Comments

by the German Banking Industry to the Consultative Document – Margin Requirements for non-centrally-cleared derivatives

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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to the Consultative Document – Margin Requirements for non-centrally-cleared derivatives

I. Introduction

The German Banking Industry Committee (GBIC) thanks the Basel Committee of Banking Supervision and the Board of the International Organization of Securities Commissions for the invitation to comment on the Consultative Document concerning margin requirements for non-centrally-cleared derivatives (hereinafter: Consultative Document) and welcomes the opportunity to provide input at this stage of the process.

We generally welcome the objective to harmonise rules for margining of bilateral derivative transactions. However, the proposals set out in the Consultative Document will fundamentally change the framework for collateral management. In this context, the profound impact of other regulatory initiatives (inter alia Basel III, obligations to centrally clear and requirements for central clearing) as well as changes in market practice (a general trend towards the extension of collateralisation in lending and funding) on the availability or liquidity of assets eligible as collateral cannot be underestimated: The projected scarcity of eligible collateral will have far reaching consequences not only for financial institutions but also for non-financial entities and the economy as a whole. For instance, excessively rigid collateralisation requirements are very likely to disincentivise market participants from hedging certain risks. This, of course would be counterproductive with regard to the general objective of enhanced risk management. We therefore specifically welcome that BCBS and IOSOC plan to conduct a quantitative impact study in order to analyse the impact of these proposals.

In addition, the implications in terms of systems changes required, and resourcing requirements to appropriately manage the new process will be complicated and burdensome. While we generally support all measures enhancing the stability of markets, we fear that the requirement to implement too many and not necessarily coordinated initiatives at the same time may in fact impede the effectiveness of risk management. Better coordination between and adequate phase-in periods for the various regulatory initiatives is therefore of paramount importance.

II. Specific Comments on the Individual Queries in the Consultative Document

1. Implementation and timing of margin requirements

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?

The phase-in period should cover a period of at least 12 months, This period should be coordinated with other regulatory initiatives. In particular, any collateralization requirements for bilateral transactions should only come into effect together with the closely related mandatory clearing requirements.

The implementation of the margining requirements will be very challenging for market participants, in particular those market participants with little or no experience with the operational processes required in connection with the posting, collection and maintenance of collateral. In addition, counterparties will need to amend existing legal documentation for the provision of collateral so that it conforms to the new

requirements and also meets other regulatory and general legal requirements regarding contractual documentation used for derivative transactions. Against this backdrop, a minimum phase-in period of at least 12 months appears to be appropriate to enable market participants to take the necessary actions and implement the requisite operational and legal framework. A long lead time is also required as market participants need to fund the collateralization (in particular initial margin) requirements. Market stress needs to be avoided.

In this connection it should be clarified that the forthcoming requirements will not have any retroactive effect and that existing transactions would therefore remain unaffected. Apart from legal issues surrounding the legal mandate for any such retroactive effect, any application of the new requirements to existing transactions would have serious and far reaching negative consequences for the counterparties and the markets as a whole.

We strongly believe that the implementation timeline for margin requirements and the clearing obligation should be closely coordinated since both elements of the new regulatory framework are directly related. All counterparties potentially falling within the scope of the clearing obligation will have to adjust their internal processes in order to ensure that they can meet both the clearing requirement and the margining (collateralization) requirements for non-cleared transactions as all counterparties will entre in to both types of transactions (non-clearing and clearing transactions). A phase-in is very important to prevent the negative consequences of a big bang implementation and a run on collateral. But this phase-in should not differentiate between centrally cleared and bilateral transactions.

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?

Yes: The primary risk connected with FX transactions is the settlement risk. This specific risk is adequately mitigated by the use of the CLS system. In its recent consultative document, the Basel Committee is urging the industry to make use of similar systems, recognizing that the so called Herstatt risk (settlement risk) is the main source of risks in the case of FX transactions. In any case a tenor of one month is in our opinion definitively to short.

Margining requirements would not add any significant further level of protection and may actually impede the existing systems by adding additional levels of complexity and exposing the counterparties to additional risks.

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?

In our view products that are designed only for risk-mitigating hedging activities should be exempted from margin requirements. Alternatively, at least certain thresholds should be applied to such products.

A further exemption should apply where a class of clearing-eligible derivatives is determined but the CCP offering clearing does not meet the regulatory criteria UCITS and other regulated investment funds have to fulfil (e.g. the CCP only offers omnibus segregated accounts).

Specifics regarding covered bonds

There should be exemptions from margining requirements for covered bonds issuers taking into account the fact that the preferential claims against the cover pool already serve as a form of collateralisation for the counterparties. This claim against the cover pool offers a level risk protection equal to collateralisation with initial and variation margins.

Covered bonds are dual recourse debt instruments issued by credit institutions (the covered bond issuer) and secured by a cover pool, typically composed of mortgage loans or public-sector debt. The entity of first recourse is the covered bond issuer. In the event of the issuer's default, covered bonds do not accelerate and the Covered Bonds and cover assets do not participate in insolvency proceedings. Instead, the source of payment switches to the cover pool, on which covered bond investors have a preferential claim. Covered bond cover pools are comprised of very high quality assets which must fulfil restrictive legal requirements with regard to asset types, LTV (loan-to-value), asset matching, etc. In contrast to securitisation transactions, these assets remain on the issuer's balance sheet and the issuer has the obligation to ensure that the cover pool constantly meets the existing legal or regulatory requirements. In other words, they will have to replace, if necessary, non-performing loans or prematurely paid debt.

An obligation to post collateral bilaterally in respect of transactions for cover pools would constitute a second level of privilege and represent an unmerited additional benefit for the counterparty which ranks pari passu with the covered bondholders, and thus already benefits from a legal privilege and has access to the cover pool of high quality assets in case of issuer default. In some jurisdictions, covered bond cover pools are also not permitted to post initial or variation margins vis-à-vis its derivative counterparties. In addition, it is common practice that cover pools of covered bonds are generally over-collateralized. Some Member States even have statutory requirement to ensure a certain level of overcollateralization. For instance in Germany, Pfandbrief Banks are required to keep a statutory overcollateralization of at least 2% of the volume of Pfandbriefe outstanding in their cover pools on a net present value basis.

The covered bond issuer should not be obliged to post margins, because he provides already collateralization by preferential claims against the cover pool.

2. Element 2: Scope of coverage – scope of applicability

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?

We concur with the approach expressed in the key principle, that any collateralisation (margining) requirements are to be limited to financial counterparties and qualified –that is – systemically important non-financial counterparties (together: qualified counterparties). However, in this context the scope of

the definition of financial/non-financial counterparties as well as the concept of "systemically important" will be of paramount importance: Here, it needs to be ensured that the scope is sufficiently narrow and clear and does not capture entities without any systemic relevance simply because they fulfil the formal criteria of the definitions. Likewise, and perhaps even more importantly, it needs to be ensured that the definitions are applied uniformly across all jurisdictions. In particular, smaller counterparties (financial or non-financial) would be severely burdened by collateralization requirements not only from an operational perspective but also simply because they will not have access to sufficiently liquid assets that meet the requirements for eligible collateral.

We do not concur with the position that the exchange of both variation margin and initial margin should be mandatory in all cases of transactions between qualified counterparties: A general obligation to post initial margin will be very burdensome for many counterparties and will, in addition, have a significant impact on the overall availability of assets eligible as collateral (in this connection the impact of parallel regulatory initiatives affecting liquidity of assets meeting the eligibility criteria for collateral needs to be taken into account).

Initial margins may also be not required from a risk perspective where counterparties are able to adequately address the specific risks involved by effective and sophisticated collateralization by way of variation margins: The purpose of IM is to cover any residual risks not covered by collateralisation (VM), in particular the risk of fluctuations of the value of collateral posted as VM in the period before a readjustment of the VM (potential future exposure). In view to the comparatively short periods of time between such readjustments, the respective entities (in particular those applying internal models) can address this risk efficiently with adequate risk management, either by sufficiently sophisticated collateralisation via VM (including haircuts on the collateral posted as VM) or capitalisation under the capital requirements regime or a combination of both. Adequate protection can be procured by adequate use of other risk mitigation techniques and through capital requirements, e.g. through counterparty limits in addition to posting VM. Even fully uncollateralised transactions can be addressed via the capital requirements without ramifications for institutional or financial market stability.

Moreover, the posting/collection of IM introduces considerable additional operational and (where third parties are to be involved in the process) also credit risks. These additional risks significantly reduce or may even outweigh the potential risk mitigating effects attributable to IM in bilateral situations. Thus, in general we see no practical need to make collection/posting of IM mandatory for transactions between qualified counterparties.

While we agree that initial margin has the advantage of "defaulter pays", we believe that it should be the choice of the relevant qualified counterparties as to how to mitigate risks. Counterparties should, where available, have the possibility to choose between various methods for addressing risk exposure, such as the holding of own funds in line with the relevant capital requirements regime, including the option to combine collateralisation and holding of own funds. A combination of robust margining (IM + VM), capital requirements and CVA hedging will effectively reduce counterparty credit risks to an acceptable level. Banks should have discretion over what risk management approach is applied by weighting risk reducing impact vs liquidity and capital costs. Under the proposed regime too much collateral is locked away from alternative ways of using it.

Furthermore, the proposal to demand mandatory posting of IM from both counterparties raises serious concerns because of the impact on the liquidity of eligible collateral (either cash or eligible securities).

This burden will be exacerbated by collateral needs for centrally cleared transactions as well as demand for the same assets in order to fulfil the liquidity coverage ratio (LCR) requirement.

One of objectives pursued with the introduction of strict collateralisation requirements is apparently the incentivisation of CCP clearing. We do, however, have doubts whether collateralisation requirements will actually promote central clearing, primarily because the main impediment for CCP-clearing are not the collateralisation requirements imposed by CCPs but rather the fact that these only offer clearing of highly standardised products.

Finally, we would like to point out that the agreements reached at the G20 summit in Pittsburgh 2009 concerning OTC-derivatives do not contain any general requirement for to post and collect initial margin. Rather they imply that margining has to be seen in a wider context with other risk mitigating instruments. This also supports our understanding that the advantages and disadvantages of margining requirements have to be carefully balanced.

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?

Yes: Thresholds are one of the tools to reduce the negative impact of increased margining requirements on the liquidity of eligible assets, where these thresholds are defined by the relevant institution itself in a manner that is consistent with the institute's risk management system (see blow). Thresholds are also an effective instrument to limit the operational complexities arising out of the exchange of collateral posted as initial margin. This holds particularly true where the periods between necessary adjustments of the initial margin are short (especially if these adjustments are to occur on a daily or even intraday basis). Adequate thresholds would also significantly reduce operational risks.

As thresholds need to be adjusted to the counterparties as well as the type of transaction/asset class involved, they also need to be consistent with the institute's risk management system. Consequently, there cannot be any rigid/uniform thresholds applicable across the board to all transactions/counterparties. Rather, counterparties should generally be free to set the thresholds themselves. Circumventions and regulatory arbitrage can be effectively avoided by issuing clear guidelines on the use and calculation of thresholds.

It should be noted, however, that margin thresholds can only mitigate the liquidity impact to a limited extent. This is due to the fact that a good portion of overall IM would be allocated to trades of a number of large dealer banks. For these counterparties the proposed thresholds would only have a limited impact.

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?

No. Thresholds as such are a useful and effective instrument regardless of the type of counterparty involved. The threshold should of course adequately reflect the risk involved and be consistent with the risk management system of the counterparties setting the thresholds.

Counterparties should therefore be able to differentiate IM thresholds in order to reflect credit risk considerations and should be able to define their internal credit risk criteria for the application of thresholds.

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?

No, any counterparty qualified to define/determine thresholds should be able to rely on this instrument.

As to our general concerns regarding a mandatory posting and collection of initial margins, see above, answer to Q4.

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

Thresholds should be set individually as part of the discretion within the framework of credit risk management. Therefore, any requirements regarding the calculation of the threshold must provide for sufficient flexibility. Thus, rigid/uniform caps or minimum thresholds have to be avoided. See also above, answers to Q5 et seq..

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 to our objections regarding a mandatory/rigid requirement to impose a general requirement to post initial margin for transactions between qualified counterparties, see our response above to questions 1 and 4. The objections and concerns raised apply even more so in the case of transactions with non-financial entities. Here, any initial margin requirements would be clearly unreasonable.

But also universal uniform variation margin requirements would be inappropriate in the case of transactions with non-financial entities. Especially smaller and medium sized entities will face serious operational difficulties if confronted with an obligation to collect and post collateral. In addition, hedging costs for their transactions may increase significantly –potentially- prohibitively. The negative impact would be exacerbated by rigid requirements regarding the eligibility of assets qualified for margining purposes: Non-financial entities will often be unable to procure such assets (as to the general impact on the liquidity of eligible assets, see our response to Q4 above)

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?

Unregulated entities will already face very considerable difficulties with implementing margining requirements limited to variation margins. Any requirement to additionally collect and post initial margin will exacerbate these difficulties. Furthermore, an increase of liquidity pressure is the potential practical effect of requiring regulated entities to post initial margins to unregulated counterparties.

The additional risk introduced by the posting and collection of initial margin for both of the counterparties (operational and credit risk) will be considerable and will almost certainly outweigh any potential risk mitigating effects associated with initial margins.

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

Exemptions for non-financial entities that are not systemically important are clearly warranted. However, market participants are not in any position to determine by themselves whether a non-financial counterparty is systemically important or not. In the interest of legal certainty and also in order to prevent a distortion of competition, there has to be a clear and objective process to determine whether a counterparty is or is not eligible for such an exemption. Ideally, this would be in form of an international register. In the absence of any such clear and objective instrument for identification of counterparties who are eligible for such an exemption (and those, who are not), market participants need to be able to rely on the information provided by their respective counterparty.

We would see some merit in two way margining of transactions with sovereigns and supranationals. This would decrease the CVA charge for the counterparty risk. The capital requirements from CVA can only be mitigated by CDS. This could initiate a feedback loop of CDS prices and CVA risk. Two way margining with sovereigns and supranational institutions reduce net collateral balances in the market while at the same time reducing liquidity constraints for all other market participants.

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?

We believe that at least the following exemptions should be considered:

- An exemption for intragroup transactions (taking into account the overall risk mitigating effects of/ limited risks involved in such intragroup transactions)
- An Exemption for regulated investment funds transactions relating to covered bonds (Pfandbriefe) because of their specific structure and the additional level of protection they offer (see our response above to question 3).

In addition we refer to our response to Q2 and our request for a clarification that margining requirements will not only apply to future transactions (as of a certain date) and that existing transactions thus remain unaffected.

3. Element 3: Baseline minimum amounts and methodologies for initial and variation margin

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?

No, we believe that the proposed parameters (10 day horizon and 99% confidence interval) are inappropriate: It is not necessary to require the holding period and confidence interval for each individual bilateral pool of non-centrally cleared OTC derivatives to exceed the relevant requirements that might be demanded by a clearing house.

The 10-day horizon is too long, especially if compared to actual practices used by CCPs. Usually, non-centrally cleared transactions can be closed out quicker than those managed by CCPs. The period should be adjustable, depending on the product characteristics and consistent with the periods used by CCPs and taking into account the legal documentation, operational capability/practices of the two counterparties, portfolio size/complexity and ability to close-out and re-hedge positions.

The 99% confidence interval is too high, considering that the historical data includes a stress period. It should therefore be reduced.

Notwithstanding the above we expressly support the approach to use internal models for the calculation of initial margins

This possibility should also be available for institutions not using the IMM Model.

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?

No. Netting should be allowed between different asset classes, where there are well-understood risk diversification benefits. Interdependencies between derivatives in distinct asset classes do exist. Correlations in these instances are widely accepted and used across the industry

Operationally, it may be difficult for bilateral counterparties to achieve the same asset-class allocation of their trades due to system constraints and internal classifications. For many it would be simpler to include all covered trades in a single initial margin calculation.

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?

In our opinion, the proposed schedule is too rigid and also too general. For example, the schedule should permit a differentiation by maturity/terms for each asset class. Moreover, the parameters set therein are far too conservative. Furthermore, additional diversifications of maturity should be implemented for equity, FX and commodity.

Many financial entities will not be able to develop internal models, and the current schedule is not granular enough meaning that it is not feasible: Enhancing the standardised schedule would avoid the disruption of the derivatives business for small financial entities. In addition, there should be a clarification that the initial margin is to be calculated taking into account netting effects.

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?

The calculation methodology for variation margin is well established. There may, however, be some counterparties in the scope that would need time to develop proper internal processes for this calculation.

Again, there should be a clarification to the effect that variation margins are to be calculated taking into account netting effects. In addition, there should be a clarification that adequate minimum transfer amounts are permissible. Minimum transfer amounts are one way to adequately minimise operational challenges in a risk sensitive manner. This holds particularly true for transactions, where the exposures are very limited and pose no systemic risk. For such transactions daily margining requirements would be inappropriate. Here, it should be permissible to agree on adequate minimum transfer amounts (for example EUR 1 and 2 Mio) which would make daily margining unnecessary for a large section of small volume transactions.

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?

The frequency in which the variation margin is to be adjusted (and thus the frequency by which payments are to be made) should depend on the risk and counterparties involved. Uniform and rigid requirements regarding the frequency have to be avoided. The frequency also depends on the level of the minimum transfer amount agreed. Daily margining will not be warranted in all cases (see response to Q 16 above) in particular with regard to small and medium sized counterparties..

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?

We indeed see a significant risk that the currently proposed rules will exacerbate procyclicality: Both initial and variation margining requirements, will necessarily put pressure on the marketplace at a time of heightened market stress. This applies in particular if these requirements are excessively rigid and conservative.

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

Minimal transfer amounts - just as thresholds – are an important instrument to permit a practical and effective collateralization by reducing operational complexity. As in the case of thresholds, the amounts have to be adjusted to reflect the relevant risks and counterparties and thus need to be determined individually. For institutions which are not able to apply internal models, a minimum transfer amount between EUR 1 and 2 Mio. should be adequate in order to mitigate operational risk and handle uncollateralised exposures.

4. Element 4: Eligible collateral for margin

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

While we fully agree that assets serving as collateral have to be of sufficient quality, it is of utmost importance that the quality requirements for eligibility are not too demanding as this may effectively exclude large sections of market participants from participating in transactions. In particular non-financial counterparties will face extreme difficulties in providing collateral in the form of cash or highly liquid securities or similarly liquid assets. In addition, the forthcoming eligibility criteria will directly influence the extent to which the future collateral requirements will affect the overall availability of such assets, that is, the degree to which there will be a drain on the liquidity of these assets. We therefore expressly welcome the fact that the Consultative Document addresses the issue of the impact of the requirements on liquidity (in this connection please cf. also our introductory remarks on the compounding effect of other regulatory initiatives which will affect said liquidity).

Based on the foregoing, we would urge the Committee to follow an approach permitting a wider range of collateral. In this context of course, the definition of the scope of counterparties covered by the future collateral requirements will be a central element: The broader the scope of counterparties covered by the forthcoming requirements, the greater the need for a definition of less restrictive eligibility criteria.

Eligibility criteria applicable to transactions cleared via CCPs cannot serve as a benchmark in this respect: CCPs require exceptionally liquid collateral in order to be able to address defaults in extremely tight timelines to reduce the systemic impact of such default and in order to avoid repercussions for the other CCP members and the market in general. The same does not apply to bilateral transactions.

A practical example of further assets which may be acceptable as collateral for a counterparty but which may not conform to rigid/standardised eligibility criteria may be a mortgage, pledges on moving property/stock/materials of an industry client or bank guarantees. The risks connected to collateral acceptable in bilateral transactions not conforming to the eligibility requirements of CCPs can be effectively addressed through adequate haircuts and other risk mitigation instruments.

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?

Uniform - that is rigid –diversification requirements applicable across the board to all transactions should be avoided. Standardised haircuts are too inflexible as they will either over- or understate the values. Counterparties should be permitted to apply their own estimates (on the basis of validated methods and models). Financial institutions should generally be able to control and monitor collateral concentration according to internally developed criteria as the risk out of collateral concentration is a function of the credit portfolio.

Based on the foregoing, we believe that the proposed standardised haircuts set out in Appendix B are too inflexible and also excessively conservative as well as impractical. At the very least, counterparties should be permitted to adjust these individually to a significant degree (at least+/- 50% Likewise, rating requirements should be reconsidered, for example by allowing a relaxation in combination with greater haircuts e.g. for corporate bonds.

Moreover, the list of eligible asset classes cannot be exhaustive: In particular non-financial entities must have the possibility to use other than a limited range of standard asset classes as collateral. To clarify the non-exhaustive nature it should be considered to introduce “other” as further category (see our response to Q 20 above regarding examples for other assets).

5. Element 5: Treatment of provided margin

Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

The proposed requirements with respect to the treatment of provided margin may be the most significant and far-reaching change to the existing practice regarding bilateral transactions (apart from the potential introduction of mandatory posting/collection of initial margins). The impact of this change has not yet been fully understood and the implementation of the new framework will be extremely challenging for all market participants not only from an operational, but also from a regulatory and legal perspective.

While we fully agree that counterparties should be able to require a sufficient degree of protection of any collateral posted, the legal implications are far from clear. In particular, it will be necessary to take into account the legal limits existing under national laws, in particular insolvency laws to “segregate” collateral effectively while maintaining sufficient operational flexibility:

For example, initial margins posted as cash can, under most jurisdictions, not be fully protected against the effects of insolvency of the party holding the account to which the cash is posted: Any cash amount will necessarily become comingled with the assets (cash) of said party and cannot be physically or legally separated from its other assets. Neither would custodian accounts (including third-party custodian

accounts) offer any protection: The custodian relationship may protect the claim for repayment but does not prevent that the cash is comingled with other assets of the recipient (custodian). The involvement of a third party does therefore not significantly increase the level of protection since this would only exchange the party in relation to which the risk exposure exists with a risk exposure to another party. As long as there are no uniform or harmonized laws protecting margins posted in cash with a counterparty or even a third party, the requirements regarding the level of protection to be afforded must therefore take into account these legal realities.

Securities deposited with a third party offer a greater level of protection. However, securities are an imperfect means to ensure collateralisation where collateral has to be adjusted and exchanged constantly within short periods of time (in particular, if this occurs on a daily or intraday basis). In addition, legal requirements under the laws of the relevant jurisdictions prohibiting excess or "overcollateralisation" and/or prescribing the immediate return of excess collateral may significantly limit the way in which securities can be employed for margining purposes. Moreover, legal enforceability of collateral transferred by way of a pledge is a complex matter. Due to different and insufficient implementation in various jurisdictions the market participants face a high legal risk of holding a legally unenforceable security interest or providing non-bankruptcy remote collateral, because the requirements for a valid and enforceable creation and/or perfection of the pledge are not complied with for whatever reason.

The Consultation Paper addresses the legal issues to some extent by encouraging jurisdictions to review their legal framework. This may, however, be insufficient as long as there is no clear common understanding based on a concept clarification of the terms "sufficient protection" or "segregation". Legal certainty can only be achieved via further harmonisation of national laws.

Consequently, it will be necessary to avoid too rigid, impractical or legally unenforceable requirements concerning segregation.

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

The proposed key principle prohibiting the "netting" of initial margins would raise fundamental concerns if it is indeed meant to prevent the posting of initial margin to cover the relevant potential future net exposure vis-à-vis the counterparty in question. Such an understanding would effectively negate the effects of netting agreements which constitute a core element of risk management for derivative transactions and which have been recognized as highly effective and efficient instruments to mitigate risks from derivative transactions, including by other initiatives of the Basel Committee on Banking Supervision. A separate issue may be the question to what extent counterparties are permitted to set-off their respective initial margin requirements (as calculated on the basis of the net exposure) against each other.

As to the question of concentration risks, we indeed share the view that initial margin requirements will result in such concentration of assets. As we already set out in our comments regarding the proposal to make the posting of initial margins mandatory, we believe that the additional risks caused hereby may outweigh the positive effects of initial margins.

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?

Re-hypothecation or re-use of collateral is a common feature as it significantly reduces transactional costs (by generation of interest on assets used as collateral) and also helps to limit the overall strain on liquidity (general availability of collateral).

Pledges, as understood under German law, would not permit any re-use, since the pledged collateral would remain the property of the pledger, subject to a security interest. The requirements for a legally valid creation and perfection of a pledge and therefore the question of re-hypothecation or re-use vary from jurisdiction to jurisdiction. This may cause a further concentration in certain types of collateral. Any right to re-hypothecate or re-use pledged collateral may cause a certain legal risk depending on the jurisdiction. As we do not think that legal risk can be avoided, we suggest to generally disallow re-hypothecation or re-use of pledged collaterals.

6. 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?

Intragroup transactions, as they are defined in the different relevant legal frameworks, often serve the purpose of centralizing risk mitigation thus enabling a group-wide risk management. Margining requirements, in particular initial margining requirements affecting such transactions would severely limit the effectiveness of group-wide risk management.

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?

In our preliminary understanding, generally speaking, intragroup transactions are currently not collateralised. This reflects the fact that the counterparties of these transactions do not constitute a credit risk. This fact is not only recognised by the existing capital requirements regime under the Directive 2006/48/EC, which had implemented the Basel II framework into European Law, but will also be recognised by future capital requirements regulation under which intragroup exposures will continue to be weighted with 0%. Furthermore, on a European level, there are discussions to exclude intragroup transaction from own fund requirements for credit valuation adjustment risk. Collateralisation of intragroup transactions would generally be counterproductive for the effectiveness of the risk mitigation measures within the group.

Collateralisation in the form of initial as well as variation margin will generally have no impact on the stability of the group as a whole. Rather, it adds additional levels of operational and legal complexities as well as additional strains on liquidity management, thereby introducing additional credit and operational risks. These additional risks and complexities outweigh any putative benefits of collateralisation. Furthermore, there are no benefits to mitigate the considerable additional costs resulting from the challenges posed by intragroup collateralisation.

7. 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?

The proposed approach meets serious concerns:

Where a home-country supervisory authority considers the local requirements to be inadequate/ inconsistent, the institutions of a group may effectively have to comply with differing requirements of a multitude of regulatory regimes. This would clearly be operationally impossible to implement.

This underlines the need for a greatest possible harmonisation of the general regulatory framework on the one hand and a significant degree of flexibility as well as room for adjustments on the part of institutions so that they may implement a consistent system applicable throughout the group.

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i.V.
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