-made products, thus being exposed to basis risk or not being hedged at all, which would increase economic risk; A no-rehypothecation requirement could remove huge amounts of liquidity from the economy, and could trigger a massive loan deleveraging process as the available sources of funding for banks are not elastic: they may have to re-allocate their available liquidity from loans to margin requirements.

2) Liquidity risk: requiring all counterparties to post IM will create systemic liquidity risk as the demand for eligible collateral would dramatically increase and affect the funding needs of the global banking system. The US Office of the Comptroller of the Currency estimated that there will be a $2 trillion impact for US banks, which would translate into $7 trillion worldwide for banks based on BIS figures for derivatives notionals.

3) Market and issuer risk: the institution that will have to buy securities to post them as collateral will be exposed to additional market and issuer risk on its holding;

4) Concentration risk: restricting eligible collateral to cash and a limited subset of eligible securities would reduce asset diversification and increase concentration risk ;

5) Pro-cyclicality: imposing the same risk-mitigation regime on the entire OTC derivatives space increases pro-cyclicality in times of severe market stress.

6) Operational risk: other risks such as legal risks of perfection of rights over the IM posted, etc.

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?

The EBF appreciates the proposal's recognition of the useful role that IM thresholds can play in managing credit risk and exposure. Thresholds can enable counterparties to differentiate by credit quality, which is an essential part of credit underwriting. However, the EBF believes that more effective tools exist to manage the general issue of systemic risk which do not pose as considerable an issue in regards to liquidity. Namely, instead of imposing IM requirements and

utilising thresholds, VM practices and appropriate capital requirements are a more effective and less disruptive means of managing systemic risk, especially when combined with regulatory initiatives that require mandatory central clearing of eligible OTC derivatives.

If BCBS-IOSCO elects to mandate IM requirements and thresholds, the EBF believes that the thresholds should be bilaterally negotiated by the counterparties in accordance with their risk perception and risk management policies. Since extending credit is a key function of banks, they have sophisticated processes, systems and staff to analyse their counterparties and their credit quality. They should have flexibility in terms of adjusting the threshold according to each counterparty's potential credit risk.

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, 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?

The EBF asserts that it is appropriate to have different thresholds that apply to different entities: this is the only way to efficiently manage counterparty risk, without overburdening the market with a "one-size fits all" approach. The use of different thresholds for different kinds of counterparties would not contribute to an unlevel playing field: it would reflect adequate counterparty risk management, as already reflected in the pricing and thresholds for bilaterally negotiated, uncleared OTC derivatives today.

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?

The EBF would support differentiation between prudentially-regulated and non-prudentially-regulated entities but not key vs. non-key market participants (as it may unfairly distort competition in specific market segments).

Prudentially regulated entities are already subject to the capital requirements set under Basel III and to supervision. Indiscriminate margining requirements would disregard the purpose of these capital requirements and multiply risk mitigants where safeguards are already in place. Both capital and collateral requirements can be used appropriately depending on the type of transaction and counterparty, one being able to complete the other without leaving loopholes.

The right balance between liquidity for IM and capital should be left at the discretion of the prudentially regulated parties.

Next to capital requirements and direct supervision, the EBF would like to point out that under the liquidity requirements set by Basel III, the application of the LCR will require prudentially regulated entities to hold additional liquidity to cover future market valuation changes. Referring to the draft of the European CRD IV, Art. 411.2 and Art 411.3 of CRR :

> *"2. Institutions shall notify to the competent authorities all contracts entered into the contractual conditions of which lead to a liquidity outflows or additional collateral needs following a material deterioration of the credit quality of the institution. If the competent authority considers such contracts material in relation to the potential liquidity outflows of the institution, it shall require the institution shall to add an additional outflow for those contracts, including corresponding to the additional collateral needs resulting, from a material deterioration in the credit quality of the institution such as a downgrade in its external credit assessment by three notches."*
>
> *"3. The institution shall add an additional outflow corresponding to collateral needs that would result from the impact of an adverse market scenario on the institution's derivatives transactions, financing transactions and other contracts if material."*

Consequently, requiring IM collection would basically double count with the liquidity requirement.

In this way, under the current proposals, a prudentially regulated entity will have to meet a deterioration in its credit quality both by posting extra IM on its uncleared derivatives, and by holding extra High Quality Liquid Assets to cover the adverse impact on its derivatives business. This means that the prudentially regulated entity will have to cover the same risk twice. Again, this argues against the mandatory bilateral exchange of IM for prudentially regulated entities.

It is obvious that implementing any such externalities as margining requirement for non-centrally-cleared derivatives will negatively affect the liquidity in the market place. More than anybody, non-financial counterparties will face this negative effect. The unwanted outcome could be the avoidance of derivatives contracts in risk management, thus increasing the systemic risk as a whole.

As to the general concerns existing in respect of any obligation to collect/post IM, see our comments above. At the very least, any mandatory requirement to collect/post IM should be as limited in scope as possible and only to counterparties which have the operational capabilities to manage the processes required in this context as well as only to transactions where the risks involved merit this.

In addition, it should be clarified that the right of counterparties to demand IM where they consider it appropriate remains unaffected.

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?[10] Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

In order to avoid any regulatory or practical arbitrage, more simple and transparent measures not based on IM amounts are welcomed. Although it is felt that thresholds should be risk sensitive, it is recognised that this creates an undesirable (and potentially subjective) volatility in the thresholds. Therefore ultimately thresholds, if any, should be standardised without distinguishing between counterparty types. Such standardised thresholds should serve as maximum eligible threshold. Within such boundary thresholds, if any, should be negotiable and should be evaluated on a simple standardised transparent measure incorporating the firm's balance sheet, credit rating of institution, VAR as measured by clearing house model.

Thresholds should be bilaterally agreed between counterparties, taking their risk appetite and credit quality into account. Thresholds should not have any rating triggers, as those lead to cliff-effects which proved in the credit crisis to be problematic.

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 already stated above, the EBF believes that a universal systematic two-way exchange of IM would have a detrimental effect on market liquidity and transaction costs in general. It would also introduce new credit and default risk.

More broadly, a demand for two-way margin fully segregated will fundamentally change the landscape of collateral management. Under the proposed rules re-use or re-hypothecation will be prohibited and as a result the market will be drained of liquidity as it will be locked in as collateral.

The requirement to collect bilateral universal IM would also impose a tremendous operational burden on those market participants such as end users that use swaps to hedge risk and do not currently collect margin. It also will confer no additional systemic resiliency. The liquidity impact and new credit and default risk would in fact be more likely to introduce instability.

Moreover, full segregation would be a great challenge to the financial markets' participants from a practical standpoint since the law varies among jurisdictions. There will also be considerable burdens to make any changes to operations in order to meet the new requirements in terms of staff, systems and procedures that need to be in place. This infrastructure would need to be supported by robust and harmonised insolvency laws.

Some additional negative repercussions could include:

1) key market participants may become more reluctant to engage in or make markets in OTC derivatives as the cost will be significant. In addition, their funding needs will be severely impacted as significant amounts of collateral may be locked up and no longer be used to provide financing;

2) all market participants whether or not they are prudentially regulated or deemed to be systemically important would be confronted with the same liquidity and funding constraints; and

3) non-prudentially regulated entities will be severely impacted in their funding needs and may refrain from using derivatives for hedging purposes even if they are the best risk management tools for the transaction.

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?

The EBF would propose not to have IM requirements for any transactions with non-financial companies that are being used to mitigate risk. Institutions already calculate the credit exposure and allocate balance sheet / risk capital based on the market value changes in the exposure.

Imposing an IM requirement may create a new source of systemic operational risk for non-financial counterparties that do not currently have systems to collect margin, segregate collateral, and conduct ongoing monitoring. Such a system would need to be very resilient and thus would add extraneous costs that will interfere with the daily business of the non-financial companies.
Furthermore, non-prudentially regulated entities will be protected from counterparty risk when transacting with a prudentially regulated entity, as the latter will have to comply with capital and prudential supervision requirements.

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

Non-financial institutions and other buy-side market participants (such as pension funds) hedge to be able to obtain certainty of cash flow. Requiring such institutions to post IM and VM defeats the purpose thereof. Non-financial corporate clients are not set up to deal with margining requirements and would ultimately borrow cash from the bank to deposit as IM which would create increased credit risk for the bank or alternatively would draw down deposits which again would impact on the bank.

The EBF therefore welcomes the exemption for transactions where the counterparty is a non-financial counterparty that does not have systemic importance. Such an exemption is most likely to ease the burden on both financial and non-financial counterparties and thus keep the focus and resources on those transactions that are more important in terms of systemic risk. However, in line with current market practice, bilateral posting of VM by sovereigns and central banks should be possible on a voluntary basis.

Any mandatory margin requirements should also clarify that counterparties would not be required to post margin unilaterally in the event that one of the parties is exempt from the requirements. In other words, the scope of the margin requirements should be limited to transactions in which both parties would be subject to them.

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?

A fundamental function of banks is to provide credit. Some of this credit is extended in connection with derivatives to hedge risk and in some circumstances the most appropriate hedging tools would be uncleared bespoke derivatives. Exempting such transactions with non-financial companies will not increase systemic risk, because the risk is already taken into account at the time the credit is extended. Prudential regulatory oversight already takes an aggregate view of these exposures, including both loans and derivatives.

Furthermore, the imposition of higher margining requirements in instances where there is no available approved clearing platform for the trade type would be punitive without promoting central clearing since it is not possible to clear such transactions. The desire to push the industry towards central clearing needs to be balanced against the availability of an appropriate industry wide infrastructure.

Small financial institutions that use derivatives solely to hedge risk should not be subject to mandatory initial margin requirements. Introduction of bilateral VM may be a suitable mechanism to address any perceived systemic risk.

Finally, there is an error in Q12: “intergroup” should be replaced with “intragroup”.

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 EBF notes that proposed measurement is based on a 99% confidence interval over a 10 days’ horizon. This is much more stringent than current practices of CCPs, which, unlike prudentially regulated entities, are not subject to the same capital requirements as prudentially regulated institutions.

The proposed approach in which participants may either use their internal, approved models or the standardised schedule is flexible enough to address the needs of different market participants. Counterparties should also be allowed to select external providers of margin calculations, and a counterparty without models should be able to elect using the models of their counterparty.

The EBF also notes that there are a variety of different IM models, including some that are based on stress testing scenarios or are or more rules based or account for portfolio margining. These models should be allowed too, including those that permit the margining between cleared and non-cleared transactions.

Furthermore, the schedule-based approach that is proposed should not be regarded as a minimum standard but rather as an alternative to the model-based approach.

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 across asset classes should be allowed wherever legally enforceable including for the standardised approach. Institutions that opt to use a simpler approach to calculating margin should not be penalized for using an approved methodology for calculating margin.

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?

The EBF believes that the standardised schedule for IM is too punitive. The level of standardised margins proposed in Appendix A is also materially higher than the current set of non-netted counterparty credit risk regulatory add-ons across asset classes. Any quantitative impact study will need to consider exactly how all participants would be impacted if the proposed margin requirements were implemented.

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?

Clarification as to the methodology for calculation of the VM is required. The netting rules as outlined could result in the derivatives market migrating to a much more standardised set of end-dates to maximise netting per product set – possibly focusing on trading particular dates as in the futures markets. This could limit the appetite for banks to provide risk management solutions to commercial customers outside the standard dates traded.

Additionally, given that a large portion of derivatives will be centrally cleared there is most likely going to be a negative impact on netting across the remaining (uncleared) book, implying increased VM.

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?

Daily exchange of collateral may be used when underlying positions can be meaningfully re-valued on a daily basis. However, this may not be done at a reasonable burden and cost in markets which are lacking observable price data. Therefore, the EBF believes that banks should have the flexibility and commercial ability to set the frequency of VM payments for instruments or markets that are less liquid.

Q18. Is the proposed framework for variation margin appropriately calibrated to prevent unintended pro-cyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?

The EBF opposes mandatory IM. Notwithstanding this, if BCBS-IOSCO does impose IM requirements the EBF agrees with the proposal that additional IM should be built up and managed over time in order to avoid procyclicality.

An individual bank's derivatives profile may vary. Significant liquidity calls due to stressed markets are mitigated by a bank's internal liquidity model. However, it is critical to strike the right balance between conservative margining on the one hand and the resulting effect on liquidity on the other hand. Being overly conservative in normal market conditions and periods of low volatility would pose extra pressure on liquidity.

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

This depends on counterparty size and its risk to the financial system. Minimum transfer amounts should be allowed to reduce operational risk and burden and should be part of the negotiations between counterparties.

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

The EBF believes that the appropriate approach to determining eligible collateral would be a principle-based approach where BCBS-IOSCO would create principles for maintaining collateral. The proposed list of eligible collateral might be appropriate if it is considered to be the minimum list of eligible collateral that parties can elect to use. There are other types of collateral that can be valued effectively, on a frequent basis, even in times of market stress. Using this type of standard for determining eligible collateral would create a system where the eligible collateral would not have to be based on exact asset classes. A broader list of collateral would also

minimize the impact of any extraordinary pricing shifts in the market for any particular type of collateral.

Non-financial counterparties may be liquidity constrained, since typical collateral supporting a borrowing relationship including swaps may include real estate, machinery, and other types of collateral. Derivatives with these types of collateral could be associated with any type of swap, including particularly a commodity swap. Currently these types of collateral are widely and successfully used as part of financing agreements. Requiring all derivatives to have a limited subset of cash and other financial instruments would make it difficult or impossible to enter into these CSA type of collateral agreements.

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?

The EBF believes 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 according to their risk management principles.

Regarding the standardized haircut proposed in the schedule:

- gold receives the same haircut as equity (15%) and is treated differently from FX (8%). The EBF notes that gold is generally considered a less-risky collateral than FX;
- 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.

If a more principle-based approach will be used, concentration limits may be added to the above list of criteria given the careful consideration of mobility or market condition of collateral in each country or jurisdiction.

Widely accepted methods exist to properly define haircuts. In the case of non-financial collateral, financial institutions have a strong tradition of sophisticated valuation methods, approved by the local regulatory authority.

Furthermore, the EBF would like to stress that the use of haircuts is connected to the collateral eligible for margining. If the type of collateral that is eligible is limited, then the use of haircuts becomes less important. If various types of collateral are eligible then the importance of applying the correct haircuts increases correspondingly.

Given that VM in different currencies and asset classes should be on a full net current exposure basis (as outlined on page 19 proposed requirements - variation margin), the EBF sees an incompatibility with currency based haircut proposed. We see this as problematic, as any given netting set consisting of more than one currency (variation margin) will be impossible to break up into its currency components to apply the FX haircuts.

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?

The EBF believes that the level of segregation should be the decision of the transacting parties. Universal mandated segregation requirements would lead to a number of unintended consequences, including:

1) introduction of new credit risk and concentration risk at the level of the key market participants;

2) uncertainty when counterparties from different jurisdictions are involved in a transaction and may be subject to different insolvency laws and regulations; For instance, depending on the jurisdictions, the transfer of the collateral could be based on different legal regimes regarding transfer in full title, pledge, re-hypothecation or not, etc. and an insolvency could be managed differently; and

3) Increasing the cost of transacting: it would dramatically inflate funding requirements and step up liquidity costs, operational costs and funding costs, driving non-financial counterparties away from effective hedging.

It should be mentioned that where client money and assets are segregated, any requirement to ensure that those assets are legally segregated from the entity receiving the collateral by placing them with a third party (i.e. a separate legal entity) should not be read as a ban on segregating the assets through affiliated entities. One of the reasons to act as such is that affiliated entities may have higher credit ratings and may be more financially robust than unaffiliated third parties. In that case, clients should not be forced to have their assets placed with a bank or custodian that poses a higher credit risk. Otherwise, forcing clients' assets to be placed with unaffiliated third parties may in fact increase the risk that counterparties are subjected to and therefore increase the overall level of systemic risk in the derivatives markets.

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?

The EBF believes that any restriction of offsetting counterparty collateral would unnecessarily tie up capital and create liquidity risk. Notwithstanding this, if any requirement to exchange

margin on a gross basis is proposed then it should be clarified that any requirement to exchange IM on a gross basis can be done on a portfolio basis. In other words, the calculation of IM might need to be done by each party on a net basis and exchanged without an offset for the margin calculated by the counterparty. Any alternative interpretation would negate widely accepted practices for effective risk mitigation such as netting and diversification.

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 pledge 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?

With VM, re-use of collateral is a common practice in arrangements providing full title transfer as it reduces transaction costs. Currently collateral is transferred on title of transfer basis and the transferee has a right to re-use received collateral accordingly.

It is important to distinguish between IM and VM. In a sense, the IM posted remains the property of the posting party unless they default, so it makes sense to segregate IM and to prevent its re-hypothecation provided both parties agree; naturally this would come at a cost compared to allowing re-hypothecation. VM is the receiver's profit on the trade and the payer has no further claim on it so it is perfectly appropriate for the receiver to re-hypothecate or re-use VM.

If re-use is fully prohibited, there will be a substantial drain of liquidity from the markets which will consequently be restrained in their capacity and could ultimately trigger negative consequences. A liquidity trap would be induced as several billion Euro/dollars of collateral (cash, securities...) would be immobilised to prevent potential systemic risk, whereas new rules concerning capital have already been put in place to protect financial institutions from systemic risk.

In addition, regulation cannot simultaneously require highly liquid and high quality assets as collateral while immobilising the assets possessing these features. If collateral management cannot be used to help market participants in supplying the eligible types of collateral, they will not be able to enter into such transactions and the functioning of the market as a whole will be impacted.

Furthermore, it is necessary to consider the difference of bankruptcy act or civil law among countries or jurisdictions.

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?

Intragroup transactions should be exempt from IM requirements in order to ensure efficient group-wide risk management. Transactions within the same group are executed for reasons of sound risk management. Imposing mandatory posting of IM would create liquidity issues, increase exposure of one entity to another, and discourage centralized risk management. Affiliate transactions are distinctly different from swap transactions with third parties because affiliate counterparties have better information about each other and can take action more quickly as needed to make a collateral call or unwind a swap.

Where jurisdictions do not recognise the joint liability arrangements discussed in the paragraph above, the posting of VM should not be required if the group meets the requirements of the relevant supervisory authority such that there is an appropriate risk evaluation, measurement and control, that the affiliates are subject to the same consolidation and that there are no current or foreseen material or practical legal impediments to the prompt transfer of own funds or repayment of liabilities between counterparties.

If proposals were to be implemented such that VM needed to be posted, there may be occasions when a subsidiary might need to borrow the collateral from the parent in the first instance. In such circumstances, the exposure of the parent to its subsidiary is simply changed from being one of a derivatives exposure to a loan of cash or collateral. What is therefore more important is the understanding of the type and size of exposures between entities with the group rather than the actual posting of VM. In the same context, if IM were to be required then that would potentially increase the exposure of one entity to another rather than reduce the risk. This could be further complicated in cross-border intra-group derivatives transactions where both regulators might require the posting of IM.

Taking all of these factors into account as well as the significance of transactions between affiliated entities to manage risk, the EBF proposes that BSBC-IOSCO not require IM for these transactions.

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?

No. As recognised by the commentary to the consultation, risks may grow in transactions that are done between affiliates located in different jurisdictions. However, as global legislation should not discriminate between if a company is national or multinational, such differing requirements should not be made based on nationality.

A more flexible and fair approach would be to introduce a threshold with regard to the size of the entity. Such threshold would need to be adjusted according to the systemic importance of that entity.

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?

Consistency with rules of other jurisdictions is very important to level the playing field in the global marketplace. Introducing mandatory margin requirements in jurisdictions where netting and/or standard collateral documentation such as ISDAs are not enforceable might actually increase risk because bankruptcy laws could introduce the possibility that counterparties could lose any posted collateral.

Legal regimes in many emerging markets do not support either netting or market standard collateral arrangements. Consequently, until such time as these legal regimes provide the necessary legal protection - both when receiving collateral and posting it - it will not be possible to comply with the BCBS-IOSCO proposals. Indeed, any obligation to post collateral will perversely create greater risk as firms would not necessarily be protected upon the counterparty's insolvency. Even emerging market jurisdictions that support netting and collateral arrangements may not implement these rules fully or to the standards of more developed markets. This may create an uneven playing field for global firms, especially as it is disproportionately more expensive to margin in emerging market jurisdictions. Sourcing collateral where repo markets are less developed and underlying government bonds are less liquid is costly.