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Re: Consultative Document on Margin Requirements for Non-Centrally-Cleared Derivatives

Natixis Asset Management (NAM) thanks the Basel Committee on Banking Supervision and the International Organization of Securities Commissions for giving it the opportunity to respond to the Consultative Document on the Margin Requirements for Non-Centrally-Cleared Derivatives.

With assets under management of 293 billion Euros (31/03/2012), NAM ranks among the leading European asset managers. It offers a wide range of effective management solutions, based on extensive expertise in European and specialized asset management including mandates, UCITS and AIF. NAM provides services to a diverse client base: institutional investors, large companies, distributors, and clients of Banque Populaire and Caisse d'Epargne.

For more information about NAM, please visit www.am.natixis.fr.

NAM has actively participated in discussions with the "*Association Française de Gestion*" (AFG) and the European Fund and Asset Management Association (EFAMA) on the Consultative Document, but wishes to express its own views separately.

In addition to its responses to the specific questions set out in the Consultative Document, NAM has some general comments which are set out below.

GENERAL COMMENTS:

NAM is concerned that the proposal for payment of initial margin will be extremely complex and difficult and costly to implement. However, if payments of initial margin are retained, we believe that regulated funds (for example, UCITS and AIF) should either be exempt from paying initial margin, or if they are not exempt, be treated as "prudentially-regulated entities" with a high threshold amount, as for banks.

Our analysis is as follows:

- Payments of initial margin

We are not convinced that the system of payments of initial margin proposed in the Consultative Document is workable, for the following reasons:

- Initial Margin is not currently market practice. In general, counterparties only require the payment of variation margin. The amount and frequency of payments of variation margin may need to be adapted, but counterparties are generally satisfied that variation margin provides a sufficient level of protection. In addition, many collateral management systems have been set up only to managed variation margin: requiring payments of initial margin would mean significant adaptations and additional cost;
- An automatic requirement for both parties to pay initial margin makes no sense for certain transactions, such as options, given that there is no counterparty risk for the buyer;
- If both parties are required to pay independent amounts, the payments would potentially cancel each other out;
- In practice, it may be difficult to ensure that the non-defaulting party actually recovers the margin paid to the defaulting party. This could involve lengthy delays and legal action;
- It will be difficult to calibrate the thresholds of initial margin posted by counterparties of very different creditworthiness;
- If certain market participants are exempt, this would give rise to incongruous situations, such as a major international bank making a one-way payment to a small, risky corporate. It is likely that banks would simply stop trading in such situations, thus preventing the corporate from appropriately hedging its risk.

Obviously, initial margin is intended to cover counterparty risk and variation margin is intended to cover market risk. However, if the philosophy is to provide for reasonable, not perfect, coverage it would be far simpler and almost as effective to reinforce the variation margin requirements.

- Initial Margin with respect to regulated funds

Funds which have limits on their global exposure to derivative instruments relative to their total net asset value, as is the case for regulated funds, do not present any systemic risk.

Moreover, Net Asset Values (NAV) are calculated on a marked to market basis with a daily publication. Thus, regulated funds are more transparent than most financial institutions.

Regulated funds are subject to very stringent rules that ensure that they will not default, thus providing a very high level of investor protection. For example, the following rules apply:

- Diversification rules for investments and limits on the underlying assets for derivatives;
- Counterparty risk limits (e.g. a regulated fund shall not have an exposure on derivative transactions of more than 10% of its assets to a single counterparty);
- assets of regulated funds are separate from the management company's balance sheet;
- an independent custodian/depositary oversees the activity of the manager and safeguards the assets;
- the manager is required to develop risk management processes with respect to conflicts of interest and processes for managing liquidity risk in order to ensure that the funds it manages are able to meet redemption requests from investors.

As a result of these prudential rules, counterparties to derivatives have very little counterparty risk on regulated funds. Historically, defaults by regulated funds have been extremely rare and such funds therefore pose very little systemic risk.

Please note that current market practice is not to require that regulated funds post an independent amount; they post variation margin only. This reflects the extremely low risk of default of regulated funds and NAM believes this should be taken into account in the proposed regulation.

For these reasons, we believe that regulated funds should be exempt from posting initial margin.

If, however, initial margin is to be posted by regulated funds, we believe that such funds should be considered to be *Prudentially Regulated Financial Counterparties (PRFC)* and that consequently a higher threshold amount (similar to the threshold applied to banks) for initial margin should apply.

Regulated funds tend to use derivatives for hedging rather than for taking positions. Applying a high minimum threshold amount would allow these funds to continue to engage in this activity without incurring excessive cost and would limit the negative impact of initial margin requirements on their liquidity.

Last but not least, requiring that they post large amounts of initial margin would have a direct effect on their performance as assets used for collateral cannot be invested elsewhere. It is important to remember that many of these funds are pension funds, mutual funds or life insurance products which are ultimately held by retail investors. Is the best use of the assets of the fund to be posting collateral for defaults which rarely occur, and which have very little impact on the financial sector, or to improve performance for investors?

More specifically among regulated funds, structured funds present different specificities that make them even more eligible to an exemption or, at least, to a higher threshold amount.
First, they are guaranteed by a bank or a banking organization that is itself considered to be a PRFC. In addition to all the arguments set out above stressing the fact that

regulated funds pose very little systemic risk, structured funds can rely on the bank guarantee in worst case scenarios.
Secondly, the majority of these funds are 100% guaranteed, so the OTC instruments in which they invest to present a near zero risk for the counterparts and therefore make Initial Margin, and even Two Way Variation Margin in some cases, irrelevant.
Secondly, the majority of these funds display a 100% capital guarantee. This 100% guarantee is explicit, as mentioned before, but also implicit.
Thus, the OTC instruments in which they invest bear this implicit guarantee making the risk highly asymmetric between those funds and their counterparts. Indeed the valuation of those instruments is in average and in majority positive, often with no cap and in profit of the fund. In the minority cases in which this valuation is negative, the downside is limited.
Therefore these funds present a very low risk for the counterparts, making thus Initial Margin, and even Two Way Variation Margin in some case, irrelevant.

IMPLEMENTATION AND TIMING OF MARGIN REQUIREMENTS

Q1:

It is worth noting that the reform regarding clearable derivatives will change our current practice considerably. We will have to adapt all our derivative agreements, our calculation and valuation models and our IT systems in order to comply with EMIR and Dodd-Frank.

The workload on firms for clearable derivatives is already substantial and a number of departments are heavily involved in this project.

Therefore, we feel strongly that **margin requirements on non-cleared derivatives should come into force after the majority of clearable derivatives have been incorporated into clearing systems.** Furthermore, with respect to non-cleared derivatives, all collateral agreements will need to be negotiated or amended. As all firms would be required to amend their agreements at the same time, timeframes need to be reasonable in order not to create a bottleneck which might particularly penalise smaller firms.

We would also like to see margin requirements for non-cleared derivatives phased-in, depending on the risk, type, maturity and complexity of the transaction.

We would also like to draw your attention to the need for **a grandfathering clause:**

- for existing contracts, as such contracts were entered into without taking into account additional capital costs or margin requirements;
- for transactions entered into by structured funds in order to avoid any negative effect on the performance guaranteed to the unit holder when the fund was launched. Indeed, the economic balance of those funds is calibrated at inception, leaving no room for additional/ exceptional costs without lowering expected return for clients.

ELEMENT 1: SCOPE OF COVERAGE – INSTRUMENTS SUBJECT TO THE REQUIREMENTS

Q2: foreign exchange swaps

A distinction should be made between:

- initial margin: foreign exchange swaps and forwards should be exempt from initial margin requirements regardless of maturity.

For NAM's portfolios using foreign exchange swaps, systematic exchange of IM would lower the performance by approximately 3 bps.

It is also worth noting that such transactions are usually hedges.
From a financial point of view, this exemption would save Euro 240 million of initial margin for the portfolios of NAM, representing a decrease of 88%. This exemption could represent for all our industry a substantial saving of liquidity, especially if re-use of collateral is not allowed, as is the case for repo and security lending transactions.

- variation margin: variation margin should apply to foreign exchange swaps and forwards with a maturity of more than a three month. These transactions do not present significant counterparty risk to market participants and are not likely to be a source of systemic risk. Variation margin is already paid on these transactions, and we do not believe it is advisable to change this practice.

For this type of transaction, settlement risk can be mitigated thanks to the use of appropriate platforms. For instance, CLS allows real-time settlement between counterparties for each pair of matched instructions by matching the corresponding debit and credit entries across Settlement Members. The development of such platforms offers an alternative to systematic exchange of Initial Margin.

Q3: Other exemptions

In our opinion, the exemption should be extended to all transactions for which the payment is made upfront and not during the life of the transaction or at maturity. For example, the buyer of an option should be exempt from initial margin. Otherwise, the buyer would be required to pay the premium and, even though the seller has zero risk on the buyer, also initial margin, thus adding counterparty risk where there was none.

As mentioned above, transactions entered into by structured funds should also be exempt from posting initial margin. First, these funds are guaranteed by a bank or a banking organization that is itself considered to be a PRFC. In addition to all the arguments set out above stressing the fact that regulated funds pose very little systemic risk, structured funds can rely on this entity in worst case scenarios.
Secondly, most of these funds benefit from a 100% capital guarantee. This guarantee is both explicit, as mentioned above, and implicit.
The OTC instruments in which they invest benefit from this implicit guarantee making the risk highly asymmetric between those funds and their counterparties. The valuation of those instruments is on average and most of the time positive, often with no cap and to the benefit of the fund. In the very few cases where the valuation is negative, the downside is limited.
As a result, these funds present a very low risk for counterparties, making Initial Margin, and even Two Way Variation Margin in some cases, irrelevant.

ELEMENT 2: SCOPE OF APPLICABILITY

Q4: Scope of applicability

As set out above, current practice is to post variation margin only, and we do not believe this should change.

With respect to initial margin, our position is different, as explained above in our general comments. We do not think that initial margin should apply at all because it will be too complicated to implement, in particular for the asset management industry. If it is to apply, the exchange of initial margin should not be mandatory for regulated funds such as UCITS but should be negotiated on a case by case basis taking into account the risk of default of each counterparty.

In addition, it is vital that the methods for calculating and valuing initial margin be harmonised (*please refer to our answer to questions 13 to 15 below*). It would be easier for counterparties to post and collect initial margin based on a standardised model of calculation and threshold.

Q5 / Q6 / Q7 / Q8: Threshold

We believe that regulated funds and specifically UCITS and (at least after the AIFM directive is implemented) AIF should be considered as *Prudentially Regulated Financial Counterparties (PRFC)* and that a higher initial margin threshold should apply, as it does for banks.

Moreover, regulated funds generally use derivatives for hedging rather than for taking positions. A higher threshold would allow such funds to continue their activities without incurring additional costs and would limit the negative impact of initial margin requirements on their liquidity.

Therefore, we propose a threshold of 500 million euros of Initial Margin for all transactions entered into between each fund and its counterparties. We believe that a threshold calculated on the basis of notional amount creates an incentive for riskier products such as Equity or Commodity derivatives compared to a threshold based on Initial Margin requirements. Indeed, the margin amount calculated on the basis of Initial Margin required would be far higher for exotic products than for vanilla products.

Q9: On two-way margin

The capital requirements for many financial institutions will be reduced if they receive initial margin.
Universal two-way margin will also have a positive effect on systemic risk by ensuring that the risks associated with non-cleared OTC transactions are covered if a counterparty defaults.
In order to ensure a higher degree of protection, we suggest investigating whether collateral could be posted to a third party, in order to avoid the problem of recovering collateral from a counterparty in default. The clearing houses could be well positioned for offering such a service, independent of their clearing business. The costs of having a third party custodian could be offset by reducing the initial margin for both parties.

However, we wish to stress that universal two-way margin would be far from neutral for markets participants in terms of liquidity, operational impact and cost.

On liquidity, universal two-way margin will have a major impact on most market participants.

Sourcing margin will be a major issue for UCITS, as structurally they do not have access to large pools of cash and are required to invest most of their assets. Especially if the practice of collateral re-use received under other transactions is forbidden.

From an operational perspective, implementing universal two-way margining will constitute a challenge for all concerned entities as internal systems, tools and processes will need to be altered or even replaced in order to take into account new workflows, calculation models etc. Depending on the existence of one or several calculation models and on how accurate definitions of haircuts, threshold etc. will be, the risk of dispute between parties may rise significantly.

Also, we need to consider the costs entailed by the implementation of universal two-way margining. As this stage, it is difficult to evaluate these costs but we can anticipate:

- An opportunity cost with a decrease in performance for final investors, reaching up to 14 basis points for investments in structured funds
- An operational cost with a volume of Margin Calls multiplied by 2, involving major operational costs for the funds and thus final investors.

Q 10 /Q 11/Q12: Regulated entities – non regulated entities

The proposal by which regulated entities post initial margin to unregulated counterparties would give rise to incongruous situations, such as a major international bank paying initial margin to a small, risky corporate. It is likely that banks would simply stop trading in such situations, thus preventing the corporate from appropriately hedging its risk.

In addition, when non-prudentially regulated entities start to experience difficulties, this proposal would accelerate their default by increasing their margin.

ELEMENT 3: BASELINE MINIMUM AMOUNTS AND METHODOLOGIES FOR INITIAL AND VARIATION MARGIN

It is stated that the methodologies must "ensure that all exposures are covered fully with a high degree of confidence".
However, the VaR proposed by IOSCO is significantly more onerous than the VaR proposed by ESMA for the CCPs. Thus, we are concerned that the margin system being proposed is intended to cover all risk that market participants have with their counterparties.
Indeed, the IOSCO consultation proposes a model-based approach consistent with a one-tailed 99 percent confidence interval over a 10-day horizon. These parameters are not consistent with the ESMA consultation paper, published on June 25th and entitled "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", in which the ESMA suggests European CCPs set up a one-tailed 99.5 percent confidence interval over a 5-day horizon for their models.

For more consistency, the Initial Margin computation should use the same parameters for a model-based approach whether the contract is cleared or not. We suggest an alignment with the parameters applicable to European CCPs.

In our view, the philosophy should be to aim for reasonable, not perfect, coverage, for the reasons set out below:

- o Capital requirements have been or will be significantly reinforced, thus reducing default risk for a large number of market participants (particularly banks under Basel III and insurers under Solvency II);
- o It would be preferable for the economy, particularly in times of recession, for assets to be used in financing the economy instead of lying dormant in collateral accounts;
- o Collateral requirements are likely to have a significant impact on market liquidity;
- o If margin requirements are too onerous, we are concerned that market participants will be less likely to prudently hedge their risks.

Q13 à Q18: Methodologies of IM and VM

We believe there should be a single model for calculating initial margin which is approved generally by the market, for a number of reasons:

- If counterparties to the same trade have different models, there will be continuous disputes about the amount of initial margin to be posted;
- Regulators do not necessarily have the resources to approve different internal models: this has been a problem with Solvency II, for example;
- Regulators in different jurisdictions are likely to have different approaches to internal models, thus exacerbating the differences between cross-border counterparties to the same trade;
- There is no incentive for market participants to develop internal models if they must be at least as conservative as the standard model.

In our view, the best approach would be to promote an industry initiative that would involve markets participants globally in order to propose and sign-off methodology on a set of standard models for various types of non-cleared OTC products. This could be similar to ISDA efforts to provide standard procedures, determinations and models for credit derivatives to the industry.

The methodologies proposed for calculating variation margin comply with regulated funds rules which require calculating the NAV daily, on a MtoM basis.

Q19: Minimum Transfer Amount

Current market practice on bilateral OTC trades is to have a Minimum Transfer Amount. The MTA for NAM's funds is currently 150 k€ and reduces the number of margin calls by 70% compared to an MTA of zero.
In accordance with EMIR, MTAs are still allowed by the regulator. The current MTA level used by NAM (150 k€) offers a good balance between risk coverage and operational efficiency and should be maintained.

ELEMENT 4: ELIGIBLE COLLATERAL FOR MARGIN

Q20/Q21: Eligible collateral

We strongly agree with the BCBS and IOSCO proposal of increasing the types of eligible collateral. If only a small pool of assets is eligible, the collateral requirements could have an impact on their price and availability.
Parties should be allowed to negotiate their own list of eligible collateral, taking into account local regulations and their in-house prudential policy. For instance, units of money market funds and other similar funds could also be included.

The delivery timeframe and the settlement rules of the securities should be an additional condition of collateral eligibility.

ELEMENT 5: TREATMENT OF PROVIDED MARGIN

Q22/23/24:

In our opinion, initial margin should be exchanged on a gross basis rather than net basis and should be held in segregated accounts with a third party custodian. This is the best protection from a counterparty's default. If it is decided that initial margin should be exchanged on a net basis, it is fundamental to define the rules on interest conflicts, on liabilities, on applicable law, on risk management process…

Moreover, we believe that re-use should not be banned but should be more strictly regulated. Indeed, liquidity would dry up and would have a negative impact on the economy. It would be preferable, particularly in times of recession, for assets to be used in financing the economy instead of lying dormant in collateral accounts.

ELEMENT 6: TREATMENT OF TRANSACTIONS WITH AFFILIATES

Q25 & 26:

Given that UCITS and AIF structures are not concerned by consolidated supervision, we are not in a position to respond to the proposed requirement to adapt margin requirements for derivatives between affiliates. However, perhaps the proposal for affiliates could be extended to apply to transactions between a fund and its custodian. In such a case, the exchange of initial margin would not be appropriate as the custodian would hold both the assets of the funds and the initial margin. We believe that in such circumstances, either no initial margin should be posted or that it should be posted to a third party.

ELEMENT 7: INTERACTION OF NATIONAL REGIMES IN CROSS-BORDER TRANSACTIONS

Q27:

We understand that, unless the host-country margin regime is not consistent with the home-country margin regime by the home-country supervisor, host-country margin rules should apply.
We agree with the proposed approach; in addition, it complies with the territoriality rules set forth in the cleared derivatives rules.
However, this rule might in certain circumstances lead to situations where, when the host-country margin regime is not approved by the home-country supervisor, one party would be required to post margin under its home-country regime while the other party would be exempt from such obligation, under its own regime.
As a consequence, it may be more appropriate to refer to the *lex situs* i.e. the law of the jurisdiction where the collateral is registered, which would ensure that a single regime applies to both parties in order to avoid discrepancies. This treatment would be coherent with the treatment of both the validity and the enforceability of collateral, to which the *lex situs (lex rei sitae)* also applies; this principle is recognized under private international law.
It would be preferable to refer to a single applicable law with respect to margin requirements such the *lex situs* in order to avoid a conflict of laws.