28 September 2012

To: Basel Committee on Banking Supervision
Bank for International Settlements
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Response to BCBS-IOSCO consultative document on Margin requirements for non-centrally-cleared derivatives

The Investment Management Association (IMA) is pleased to submit its response to the BCBS-IOSCO consultative document on "Margin requirements for non-centrally-cleared derivatives".

IMA is the UK based trade association for investment managers. Our members manage investments worth more than £4 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the "buy side" of the market, accessing capital markets on behalf of their clients.

The attached Annex contains our answers to the questions raised in the consultation paper. A summary of our key points is set out below.

Key IMA points:

- We support the key principles proposed in general terms, as they seek to promote a desirable environment for non-centrally cleared trades. However, we question how and the extent to which they can be achieved through detailed regulation and how they can be objectively measured.
- Whilst we think that the introduction of initial margin will create potential problems generally in terms of liquidity and specifically for clients of our members in terms of performance impact and costs, we do not object in principle to the introduction of initial margin for non-centrally cleared trades, provided that it is two-way, sufficiently flexible to reflect counterparty credit risk and appropriate safeguards and rights over assets posted are provided.

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- The consequences of posting initial margin on IMA members' clients can be mitigated if it is acknowledged that non-systemically and highly capitalised counterparties such as most pension schemes, insurance vehicles and regulated collective investment schemes should be required to post lower amounts of initial margin to reflect the fact that the likelihood and consequences of default by such entities is relatively low. Such entities are not currently required to lodge initial margin with bank counterparties. This recognises the extremely low risk of default given the extensive degree of regulation applied to such funds, their underlying investment profile, historically low leverage levels and their focus, which is investment rather than trading.
- The effect of initial margin requirements on fund performance can be substantially mitigated if appropriate models using security over segregated accounts, providing flexible substitution rights, and with a broad range of eligible collateral assets are allowed. We therefore welcome the proposals in the consultation paper in relation to eligible collateral and treatment of collateral posted. These will also help to reduce the counterparty risk associated with posting initial margin. It should not be over looked, however, that collateral segregation models will have associated custody, legal and other operational costs. Initial margin posted should not re-used or re-hypothecated by the receiver. To provide otherwise would undermine the principles behind segregation and bankruptcy protection.
- Initial margin models should take into account counterparty risk. Unlike in the centrally-cleared world, initial margin in the bi-lateral world has a key role to play in relation to counterparty risk management and as such should be appropriately calibrated to reflect the likelihood of default. The key cost not covered by initial margin is replacement cost. Replacement cost will not be an issue if counterparties do not default.
- Instead of using fixed notional threshold amounts above which initial margin is payable, regulators could consider applying minimum margin amounts reflecting the position risk, which are adjusted upwards for different types of counterparty to reflect the underlying systemic nature of their business models and capital position. These amounts could then be increased further by negotiation where the receiving counterparty has particular concerns with the financial status of the posting counterparty.
- We believe that FX transactions with a tenor of less than 3 months should not be covered by the margin requirements proposed. We do not believe that FX contracts are exactly comparable to other OTC derivative contracts, and note that the FX market has already found ways to mitigate the key risks associated with these transactions.
- We do not think that it is sensible to limit the use of initial margin to entities that are prudentially regulated. Initial margin should in principle be posted by all financial counterparties.
- The exemptions from the margin requirements should also cover entities that are not subject to mandatory clearing in their relevant jurisdiction (such as is the case for pension funds under EMIR for an initial period). If initial margin models do not provide appropriate calibration to take into account counterparty risk, an exemption should also be considered for UCITS and other regulated funds from the initial margin requirements.
- Whilst we appreciate that one of the objectives of the proposals is to promote central clearing, we do not believe that the central clearing model for margins is the appropriate reference point for non-centrally-cleared transactions. It ignores the very different nature of the relationships between a centrally cleared and non-centrally cleared transaction. It

also ignores the fact that at least initially, for some OTC derivatives there will be no central clearing solution.

- Market participants should be free to choose between standardised models or internal models for initial margin and haircuts. The standard models proposed in the paper are far too simplistic to be useable by most counterparties. Internal models should be approved by regulators and be transparent.
- We support the second approach to eligible collateral outlined in the consultation paper which allows a broader set of eligible collateral but imposes haircuts to reflect the perceived liquidity in stressed circumstances of a particular asset type and we think that a list of collateral is sensible. However we would also like to see included money market funds and units of other highly regulated funds such as UCITS in Europe.
- We support the proposition that there is consistency in approach at an international level and that no transaction be subject to more than one set or rules on margin requirements. However, we do not think that the proposals achieve this and could result in two different regulatory regimes applying to the same transaction.
- Phase in of the requirements should be linked to that of mandated central clearing, with an appropriate time-lag to ensure that market participants and markets generally have time to implement and adjust to central clearing first and are not trying to adjust to two new regimes at the same time.

We are, of course, very happy to discuss any of our comments with you in greater detail.

Kind regards

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