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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
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Dear Sirs

**Consultative Document on Margin Requirements for Non-centrally-cleared Derivatives**

We refer to the consultative document on margin requirements for non-centrally-cleared derivatives issued jointly by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in July 2012. On behalf of our members, we set out in the attachment our comments on the proposals in the consultative document.

We hope you would find our comments useful. For any questions, please do not hesitate to contact us.

Yours faithfully

p.p. Ronie Mak
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy),
Hong Kong Monetary Authority

**<u>HKAB's comments on Consultation on Margin Requirements for Non-Centrally-Cleared Derivatives</u>**

We set out below our responses to the questions in the consultative document on Margin Requirements for Non-Centrally-Cleared Derivatives:

**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?**

We anticipate significant challenges for implementation. These include:

- Building the infrastructure for segregated posting of margin
- Bankruptcy laws may need to be reviewed
- Updating netting and collateral agreements documentation
- Sourcing of the needed margin at a time when industry also needs to increase capital ratios and comply with Basel III liquidity and funding requirements
- Working with regulators on margining models
- Considering global rules for consistency

We suggest a phase-in implementation, and margining of uncleared transactions should not be mandated before commencement of mandatory central clearing and the build-up of the clearing infrastructure for the whole market. We do not expect implementation before 2015 because the progress of the mandatory clearing under central clearing counterparty (CCP) and trade depository may be different in various jurisdictions.

**<u>Element 1: Scope of coverage –instruments subject to the requirements</u>**

**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?**

Exemption of FX transactions should be in line with the US to avoid global inconsistency. CLS Bank's settlement system today eliminates virtually all settlement risk to CLS Bank participants and there will be efforts to enlist more CLS Bank participants, with broad support from FX dealers and central banks around the globe. However CLS settlement covers only seventeen currency pairs at present and we suggest the exemption cover all currency pairs regardless of

whether they are CLS eligible or not. To address the remaining mark-to-market credit risk, credit support annexes ("CSAs") are heavily used and are a particularly effective risk mitigation tool.

Mandatory clearing for FX swaps and FX forwards would therefore deliver almost no incremental credit risk mitigation. We believe that the significant operational risk and costs to the global payment system of implementing mandatory clearing far exceed the benefits of mitigation for the small residual unsecured credit risk of FX swaps and FX forwards.

In addition, the FX market has performed well throughout most crises, including Lehman, without a drying-up of liquidity or material losses.

**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?**

Products that demonstrate liquidity or where risks can be hedged easily should be granted exemption. They are normally instruments used for transferring out financial risks.

It is also suggested that commodities forwards or other types of physically settled trades should be exempted from the margining requirement.

**<u>Element 2: Scope of coverage – scope of applicability</u>**

**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?**

Regulators should identify products that are liquid and standardised enough and mandate these products for central clearing. All other products should be taken to be not necessarily suitable for central clearing and consequently should be dealt with outside of CCPs. Depending on calibration, the resulting liquidity impact of mandatory bilateral margining of uncleared transactions might pose systemic risk.

Unlike CCPs, banks do have capital to absorb losses. Banks usually expect a small fraction of exposures to be lost due to default and adapt their pricing and capital levels appropriately. This is not in question for lending exposures, but for derivatives transactions. Banks have the capability to review the risk attached to their counterparties and will continue using internal models and their own

judgment for banking book transactions rather than to eradicate losses due to default at nearly all cost.

There are two important risk management approaches:

(a) Capital should scale in a manner that reflects the risk contribution of each part to the whole in stressed conditions, and

(b) Margin on the other hand is additive across clients and specific to each client for their protection. The amount of margin held in aggregate will greatly outstrip the amount the bank could lose and such cost of this inefficiency will be borne by clients.

Addressing the issue of systematic risk through margin requirements will not necessarily solve the problem and is wasteful in an economic sense because it ignores risk diversification effects that is observable even in crises.

There is also uncertainty for non-defaulting party to recall initial margin posted or only able to claim that as unsecured receivable due to local insolvency law. In this case, mandatory requirement for exchange of initial margin would increase the number of legal disputes.

These proposals are expected to be implemented via Regulatory Technical Standards set by European Market Infrastructure Regulation for covered European counterparts. Within the US, the Commodity Futures Trading Commission, Securities and Exchange Commission and other regulators are developing standards for implementation under existing US legislation such as Dodd Frank. As a G20 initiative the aspiration is that these proposals should be implemented globally. It is however possible that in some banks' footprint market, competitors will not be obliged to follow these proposals if not implemented across a broader range of jurisdictions. There are however proposed exemptions provided for sovereigns, central banks and non financial entities not systemically important.

Given the stated intention to create a level playing field, any transaction with a counterparty in a jurisdiction that has not adopted these proposals should be made exempt.

Many emerging market legal regimes do not support either netting or market standard collateral agreements. Consequently until such time as legal regimes in these jurisdictions do support such agreements there is likely to be a disproportionate impact on some banks. Furthermore, any obligation to post more collateral in such jurisdictions will result in an increase in risk rather than mitigating risk and consequently liquidity will decrease and costs will increase.

Collateral arrangements with counterparties in jurisdictions which do not have sufficient legal and regulatory frameworks will result in creating more risk rather than less risk. All transactions in such jurisdictions should therefore be made exempt from these proposals.

**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?**

Initial margin (IM) thresholds is an appropriate tool for managing the liquidity impact of the proposed requirements. It can reduce the operational burden in collecting initial margin below the thresholds in terms of the time effort and cost for market participants. It will be consistent with the goals of the margin requirements since we should focus more on key market players or some G-SIFIs.

However, the major shortcoming of IM thresholds as suggested in the paper is that they do not take counterparty quality into account. Banks usually have a credit function which analyse the creditworthiness of trade counterparties.

To reduce the liquidity impact, we suggest the use of thresholds to be negotiated by both sides. Allowing setup of a threshold to a client that depends on the risk appetite of a firm would reduce the liquidity impact to their counterparties whilst reducing the tail risk by collateralising all exposures above the agreed threshold.

The consultation paper suggests that "margin can be seen as offering enhanced protection against counterparty credit risk where it is effectively implemented". We, however, see capital as an important toolbox in providing the ability to absorb losses to the system. We consider the combination of the use of IM and enhanced capital rules under Basel III regime can effectively reduce the systemic risk, promote central clearing and limit liquidity impact. Basel III has strengthened the capital framework of banks considerably - CVA capital add-on builds a large capital buffer to cover the change of counterparty quality and banks are encouraged to manage the counterparty risk through external hedges. Mandating universal IM without thresholds would reduce all incentives to use credit protection. Asset Value Correlation will be increased for financial counterparties, therefore taking the increased correlation of such counterparties during stressed periods into account.

**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?**

We consider that standardised thresholds that do not take credit quality into account would not be an efficient use of liquidity. To further reduce the liquidity impact, we suggest the use of thresholds to be negotiated by both sides. Setting a threshold to a client that depends on the risk appetite of a firm would reduce the liquidity impact to their counterparties.

When defining systemically important entities, regulators should not solely rely on nominal amounts as these are absolutely not indicative of risk.

The use of thresholds may result in an unlevel playing field among different market participants with different amount or % for the initial margin thresholds since market participants must seek the most cost saving way to fulfill the mandatory requirements. It gives an advantage to those FIs which have higher initial margin thresholds.

The systemic risk posed by an entity can be considered as a primary factor, credit rating may also be considered since it is more transparent. Data on an entity's derivative activities, such as transaction volume and outstanding, can be used to determine an entity's systemic risk level.

**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?**

Transactions between two systemic counterparties should be covered by IM. These counterparties should be allowed to negotiate thresholds depending on differing credit quality. Prudentially regulated firms, which should include all systemic important banks, are generally better capitalized to sustain the IM outlay.

Beside specific regulatory capital requirements and direct supervision, crediting rating or a status in certain regulatory schemes of an entity (eg G-SIFI) should also be used to consider together with prudentially regulated entities. It should also cover financial institutions and should not just be restricted to prudentially regulated entities.

**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?**

The regulatory capital regime already provides a guide to banks as to which counterparties should have higher and lower thresholds: exposure not covered by initial margin will need to be covered by capital and the capital charge will be higher if the counterparty is lower-rated than if it is higher-rated. It should be left to banks to operate within this regime and set thresholds in a way that optimises capital consumption.

Further clarification is required on the calculation of the initial margin threshold requirements. Is IM to be calculated on the basis of each trade booking or when the whole portfolio which is nearly over the threshold? If counterparties use different models to evaluate their own IM, discrepancies must be shown and indicated on how these discrepancies are resolved.

**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?**

Potential effects are as follows:

- Reduced volumes and liquidity of instruments that cannot be cleared, making it more challenging for market participants to manage the risk of these positions.
- Bespoke derivatives will become more expensive and unaffordable, forcing clients to use standardized instruments with increased basis risk.
- Scarcity of eligible collateral
- Increased leverage of both banks and non-banks for margin funding
- Operational challenges, at present not all geared up to high volumes and straight-through-processing
- Significant systems spending will be required up-front to monitor and manage collateral held at third parties and the cost of managing this collateral on an on-going basis will rise.
- Documentation risks; thousands of netting and collateral documents would

have to be re-negotiated

If there are different requirements of initial margin thresholds for key market participants, prudentially-regulated entities and non-prudentially regulated entities with full amount margin exchange, the market may seek lower regulatory costs, i.e. prudentially-regulated entities will trade with same class only to lower the margin; on the other hand, a key market participant may try to avoid trading with another key player in the market.

As the contract for non-centrally-cleared-derivative is usually non-standardized, dispute in calculation of notional exposure and margining amount would be foreseeable.

**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?**

We assume the unregulated counterparties in a non-centrally-cleared derivative transaction should most probably be under the class of systemically-important non-financial entities and will usually be the clients of a bank. If the regulator requires regulated entities to post initial margin to clients, it will create higher systemic risks in the financial sector since it changes the market practice (usually only banks require margins from clients for derivatives trading) and also seriously affects the liquidity of the banks with many such kind of transactions.

If posting IM to unregulated counterparties will be mandated, a third party custodian should be more preferable. On the other hand, if third party custodian account is used for segregation of initial margin, it would impose additional operating cost and that would be significant to small size market participants.

Prudentially regulated firms should be allowed to set thresholds based on risk appetite and credit quality of the counterparty.  We would prefer to have only systemic counterparties to collect IM, which would reduce the liquidity impact and operational burden of exchanging bilateral IM.

Unregulated counterparties rely on primes and custodians to administer margin flows. The technical and legal capabilities of custodians & sub-custodians vary considerably. The costs of segregation will encourage buy-side participants to concentrate their non-cleared business with one or a very small number of banks, leading to increased systemic importance of these banks in the market and this may result in bigger market shock when these banks experience liquidity problems.

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

We support exemption of corporate non-systemic entities, with expectation of similar exemption applying to private investors. Banks should rely on their credit analyst's judgment to determine whether a non-financial entity is sufficiently creditworthy to justify not being charged initial margin.

On the other hand, sovereigns and central banks are not 100% risk-free and are very much systemically important.

**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?**

The obligation to collect initial margin should be waived for participants that are not systemically important. By definition, corporates and private investors will not spread contagion. A tiered charge can be considered for sovereigns and central banks.

**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?**

The exchange of initial margin boils down to an exchange of credit risk with liquidity requirements / risk. Costs to be carried by pension funds, insurance companies and asset managers, would make the market access products more expensive.

Regulators already have bandwidth problems approving existing models. We doubt if there is bandwidth to review margin models in the level of detail envisaged in the consultation paper. We suggest aligning the requirements for margin models with existing market and credit risk models as far as possible to exploit synergies in supervision.

Although the paper suggests that initial margin models be calibrated to a period of stress, the model cannot be calibrated to periods that are stressful for all portfolios at the same time. As such, if a different event or larger event occurs this will feed immediately into the margin calculations, and impact of such a rise could be

massively pro-cyclical. The regulators should give consideration to managing the procyclicality, systemic risk and model risk introduced in Basel framework by aligning market risk (VaR), counterparty risk (EAD), CVA (VaR) and margin models (VaR) on the same standards and methodologies.

With IM, the scope for disputes increases dramatically – not only the current exposure valuation could be disputed, but historical scenarios and other model inputs and assumptions might lead to different results. Industry needs robust dispute management procedures for IM.

IM setting can be done via (1) internal models which are approved by regulators and are constantly monitored and updated for IM and variation margin (VM) or (2) standardised tables. This raises issues that while sophisticated banks have the ability to create internal models which would result in lower IM and VM, there does not appear to be a provision within the proposal for a situation when two FIs face each other and are unable to agree between internal model approach and standardised approach. We believe that any such transaction involving two entities (i.e one of which is regulated under these proposals and the other is not) should be made exempt.

**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?**

Given the high impact on liquidity, and the ability to take netting benefits between asset classes if the counterparty defaults, we believe disallowing netting between asset classes to be overly conservative. Recognition at least must be given to offset between FX transactions and FX risk embedded in transactions in other asset classes otherwise the incentive to hedge FX exposures will be eroded through increased hedging costs.

**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?**

We consider that the standardised margin percentages are overly conservative. Given that CEM (which the schedule is based on) estimate the potential future exposure over one year, whilst initial margin is meant to cover a margin period of risk of 10 days.

For the asset class of foreign exchange/ currency, please clarify what is the rationale to set the IM requirement at 6% of notional exposure (in Appendix A)? And will there be a different % in relation to different tenors?

**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 scope of variation margin is not clear from this paper – is this in line with IM, or will variation margin be collected from all market participants, including corporates, sovereigns and central banks?

**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?**

We agree with exchanging VM on a daily basis, but calculation of the margin at T+1 as per current CSAs would cause least disruption, and with a materiality threshold for operational considerations.

**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?**

As the scope of these margin rules will be professional counterparties, one would expect that these market participants are able to manage the risk of their portfolios over time. There are already market measures in place for increased margin monitoring and frequent margin calls under adverse market conditions, which serve as similar purpose of additional initial margin.

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

As the minimum transfer amount (MTA) is the maximum of uncollateralized exposure that can build up, this can be set to a level that balances operational effort but captures significant daily MTM moves for the portfolio each client is likely to have against potential exposure. This level should be left for counterparties to decide, depending on portfolio size and credit quality of the counterparties, or could be capped at a few million dollars. A percentage based on initial margin between both parties as the level of minimum transfer amount can be considered.

**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?**

Whilst for VM cash and liquid bonds floored at AA are ideal, for IM the pool of eligible collateral should be much wider, partially to mitigate the liquidity impact.

We welcome the wider pool of eligible collateral by extending the list as follows:

- Banks should be permitted to accept a wide range of corporate bonds and equities, i.e. not just "high quality" or "major index" if these positions are liquid and are maintained within concentration limits to ensure that single-issuer, country and sector exposures
- Letters of credit, potentially floored to a minimum rating of the bank issuing these. Wrong-way risk and concentration considerations would be especially important for such collateral

That said, strict criteria need to be defined for posted collateral. These criteria should include (1) market depth and liquidity, (2) appropriate haircut, (3) concentration limits (by country, sector and industry) and (4) absence of wrong way risk. Counterparties should have the flexibility in bilateral agreements to agree more stringent criteria and mechanisms for haircut re-assessment so as to make sure the risk in the collateral portfolio can be managed.

There must be provisions for including local government bonds, currencies, equities and not just G10 currencies and papers as eligible collateral. Unless local currencies and liquid sovereign and other issuer paper are deemed eligible for both counterparts, then it is possible that one or either may not have the eligible collateral or the costs of raising eligible collateral may be so prohibitive that liquidity may suffer and transaction costs rise to a point where pricing of a trade exceeds any benefit of transaction itself. As such, it is required to enlarge the scope of eligible collateral. Please clarify whether any cross-border transactions in relation to what types of collateral could be posted between counterparts.

**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?**

Regarding diversification requirements, we believe that even for highly liquid good quality collateral one should not be allowed to post 100% of the same or

similar securities - the recent changes with some government securities show how quickly a risk-free impression can change.

If margin models are used, the use of these models has to be agreed between both counterparties. Less sophisticated participants should have the option of using the haircuts determined by the model of their counterparty on a consistent basis.

Banks should be permitted to model jointly the exposure and the collateral. This would allow wrong-way risks to be accounted for explicitly and recognise diversification between the exposure and the collateral.

**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 rules need to distinguish clearly between requirements for collateral treatment between IM and VM. We consider that bilateral IM should be kept in a segregated way and should not be re-hypothecated and affected by bankruptcy of the entities concerned. For unilateral IM, the option for segregation should also be available. However, we believe that VM should not be subject to the above restrictions.

For IM, "immediately available" should include a few days' delay. The custodian needs time to establish that the margin of a defaulted counterparty can be released to the counterparty of the defaulter, depending on local bankruptcy regimes.

We, however, note that there are material operational difficulties in the segregation of margin:

- banks cannot post cash as IM because of far too high funding capital charges
- pledging of securities seems the only way that this process could work, but it is key that these connections are fully automated (which is not the case at present) to permit timely release of collateral
- operational challenges with the tri-partite clearing market at present is not geared up to high volumes and straight-through-processing
- significant systems spending will be required up-front to monitor and manage collateral held at third parties and the cost of managing this collateral on an on-going basis will rise

Rules need to be introduced for the default of a custodian. In this situation, the

counterparty of the entity that posted collateral to a new defaulted custodian should not have to treat this collateral as lost, but rely on mechanisms to either recover or port this collateral in a timely fashion in the framework of the resolution plan of the custodian. Requiring the counterparty to post IM another time would cause liquidity requirements exactly in stressed market conditions.

The industry (represented by ISDA, RWA and IBF) are raising the issues around gross margining and restrictions on the re-hypothecation of collateral. For some banks, these proposals raise more complex cross border issues, especially where any local legal jurisdiction does not support enforceability of netting and collateral. Unless the treatment is symmetric between the two counterparts and their associated legal jurisdiction, then these proposals actually introduce more risk rather than reduce it. This is likely to result in less liquidity and higher transaction costs, which will be passed back to clients.

For local jurisdictions with legal regimes which do not support the enforceability of netting and margining arrangements they are likely to see a decrease in liquidity and an increase in costs preventing local counterparts accessing the derivatives markets. Consequently lobbying to adapt their legal framework, or developing a process which may allow full margin recognition within other legal jurisdictions should be investigated. Until such time as netting and margining are sufficiently supported by the respective legal frameworks, all transactions should be made exempt.

**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?**

We believe initial margin should be exchanged on a gross basis. There are in fact only a few global custodians that would have the ability of providing tri-partite custody service to the industry on a global basis. For some countries, most of them will share sub-custodians. Therefore we are worried about the concentration risk with third-party custodian banks, especially as some of them are also derivatives market participants.

**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?**

We assume the consultation paper talks about IM only when mandating that collateral should not be re-hypothecated. VM clearly should not be restricted in this way, and market participants should be free to pay received VM to other counterparties where they have to post VM.

Re-hypothecation or re-use collaterals would mitigate the liquidity impact, however, we cannot see any credible way achieving this without introducing other form of creditability issues.

**<u>Element 6: treatment of transactions with affiliates</u>**

**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?**

We do not have concern about posting VM on transactions with affiliated entities as CSA is commonly signed within the banking industry for these types of transactions. However, we disagree that national regulators should impose IM and be given any discretion in determining the requirements of IM to avoid regulatory arbitrage and an unlevel playing field. This is because any restrictions on the ability to manage these limits by enforcement of the collateralisation of inter entity transactions may have the unintended consequence of reducing liquidity, increasing costs in some local jurisdictions which will be inevitably passed back to the end clients. Arguably, a bank with a subsidiary structure is safer than if the whole business were to be kept on one balance sheet. Also, recovery and resolution controls should address concerns about regulatory arbitrage. Inter-entity exposures should be made exempt from these proposals as they are managed already under local regulations and credit limits.

**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 case of two separate legal entities, it should make no difference in terms of VM whether these are in the same or different jurisdictions.

Some banks may have a different view that the exchange of VM between affiliates within the same national jurisdiction should not be required.

## 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?**

For bilateral margining, IM requirements should be calculated in the same way for both counterparties of a transaction. We therefore question how exactly the exchange of IM should work if one of the two counterparties is subject to different rules. In the worst case a firm would have to run as many margin models as jurisdictions of its counterparties, or if appropriate, standardized rules should apply.

To avoid regulatory arbitrage, it is desirable for the same rules to apply globally.

Unless all regulators and regimes adopt and support these proposals uniformly then some of the core objectives set-out in this proposal will not succeed. Given the multitude of local jurisdictions that some banks operate across, the implications of not having a uniform approach are clear. Fundamental issues such as the enforcement of netting and collateral are not supported in some of the key markets, and the posting of collateral could increase risk rather than reduce risk. The consequences for these markets are likely to be a reduction in liquidity and product scope as well as an increase in costs for the end users.

## Other concerns or issues

- Some banks may have participated heavily in the markets that CCP has not yet been established as widely acceptable clearing entities in these jurisdictions. As a result, most of their transactions would fall under these proposals until these CCPs have been established. As such it will be more appropriate to exempt any transactions that are executed with a counterparty in the markets that CCP has not yet been established.
- There are concerns around the impact of margining on collateral availability and cost. There is a consistent view with ISDA that there needs to be a more comprehensive examination of how the counterparty risk is managed, and how the use of capital charges interacts with the posting of collateral.
- The industry has concerns about the scope of the eligible collateral (which should be wider); the instruments covered and the counterparties subject to the rules (e.g. to exclude non-financial firms from these proposals).
- Given their geographic footprint, some banks are more likely than Western-focused banks to face counterparties in jurisdictions where there are doubts over the enforceability of industry accepted standardised collateral arrangements embodied within the ISDA standard Credit Support Annexes. This means that in order to comply with the new proposals globally, they would either have to lobby for changes in law in those countries (which may take years) or build bespoke

collateral solution in each jurisdiction (which would be time-consuming, expensive, inflexible and likely difficult to operationalise).

- It is recommended that the BCBS/IOSCO Working Group take into account the jurisdictional difference in collateral treatment when developing their proposals. For example, the posting of initial and variation margin can reduce systemic risk but only in jurisdictions where the legal framework supports such risk-mitigating techniques. Where this is not the case, a firm's inability to enforce collateral could lead to an increase, rather than a decrease, in systemic risk. In addition, the cost of entering into transactions with non-financial firms becomes prohibitively expensive for some banks either because of collateral scarcity, increased cost, or the increased risk associated with posting collateral in different jurisdiction. These impact will be felt by the real economy, in that non-financial firms may choose to leave some risks unhedged. This would increase economic risks, even if the systemic risks in the financial sector decrease.