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**Re: Response to the consultative document on" Margin requirements for non-centrally cleared derivatives" issued by the Basel Committee on Banking Supervision and the Board of the International Organisation of Securities Commissions in July 2012.**

**Background:**

Thank you for the opportunity to respond to the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") with respect to the Consultative Document "Margin requirements for non-centrally-cleared derivatives" of July 2012.

I am responding on behalf of European Bank for Reconstruction and Development (EBRD or the Bank), which is a triple-A rated International Financial Institution (IFI). EBRD, in common with other triple-A rated IFIs and Multilateral Development Banks (together MDBs), is an active user of bilaterally traded over-the-counter ("OTC") derivatives since the early 1990s, and has, for several years, been able to hedge the risks inherent in exotic and complex bond issuance through the bilateral OTC derivatives market, thereby widening the scope of the Bank's funding instruments, investor base and investment universe, and thus improving the cost of funding, the ability to provide financing in its countries of operations at rates that would not be otherwise available, and investment returns. EBRD has also been able to facilitate the hedging of risks for its clients by structuring loans to minimise project risks, including by fixing or capping rates on amortising structures, by hedging a project's sensitivity to inflation or commodity prices, and by offering local currency loans to non-exporters. All such client hedges are fully offset with the market, for which the OTC derivatives market is usually the sole provider.

EBRD currently has approximately 1,700 outstanding OTC derivatives trades with 48 counterparties with whom we have ISDA Master Agreements and Credit Supports Annexes ("CSAs") under which we can call collateral daily. Under the terms of EBRD's CSAs, as EBRD is triple-A rated by the three referenced rating agencies, we do not currently post collateral. Were the Bank's collateral agreements to have required the Bank to post collateral against its bilateral derivatives transactions that were in favour of the counterparty, over the last few years the Bank would have needed to post close to USD 1 billion in US Treasuries, other triple-A government bonds, or cash. This sum could rise exponentially with changes in interest rates and foreign exchange rates.

If, as is currently proposed, margin requirements are imposed and the capital charges for bilateral OTC derivatives are raised to discourage non-standardised trades as well as trades outside a CCP, the costs are likely to be passed on to the end-user. Of EBRD's total derivatives portfolio of USD 90 billion (by notional amount), only USD 27 billion are vanilla interest rate swaps in major currencies. Even an increased charge of 1 basis point on EBRD's "non-standardised" trades would equate to a cost of USD 39.1 million, and the proposed charges are considerably in excess of this.

Under the current consolidated text of EMIR, the MDBs are not subject to its clearing and bilateral risk management requirements. This not only recognises their high credit quality, but also their role in economic and social development, and their ownership and governance structure. If, however, margin requirements (as well as capital charges under CRD IV) for bilaterally traded derivatives are significant, and include transactions with MDBs, we are concerned that these key institutions will be exposed to increased liquidity and credit risks as well as costs on derivative transactions that are solely used to hedge assets and liabilities. These effects may impede our ability to borrow from a diverse investor base, to offer our clients appropriate hedges, and to support the development of domestic capital markets and local currency financing in accordance with the G20 action plan. We may also be forced to refrain from offering our clients many of the hedges and local currency loans that we currently engage in, or find that the significant additional cost of such hedges discourages our clients from minimising their risks.

We would also note that, in relation to both margin requirements and capital charges, were EBRD and other MDBs not to be exempt, there would be a marked incongruity between the treatment of our bonds and that of our swaps. In recognition of our sovereign shareholders, special status, and excellent credit quality, our bonds are 0%- risk weighted assets under both the Basel framework and the proposed CRD IV (Article 112.2), whereas our swaps, which have the additional benefit of being subject to netting under an ISDA Master Agreement as well as posting collateral were we to be downgraded below triple-A, would be treated as riskier instruments.

If EBRD were not deemed exempt from the requirement to post initial margin and variation margin, this would have significant implications for the EBRD's liquidity position. In common with all MDBs, bar EIB, as non-banks, we do not have access to a lender of last

resort to cover these margining requirements. We would therefore likely need to increase our long-term borrowings to cover collateral requirements.

In addition to the liquidity implications, any requirement to post initial and variation margin will significantly increase the level of credit risk and costs that EBRD would be exposed to, both because of the requirement to post collateral to less well rated entities than EBRD, but also because additional liquidity raised in advance to ensure the ability to post in the future would need to be placed in the market either at a loss or with less-well rated entities.

**<u>Executive Summary:</u>**

- **There is a need for further analyses before imposing margin requirements**:
  We are concerned about the impact of imposing margin requirements in terms of the sufficiency of collateral overall; the likely affects of this massive additional collateral demand on institutional investors both in terms of the availability of high-grade investment instruments and their returns; the likely effect on emerging markets (and probable increased pressure of "Balkanisation" of such markets) because of the lack of access to acceptable collateral; as well as the rising costs, credit and liquidity risks for end-users and thus the effect on the real economy.

  We believe that it is premature to impose the proposed requirements without assessing these consequences more fully (including the combined effects of the mandatory clearing requirement, Basel III and this proposal).

- **The scope of the proposal should exclude all end-users of derivatives for hedging purposes:**
  The exclusion would thereby cover EBRD and the MDBs in addition to the proposed exemptions for sovereigns and central banks. Indeed, were a full impact assessment to reaffirm estimates of a collateral requirement of approximately USD15 trillion to cover proposed margin requirements for non-cleared OTC derivatives, serious consideration should be given to limiting the scope of the proposal solely to trades between systemically important financial institutions. This is logical not only because this is substantially where systemic risks reside, but to the extent that such institutions have access to a lender of last resort, the liquidity and operational risks associated with significant increased collateralisation are thereby minimised.

  Furthermore, the current proposal seeks to eliminate or significantly reduce the credit risk that systemic banks are taking - although managing credit risks is fundamentally the business of banks - by transferring these risks to MDBs and other hedging end-users in the form of liquidity, credit and operational risks that is not their primary business.

  The significant costs associated with the proposal, together with proposed increased capital charges for uncleared derivatives will likely limit the availability of and demand for appropriate hedging instruments, thereby increasing systemic risks.

**<u>Responses to the Discussion Paper's Questions:</u>**

## Q1.

***What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives?***

We believe that there should be a full analysis of the impact before implementation of margin requirements for non-cleared swaps, as the imposition of IM may imply a significant shortage of appropriate collateral. The assessment should not only include an understanding of total collateral requirements both for uncleared and cleared derivatives, but also the liquidity risks for all counterparties who do not take in deposits and who do not have a lender of last resort (if it is envisaged that any such entities be covered by this regime). There should also be an assessment of the risks to the development of local capital markets and local currency funding and hedging for emerging economies if collateral requirements and capital charges are onerous (noting that the availability of collateral and shortage of capital are generally omnipresent in emerging markets.)

There will need to be delays to cover the approval time for models that cover margining requirements. Furthermore, issues associated with the collection and exchange of collateral, such as segregation, rehypothecation rights, and the bankruptcy resolution regimes are critical to ensure that systemic risks are not increased by these measures.

***Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated?*** We believe that the same issues as noted above in relation to collateral requirements, margining, segregation, bankruptcy resolution and liquidity risks of margining for those without a lender of last resort pertain to the central clearing requirement, and therefore both should be subject to an appropriate study of the risks and challenges before implementation.

***If coordination is desirable, how should this be achieved?***
We believe that the margin for non-cleared derivatives should mirror that for cleared derivatives by appropriate type. In the absence of global bankruptcy rules, the resolution regime for bilateral trades executed in legal and regulatory regimes that recognise netting and collateral arrangements is likely to be better understood, and therefore systemic risk will be minimised. Following appropriate changes to bankruptcy resolution, requirements can be reassessed and tweaked to favour central clearing.

**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?***

Foreign exchange (FX) risks can be managed through an FX catch-all clause in the CSAs and through the use of Continuous Linked Settlement ("CLS") to limit the main risk in FX trades – settlement risk. Therefore such appropriately managed FX trades below 1-year should be exempted from margin requirements.

***Are there any other arguments to support an exemption for foreign exchange swaps and forwards?***

The U.S. Treasury has proposed exempting FX swaps and forwards from margin requirements, and it is important to provide consistent treatment across all jurisdictions.

**Q3.**

***Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered?***

As alluded to earlier, the imposition of margin and capital requirements for non-cleared trades is likely to significantly reduce the availability and/or make appropriate heging prohibitively expensive for end users, while also introducing additional liquidity, credit and operational risks. This is likely to be even more pronounced for end-users in emerging markets. Where an end-user, who is unlikely to be the source of systemic risk, can pass on the additional costs, their customers will be paying the increased charges that are intended to cover systemic risks. This is not only likely to harm the real economy, but seems no more acceptable than tax payers bearing the cost of systemic risks in the banking system.

***How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?***

We believe that, were regulators to focus the margining and capital requirements on OTC derivatives traded between systemic banks and other financial institutions that do not use derivatives purely for hedging purposes, this would ensure that the major systemic risks are monitored and managed without imposing significant risks to end users and therefore to the real economy.

**Q4.**

***Is the proposed key principle and proposed requirement for scope of applicability appropriate?***

The proposal to exclude sovereigns and central banks should be extended to multilateral development banks (MDBs) such as EBRD, who are also excluded from the scope of EMIR. We think that non-financial entities that are not systemically-important should be exempted from the scope of applicability.

The imposition of margin requirements in respect of non-cleared swap transactions of EBRD and other MDBs could be seen as amounting to an attempt to interfere with the governance of such MDBs, a matter ultimately under the control of their collective memberships, and as such would be inconsistent with the privileges and immunities bestowed upon them. An attempt to interfere with the governance of MDBs would represent a serious intrusion and a deviation from the pattern of expressly or implicitly exempting them from regulation. MDBs have been able to fulfil their mandate on a global basis with the understanding of governments that national regulatory regimes were not intended to apply to their activities - for example the United States has a consistent record of regulatory forbearance with respect to MDBs.

As to the EBRD in particular we refer to the Agreement Establishing the European Bank for Reconstruction and Development, an international treaty entered into on 29 May 1990, which establishes the EBRD (the "AEB"). The European Union as well as all EU member states are among the 65 members of the EBRD and hence, as a matter of public international law, are bound by the provisions of the AEB. Under the AEB, to enable EBRD to fulfil its purpose and functions, EBRD is accorded certain privileges, immunities and exemptions, including: that no actions may be brought against the EBRD by or deriving from its members; that its assets are to be free from restrictions, to the extent necessary for it to carry out its purpose and functions, and from seizure, attachment or execution before delivery of final judgment against it as well as from taking or foreclosure be executive or legislative action. Comparable provisions can be found in the international treaties establishing the other MDBs.

Without such privileges, immunities and exemptions, the ability of MDBs to accomplish their mandate would be diminished through their being exposed to the risk of interference by a host of national legislators.

The imposition of margin requirements on MDBs would have detrimental effects on the ability of the MDBs to carry out their objectives and upon their freedom to deploy their assets, without such requirements being necessary or providing corresponding benefits, in light of the MDB's non-systemic importance, their existing governance arrangements though their collective membership and their relative credit strength.

***Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact?***

To the extent that sovereigns, central banks, MDBs and end-users using derivatives for hedging purposes are exempted from the requirement to centrally clear standardised derivative contracts, promotion of central clearing to such entities is not relevant. Furthermore such entities, who use derivatives solely as hedging tools, are not adding to systemic risks. To the contrary, inclusion of such entities in the scope of the proposed requirements will likely impose significant liquidity, credit and operational risks that they cannot manage as well as significant additional costs.

The significant increase in demands for additional collateral and the requirement that the collateral remain segregated and not re-hypothecated, will likely cause additional systemic risks (especially in the absence of global bankruptcy rules), as well as costs to the global economy.

***Are there any specific adjustments that would more appropriately balance these goals?*** Were regulators to insist on collateralisation by end-users, we believe that a system that provides considerable thresholds for end-users (including unlimited thresholds for the strongest "triple-A entities) before a requirement to post collateral is triggered, but which recognises any deterioration of the credit risk of such institutions in small incremental steps would balance goals appropriately. Thus initial margin would reflect the riskiness of the counterparty, so that those that are most highly rated pay less as a proportion than those that are less-well rated. The step changes should be small, ideally reflecting each rating notch so that there is no dramatic change from one day to the next, which may exacerbate pro-cyclicality. (n.b. EBRD's CSA agreements require entities rated AA+/Aa1 or lower to post collateral with the thresholds reducing at each rating level until fully collateralised. Thus, when other banks were calling AIG for collateral during the crisis for the first time, EBRD was already appropriately collateralised, having started to call collateral two years prior. The problem with AIG was not that triple-A rated entities don't post collateral, but that they had not been asked to post collateral by their counterparties until long after they had been downgraded below triple-A. At that time, the step change was too large.

***Does the proposal pose or exacerbate systemic risks?*** As noted above, inclusion of end-users using derivatives as hedging tools, who have no lender of last resort within the scope of the proposed requirements will likely impose significant liquidity, credit and operational risks that they cannot manage as well as significant additional costs. Furthermore, the significant increase in demands for additional collateral and the requirement that the collateral remain segregated and not re-hypothecated, will likely cause additional systemic risks (especially in the absence of global bankruptcy rules), as well as costs to the global economy. We may also see that institutional investors will have less easy access to the most creditworthy instruments because of a shortage of collateral, which is also likely to drive down the yields of such collateral.

Where costs and risks are deemed too high for end-users, they will likely not hedge, increasing their vulnerability to market prices. In the case of emerging markets, any deterrent from developing appropriate local currency hedging instruments is likely to increase dollarisation/euroisation of the economy affecting the retail, and institutional markets alike. This, in turn, limits the effective policy levers of the central bank to regulate an overheating or underperforming domestic economy.

*.**Are there any logistical or operational considerations that would make the proposal problematic or unworkable?***

The major factors that make the proposal problematic/unworkable are the requirements for those without easy access to collateral and/or a lender of last resort to post collateral; the need for such collateral to be appropriately segregated; the overall shortage of appropriate collateral; the absence of global bankruptcy rules; and the increased costs for non-systemic counterparties that may deter them from hedging.

## Q5.

***Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements?***
The use of thresholds is an appropriate tool for mitigating the adverse liquidity impact of the proposed requirements, provided that threshold levels are set high enough. We recommend that market participants be allowed to set thresholds that reflect credit quality, counterparty type, trade category, as well as their own internal capital requirements, and liquidity and risk appetite.

It should also be recognised that, (unlike the situation pertaining to a CCP), in a bilateral derivatives framework, a non-defaulting counterparty has no obligation to replace defaulted contracts with a new ones, thus reducing the need for IM , ad even more so where the bilateral contracts are subject to netting.

***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?***

We recommend that market participants be allowed to set thresholds that reflect credit quality, counterparty type, trade category, as well as their own internal capital requirements, and liquidity and risk appetite. Financial institutions are and indeed should be in the business of making credit decisions in relation to the amount of unsecured risk that they are willing to extend to a given counterparty for a certain type of trade. This should be no different.

***Is the use of thresholds inconsistent with the underlying goals of the margin requirements?***
The use of thresholds is not inconsistent with the underlying goals of the margin requirements, as the stated objective is to enhance protection against counterparty credit risk, and not to eliminate such risk all together irrespective of the costs to the global economy and market liquidity.

***Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance?***
Implementation of differing threshold levels in different jurisdictions would encourage regulatory arbitrage. Where the threshold level is determined by a financial institution's risk appetite, this should not be the case.

***If so, are there steps that can be taken to prevent or limit this possibility?*** Efforts by the BCBS/IOSCO to promote a consistent global approach would prevent or limit regulatory arbitrage.

**Q6.**

***Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements?***
As aforementioned, market participants should be allowed to set thresholds that reflect credit quality, counterparty type, trade category, as well as their own internal capital requirements, and liquidity and risk appetite.

***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?***
As noted earlier, the credit quality of the counterparty should largely determine this, but where it is intended that the counterparty may be required to post collateral, this should be done in small incremental steps to mark changes in credit deterioration rather than a zero threshold that persists from triple-A to single A, when full collateralisation is suddenly required (as in the AIG case).

***Would the use of thresholds result in an unlevel playing field among market participants?***
We believe that this cost, which primarily covers the risk of default, should not be uniform across counterparties irrespective of rating, as the likelihood of a triple-A rated supranational defaulting is significantly lower than that of other less well-rated counterparties.

If all counterparties are required to be margined equally, irrespective of credit rating, this may increase the amount of business that less well rated entities may undertake, and decrease the exposure that better rated counterparties would be allowed (by their internal risk management) to take, creating new systemic risks. This would be in direct contrast to the more rational position that exists currently for bilateral trades, which sees counterparties impose low or no thresholds on more vulnerable counterparties.

***Should the systemic risk posed by an entity be considered a primary factor?***
Systemic risk, posed by an entity should indeed be a key consideration in the margin framework for OTC derivatives.

***What other factors should also be considered?***
As aforementioned, credit quality, counterparty type, trade category, as well as a market participant's own internal capital requirements, and liquidity and risk appetite should be considered.

***Can an entity's systemic risk level be meaningfully measured in a transparent fashion?***
To the extent that regulators have already developed criteria for establishing whether an entity is systemically important, it is hard to see how this question could be answered in the negative.

***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?***

Over and above the regulators' criteria for establishing whether an entity is systemically important, the volume of an entity's activities in non-centrally-cleared derivatives that are not exact hedges of their balance sheet exposure is also a factor in determining whether an entity is systemically important – especially where they become a "price-maker" not just a "price-taker), as was the case with AIG.

***Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?***

Notional amount is not by itself a determinant. It is more to do with unhedged balance-sheet exposures and the "price-making" function.

## 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?***

Yes, assuming consistent application for foreign entities.

## Q8.

***How should thresholds be evaluated and specified?***

As previously stated, we believe that thresholds should not be specified by regulators, but rather should be set by the market participant to reflect credit quality, counterparty type, trade category, as well as their own internal capital requirements, and liquidity and risk appetite. They should also reflect the documentation in place i.e. ISDA Master Agreements that allow for netting.

## 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?***

As stated in response to Q4, the imposition of universal two-way margining would see the inclusion of end-users using derivatives as hedging tools, who have no lender of last resort. This will likely impose significant liquidity, credit and operational risks that they cannot manage as well as significant additional costs.

Furthermore, the significant increase in demands for additional collateral and the requirement that the collateral remain segregated and not re-hypothecated, will likely cause additional systemic risks (especially in the absence of global bankruptcy rules), as well as costs to the global economy. We may also see that institutional investors will have less easy access to the most creditworthy instruments because of a shortage of collateral, which is also likely to drive down the yields of such collateral.

Where costs and risks are deemed too high for end-users, they will likely not hedge, increasing their vulnerability to market prices. In the case of emerging markets, any deterrent from developing appropriate local currency hedging instruments is likely to increase dollarisation/euroisation of the economy affecting the retail, and institutional markets alike. This, in turn, limits the effective policy levers of the central bank to regulate an overheating or underperforming domestic economy.

***How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives?***

The current practice for MDBs such as EBRD is that we are exempt from the requirement to collateralise, in recognition of our triple-A rating. Where our counterparties are also triple-A rated, (which is extremely rare), they would also not post collateral to us. Therefore we would be required to post collateral to less well-rated entities than ourselves, thereby increasing our credit risk. If thresholds are pre-specified by regulators and universal, this credit risk is more pronounced, as it will not take account of the credit differential between ourselves and our market counterparties. In addition, it may mean that we receive more collateral from our counterparties, if we cannot specify a threshold below which they do not have to post collateral. Whilst this may be viewed as a reduction in our credit exposure, it is important to note that, at the current time, most counterparties have a preference to post cash collateral rather than securities. This cash, on which we are required to pay interest according to market rates, poses additional credit risks for us.

The liquidity risks for non-deposit taking institutions with no lender of last resort such as the EBRD and other MDBs have been mentioned in response to earlier questions. It is perhaps also worth noting that the liquidity risks for MDBs in posting collateral are flagged in Standard and Poor’s July 2012 paper “Multilateral Lending Institutions and Other Supranational Institutions Ratings Methodology”.

***Are there practical or operational issues with respect to universal two-way margining?***

Most OTC derivative market end users are neither set up to collect collateral, nor to post it. Universal two-way margining would therefore give rise to significant additional costs and risks.

## 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?***

We believe that requiring regulated entities particularly systemically important ones - to post IM to unregulated counterparties would likely increase systemic risk. As mentioned above, not only are end users not set up to collect collateral, but regulated entities are also subject to minimum capital requirements, which is also largely covering the same risks. Therefore this appears (superficially) to be a "belt and braces" measure, but in fact is one which undermines stability rather than increasing it.

***Does this specific requirement reduce, create, or exacerbate systemic risks?***

As noted above, it will increase systemic risks. Most OTC derivative market end users are not set up to collect collateral nor indeed to hold it in segregated accounts. They would also be required to post a return on collateral held further increasing the management challenges.

***Are there any logistical or operational considerations that would make the proposal problematic or unworkable?***

Most OTC derivative market end users are not set up to collect collateral nor indeed to hold it in segregated accounts. They would also be required to post a return on collateral held further increasing the management challenges. Furthermore, if such end-users are required to post collateral, this may drive them back to bank counterparties seeking the transformation of non-standard collateral types through repo lines, which merely re-categorises the exposure, but does not diminish it. Where repo lines are uncommitted, they will be especially vulnerable in stressed market conditions, thereby increasing systemic risks.

## Q11.

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

Under the current consolidated text of EMIR, and in addition to non-systemically important financial entities, sovereigns, and central banks, MDBs are not subject to its clearing and bilateral risk management requirements. In relation to the MDBs, this not only recognises their high credit quality, but also their role in economic and social development, and their ownership and governance structure. If, however, margin requirements were to be imposed on bilaterally traded derivatives with MDBs, we are concerned that these key institutions will be exposed to increased liquidity and credit risks as well as costs on derivative transactions that are solely used to hedge assets and liabilities. These effects may impede our ability to borrow from a diverse investor base, to offer our clients appropriate hedges, and to support the development of domestic capital markets and local currency financing in accordance with the G20 action plan. We may also be forced to refrain from offering our clients many of the hedges and local currency loans that we currently engage in, or find that the significant additional cost of such hedges discourages our clients from minimising their risks.

Moreover, imposing margin requirements on entities such as MDBs would be the economic equivalent to having to clear trades, and this is a curious result as MDBs are exempt from clearing.

**Q13.**

***Are the proposed methodologies for calculating initial margin appropriate and practicable?***

The proposed methodologies for calculating IM seem inappropriate and impracticable. They do not take account of credit differentials or netting across asset classes. There may also be significant delays associated with the approval of internal models. Furthermore, it may be very difficult to ensure agreement between counterparties on IM valuations in a timely manner.

***With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate?***

Please see above.

**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?***

We believe that model-based initial margin calculations should not restrict diversification benefits to be operative within broad asset classes but should allow for diversification benefits across asset classes, where the legal regime supports netting and offsetting.

***If not, what mitigants can be used to effectively deal with the concerns that have been raised?***

As noted above, we believe that the benefits of netting should be factored in across asset classes.

**Q15.**

***With respect to the standardised schedule, are the parameters and methodologies appropriate?***

The proposed standardised schedule is applied on gross notional amounts, rather than net notional amounts, thereby significantly over-estimating margin requirements.

***Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated?***

The proposed parameters overstate the risks covered by the IM calculation.

***Are they appropriately risk sensitive?***
As above.

***Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?***
As above.

**Q16.**

***Are the proposed methodologies for calculating variation margin appropriate?***
Variation Margin ("VM") like IM needs to recognise the benefits of netting under an ISDA Master Agreement.

***If not, what approach to the calculation of baseline variation margin would be preferable, and why?***
As above.

**Q17.**

***With what frequency should variation margin payments be required?***
Daily margining should be required for all systemically important entities and regulated financial institutions. For all other counterparties, it should be determined between the parties themselves.

***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?***
As noted above, we believe that less frequent posting should be acceptable if agreed between the parties, except where both parties are systemically important entities.

**Q18.**

***Is the proposed framework for variation margin appropriately calibrated to prevent unintended pro-cyclical effects in conditions of market stress?***
We do not believe that two-way exchange of VM is appropriate for end-users that do not have a lender of last resort and easy access to collateral, as this will pose significant liquidity risks. It will also add to the shortage of appropriate collateral.

While BCBS/IOSCO flag the risk of disputes given the relative complexity and illiquidity of the instruments, we would note that during Lehman's default, EBRD found valuations of the more complex and illiquid transactions that were very much within the mark-to market valuations we had assessed and against which we held appropriate levels of collateral. Increasingly, however, the complexity and lack of clarity with regard to the regulatory reform of derivatives is giving rise to a wide disparity of market quotations and

significant uncertainties. Therefore the effective level for replacing a transaction has become much less transparent over the last two years.

***Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?***
The "cliff-edge effect" occurs during times of increased market stress, when margin requirements may be increased to reflect the increased riskiness, thereby adding to pro-cyclical liquidity pressures. Where thresholds diminish in small increments according to credit rating, and where the thresholds reflect each bank's risk appetite and credit view, pro-cyclicality is minimised. This creates greater stability than the situation for cleared trades. We are concerned that CCPs exacerbate cyclical flows in stressed conditions, by demanding significantly greater margins to reflect a marked increase in market volatility and worsening of credit concerns. We have noted, for example, that widening credit spreads have in the past been cited as a reason that a CCP has required greater margins on particular bonds cleared, which in turn triggered selling of the very bonds widening spreads further, subsequent to which the rating agencies cited the widening of spreads and market volatility as a reason to take rating action, which further reinforced the cycle. In relation to the clearing of derivatives, the same process could be even more amplified given the reflections of stress in the mark-to-market of the swaps, credit stresses of clearing members, and the value of bond collateral.

## Q19.

***What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?***
Given the need for regulatory consistency, we believe it wise to reflect the CFTC's proposed minimum transfer amount of $100,000 equivalent.

## Q20.

***Is the scope of proposed eligible collateral appropriate?***
The parties themselves should determine what collateral they are willing to accept, and what haircuts they should apply, as they will need to take into account such factors as the governing law of their ISDA Master Agreement, the jurisdiction of the counterparties, potential limitations for wrong way risk etc. It is also important that liquidity of collateral should not be judged in terms of how much an asset trades, but rather by its high credit quality (preferably triple-A rated, but this could include high double-A rated government bonds in the largest most liquid markets. A determinant of liquidity in addition to the rating is the acceptance of the relevant bond for repo with the ECB or a central bank in a country rated at least double-A.) In this context, bonds issued by EBRD and other MDBs should be incorporated in the proposed list of eligible collateral.

***If not, what alternative approach to eligible collateral would be preferable, and why?***
As noted above, the parties themselves should determine what collateral they are willing to accept, and what haircuts they should apply, as they will need to take into account such

factors as the governing law of their ISDA Master Agreement, the jurisdiction of the counterparties, potential limitations for wrong way risk etc.

As previously mentioned, most OTC derivative market end users are not set up to collect collateral nor indeed to hold it in segregated accounts. They would also be required to post a return on collateral held further increasing the management challenges. Furthermore, if such end-users are required to post collateral, this may drive them back to bank counterparties seeking the transformation of non-standard collateral types through repo lines, which merely re-categorises the exposure, but does not diminish it. Where repo lines are uncommitted, they will be especially vulnerable in stressed market conditions, thereby increasing systemic risks.

**Q21.**

***Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility?***
We believe that the counterparties themselves should be allowed to determine their risk appetite and thus concentration limits based on their assessments of the enforceability of netting, the specificities of the credit, and the governing law.

***If so, what types of specific requirements would be effective?***
As above.

***Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative?***
The proposed standardised haircut schedule ignores the effect of netting, and therefore significantly overstates the risks.

***Are they appropriately risk sensitive?***
As above.

***Are they appropriate in light of their potential liquidity impact?***
As noted above, the parties themselves should determine what haircuts they should apply, as they will need to take into account such factors as the governing law of their ISDA Master Agreement, the jurisdiction of the counterparties, potential limitations for wrong way risk, etc.

***Are there additional assets that should be considered in the schedule of standardised haircuts?***
As above.

**Q22.**

***Are the proposed requirements with respect to the treatment of provided margin appropriate?***
The proposed requirements with respect to the treatment of provided collateral are not

fully appropriate, because setting margin requirements on a gross, rather than a netted basis overstates risks, and will aggravate the likely collateral shortage.

The requirement to segregate, and not re-hypothecate collateral risks adding to the squeeze on available collateral. These requirements are more important in a CCP in the absence of global (or even EU-wide bankruptcy rules) and where the CCP has no lender of last resort, but for bilateral trades between regulated financial institutions in known jurisdictions, the relevant risks associated with insolvency regulations can be more easily assessed. For such entities, the questions of segregation and re-hypothecation of collateral should be subject to mutual agreement.

***If not, what alternative approach would be preferable, and why?***
As noted above, we favour allowing the decisions on segregation and re-hypothecation of collateral for bilateral trades between regulated financial institutions to be subject to mutual agreement. This not only recognises their greater ability to assess the relevant risks associated with insolvency regulations, but also the fact that they will have access to central bank liquidity if there are substantial delays in recouping collateral in the event of a counterparty default.

Segregation of cash collateral is important given its fungibility.

***Should the margin requirements provide greater specificity with respect to how margin must be protected?***
In the absence of global bankruptcy legislation, the regulatory push for increased collateralisation may not reduce systemic risk significantly (or at all), while significantly adding to liquidity pressures and driving costs and credit risks higher especially for non-systemic end-users.

***Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?***
As previously noted, the proposed key principle and proposed requirement are likely to create a shortage of collateral by overstating the risks, and potentially requiring non-systemic end-users to collateralise, which will significantly add to their liquidity and credit risks as well as costs, but will not reduce systemic risks in the absence of global bankruptcy rules.

**Q23.**

***Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate?***
No. Where the legal basis for netting and offsetting exists, margining should be based on netted exposures.

***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?***
Yes, unless the current circumscribed group of banks specialising in custody is extended significantly.

**Q24.**

***Should collateral be allowed to be re-hypothecated or re-used by the collecting party?***
IM collateral should be held in segregated accounts at third party custodians without the opportunity for re-hypothecation. VM collateral between regulated financial counterparties should be subject to agreement between the parties.

***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?***
It is hard to generalise, as it will depend on the jurisdiction.

***What would be the systemic risk consequences of allowing re-hypothecation or re-use?***
There are systemic risk consequences in allowing re-hypothecation, especially if the counterparty has no access to a lender of last resort to cover liquidity pressures arising from delays in recouping collateral. There are also systemic risk consequences in not allowing re-hypothecation, especially between regulated financial institutions, given the likely shortage of appropriate collateral.

**Q25.**

***Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate?***
Non-centrally cleared derivative trades between affiliated entities should not be subject to margin arrangements especially where the affiliate is governed by rules and supervision that is largely consistent with the finalised rules.

***If not, what alternative approach would be preferable, and why?***
As above.

**Q26.**

***Should an exchange of variation margin between affiliates within the same national jurisdiction be required?***
Yes.

## Q27.

***Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate?***

It is important that regulatory regimes should be largely consistent across jurisdictions to create a level playing field, and should not impose additional or duplicate margin requirements for non-cleared derivatives. It is vital that the rules governing cross-border trades are well understood, so that it is clear which regulatory regime defines the margining requirements. (The greater the harmonisation, the less the governing regime is material.)