Intesa-Sanpaolo comments on the BCBS-IOSCO Consultative Document on "Margin Requirements For Non-Centrally-Cleared Derivatives"
September 24, 2012

Intesa Sanpaolo welcomes the BCBS consultative document on "Margin Requirements For Non-Centrally Cleared Derivatives" and would like to provide herewith some high level targeted comments.

Intesa-Sanpaolo shares and supports the two main objectives of a regulation regarding margin requirements:

1. Reduction of systemic risk;
2. Promotion of central clearing.

However, we have some concerns on the proposals that are set forth in the consultation document and would like to provide some alternative suggestions.

In particular, we believe that collateral management should be promoted as one of the techniques to manage the counterparty risk. Collateral management should be considered among the mitigation techniques and be at the disposal of supervised entities to hedge this risk. The other techniques will be analysed in the second section of this document.

The document is organized as follows: in the first section we identify a list of negative effects which are in contrast with the proposal's objectives and in some cases can increase the systemic risk; in the second section we summarize some general principles to address the two identified goals; in the third section we detail the Intesa Sanpaolo's proposal.

I. Negative effects that would derive from the introduction of an Initial Margin

We believe that mandatory exchange of Initial Margin (IM) posted by **Prudentially Regulated Entities** (PREs) could **increase systemic risk** for the following reasons:

1. **It would disincentive the counterparty risk management.** The main effect of this proposal is the reduction of counterparty risk, by transferring this risk to other areas (concentration, liquidity, credit, un-hedging of market risk). This would occur, while the banking industry is currently:

    a. Investing on and developing internal models and control processes;
    b. Upgrading collateral management tools and processes;
    c. Reviewing contractual agreements;
    d. Developing CVA desks to manage the counterparty risk according the upcoming Basel III framework.

This process is driven by the potential saving in terms of capital requirements that justifies the costs. Within a framework which requires the mandatory elimination of counterparty risk through IM posting, the incentives for all these developments will be reduced or even cease. This is in contrast with the aims of the Basel III regulatory framework and represents a potential source of systemic risk, because it does not provide significant incentives to manage the residual counterparty risk. The latter risk is difficult to eliminate through the

standardization and the central clearing of all derivatives: OTC transactions between dealers are almost always centrally cleared, but dealers to client transactions are not necessarily standardized and centrally clearable. When offering OTC products to clients to hedge economic risks it is important for the bank to be able to understand and manage this risk properly; this is all the more important in the case of non standardized trades.

At the current status of Basel III evolution, the cost for non clearing OTC derivatives is paid by banks in terms of higher capital charge (with the requirement for a CVA charge for non cleared transactions). This is already an incentive for banks to centrally clear OTC derivatives whenever possible. We do not believe that another incentive in terms of mandatory initial margin requirement is needed if this has the unintended consequence of having a negative impact on the liquidity and on the business model. We therefore would foster policy makers to aim for a better coordination and consistency among different regulatory proposals.

2. **It would disincentive central clearing.** As already said, the main effect of the current proposal is the reduction, or the likely minimization, of the counterparty risk, by requiring an extreme form of risk mitigation provided by the effective elimination of the counterparty risk exposure through the imposition of both IM and VM. By doing so, capital requirements on this topic wouldn't be needed anymore. Please note that Covered Entities still have to comply with some capital requirements (Basel III proposal) for centrally cleared OTC derivatives, because they have to post IM in an asymmetric way (Institutions pay but do not receive IM). It is not clear the incentive to central clearing within this framework.

3. **Liquidity shock**. By applying the regulation as proposed, the liquidity needs of the Covered Entities to match IM requirements will be very impressive. That would lead to a significant liquidity shock. The results of the QIS in Intesa-Sanpaolo confirm that in any case (with or without thresholds and also reducing the scope in terms of counterparty or instruments) the liquidity needs will be unsustainable.

4. **Funding the real economy**. A very high percentage of the collateral pool currently available in the market would have to be pledged as IM: if segregated, it would reduce the liquidity available for lending and affect the ability of financial institutions to fund themselves at competitive levels and to lend money to the real economy. As a consequence, the monetary base provided by ECB will be partially drained from the private sector to be immobilized as IM.

5. **Un- hedged economic risks**. The higher funding cost faced by OTC derivatives providers for posting IM will result in less competitive prices for derivatives offered to clients. In some cases, the very expensive hedging costs could discourage some OTC derivatives users to hedge their risks. Specific risks would, therefore, remain un-hedged, and will thus pose a potential systemic risk.

6. **Concentration Risk**. The higher funding cost faced by OTC derivatives providers for posting IM would inevitably lead to widen the bid/offer spread for derivatives offered to clients in order to balance the costs related to IM posting: this spread would be highly depending on the funding cost of each institution. This could lead to a concentration of the OTC derivatives business in the hands of a few players, which can offer these products with tighter bid/offer spread thanks to their lower funding cost. The systemic risk could be exacerbated by this kind of concentration which will be highly related to future developments of the funding structure of each player. Please note that PREs are already subject to prudential capital requirements, and to specific capital charges which cover current and potential counterparty risk: the introduction of a mandatory IM exchange seems to overlap with capital requirements.

In addition, a level playing field is not warranted if mandatory rules can be applied in a different way to Covered Entities which are active in the same business (SIFIs vs not SIFIs for instance).

7. **Risk transfer.** The goal of reducing or minimizing the counterparty risk could possibly not be achieved. Under this new framework, every Entity must fund itself before dealing an OTC derivative: it would have to borrow on the funding market the IM, which will then be posted to the benefit of the OTC derivative counterparty. This means that every Entity is likely to transfer some risk from the counterparty's side to the credit one. We do not believe that this kind of risk transfer, instead of a genuine "de-risking", should be aimed at in order to reduce the systemic risk: the counterparty risk is often a potential risk, which is likely to materialize only in the close-out process (when the Entity has to manage simultaneously the counterparty's default and the increased positive exposure provided by the derivative MTM), whereas the credit risk implies a "full risk" represented by the instantaneous and effective exposure.

II. Mitigation techniques

We strongly invite the BCBS to consider the possibility of leaving to PREs the choice to define the kind of risks they want to take on (i.e. counterparty, credit, liquidity etc) and how to mitigate them: it is ultimately the core business of a PRE. We believe that the best way of managing systemic risk is not through the mandatory elimination of the risk by transferring it to other forms.

There are a number of regulations both at international and EU and US levels (e.g. Basel III, EMIR, Dodd Frank Act) that are being implemented that address the risks posed by non-centrally cleared derivatives. In particular Basel III is requiring higher capital requirements for those trades and is providing incentives to the development of internal models and processes.
We believe that the different regulations should be developed in a coherence way; the Mandatory Initial Margin requirements seems to overlap all the Basel III framework, because it will strongly reduce the exposure to counterparty risk, and all the Basel III counterparty rules, that are based on the exposure, will become useless or even not applicable, and will not achieve the Regulator objectives.

We believe that, regarding counterparty risk, there are different mitigation techniques that should be promoted:

1. **Collateral Management**. Robust mandatory (where feasible) Variation Margin collateral management, reducing the liquidation time as much as possible, will not generate the above mentioned systemic risks. In our view, Initial Margin should be promoted as a technique to reduce counterparty exposure, but the choice of either using IM (and pay funding cost) or taking on counterparty risk (and pay capital requirements) should be left to PREs.
2. **CVA desk**. Active management and hedging of CVA exposure.
3. **Contractual agreements**. Reinforcing of legal documentation so as to ensure a better protection.
4. **Reporting of counterparty Exposure**. Reporting to Regulators of the main counterparty exposure.

We believe that the proposals regarding Collateral Management and Margin Requirements should be taken in respect of this framework.

We would like the BCBS to consider some proposals that we would like to suggest.

III. The Intesa Sanpaolo proposals

a) No mandatory Initial Margin;
b) Incentive of IM as a technique to reduce counterparty risk, for instance reducing capital requirements for trades subject to IM;
c) Variation Margins should always be exchanged and cover full mark-to-market;
d) Variation Margins to be adjusted on daily basis, subject to minimum threshold.
e) No mandatory margins to be exchanged between members of the same group.

We believe that in any case the BCBS proposal should always be mindful and set rules that keep the level playing field, for all entities subject to the same regulatory framework (PREs).

For any further comments or questions, please contact Intesa Sanpaolo at the following addresses:

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