International
Capital
Market
Association

ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

September 28, 2012

Sent by email

Dear Sirs,

BCBS/IOSCO Consultative Document 'Margin Requirements for non-centrally-cleared derivatives'

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the BCBS/IOSCO Consultative Document on Margin Requirements for non-centrally-cleared derivatives'.

General comments

- As provided for in EMIR regulation in Europe, 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 **grandfathering clause** is absolutely necessary to exempt existing transactions from collateral requirements even in case of reset lowering risk (to clear excess counterparty risk or to diminish notional amount, for example)
- There may be a rush of all stakeholders on collateral due to the fact that all operations will have to be collateralised at once and to a higher degree than eventually required, simply by lack of recognised CCPs. A staged implementation calendar is therefore required.
- The current wider regulatory agenda is requiring ever more (high quality) collateral, at a time when there is the downgrade of a substantial part of previously reasonable good collateral, and it is widely perceived that the market will suffer from a shortage of high quality collateral.
- A broad universe of assets as eligible collateral is therefore needed.
- An international framework is desirable to avoid market fragmentation and regulatory arbitrage.

Specific questions

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?

Operationally the introduction of systematic collateralisation will involve important investments for the buy-side, and therefore due consideration should be given to the magnitude of the project involved. The timeline should without a doubt take into account other related regulatory initiatives. The implementation calendar should start with centrally cleared operations and initiate mandatory collateralisation, and follow with the implementation of developments regarding non-centrally cleared operations. Indeed these operations are defined by the fact they are not eligible to central clearing (a requirement that has therefore to pre-exist). Moreover there may be a rush of all stakeholders on collateral due to the fact that all operations will have to be collateralised at once and to a higher degree than eventually required, simply by lack of recognised CCPs. In addition the current wider regulatory agenda is demanding ever more collateral. Coupling this with the downgrade of a substantial part of previously reasonable good collateral, it is widely perceived that the market will also suffer from a shortage of high quality collateral.

Steps should therefore be taken to ease the transition to new requirements, thus allowing markets some time to absorb and adapt. Providing for an extended phase-in period is one obvious way in which to facilitate the transition, without any need to compromise desired longer-term goals.

In establishing the timeline, consideration should be given to existing trades and avoid any type of back loading of transactions which have previously been executed. Past transactions would have been arranged in light of the context then applicable, and it may be economically detrimental to introduce new costly requirements on these trades. A grandfathering exemption should therefore be taken into consideration.

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?

AMIC members agree that below a certain maturity, foreign exchange swaps and forwards should be exempted from margining requirements. Indeed the foreign exchange market is probably the most liquid of all markets, and derivatives as swaps and forwards on the foreign exchange are also very liquid on most currencies, and therefore pose less systemic risks. It is worth noting that the FX market performed well throughout the last crisis, as well as previous crises, handling multiple defaults including Lehman Brothers' without a drying up of liquidity or material losses. Any tenor-based margin requirements would encourage avoidance by trading just below the threshold leading to increased roll and settlement risk. In order to minimise the aforementioned risk AMIC members would suggest the cut off to be set at a tenor that captures a large proportion of all transactions. Particularly given the low level of residual risk associated with FX swaps. Recent Oliver Wyman research and market discussions suggest that for short dated FX transactions (months), the risk exposure is weighted towards settlement risk (>90% of total risk exposure) rather than the credit risk component. In other words, settlement risk dwarfs all other risks in the FX market. For instance, the analysis illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a transaction involving foreign exchange instruments with a maturity of 6 months and 89% for instruments with a maturity of 2 years. In addition following extensive study of systemic risk, central banks and FX dealers went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank as a global settlement bank. For smaller currencies local banks are often very active at providing liquidity. Thus, initial and variation margining should be left to the assessment of counterparties and not regulated.

AMIC members would also recommend that the proposed guidelines consider the exemption of longer-dates cross-currency swaps – that are key to the efficient management of long-term liabilities for both banks and corporate end-users, as financial institutions may otherwise manage their cross-currency balance sheet exposure on a short-term basis and thereby increase refinancing risk.

AMIC members recommend therefore the exclusion of FX swaps of under one year from the scope of coverage of the margining proposal and the exemption of long dated cross-currency swaps.

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?

AMIC members consider that there are other exemptions from margining requirements that appear justified.

Across all products:

- there is a maturity threshold of materiality under which there is no risk of a systemic scale, and
- as explained in Q1 existing trades should benefit from a grandfathering exemption.

Other criteria could reasonably be also taken into account:

- Liquidity, of firstly the underlying instrument and secondly the specific derivative.
- Risk incurred, all forms of hedging activity, for instance of existing risks in a portfolio, should be exempted from initial margin requirements as they offer economic benefits.

<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?

AMIC members agree with the key principle that *'all covered entities (i.e. financial firms and systemically-important non-financial entities) that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions'*. This may mean that the appropriate margin requirement is zero in some specific instances. However the practical implementation of the key principle remains contingent on the availability of sufficient collateral eligible assets. Some market participants may struggle to find the required collateral and either borrow the needed funds, or ask banks to transform lesser quality collateral into collateral that complies with the rules. Neither outcome would reduce risk in the system, but would only move risk around and make it less transparent.

However the proposed requirement adds the idea of *'mandatory minimum amounts on a bilateral exchange'.* Later in the consultation document, the requirement is more specific as it demands that gross amounts, which may be different for each counterparty of the same deal, have to be exchanged on a segregated basis. From an operational perspective, the industry will have to overcome sizeable challenges:

- Building the infrastructure for segregated posting of margin. Given the widespread exchange of IM envisaged by regulators, these need to be automated processes,

and the industry will need to develop standards for enabling straight-through-processing of collateral movements, pledges and releases of these pledges.

- There is the possibility that bankruptcy laws need to be updated to reduce legal risk in these arrangements.
- Sourcing of the needed margin at a time when the banking industry will also need to increase capital ratios and comply with Basel III liquidity and funding requirements.
- Legal documentation will have to be updated and reviewed.

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 threshold is a key element to assess the efficiency of the proposed requirements in terms of both systemic risk and liquidity impact of mandatory collateralisation. However, all transactions will also be reported to the Trade Repository enabling regulators to make further assessments.

Initial margin thresholds allow counterparties to decide or not to make margin calls according to their risk policy. This practice will probably incentivise counterparties to develop best practices so that they do not have to post margins above the threshold.

AMIC members believe that thresholds should be small in amount, and in fact be consistent with those applying to non-financial entities under EMIR (i.e. notional amount of 1bn for credit or equity derivatives and 3 billion each for IRS, FX or commodity).

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 thresholds should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevelled 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?

AMIC members prefer a very restricted approach when defining who could benefit from an initial margin threshold. The aim is clearly to avoid systemic risk to develop on derivative markets. Thus there should be different levels of threshold depending on the level of supervision and risk control requirements applying to each.

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?

'Prudentially regulated entities' seems to only refer to banks in the consultation paper (p.10), under the definition of *'participants (that are) better equipped to manage the risks of non-centrally cleared derivatives and/or absorb the losses associated with any realised counterparty default'.* Yet banks are not the only entities that meet the requirement and in fact as far as the highlighted risks are concerned, the asset management industry is far less exposed. Indeed funds are managed by authorised fund managers that must develop a risk control function totally independent from the fund management activities; moreover they are not enabled to over-leverage their positions (not more than to a 200% exposure for UCITS) and they only invest the capital they have received from investors. Funds are also closely supervised by their national regulator and must comply with a full set of strict regulation (UCITS and AIFM directives in Europe) requiring for example diversification, limits on the level of risk exposure, an active risk management and risk control. Moreover valuation is the most common exercise for a fund manager as it must publish a controlled NAV on a regular basis, i.e. daily in most cases. Furthermore funds are controlled not only internally by the management firm but also by their depositarys and their external auditors and submitted to a close supervision by the regulator. It is arguable that funds are far less risky than banks and should benefit from a larger threshold. Lastly, all the assets of a fund represent intrinsic collateral for counterparties since counterparties are senior to unit- or share-holders of the fund.

AMIC members believe that prudentially regulated entities should include supervised entities and mention specifically funds – on the basis of their limited leverage. However we would refer to our response in Q.6. and our suggested approach to IM is concerned.

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?

From an operational point of view it seems difficult to implement the evaluation of thresholds applying to an initial margin requirement as anything different than an amount of this margin requirement, since the threshold applies to a diminution of the margin effectively called. To ensure consistency, counterparties which agree on the computation of the amount of initial margin should use the same method when applying the threshold – thus maintaining the use of internal models, a current practice, as long as the models used satisfy both supervision bodies and counterparties. However we would refer to our response in Q.6. and our suggested approach to IM is concerned.

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?

AMIC members are concerned that the buy-side will face substantial operating costs and accrued operational risk if they are forced to implement a two way margining system on a gross basis. In fact in comparison to the level of risk existing in funds, in particular with a leverage of less than 2x, the requirement is disproportionate. Moreover new practices will require re-negotiation of contracts with counterparties and amendments to the agreement with the depositary (to deal with potential conflicts of interest for instance).

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?

AMIC members refer to their response to Q.7 and believe that funds should be considered as regulated entities in respect of exchange of collateral.

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

AMIC members have no comments.

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?

AMIC members refer to their response to Q.7 and the fact that funds are highly regulated and closely supervised, are far less risky than banks and other financial or non-financial entities and should benefit from the highest level of threshold.

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 two proposed methodologies for calculating initial margin offers diversification, which is a positive step. AMIC members support the fact, as noted in the consultation paper, that internal models are approved by supervisory authorities and subject to strict internal governance. However this requirement is not appropriate for the buy-side as, in the context of derivatives, internal models are meant to question prices provided by counterparties rather than producing prices with a view to trading on them. Moreover there is a risk of regulatory arbitrage if local authorities do not rely on the same approach to validate models.

Therefore a more practical solution would be for a fund to be authorised to rely on the calculation of initial margin which had done through an authorised model developed by its

banking counterparty, or a third party, provided that the fund manager receives reassurance regarding this calculation (as is the case for NAV publication).

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 VAR amount is not adapted when the EMIR consultation mentions 2 or 5 days.

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?

AMIC members are not opposed to the segregation of broad asset classes when implementing netting of margin requirements. However a consistent approach in line with prudential requirements of banks is 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?

AMIC members agree on the fact that the level of initial margin expressed as a percentage of notional exposure appears overly conservative when the initial margin is meant to cover a margin period of risk of 10 days, even when taking into account that margin is calibrated to a higher percentile.

AMIC members are also concerned by the very restrictive view taken in respect to netting of notional positions. Footnote 13 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. A standardised approach must be simple when computing initial margin but not over-simplistic when assessing the associated risk. The opening for netting models suggested in favour of entities submitted to a required capital regime should be extended to other entities and especially funds which monitor their risk.

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?

AMIC members agree that the dispute resolution procedure is very important notably when there is a difference of significance between counterparties valuations (and thus margin calls).

As explained in our response to Q.13 AMIC members recommend that buy-side internal models might be used without prior official validation or the margin calculations are done through an authorised model developed by a banking counterparty, or a third party.

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?

Market participants define the criteria of frequency and level of MTA according to their own risk policy and reach a balance between appropriate level of risk and acceptable cost. AMIC members believe that some flexibility is required here, and no guidelines should be issued (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.

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?

The advantage of the standardised method is that the initial deposit is fixed and will not be revised. When using a model method initial margin will be adjusted. As long as models are authorised by a supervisory entity it is expected that non-procyclicality will be examined and mitigated before authorisation.

AMIC members believe that discrete calls for additional initial margin should indeed be discouraged – through robust notification processes or should be done on a gradual basis.

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

AMIC members note that fund regulation already limits the exposure to counterparty risk and thus makes it impossible for funds to have too large uncollateralised positions.

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?

AMIC members agree with the approach taken of permitting a broader set of eligible collateral and to address the potential volatility of such assets through application of appropriate haircuts to their valuation for margin purposes.

On the proposed list of eligible collateral which is not meant to be exhaustive but illustrative, in addition to cash the list should include money market instruments and Money Market Funds; in addition to bonds, money market instruments and bond funds; in addition to equities, funds investing mainly in these equities; as well as other types of funds.

AMIC members would therefore welcome a wider pool of eligible collateral, given the collateral supply issues discussed elsewhere in this response.

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?

AMIC members would like to highlight the fact that having each national supervisor develop its own list of eligible collateral has major implications for cross-border derivatives and transactions. Indeed the G20 has varying definitions of what it deems to be high quality collateral, which could lead to a fragmentation of the market.

One should not lose the aim of collateralisation: it is a way to mitigate risk on derivative instruments. 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. What counts most is not the credit quality and liquidity of collateral (this can be dealt with using appropriate haircuts) but the correlation between collateral value and the underlying exposure.

When discussing haircuts in page 24, the paper expresses the view that firms should "have an incentive to develop internal models" for computation. This is probably not a good approach. Firstly models tend to incorporate statistical data and introduce cyclicality. Secondly some market players may lack the capacity to develop internally risk-sensitive quantitative models. They would need to adopt standardised haircuts, which are set conservatively and which increase cost to be borne at all times by market participants.

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?

Collateral treatment of IM and VM need to be clearly distinguished, and a choice between bilateral or unilateral IM offered. Bilateral IM should be kept segregated and bankruptcy remote without re-hypothecation, whilst unilateral IM should have the option for segregation available. VM should not be restricted. VM received from one counterparty will usually be paid out to provider(s) of the hedge(s). Not allowing VM to flow freely though the financial system would increase the liquidity drain even more, without clear benefit.

AMIC members also suggest that promoting an internationally recognised framework could be helpful, though difficult.

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?

Exchanging initial margin on a gross basis and segregating and banning the re-hypothecation of it would significantly increase the need for collateral, and the cost of funding it. It is not clear whether there would simply be enough high grade collateral available to meet the margin requirement s for transactions resulting from the proposals.

There are only a few global custodians that would have the ability to provide tri-partite custody service to the industry on a global basis. For some countries, most of them will share sub-custodians. Therefore the ensuing concentration of risk is a concern to AMIC members.

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?

The risk does not lie with re-use or re-hypothecation but with the level of leverage and interconnectedness 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.

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?

AMIC members do not have any comments.

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?

AMIC members do not have any comments.

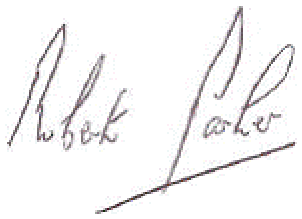
Element 7: Interaction of national regimes in cross-border transactions

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?

This issue is very important and a coherent international regulatory framework, capable of efficiently accommodating cross-border business.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,



Robert Parker
AMIC Chairman