Position Paper

Insurance Europe response to BCBS-IOSCO consultative document on margin requirements for non-centrally-cleared derivatives

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Summary

Insurance Europe welcomes the opportunity to respond to the BCBS-IOSCO consultative document on the margin requirements for non-centrally-cleared derivatives.

We welcome an international approach for margin requirements on non-centrally-cleared derivatives, as it is meant to minimize potential cross-border arbitrage and, in addition, it will diminish cross-jurisdictional conflicting margin requirements. Nonetheless, we express our concern that the consultative document reveals several risks of arbitrage between different regulations or different model approaches.

However, it is important that care is taken in deciding the scope so that margin requirements are only introduced where needed from a risk point of view; therefore, foreign exchange swaps and forwards should be exempted from margin requirements, as we believe that the risks do not warrant the additional costs.

We would also like to emphasize the fact that the proposed requirements will require organizations to undertake significant process, data management, and system changes to achieve upgrades in the areas of data management, stress testing, counterparty risk, and capital management infrastructure.

Therefore, we consider that any quantitative impact study should also contain an assessment of the different operational aspects, as well as the economic impacts that market players would face, following the new requirements.

We support convergence of requirements between centrally-cleared and non-centrally cleared OTC derivatives and we believe that the collateral requirements under a non-centrally-cleared contract should not be more onerous than those generated under a centrally-cleared contract.

Please find our detailed comments on the proposed requirements below.

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1. Implementation and timing

We believe that alignment with centralised clearing is desirable, as non-alignment would generate significant risks of arbitrage, cross-border conflicting margin requirements and operational issues. It would be desirable to envisage a parallel implementation of the technical standards defined by ESMA for centrally cleared derivatives and the implementation of the technical standards for non-centrally-cleared derivatives.

Nonetheless, given the processes that have to be defined, implemented or updated in the bilateral OTC space, the timeline should reflect the significant implementation effort that would be required.

2. Scope of coverage

Foreign exchange swaps and forwards should be exempted from margin requirements, as we believe that the risks do not warrant the additional costs. Given the US treatment of these assets, we believe that the exemption would limit cross-border arbitrage opportunities and would encourage alignment in practice.

Moreover, we consider that the purchaser of upfront premium options should be exempted from initial margin requirements, as the purchaser poses no further risk after payment of the premium.

3. Margin framework, haircuts and standardisation

To set adequate initial margin requirements in the bilateral OTC space is much more difficult than in a CCP environment, where the methodologies are provided and calculated centrally. Moreover, the higher the complexity and the level of subjectivism in calculating margin requirements, the higher the risk of dispute between different counterparties as well as the risk of non-compliance there where the defined rules are not clear and exhaustive.

The approach described for setting margin requirements under a threshold model is, from our perspective, very complex and we would like to have a clear and complete framework regarding the definition of such threshold levels. Thresholds should be calculated in a clear and transparent way.

Taking the financial strength, as well as the degree of prudential-regulation into account, could be assessed as relevant parameters for threshold definition, yet it would also require a clear definition of what a "good" financial strength and/or prudential regulation mean.

Generally, the use of internal models gives incentives for model arbitrage and opens up reconcilement issues. Given a high risk of discrepancies between different internal models among different market participants, the use of internal models could generate a number of operational challenges – such as making valuation and dispute resolution more difficult. Nonetheless, a quantitative impact study should assess any significant differences in margin requirements in specific cases of portfolios consisting of multi-asset non-centrally-cleared derivatives as well as portfolios with a combination of different derivatives such as interest rate swaps, options and total return swaps, where risk at a portfolio level is significantly lower than aggregation of individual risk components. In such cases, an internal model assessment could be allowed, after validation by a national authority, or even standardisation via a third party.

The calculation of two-way-margin may be very complex if we condition it on an agreement between parties regarding which model for calculation to use. If no agreement can be reached, it would mean that a number of disputes have to be managed in the network of a bilateral OTC trading environment. Also, the amount of transactions will increase and has to be facilitated in terms of transfer of title.

Where standardised derivatives are not yet centrally cleared, it is recommended that margin requirements and haircuts should be standardised (and based on anticipated CCP requirements). Therefore, we believe that the working group should give strong consideration to standardising margin requirements and haircuts. These could be implemented as either prescriptive requirements from the regulator or through the use of a prescribed set of models and methodologies (aligned to those underlying CCP calculations).

Cross asset tail correlation is an especially difficult modelling issue. The approach to keep them out completely is therefore comprehensible, albeit a little radical. A scenario-based standard approach could address the issue without ignoring cross assets effects altogether.

The standardized approach for initial margin schedule is very general. For example, credit charges with no reflection of credit quality are not very adequate. Instead of giving fixed percentage stresses, a model in which

defined periods of historical stress and a maximum function on that would solve the problem of not capturing specific risks. We consider that in the current proposal we lack specifications for numerous derivative contracts used by market participants, while including them in an "other" class (see Appendix A) might not exhaustively and reliably approach all types of derivatives with their embedded risks.

Moreover, if we apply the approach set out in Appendix A to straddles on shares, a double counting will occur with regard to a 15% stress level on the nominal (once for a put and once for a call). Therefore, in case of an identical underlying between the same parties netting should be allowed or these two transactions should be seen as one.

There is no method for variance swaps described, while the maximum requirement level does not appropriately reflect the risks of variance swaps; therefore, a standard could consider the following proposals:

i) Calculation of the 30-day realized variance of the underlying asset on historical data that incorporates:

a. a period of significant financial stress, AND

b. at least 1 year of historical data

ii) Calculation of the 10-day changes of the 30-day realized variances as i)

iii) Initial margin for long positions: change of the respective Variance swap based on a shift in variance expectations according to a 1% confidence interval of the 10-day changes as in ii) Initial margin for short positions: change of the respective variance swap based on a shift in variance expectations according to a 99% confidence interval of the 10-day changes as in ii)

We emphasize the fact that the proposed standardised initial margin and haircut schedules are based on calibrations stemming from Basel regulations on the banking sector and do not take into account Solvency II figures. We further consider that stress related changes of haircuts are important to dampen procyclical effects of variation margins.

The minimum transfer amount should be relative to the size of liquid assets of involved counterparties. Although this generates advantages for big entities, defining fixed and not relative amounts doesn’t account for the different risks of different balance sheets’ size. Relative amounts would therefore mean applying ratios to counterparties in a symmetric way (which would translate into a similar level of relative burden for counterparties).

We consider that exemption of sovereigns and central banks is appropriate.

4. Eligible collateral for margin

We support the broadening of eligible assets spectrum, particularly in relation to high quality and liquid assets, such as:

- Cash
- Sovereign Debt like US/EU, EFSF (minimum rating AA-/Aa3)
- Corporate bonds and covered bonds (minimum rating AA-/Aa3)
- Equities, Large Cap Indices
- International Agencies’ issues, such as World Bank, IMF, EIB.

However, the inclusion of more volatile priced assets will result in an increased frequency of margin transfers. As long as a clear definition of “high-quality” equity is not given, the haircut levels for equity should be calibrated in such a way as to incorporate the associated risk.

We believe that there should be no concentration limits included as a condition of collateral eligibility, as any such requirements would be difficult to assess.

5. Treatment of Provided Margin

The treatment of provided margin is a key concern. If posted margin can be re-hypothecated, this results in increased exposure to the banks and potential systemic risk.

Although re-hypothecation benefits the end user through cost reduction of derivative trades, it also creates additional counterparty credit risk since the end user may not receive the collateral back when the dealer suddenly defaults.

We are also aware of the fact that in specific cases not allowing for re-hypothecation generates an important liquidity problem. Therefore, we believe that an appropriate measure meant to overcome excessive liquidity requirements, while limiting over-exposure to systemic risk would be to limit the use of re-hypothecation of collateral by imposing different limits. If re-hypothecation is to be allowed in between certain limits, this should only be possible if both parties to a contract explicitly agree on re-hypothecation.

With respect to margin custodian agents, we believe that the buy side should nominate them, in order to avoid conflicts of interest.

6. Transactions with affiliates

Global insurers use intra-group transactions to give economic benefit to affiliates from centrally contracted hedges, e.g. an interest rate swap for an annuity portfolio. The external leg is fully collateralised under an ISDA CSA.

We believe that intra-group transactions do not contain any systematically relevant risks for non-group market participants. The risks remain in the group. Further intragroup transactions do not change the overall risk profile of a group.

We therefore support the minority view in BCBS/IOSCO group: initial and variation margin should not be mandatory in intra-affiliate transactions, provided appropriate risk management in place (centralised risk procedures, same consolidation and no impediments to the transfer of funds or repayment of liabilities).

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