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Response to BCBS and IOSCO on the Consultative Document: "Margin requirements for non-centrally-cleared-derivatives".

Mitsui & Co. Commodity Risk Management Ltd. ("MCRM") & Mitsui Bussan Commodities Limited ("MBC")
MCRM and MBC are UK registered firms, authorised and regulated by the Financial Services Authority ("FSA") with subsidiaries and affiliates in Singapore and New York. Both firms are subsidiaries of the industrial conglomerate, Mitsui & Co., Ltd. incorporated in Japan. Both firms are engaged in providing commodity risk management services to global industrial and commercial clients.

Summary
It is understood by MCRM and MBC that the objectives for formalising margin requirements for non-centrally-cleared derivatives are:

- Reduction of systemic risk in the derivatives market place
- The promotion of central clearing wherever practicable
- Avoid undue impact on liquidity

Our responses are therefore made with those three goals borne in mind.

We feel that the main issues that need to be addressed as a result of this consultation are:

1. Timescales – realistic timescales must be provided for the implementation of the rules (Q1)
2. Appropriate exemptions for end-users (and hedge providers to end-users) to minimise disruption to the "real" economy as a result of the proposed rule changes (Q11-12)
3. Appropriate IM level for "Commodities" - a punitively high level of 15% (of notional) for the purposes of IM calculations does not reflect the absolute or relative levels of risk posed by these products (Q3)
4. IM thresholds have to take into account the systemic risk posed by the respective counterparties – end-users and small financial firms pose significantly lower systemic risk (whilst also being disproportionately hit by liquidity constraints) and should therefore see higher (proportionally) thresholds before there is a requirement to transfer funds (Q5)

Responses by Question

Implementation and timing of margin requirements

Question 1.

Due to the timescales related to this consultation process and the subsequent time required for businesses to construct the necessary operational, IT and legal frameworks to meet the proposed requirements, we can not envisage all firms being ready prior to Q1 2014. Even for financial counterparties that currently conduct margined business, there will be a significant effort required to re-paper their business in accordance with the new standards, ensure that the IT systems are prepared and to conduct the necessary internal cash flow analysis and business model reviews. As has been acknowledged in the Consultative Document (CD), liquidity will be a major concern for firms going forward, so firms will need time to review their trading strategies and funding models to ensure they can operate within the new regime.

For non-financial counterparties and firms that are not regularly in the business of conducting margined derivatives business, we feel it would be appropriate to allow a further transitional period to allow them to put in place the necessary systems and processes and would suggest Q1 2015 as an appropriate timescale.

Element 1 – instruments subject to the requirements

Question 2.

Where FX swaps and forwards are utilised for risk mitigation purposes, they should be exempted from the margining requirements discussed here. By way of example, global commodities are priced primarily in US Dollars so whenever a firm is not domiciled in the US it has to hedge the currency risk of its transactions as a risk management measure. There is no way these trades could be construed as speculative and a requirement to margin these hedge transactions would result in higher costs being passed on to end users.

One solution could be to link the hedge to a specific transaction as part of the trade reporting as this would ensure that an exemption could not be abused.

Question 3.

The key issue here is that "commodities" captures such a wide range of products that firms are being hit with a punitive 15% of the notional underlying – what is the basis for the 15% figure?

Further, "commodities" can represent anything from exotic option structures on the prices of illiquid products to vanilla differentials and cracks on Brent Crude – we strongly feel it is inappropriate for all types of transaction to be subject to a 15% initial margin ("IM") requirement.

Whilst full exemptions may be incompatible with the stated aims, the levels of IM to be applied should be commensurate with the risk posed by a specific product and not determined as the result of a sweeping generalisation or catchall provision.

Element 2 – scope of applicability

Question 4.

The "Key principle" is sufficient for its purpose so long as adequate weight is given to the term "as appropriate to the risks" in the interpretation. It is our belief that there will be transactions which are of such low risk or the risks mitigated by other measures (guarantees, regulatory capital etc.) that there will not see any tangible benefits in terms of risk reduction or increased incentive to centrally clear by the transfer of initial and/ or variation margin.

The "Proposed requirement" does not have the same caveat with regards the transfer of margin being "appropriate to the risks". We feel that this unduly limits the scope of the margining requirements to be set appropriately for given transactions. As previously mentioned, there will likely be trades that are of little to no risk due to alternative mitigants that the transfer of initial or variation margin will create liquidity issues whilst doing nothing to reduce systemic risk or boost the case for centralised clearing.

Question 5.

Initial margin thresholds, set at an appropriate level can play an important role in ensuring that the liquidity impact of the new measures is mitigated. In line with the BIS-IOSCO objectives, the proposal below centres on the systemic risk of the trading activity and proposes a threshold in accordance with this (as well as the requirement not to disincentivize central clearing). On this basis, it would make sense that trades between firms posing a greater systemic risk should be subject to lower thresholds or a greater degree of risk mitigation.

Relative Systemic Risk			
	Key Financial Counterparties (KFCs)	Financial Counterparties (FCs)	Non Financial Counterparties (NFCs)
Key Financial Counterparties	Medium/High	Medium	Medium/Low
Financial Counterparties	Medium	Medium/Low	Lower
Non Financial Counterparties	Medium/Low	Lower	Lowest

We would propose that firms should be able to set the margin threshold at a level commensurate with both the level of regulatory capital they hold and the systemic risk they and the counterparty pose to the financial system.

As a key target of the initial margining arrangements is the reduction of systemic risk, the threshold should be linked to the increasing of systemic risk in the trading. This could be covered by constructing a tiered threshold system based on the number of trades with a counterparty.

For example:

Commodities	1-10 trades	11-100 trades	100+ trades
	Threshold per trade in relation to the firm's financial resources		
KFC -> KFC	**Low**	**Low**	**Low**
KFC -> FC	**Low**	**Medium/Low**	**Medium**
KFC -> NFC	**Low**	**Medium/Low**	**Medium**
FC -> KFC	**Low**	**Medium/Low**	**Medium**
FC -> FC	**Medium/Low**	**Medium**	**Medium/High**
FC -> NFC	**Medium**	**Medium/High**	**High**
NFC -> KFC	**n/a**	**n/a**	**n/a**
NFC -> FC	**n/a**	**n/a**	**n/a**
NFC -> NFC	**n/a**	**n/a**	**n/a**

(Commodities trades involving NFCs represent a minimal level of systemic risk, however due to the fact that they do not hold regulatory capital, a flat rate or a figure based on their total assets may be appropriate.)

The key point this is trying to convey, is that all factors impacting on systemic risk should be considered (i.e. the size of the counterparties involved, the volume of trading being conducted and the amount of financial resources held by the counterparties) – a model similar to that above could allow for this.

What is the appropriate threshold level to manage liquidity costs whilst not increasing systemic risk or inconsistency with the clearing mandate? Due to restraints on time and resources we are not able to supply robust figures on this so instead would ask BIS-IOSCO to consider this approach when conducting their own analysis and implementing the thresholds.

Question 6.

Any differentiation in thresholds could potentially create an unlevel playing field, however in order to reduce the systemic risk of trades with certain counterparties it may be proportionate and appropriate to do so. Where firms maintain significant levels of regulatory capital for example, this has the effect of reducing their systemic risk to the markets (at the cost to itself of holding the capital). This capital in part mitigates the risk that would otherwise be covered by the margin so consequently, it would not be unreasonable for firms already incurring costs to hold capital, to have a higher threshold than would otherwise be considered.

Question 11.

We strongly support the proposed exemptions from the margin requirements for non-financial entities and believe that these are critical for reducing the impact of the changes on commercial entities that pose little to no systemic risk and would be unduly impacted by the proposed legislation.

Question 12.

We would strongly recommend the use of a specific exemption in respect to firms hedging positions they have executed with an end-user.

Under the proposed EU and US rules, end-users and NFCs may obtain exemptions from the margining and clearing requirements. This is strongly supported but does nothing to mitigate the increased costs of providing the hedge by the bank or investment firm with who provide the end-user hedge trades.

We have previously raised similar discussions with both the FSA and EBA and have noted that the CFTC has utilised a similar arrangement with respect to the calculation methodology for position limits with the use of pass-through swap offsets ("PTSOs") found in 17 CFR 151.5(4).

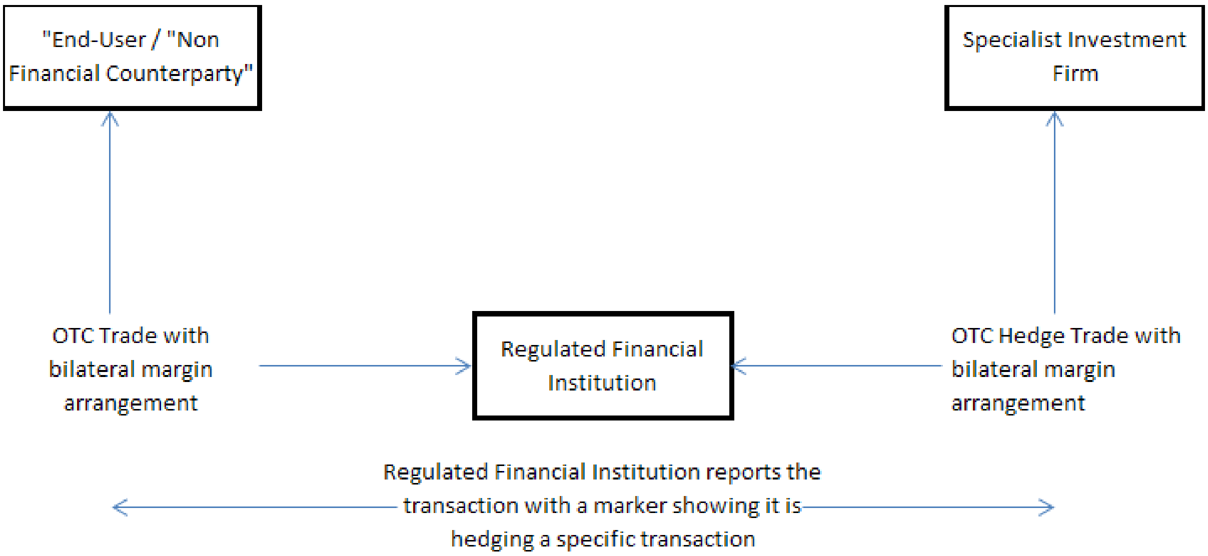
To paraphrase the PTSO rule, where a swap is executed opposite a counterparty for whom the swap transaction would qualify as a bona fide hedging transaction...such swaps shall also be classified as a bona fide hedging transaction... provided that the subsequent trade is for the purpose of reducing the risks attendant to the initial trade.

Such an exemption would result in:

1. End-users not having to pay inflated prices to enter into risk mitigating hedges; and
2. Would lower risk as investment firms would be able to more effectively hedge the subsequent trades without having to keep it on their books to reduce cost.

The provision of this exemption would therefore not **result in an increase in systemic risk** (and would likely reduce it as end-users and investment firms would be more inclined to hedge their risks) and would **increase the liquidity in the markets** through more participation and reduction in capital committed unnecessarily to margin. Whilst this arrangement would not incentivise firms to centrally clear, this is likely a moot point as without the exemption, the trades would be less likely to occur in the first place. Such a scenario would otherwise leave the impacted firms sitting on greater amounts of risk on their own balance sheets.

The transactions can be summarised below:



Element 3

Question 13.

Without seeking to show tacit support for the 15% level for commodity transactions IM, the proposed methodologies for calculating initial margin appear appropriate and practicable.

Question 17.

We believe that variation margin is an important tool for managing both risk and cash in a more efficient manner than initial margin. The purpose of initial margin is to reduce the impact of a default between variation margin calls. We would prefer to see lower initial margin calls with more frequent (intra-day) variation margin calls. Many firms have invested heavily in platforms to manage margin and cash efficiently and this type of arrangement would be straight forward to implement and reduce the need to pass additional costs of initial margin to end-users.

Question 19.

We feel that it would be appropriate to set Minimum Transfer Amounts ("MTAs") in line with both the threshold calculation applied to IM as well as allowing firms to exercise commercial prudence. As there is the possibility of firms attempting to circumvent the payment and receipt of VM, it may be appropriate to place a ceiling on the MTA in respect of the notional value of the commodity underlying the trade.

Element 5 – Treatment of provided margin

Question 23/24.

It is appropriate to look at these two questions as one, as the effects are both inter-related and cumulative. Our view is that the gross bilateral exchange of initial margin represents too great a burden on liquidity for many firms. The impact will simply be to strangle certain trading activity to the detriment of end-users and the markets generally. Thresholds will serve to ameliorate the situation as long as they are set at sufficiently high levels however until these levels are known, it is not possible to state what further action may be required.

As a specialist risk management firm we are concerned how firms like ours can continue to offer bespoke OTC contracts for end-users and then effectively hedge the risk in the markets in a timely and cost-effective manner. It is all well and good exempting end users from the IM and VM requirements, however firms then need to hedge these risks themselves in the market and there are many cases where it is not practical to do this using exchange traded contracts.

We will then find ourselves in the position that we have to increase costs to end-users (or even refuse to provide hedging services) as it is not possible to hedge in a cost-effective manner the risk that we take onto our books as part of the trade. This therefore harms end-users, increases risk and concentrations of risk as well as impacting on liquidity.

Our solution therefore is for BIS/IOSCO to consider our proposal above for a look-through with respect to hedging trades and to ensure that thresholds (especially in regard to smaller firms that pose little or no systemic risk) are set at an appropriate level.

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

Question 27.

The main issue we see here is in relation to the exemptions to the clearing obligations in different jurisdictions (e.g. EU exempts firm's below the "Clearing Threshold" but the US exempts "end-users" on a transaction by transaction basis). How are these going to be reconciled? There is the potential for firms to incur significant

costs in meeting compliance requirements across multiple jurisdictions unless a common standard is applied however this does not seem possible at this late stage.

Summary

In conclusion, we strongly encourage BIS and IOSCO to consider the hedging "look-through" exemption discussed above and are happy to enter into further discussion on the subject to explain further our proposals.

In our view, with a mixture of appropriate exemptions, well considered thresholds and sufficient time for firms to implement the rules, then these substantial rule changes may be practicable. The decision makers must have the impact on firms in the real economy at the front of their mind when finalising the rules.

If you wish to discuss anything raised in this paper, please contact me at matthew.roy@mcrm.com.