European Fund and Asset Management Association

EFAMA's RESPONSE TO BCBS/IOSCO CONSULTATION ON MARGIN REQUIREMENTS FOR NON-CENTRALLY-CLEARED DERIVATIVES

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 57 corporate members approximately EUR 14 trillion in assets under management of which EUR 8 trillion was managed by approximately 54,000 funds at the end of 2011.

Thank you for giving us the opportunity to submit evidence on the consultation on Margin requirements for non-centrally-cleared derivatives. The present reply first sets out some general comments (see Section I hereafter) before commenting the various principles of the Consultation Paper (please refer to Section II below).

I. General Comments

EFAMA welcomes as very positive and fully supports the initiatives aimed at enhancing safety and transparency in the over-the-counter derivatives market.

Although we agree with many key ideas, principals and requirements, we wish to submit the following general remarks before providing our answers to the consultation (see Section II).

As per the presentation made at the roundtable on margin requirements held on 7 September, we would like to highlight the following elements:

1. <u>Scope of coverage and scope of applicability</u>

EFAMA support the BCBS / IOSCO proposal regarding the scope of coverage and scope of applicability.

However, EFAMA is in strong disagreement that asset managers should post and collect initial margins (IM). Funds (especially UCITS or other regulated funds) are subject to stricter rules than other financial institution and will not materially contribute to systemic risk. Due to their very low risk of default, the funds should be exempted from posting initial margins.

As explained in the answers to the questionnaire, the exchange of IM would also create severe liquidity issues for several ranges of investment funds' structures and would not cover the counterparty risk.

Additionally, we believe that some precision or exemption should be clarified:

- In the terms used in the questionnaire, we wish to remind that the aim is not to cover all derivatives: either centrally cleared OTC instruments and listed derivatives should be clearly excluded of the current scope or the consultation's definition should be adapted; and
- FX Swaps and FX Forwards mentioned in the consultation document should be excluded in order to maintain level playing-field amongst application of G20 requirements.

2. <u>Margin and Liquidity</u>

EFAMA support BCBS / IOSCO principles of broad margining requirements.
Appropriate set of capital is a key element to enhance the safety of the market. Margining ought to be very dynamic and provides flexible and efficient tools to improve further the risk mitigation.

However, EFAMA would like, firstly, to remind that the collateralization of OTC derivatives, being cleared and non-cleared OTC-derivatives, by investment funds is different from credit institutions.

Liquidity is a key element in the collateralization of bilateral OTC derivatives, especially for the investment fund industry where restrictions are due to the following rationale:
- Redemption on a regular basis; and
- Investment funds have to be invested in accordance with the relevant investment objectives of the fund (defined either in legislation or prospectuses).

By being too restrictive in the final guidelines, investment funds would face liquidity issues. This will lead to a situation where investment funds would no longer be in a position to efficiently managed assets on behalf of final investors which will directly lead to reduced benefits for final investors as some collected cash couldn't be invested to meet the expected returns.

Secondly, we would like to highlight the possible impact of ESMA guidelines on UCITS. These proposed guidelines seek to restrict even further the re-use of cash collateral by banning or strictly controlling the use of repo transactions. This restriction would then further reduce liquidity in the market.

Thirdly, universal two-way initial margin on gross amount will cause larger problems than benefits provided.
The absence of homogeneity in insolvency rules and bankruptcy laws between countries could lead to the transformation of initial margin made of cash into an unsecured credit subject to recovery rate upon the default of that counterparty.

Finally, global regulators should consider the cumulative effects that different regulatory initiatives (both on cleared and uncleared derivatives) will have on market participants. For example, collateral requirements for both cleared (by CCPs and clearing firms) and uncleared derivatives (by regulators) will have significant effects on liquidity. The same assets will be required to cover the same instruments.

Consequently, we support the proposal in the consultation document to include equities in major stock indices and would like to add shares of funds issued in OECD countries as eligible collateral to support liquidity but would like to abandon the idea of IM for investment funds.

3. Uniform application of margining

EFAMA support BCBS / IOSCO principle of uniform application to allow effective margining across actors.

We support the statement that the effectiveness of margin requirements could be undermined if the requirements are not consistent internationally and that this could lead to regulatory arbitrage and competitive advantage.

Legislators and regulators should ensure to use the same definition (identical terms must have the exact same definition) and ensure identical application of the definitions and principals across countries to enable level playing field and support legal certainty globally.

EFAMA would like to insist on the fact that various legislative initiatives are using similar notions or are aiming at strongly interlinked notions (e.g. CDS being an OTC derivative must have the same treatment across legislation. E.g. in Europe, this would apply to Short Selling, CRD IV and EMIR).

We would expect that the ESAs agree with BCBS/IOSCO on a consistent framework for the requirements for centrally and bilateral collateralization of OTC derivatives.

4. <u>Phase-in</u>

EFAMA welcomes the willingness of BCBS/IOSCO to assess the future status of existing transactions.

We support, as said before, the statement that the effectiveness of margin requirements could be undermined if the requirements are not consistent internationally and that this could lead to regulatory arbitrage and competitive advantage.

The implementation of the Dodd-Frank Act, EMIR and similar regulations in Asia-Pacific region is and will remain an enormous challenge for market participants as the existing operational and legal framework for OTC derivatives has to be significantly changed in order to comply with the new regulations. The impacts of such new regulations with regards to such framework modifications are amplified for the buy-side as their infrastructure is usually less sophisticated and resources are more limited in comparison with a globally operating dealer.

Consequently, the existing derivative instruments should not be retroactively concerned by new regulation as their economic conditions may just be impossible to maintain with the constraint of a collateral. A grand fathering clause is absolutely necessary to exempt existing transactions from collateral requirement even in case of reset lowering risk (to clear excess counterparty risk or to diminish notional amount, for example).

Section II. Comments regarding the Consultation Paper

<u>Implementation and timing of margin requirements</u>

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 (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

EFAMA is of the opinion that the appropriate timing should be synchronized but not simultaneous collateralization of centrally cleared and non-centrally cleared derivatives. As there is an interaction between regulations, we strongly believe that the regulatory initiatives must be coordinated. The impacts on liquidity and on OTC derivatives markets in general by the different risk mitigation rules and regulations currently under way are not fully assessed yet. A step by step implementation commencing with central counterparty clearing and trade reporting requirements seems recommendable before starting to implement bilateral margin requirements.

The phase-in should be such as to enable regulators to assess the liquidity impact at each stage and also allow counterparties to spread the cost and burden of the changes to their systems and documentation over a reasonable period.

The implementation time frame should be set in a consistent fashion across the international financial landscape, taking into account international and more local regulatory initiatives implementation across different jurisdictions so as to mitigate any undesirable effects caused by mismatches between regulatory incentives and market practice over the short to medium term.

EFAMA's proposed approach is then to start with centrally cleared operations and initiate a second phase with mandatory collateralization on non-centrally cleared operations afterwards as these operations are defined by exclusion from centrally cleared operations.

The implementation of the requirements for non-centrally-cleared derivatives by the investment fund management companies involves various market participants (e.g. custodians, external collateral manager, selection of solvent counterparties, valuation service provider, etc.). Therefore, the legal and operational framework of non-centrally-cleared derivatives concluded between the buy-side firms and the relevant counterparties need to be negotiated on a bilateral basis which usually takes more time compared to centrally cleared derivatives.

A minimum delay of 6 to 12 months after central clearing started with authorized CCPs (and supposes that legal standard documentation is available beforehand) is, operationally, the minimum delay to get organized.

Consequently, EFAMA members believe that an average of 2 years to prepare and adapt the legal and operational margining requirements on non-centrally-cleared derivatives would be a minimum time to implement non-cleared derivatives.

Counterparties should however be free to implement sooner – in fact in many financial counterparties already exchange variation margin on a wide range of OTC derivative transactions and call for initial margin or independent amounts where there are concerns over the financial stability of their counterparty.

Another important element for EFAMA is to introduce an exemption for existing deals and avoid any type of back-loading.

We believe that apart from appropriate phase-in periods, a grandfathering mechanism must be introduced.

Existing ongoing derivative transactions should be exempted from new margining requirements. Especially formula funds, funds with capital guarantees and other structured Funds cannot comply with margin requirements without being completely restructured.

Restructuring to comply with new regulation is not balanced as funds are already highly regulated and do not contribute to systemic risk.

Additionally, restructuring past operations economy would be jeopardized by introduction of new costly requirements. This exemption could have to last as long as the deal is not modified (except changes aiming at lowering the risk, be it through notional amount diminution or reset to lower counterparty risk…).

Part B: Key principles and proposed requirements
Element 1: Scope of coverage – instruments subject to the requirements

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?

EFAMA supports view that below a certain maturity, foreign exchange swaps and forwards should be exempted from margining requirements. We share the BCBS/IOSCO position that such products do not present significant counterparty credit risks to market participants and should not be considered as a source of systemic risk. The market infrastructure (e.g. CLS) supports the settlement of these instruments which reduce the settlement risk associated with these products.

EFAMA members' experience is that the experience shows that maturities below 3 months (meaning 97 days) represent close to 90% of positions existing in the funds and 1 year more than 99%.

We suggest that 1 year is a proper limit for exemption and stress that, in any case, it would not be efficient to introduce a limit shorter than 3 months.

We believe that the requirements to collect and post IM for foreign exchange swaps and forwards and the high costs involved in order to implement the process of IM by the investment fund management companies outweigh the benefit to mitigate the counterparty credit risk.

We think that the regulatory framework for the collateralization of foreign exchange swaps and forwards across jurisdictions should be consistent in order to avoid any regulatory arbitrage for market participants active in the foreign exchange market. As soon as the US Treasury exempts foreign exchange swaps and forwards from the swap provisions of the US laws, BCBS/IOSCO should also recommend exempting these instruments.

Finally, should, the margining of such instruments be imposed we fear that those risks could not be covered to same extent because the underlying derivative instrument becomes too expensive and would unnecessarily bind liquidity.

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?

EFAMA believes that some other exemptions from margining requirements could be justified.

Firstly, and this applies to all products, there is a threshold of materiality under which there is no risk of systemic scale.

Secondly, existing deals should benefit from a grandfathering exemption of collateral as long as they exist and even if they are reset in a manner that does not increase the total exposure of counterparties.

Thirdly, we think that BCBS/IOSCO should consider an exemption of OTC products when a regulator (e.g. ESMA) declares a class of derivatives as clearing eligible but no CCP offers adequate servicing like segregation arrangements as required in Article 39 EMIR (omnibus- and individual segregation).

Lastly, some additional specific product exemptions could be implemented around product definitions that would be more granular than those of the main swap categories (credit, equity, rates, commodities, other).

The criteria to qualify for a product exemption should take into account the specific purpose, structure and use of a derivative transaction.
The following transactions could be considered:
- Intra-group OTC derivative transactions;
- Any OTC derivative transaction entered into by a party for hedging purpose (any initial margining requirement for those transactions would bind liquidity that could then discourage parties from hedging economic risks and lead to systemic risk);
- Any OTC derivative transaction that deploys a daily reset mechanism which neutralize counterparty credit risk for both parties with predefined Mark-to-Market thresholds at same level as margining thresholds.

Element 2: Scope of coverage – scope of applicability

As a general comment on the second element, EFAMA members are concerned that the financial soundness of the counterparty is not considered as a key consideration in determining the amount of initial margin which should be posted.

Unlike in the centrally-cleared world, initial margin in the bi-lateral world has a key role to play in relation to counterparty risk management and as such should also reflect the likelihood of default.

The key cost not covered by initial margin is replacement cost. Replacement cost will not be an issue if counterparties do not default.

Q4. 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 first key element to answer this question has been elaborated by EFAMA during the roundtable session on margining for bilateral transactions: we fully support the proposal for two-way variation margin by all counterparties across all trades covered by the regime but do not support the application of universal two-way initial margin.

EFAMA is of the opinion that non-prudentially regulated financial counterparties (NPFRC, e.g. such as most pension schemes, insurance vehicles and regulated collective investment schemes as defined in the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP dated on xx) that are not systemically important and does not pose little or no systemic risk should not be required to post and collect Initial Margins (IM).

We therefore encourage BCBS and IOSCO to impose more granular definitions of financial entities which recognize the risk profile and the systemic relevance of a financial entity.
In this context, we would like to draw your attention to the fact that the collateralization of cleared and non-cleared OTC derivatives by investment funds is quite different from credit institutions since investment funds have to comply with investment fund law and contractual restrictions of the relevant investment fund. In addition, the provision of initial margin is likely to affect returns for such counterparties and as their positions will generally be directional, netting of exposures will rarely be available. By contrast credit institutions providing services to clients will have multiple exposures which are likely to net off.

Investment funds are highly regulated products (e.g. by the UCITS or AIFM Directives as well as by national legislation).

The counterparty credit risk to a financial counterparty is limited due to the following European investment fund provisions as referred in UCITS Directive:
According to Article 41 para 1 (a) of Directive 2010/43/EC, the incremental exposure and leverage generated by the managed UCITS through the use of financial derivative instruments including embedded derivatives pursuant to the fourth subparagraph of Article 51 para 3 of Directive 2009/65/EC shall not exceed the total of the UCITS net asset value.

The regulatory provisions applied by UCITS could be compared with the prudentially regulated financial counterparties capital requirements to the effect that investment funds have to hold a much higher “capital ratio” as they are leveraged at the most only 100 percent. A UCITS should be capable to meet at any time all its payments and delivery obligations arising from transactions involving financial derivative instruments (cf. Box 28 of CESR’s Guidelines on Risk Measurement and the Calculation of Global Margins).

Additionally, investment funds are subject to counterparty risk limits (10% of the NAV).

Due to the existing counterparty concentration limits, the risk management processes of the investment funds respectively their manager but also the new obligation to collateralize any OTC derivative not subject to a clearing obligation, we believe that with respect to OTC derivatives not centrally cleared, there is no risk that can be mitigated through Initial Margins (cf. our answer to Q13) and that there would only be a remaining theoretically counterparty risk (regarding a over-collateralized position) to be borne by the investors of other regulated investment funds. Consequently, only Variation Margin should be required to investment funds.

Finally, a requirement to post and collect initial margins will require many participants to set up new or improved systems which will incur upfront systems and legal costs and mean increased on-going administrative costs. It is difficult to quantify the amount exactly.

Consequently, from EFAMA's perspective, the provision in Article 11 para 3 EMIR that only requires the accurate and appropriately segregated exchange of collateral are sufficient and margining for investment funds should be limited to two-ways Variation Margins.

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?

EFAMA members are of the opinion that margin threshold could be a very efficient tool to deal both with the efficiency of the regulation in terms of systemic risk and the liquidity impact of mandatory collateralization for investment funds.

However, we do not think that the various approaches outlined are sufficiently flexible or reflect the reality of the underlying counterparty risks.

This threshold could be different by counterparty and would allow counterparties to have the option not to call for margin and it does not forbid market participants to decide otherwise according to their risk policy.

It is also obvious that smaller participants will not have any impact on the broader view of a systemic risk analysis. In any case, all transactions would have to be reported to the Trade Repository and enable regulators to react if needed.

For the reasons provided in our answer to Q4, we believe that costs of implementation as well as ongoing costs will incur as soon as a market participant has to consider margin requirements. Therefore we expect that a too low threshold might not reduce the costs significantly.

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, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

EFAMA members are of the opinion that regulated investment funds should not be considered as a systemically important party and does not pose any systemic risk. Using an analogy, the default of the vast majority (if not every investment fund) could not cause a so-called "shock-wave" that would have systemic impact to the market.

EFAMA believes that regulated investment funds should be excluded from the requirements to collect and post IM as explained in our answer to question 4.

Our members are of the view that it is a very complex matter to consider triggers across different entities. We believe that IM thresholds' determination should be within the remit of the 2 counterparties. Financial firms should have the opportunity to internally assess with their counterparty credit analysts this credit parameter ("the threshold") using qualitative and quantitative assessment on topics such as but not limited to reputation, organization, governance, regulatory environment, business/strategy, risk controls and levels, liquidity, leverage, BCP/DRP and IT framework. This assessment should result in an appropriate, risk-oriented and conservative threshold negotiated and agreed by the firms. As such, our opinion is that this threshold should be set high enough depending on the typology of firms (banks, pension Funds, insurance, regulated Funds, unregulated hedge funds, etc.) and the internal credit assessment of the parties in order to address the point highlighted by this consultation paper on the liquidity costs keeping in mind a sound risk-focused approach.

This threshold should be consistent with the level of exemption of central clearing applying to non financial entities under EMIR (1 billion € notional value for each of credit or equity derivatives, 3 € billion for each of IRS, FX or commodities) with a view not to favor not centrally-cleared transactions. For regulated and strictly supervised entities the threshold should allow transactions with no material impact on systemic risk level and be 5 or 10 times higher due to the risk control skills of the entities. With respect to SIFIs, it is our understanding that closer supervision and higher capital requirements sufficiently reduce systemic risk not to impose a lower threshold to them that would bias competition among market participants.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie 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?

EFAMA agrees with BCBS/IOSCO assessment that the usage of the IM threshold should be restricted to prudentially regulated entities which have to adhere to specific regulatory capital requirements, with direct supervision and which collapse may cause a widespread disruption to the financial system.

In our view, the use and benefit of initial margin thresholds should not be limited to prudentially regulated entities. Funds, if covered in the scope of this consultation and despite our position, might have to also be subject to regulation and supervision and should therefore be considered in the same category as prudentially regulated entities. UCITS are only one example of entities which should benefit from the same level of initial margin thresholds, if any required.

The application of thresholds for initial margin should not be based on broad counterparty categories, but should reflect the credit quality of the counterparty in question and the risk of default. This should be based on the assessment of each counterparty.

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?

EFAMA members are of the opinion that the threshold should be determined as a function of the rating/default probability estimated by the counterparties, as well as the level of exposure, in

particular, counterparties such as pension funds, insurance companies and regulated funds which have a low risk of default should in a threshold model generally have a high threshold applied.

EFAMA believes that the threshold evaluation techniques depend on the size of the firms involved. We do not believe that the models should be mandated but should be agreed between the counterparties (or their agents/investment managers) and should be flexible. However, we also believe that regulated counterparties (and their agents) should agree their models with regulators; and that models should reflect the different types of counterparties and the underlying credit quality and risk of default of each.

EFAMA believes that the specification of the threshold should be calculated in a simple and transparent way. Consequently, it is consistent to express the threshold applying to an initial margin requirement as an amount of this margin requirement. From an operational point of view any other suggestion or any change in method seems very difficult to implement. As a matter of consistency, it is advisable that the counterparties which agree on the computation of the amount of initial margin use the same method when applying the threshold.

We are of the opinion that smaller actors could set their model based either on standardized models or on large well equipped institutions' internal models to determine thresholds, initial margins and haircuts. Internal models should however be approved by the relevant regulatory body and be available to parties to which they are applied.

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 expressed during the Roundtable on margining requirements and across this consultation, EFAMA is of the opinion that two-way initial margining will cause greater problems than benefits provided.

EFAMA members believe that the requirement to post initial margin will have the following impacts on the clients of investment managers, with a subsequent impact to the market more generally:

(i) Lower investment returns, in particular for pension funds, insurers and investment funds, as counterparties will be required to move away from assets that provide higher returns to those that provide greater liquidity, such as cash or near cash assets; and
(ii) A reduction in the volume of OTC derivatives trading and consequently less risk management of funds, and liabilities, where such contracts are used for hedging and investment purposes; and
(iii) The move to more liquid assets such as cash will have the unintended consequence of reducing demand for equity and fixed income products making it more difficult for corporate and government bodies to raise funds in the capital markets; and
(iv) Greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme's benefits; and
(v) A further squeeze on the availability of eligible collateral assets as the cleared and un-cleared OTC derivatives markets compete for the same pot of assets; and

(vi) A real concern that the industry of asset management will face increased operating costs and accrued operational risk if forced to implement two way margining system on a gross basis; and

(vii) The application of a universal two-way margin approach for non-centrally-cleared derivatives could also have an adverse practical effect on investment funds as it will mean that investment fund management companies have to set up a large number of new pledge account for IM in order to fulfill the segregation obligation which will increase the costs of implementation for the investment fund and could simultaneously reduce the fund performance without any additional benefit in the reduction of counterparty credit risk.

Consequently, the only practically and financially acceptable way for investment funds would be to operate a balanced two-way Variation Margining system with exchanges of net amounts.

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?

EFAMA would like to insist in reminding that investment funds are regulated entities in respect of ownership and exchange of collateral.

EFAMA believes that the posting of margin for non-centrally-cleared transactions based on the systemic importance and underlying financial stability of each counterparty, as well as the risks posed by the relevant product is an important tool to support stability.

This requirement should take into account the structure of capital models for some prudentially regulated entities that is actively working against the posting of initial margin model. These rules should be amended to ensure that there is symmetry in treatment for capital purposes between margin posted and margin received and/or sufficient flexibility to take into account segregation structures which provide security and bankruptcy remoteness for margins posted. Capital models should encourage the posting of margin where this is sensible to protect other market participants.

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

EFAMA does not think that the proposals go far enough. Any *per se* exemption should also be linked to the exemptions from central clearing provided in each jurisdiction.

For instance, under the European Regulation on OTC derivatives, central counterparties and trade repositories (EMIR), there is an exemption from mandatory central clearing for certain types of pension arrangements for an initial period of 3 years in order for the market to find solutions for collateral provision by pension funds which does not adversely impact they financial solvency (by requiring that a large portion of their assets are in cash and/or tied up in margin accounts). Such entities should be exempt from any additional requirements in the non-centrally-cleared space designed to promote or encourage central clearing. Otherwise the exemption from central clearing will be of little use.

Additionally, we believe that sovereign and central banks should be exempted too.

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?

As mentioned above, EFAMA believes that the exemptions from the margin requirements should also cover entities that are not subject to mandatory clearing in their relevant jurisdiction (such as pension funds under EMIR).

We also believe that other regulated entities such as investment funds should also be exempt from the initial margin requirements as they are not systemic entities.

Due of the cover rule, regulated investment funds are only allowed to enter into derivatives which can be fulfilled with the assets belonging to the fund. UCITS and other regulated investment funds have to consider counterparty concentration limits are obliged to collateralize non centrally-cleared OTC as set out in EMIR.

We would like to remind here again that regulated investment funds should not be subject to any IM requirements because:

- Regulated investment funds are already subject to a very high degree of regulation; and
- Due of the cover rule, regulated investment funds are only allowed to enter into Derivatives which can be fulfilled with the assets belonging to the fund;
- Regulated investment funds have to consider counterparty concentration limits and of course are obliged to collateralize as set out in EMIR;
- Even in case of the default of a counterparty, the potential loss, being the remaining risk addressed by any Initial Margin measures, is limited by the applicable regulation as well as collateralization;
- Regulated investment funds are not systemic relevant.

<u>Element 3: Baseline minimum amounts and methodologies for initial and variation margin</u>

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?

Whilst EFAMA appreciates that one of the objectives is to promote central clearing, we do not believe that the central clearing model for margins is the appropriate reference point for non-centrally-cleared transactions. It ignores the very different nature of the relationships between a centrally cleared and non-centrally cleared transaction. It also ignores the fact that at least initially, for many OTC derivatives there will be no central clearing solution.

As regards to initial margin, as mentioned above, the model should also take into account the likelihood of default of the relevant counterparty.

We do not believe that the models should be mandated but should be agreed between the counterparties (or their agents/investment managers) and should be flexible. The most flexible solution

is to allow counterparties to agree the methods that will be used and to have full transparency of methodologies and calculations and robust dispute resolution processes.

However, we also are of the opinion that it would be helpful for regulated counterparties (and their agents) to agree their models with regulators; and that models should reflect the different types of counterparties and the underlying credit quality and risk of default of each. This would allow a complete transparency for counterparties who accept the use of the model.

EFAMA's understanding is that a key factor which should be taken into consideration is the credit quality and probability of a particular counterparty defaulting. That is the critical risk in each bilateral contract.
We also agree that such models should be subject to an internal governance process to assess, test and validate the model on an on-going basis.

The definition of the quantitative model could be built as follows: an investment fund should be authorized to rely on the computation of initial margin done according to an authorized model developed by its prudentially regulated counterparty, or a third party, provided that the fund manager challenges this calculation. Securities market and banking authorities would on a second step review the reciprocal valuation models.

Furthermore, the final approach should be consistent with, in Europe, EMIR requirements for initial margin for centrally cleared transactions. In that respect the 10 day horizon period is probably not adapted as EMIR consultation paper mentioned 2 or 5 days: the longer of the two will be sufficient not to favor non-centrally cleared operations.

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?

EFAMA members do not think that margin calculations on a portfolio basis should be limited to specific asset classes but should be permitted across asset classes where transactions are covered by the same legally enforceable netting agreement. We believe that the proposals in this respect are therefore too restrictive despite the fact that the calculation of a model-based margin approach across different asset classes is very complex and a difficult modeling issue.

Here again, a consistent approach with prudential requirements of banks seems appropriate and stable long term correlations are usually considered as relevant

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?

EFAMA welcomes the principle of a standardized schedule which is simple enough to be transparent and easy to understand.

We agree that market participants should not be allowed to pick and choose between models to suit their purpose or increase the amount of initial margin to be posted to them.

We agree that rigorous and robust dispute resolution procedures will be required whatever the model adopted by counterparties and that the parameters of this should be agreed up-front to avoid unnecessary periods of uncertainty, especially in stressed market conditions.

However, we have some concerns as we believe that the standardized approach might be slightly too general.

We, here again, want to insist on our view that initial margins should not be applied to investment funds.
Should it be decided otherwise, we believe that the level of initial margin expressed as a percentage of notional exposure is expected to be conservative and may seem overly so when considering the fact that the aim of the initial margin is to allow for the time to unfold an existing transaction which may be rather short for many liquid derivatives (IRS or FX for example).

Another aspect that wouldn't be optimal in a standardized approach is that Credit Charges with no reflection of credit quality is not very adequate. Instead of giving fixed percentage stresses, defined periods of historical stress (Lehman Crisis) and a maximum function on that would solve the problem of not capturing specific risks.

EFAMA is also concerned by the very restrictive view taken in respect to netting of notional positions. Foot note 13 at the bottom of page 18 simply considers the case of netting two opposite IRS with the same maturity and probably the same floating reference. Some flexibility in terms of maturity is needed.

In terms of risk sensitivity, a standardized model based on very limited variables can never really be risk sensitive. If the object is to achieve risk sensitivity then a more sophisticated model should be used. The model proposed is a very blunt instrument especially when related to notional rather than real exposure levels. This however has benefits, in that the amounts required to be posted will remain more stable and less prone to procyclical effects.

The opening for netting models suggested in favor of entities submitted to required capital regime should be extended to other entities and especially funds which monitor their risk.

A standardized approach must be simple when computing initial margin but not over-simplistic when assessing the risk basis.

Consequently, we agree that it is sensible to have the fall-back of a standardized schedule, but this should not be taken as the baseline for any internal model. In particular, the model cannot take into account the risk of a particular counterparty defaulting. In this regard, we believe that such a standardized approach should only ever be used alongside an appropriate margin threshold model.

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?

EFAMA agrees with the principle of the proposals on the calculation of variation margin.

Asset managers are very well equipped to value, most of the times on a daily basis, their portfolio as they must publish an official NAV for each fund.

This practice shows that the challenge mentioned at the bottom of page 19 can be met.

For asset managers, we strongly recommend that internal models might be used without prior official validation and/or that models approved by the authority relevant for the counterparty (a bank in most cases) be accepted.

More specifically, we are of the opinion that dispute resolution procedures are very important in that case as it is the only way not to be blocked when there is a difference of significance between counterparties valuations (and thus margin calls).

We do not share the assumption of BCBS/IOSCO regarding the disputes (cf. pages 19 and 20 of the Consultation Paper). Standardized master agreements, like for example the German Master Agreement for Financial Derivatives Transactions or the ISDA Master Agreement and Credit Support Agreement include rigorous and robust dispute resolution provisions. From an example perspective, in the German Master Agreement, it is set out in this regard that the undisputed amount is to be collateralized immediately. Furthermore there is a tight timeframe for solving the dispute. Therefore even disputes regarding high complex OTC derivatives no not lead to an increased default risk.

Consequently, regarding MTAs, we are of the view that the MTA should be set at a level that would allow appropriate risk coverage without creating extra operational risk through too frequent margin calls, causing increased numbers disputes and errors. We would then suggest setting a MTA for investment at a level around EUR 500.000,00 but that could be lowered contractually and upon request of the asset managers, especially for so-called umbrella investment funds.

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?

EFAMA is of the view that the calculation of the variation margin should be done on a daily basis and variation margin should applied daily if the counterparty exposure of the non-centrally-cleared derivatives reaches the MTA.

We believe that some smaller market participants may find it challenging to carry out a daily exchange of collateral to cover variation margin, both from an operational and a cost perspective. However, for most market participants this is and has been standard practice for a long time.

However, we also are of the understanding that the operational and risk perspective could be summarized as follows: the higher the frequency or the lower the MTA, the better the safety and the higher the operational cost.

Market participants should define these criteria according to their risk policy and reach a balance between lower risk and higher cost. Regulators should not go further than expressing a recommendation since there are instances where some flexibility is required (long term swaps in insurance portfolios for example).

The time horizon taken into account when computing the initial margin relates to the liquidity of the product and its underlying not to the frequency of computation of variation margin. However establishing a link between the two is relevant as a matter of simplification that would only apply to the model method though.

As stated above, we believe that there is no reason to consider Initial Margins regarding OTC Derivatives not being centrally cleared for investment funds.

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

EFAMA supports the proposition that cliff-edge triggers should be avoided as far as possible and that initial margin, if any, should be built up over time in order to mitigate procyclical effects, however, models should not be as conservative as to discourage activity and adversely impact liquidity in period of market calm.

The advantage of the standardised method is that the initial deposit is fixed and will not be revised.

As long as models are authorised by a supervisory entity it is expected that non-procyclicality will be examined and mitigated before authorisation.

As far as discrete calls for additional margin are concerned, the main risk stems from the use of the threshold. When deciding not to call for margin that is below the threshold, a counterparty uses a possibility but may decide to change its view and call for margin. This would be a major discrete call and should be addressed either with a provision of advance notice of more than a week or delayed progressive call over a given period of time.

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

According to EFAMA members, MTA can be expressed either as an absolute amount or as a percentage of the net asset of the fund in order to keep materiality in view for larger funds.

Regulation applying to funds limits the exposure to counterparty risk and thus makes it impossible to have too large uncollateralised positions. Regulators should not go further than expressing a recommendation as there are instances where some flexibility is required (dedicated portfolio within a group for example).

We also refer to the answer given to question 16.

<u>Element 4: Eligible collateral for margin</u>

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

EFAMA believes that the proposal made by IOSCO adequately address all risk types inherent to collateral management: market, liquidity, credit and FX risks. However to face the current market conditions and evolving regulations, we believe that the scope of eligible assets as collateral for bilateral non-CCDs should be less restrictive in order to leave some flexibility to both parties.

EFAMA is of the opinion that eligible collateral should be:

(i) defined broadly in order to limit liquidity impact; and
(ii) accompanied with appropriate haircuts to increase safety.

When expressing the key principle the paper might go too far in defining the wrong way risk. We are of the opinion that it should be limited to the exclusion of papers issued by counterparty and affiliates and not refer to “significant correlation with credit worthiness of the counterparty”.

As regards the underlying, this may not be possible where hedging is linked to assets held and therefore available as collateral. At some given times mathematical correlation might be high between issuers without proper rationale except for fear.

We would like to add some additional suggestions on the proposed list of acceptable collateral which is not meant to be exhaustive but illustrative:

- Gold could be seen as a volatile commodity which is not appropriate for collateralization and isn’t available to UCITS anyway, thus not offering extra liquidity to entire financial industry; and
- To support liquidity of the markets, we would recommend to recognize as eligible collateral units of highly regulated funds such as UCITS in Europe and corporate bonds down to a rating considered acceptable by the authorities or down to investment grades issued in OECD countries; and
- To some extent, consider as eligible collateral guarantees issued by a bank (in the meaning of Art. 46 para. 1 EMIR) which could offer some welcomed liquidity. Otherwise, open-ended real estate funds (being qualified as AIF) might have problems providing eligible collateral.

From a more marginal perspective, BSBC and IOSCO might also consider that the financial crisis has shown that the assets currently being deemed highly liquid and of highest quality might lose these characteristics in other market scenarios.

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?

EFAMA supports having the option to use standardized haircuts as well as internal models so market participants can decide.

One should not lose the aim of collateralisation: it is a way to mitigate risk on derivative instruments. Applying a large haircut to an instrument with lower liquidity will potentially further impact the liquidity of that instrument, to the extent that it is used for collateral purposes. If haircuts are being applied is it necessary to also have diversification limits. Similarly, if there are concrete diversification limits, is it also appropriate to apply conservative haircuts?

The level one risk lies in the derivative instrument and level two with the quality of the counterparty. These are the key elements and should be closely monitored. Collateral is an efficient tool to reduce risk but it should not be the focus of the risk management as it is a third level risk. Bankers use to say that “a good guarantee does not make a good credit” to stress how important it is to keep in mind the reality of the risk.

In consequence we feel that regulators should not regulate too much in details what can be left to the initiative of professional market participants.

We think that the appropriate application of haircuts for collateral should be left to the counterparties. It is difficult to assess whether haircuts are sufficiently conservative as in stressed conditions the value of some individual securities is likely to fluctuate widely. On the other hand, the market itself may not

be so severely affected and some securities may not lose value but may gain is they are seen as a haven.

When discussing haircuts in page 24, the paper expresses the view that firms should “have an incentive to develop internal models” for computation. When applying to a fund, the list posted in annex B should take into consideration the weighted average maturity of the portfolio of the fund.

Diversification that UCITS and other regulated investment funds have already to consider is an adequate principle but has to be appreciated at the global level of an entity and not on the collateral only. The only rule that could be included in the regulation is the exclusion as collateral of any instrument issued by the counterparty or an affiliate.

Element 5: Treatment of provided margin

EFAMA disagrees with the proposal made by BCBS/IOSCO to collect and post initial margin. We don’t agree that initial margin should be required from all counterparties but suggest that this can be covered off by applying some sort of threshold as discussed in our response.

According to principle 5 below, the IM should all be segregated from the regular collateralization process. This process can only take place via the pledge of collateral or by appointing a trustee. However, there is legal uncertainty regarding the applicable law of property when the relevant security is certified in a multiple share document.

EFAMA’s point of view is that the requirements proposed in Article 11 in the EMIR regulation are sufficient. The mentioned article does not require the exchange of initial margin. We are of the opinion that the daily exchange of collateral, the application of appropriate haircuts and a caped minimum transfer amount should be sufficient in order to mitigate existing counterparty credit risk.

Otherwise, there would be a terrible rush on collateral due to the fact that all operations should be collateralized at once.

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?

As express at length, EFAMA does not agree with the proposal of principle 5 made by BCBS/IOSCO to collect and post initial margin.

The global analysis of the necessity to segregate margin in accounts accessible to caller-receiver in case of default of the poster and reversely recoverable by poster in case of default of caller is very sensible.

We note also that whilst an asset rich client such as a UCITS or pension fund would benefit from well secured arrangements, preventing re-use of assets, credit institutions may find it harder to accommodate having their assets tied up in secured IM. However we would suggest that in the interests of reducing systemic risk and (post Lehman and MF Global) improving investor protection, secured models are the only viable option to deliver on both ambitions.

Should initial margining be maintained, we believe that initial margin should be posted on a net rather than gross basis where there is an exchange of margin and also the proposition that cash and non-cash assets posted as initial margin should be segregated in such a way as to fully protect the posting party in the event of the collecting party's bankruptcy. Counterparties should also be free to choose whether such assets are also segregated from the cash and/or non-cash assets of other counterparties of a market participant. We also support a default position that such cash and non-cash assets should not be re-hypothecated or re-used, although this should be subject to the parties agreeing otherwise.

Indeed UCITS and other regulated investment funds are already to a high extent subject to the proposed requirements:
According to para. 40 i) of ESMAs Guidelines on ETFs and other UCITS Issues, non-cash collateral received should not be sold, re-invested or pledged.
According to para. 40 j) of ESMAs Guidelines on ETFs and other UCITS Issues, cash collateral received should only be

- Placed on deposit with entities prescribed in Art. 50(f) of the UCITS Directive;
- Invested in high-quality government bonds;
- Used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis;
- invested in short-term money market funds as defined in the Guidelines on an Common Definition of European Money Market Funds.

It is true that local jurisdictions may have different tools to achieve such a result and any suggestion to promote an internationally recognised framework could be helpful, though difficult. The main two points to discuss are those expressed in the following two questions (Q23 and Q24).

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?

As stated above, EFAMA believes that there is no reason to request Initial Margins regarding OTC Derivatives not being centrally cleared for investment funds.

The absence of netting and the exchange of gross margins seem at first look consistent with the aim to mitigate risk.

However, as far as funds are concerned, all the assets are intrinsic collateral (since counterparties are in their claim senior than unit holders). Thus the exchange on a net basis would be preferable. Additionally, the operational difficulties to set up a two way gross margining are not to be overlooked and the principle of proportionality (to the risk incurred) should lead to the conclusion to exchange net margins.

The concentration of risk on the head of the few custodians/depositaries that would receive initial margins on a gross basis from both sides is severe. The risk that will be increased by the initial margin flows will be operational risk (including legal risk) as assets are shifted around the system from one bank/custody account to another and potentially into different jurisdictions with different asset protection regimes. Regulators and market participants should consider developing other legal ways to leave collateral with the counterparty and maintain it at the hand of the beneficiary. A revision of the directive on collateral could give the opportunity to enhance such a new legal framework in a standardised form throughout Europe.

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 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? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

EFAMA considers that the re-hypothecation or re-use of variation margin should be allowed, although market participants should be entitled to restrict this by agreement to the extent it does not conflict with the security interest being given. Where re-use is allowed, market participants should still be entitled to get back assets of the exactly the same type and value as those posted.

The risk does not lie with re-use or re-hypothecation but with the level of leverage resulting from these practices. Regulation should then limit the level of leverage and regulate the abuse and not the use of re-use and re-hypothecation.

Funds, especially UCITS, are strictly limited by law in that respect. Many funds are also limited in their articles of incorporation and prospectus. When the beneficiary of the collateral has total property right on the collateral it is improper to use the word re-use instead of "disposition" or "use" of the collateral.

An example of reasonable use of collateral received is back to back transactions: the collateral received by B from counterparty A should be re-usable by B in order to hedge with C its risk in a back to back transaction by which it suppresses its market risk. Thus, a limited number of instances where total risk is not increased should be considered for (re-)use or re-hypothecation (with the approval of the constituent of the pledge).

As regards initial margin, should they be mandatorily applicable, we consider that the default position should be that such amounts/assets are not re-used or re-hypothecated by the receiver, even though we understand that this could create pressure on the liquidity of certain instruments. To provide otherwise would undermine the principles behind segregation and bankruptcy protection. Re-use or re-hypothecation of initial margin assets could be permitted by counterparties on a case by case basis if tight restrictions were placed around such practices in terms of types of re-use, segregation and protection of assets obtained as a result of re-hypothecation/re-use for the posting party and any other benefits were shared.

Element 6: Treatment of transactions with affiliates

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?

EFAMA members do not think that the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities are appropriate.

If companies of the same group, which are fully consolidated and members of the same protection scheme enter into OTC derivative transactions, any losses resulting for one of the two counterparties do not have any negative impact on the stability of the financial markets.

We believe that, in compliance with the provisions of EMIR, non-centrally-cleared derivatives between affiliated entities should not be subject to any collateralization requirement.

As far as it is intended to give discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities to the local supervisory authorities, we believe that this could result in regulatory arbitrage and an unlevel playing field.

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?

EFAMA members do not see any benefits from such an approach.

If companies of the same group, which are fully consolidated and members of the same protection scheme enter into OTC derivative transactions, any losses resulting for one of the two counterparties do not have any negative impact on the stability of the financial markets.

Element 7: Interaction of national regimes in cross-border transactions

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?

EFAMA is of the opinion that this issue is very important and should certainly be addressed with a maximum of clarification.

The suggested rules are consistent with general legal framework.
We support the proposals to ensure that there is consistency in the approach and that no transaction is subject to more than one set of rules on margin requirements.

Financial markets operate across borders and are highly international. Any developments need to be implemented so that they can operate in this environment and do not impinge on the efficiency of the markets.

However, we do not think that the proposals achieve this and we do not agree with BSBC/IOSCO´s opinion that collateral requirements in the jurisdiction of a company shall apply to foreign subsidiaries. We believe that the relevant national laws and regulations shall apply. Otherwise a fragmentation of applicable rules would take place within the same country, which might lead to a distortion of competition and of course would lead to uncertainty regarding the responsible supervisory authority. The regime of branches may disrupt the level playing field approach as the branch will follow its home regulation when banks organised through a subsidiary in the same country will follow the local regime of the host country. If these two regimes are mutually recognised as equivalent, the difficulty disappears.

The more flexibility that can be built into each local regime the easier it will be for counterparties acting on a cross border basis to agree margin and collateral provisions which comply with all relevant jurisdictions.

These rules do not put shade on the existence of a jurisdiction clause in the contract defining the applicable law and the relevant court. They show how relevant it would be to achieve a common international type of contract.

For this reason we urge BCBS-IOSCO to propose that national regulators implement these proposals at the highest level, whilst at the same time ensuring that amendments are made where necessary to detailed local requirements to ensure consistent regulation to avoid to a maximum possible regulatory arbitration and duplicative or conflicting margin requirements.