The Royal Bank of Scotland (RBS)

Response to BCBS IOSCO Consultative Document

Margin requirements for non-centrally cleared derivatives

27 September 2012

The Royal Bank of Scotland Group ("RBS") welcomes the opportunity to respond to the Basel Committee on Banking Supervision ("BCBS") International Organisation of Securities Commission ("IOSCO") consultation "Margin requirements for non-centrally cleared derivatives". We also wish to express our support for the Working Group of Margin Requirements (WGMR) in undertaking a Quantitative Impact Study, the results of which we submitted on 7 September. In this respect, we look forward to working with policymakers as they incorporate the QIS projections into more specific policy recommendations.

RBS understands policy makers' rationale of seeking to reduce systemic risk and interconnectedness of market participants' exposure to non-cleared OTC derivatives through a mandated margin (Initial and Variation) regime and supports regulators' endeavours to seek a globally aligned approach. We also support appropriate use of CCPs to reduce risk in the financial system and recognise the role regulators have assigned to central clearing as a mechanism for achieving these objectives. RBS has long been an advocate of central clearing and was one of the founding members of LCH SwapClear in 2000. As a G14 Bank, we have also been at the forefront of clearing initiatives globally and have devoted considerable resources to assisting in the development of CCP services for OTC dealer and client communities. However, given the growing importance of CCPs to the financial system, it is critical that only those products that are genuinely suitable for clearing (i.e. are liquid and sufficiently standardised) are mandated to clear. A meaningful volume of outstanding transactions will not meet these criteria for the foreseeable future.

We have contributed to the International Banking Federation, the International Swaps and Derivative Association, ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") responses to which we are broadly aligned. We have not, therefore, provided a response to the specific questions, but would like to emphasise the most pertinent points or those where these trade associations were unable to reach consensus.

To summarise, RBS is concerned that the baseline proposition for universal Initial Margin will generate a very large quantum of margin requirements which are disproportionate in comparison to policy makers' objectives and form a new source of systemic risk. We are confident that the liquidity implications of universal implementation will have serious unintended consequences for the economy. In forming these views we have made the assumption that Initial Margin is segregated and cannot be re-hypothecated, as this prevents margin posting generating its own counterparty credit risk. The result of such a requirement is that the initial margin becomes trapped liquidity. Our internal quantification is consistent with external estimates in the £5-10 trillion range. Removing this amount of liquidity from the global economy is very likely to have serious impacts on economic growth and employment. By way of comparison two rounds of Quantitative Easing (QE) in the UK amounted to £375 billion and in the US QE is more than $2 trillion and ECB 3 year LTROs were a combined € 1.020 billion.

We appreciate that the WGMR is alert to these matters and is minded to phase in with those concerns in mind. However, even a longer implementation window along the timeframes envisaged by Basel III would not adequately mitigate our concerns against the backdrop of other contemporaneous prudential measures (e.g. Capital ratios) and participants' propensity to accelerate compliance. In case of Initial Margin, participants would likely "hoard" liquidity immediately in anticipation of material future outflows.

RBS is a proponent of universal Variation Margin as a risk management tool. In addition, we support judicious use of Initial Margin, where part of a robust risk management framework. However we feel mandating use of Initial Margin requires substantial further study. We believe that the vast majority of OTC derivative transactions currently involve a financial institution subject to prudential capital requirements. This capital requirement – which will substantially increase under Basel III - currently underpins the OTC derivative markets' counterparty credit risk. The transition from a "survivor pays" (capital) model to a "defaulter pays" (margin) model is superficially attractive to banks, but we do not believe its impact has necessarily been fully thought through to permit safe implementation at this time. Work conducted by the Basel level has underscored the linkages between margin and pro-cyclicality[1] which we urge the WGMR to carefully consider along with other issues raised in this document and through trade association responses. In addition, as noted above, universal Initial Margin as envisaged by the WGMR is very likely to have damaging consequences on market liquidity.

These and other related concerns are discussed below:

<u>Securities markets efficiency</u>

- One important contributor to maintaining the efficiency and liquidity of the securities market (such as government bond markets) is the presence of a vibrant and functional repo market. Repo markets allow market participants to access secured and effective funding in order to finance activities. In addition repo markets also allow market makers to offer liquidity to clients in securities that they do not already own.

- Following the introduction of mandatory Initial Margin many market participants expect that due to a large reduction in the supply of high grade collateral (due to this collateral being segregated and non-rehypothecated) the repo markets will become much less liquid leading to what some have termed a 'collateral crunch'. Under this scenario, activities such as borrowing securities to make markets or lending money secured by securities will become significantly more expensive and is likely to result in significantly less activity. This is also likely to lead to lower overall volumes and liquidity in the cash government bond markets.

[1] "The role of margin requirements and haircuts in pro-cyclicality" March 2010

- Derivative users are expected to avail themselves extensively of repo markets to furnish Initial Margin as might be required. Currently the overwhelming majority of repo transactions are relatively short dated compared to derivative transactions. The requirement to post collateral for the duration of a swap is an element of "maturity transformation" which introduces new risks.

Increased concentration risk

- Mandated Initial Margin, as envisaged in the consultation, also may increase the concentration of risk within a handful of firms thus reducing competition. This is because firms will be incentivised to transact with a limited number of counterparties (i.e. those with existing positions with the client) to avail of portfolio synergies (offsets) to minimise incremental initial margin. CCPs are often referred to as 'natural monopolies' due to the benefits of margin netting for counterparties. Using the same logic, counterparties are likely to consolidate their future activities to other counterparties where they have offsetting positions. This will lead to higher barriers to entry for new market participants and a consolidation of activity in incumbent counterparties therefore increasing systemic risk. One could mitigate this by requiring each transaction to be margined in isolation, but this will certainly raise the liquidity impact to unmanageable levels. Our clients would likely scale down investing, exporting and employing staff, as they could no longer hedge relevant business risks.

- The requirement to segregate assets is also likely to increase exposure to a concentrated small group of firms operating as custodians which could be a new source of systemic risk.

Higher costs could reduce genuine hedging

- We agree that non-systemic non-financials firms should be exempted from the scope of any margining requirements It is important that treatment of these firms is aligned with proposals for mandated central clearing which in the EU and US recognises the importance of not penalising non-systemic non-financials from using derivatives to hedge commercial or treasury risks.

- There is a concern that systemic risk could increase if higher costs associated transacting derivatives results in lower overall levels of activity. The imposition of mandatory Initial Margin will require that firms collecting margin have the operational infrastructure, legal re-documentation and procedures in place to accommodate segregation (assuming that they do not use a third party, although this will lead to other concentration concerns as outlined above).

- Implementing these changes will be monumental and very costly while also increasing the compliance requirements on regulators to ensure that these funds are being adequately managed. In addition there is a risk that it will not be fully implemented by all counterparties.

- In addition, the costs to firms of restructuring their collateral management infrastructure to accommodate segregation will be non-trivial and likely to lead to economies of scale among a handful of very large custodians, as noted above. The result is increased concentration and risk and a reduction in competition.

- Tying up high quality collateral in this way will also make achieving the Liquidity Coverage Ratio under Basel 3/CRD 4 much more difficult (assuming the current definition of liquidity buffer remains).

- Depending on the counterparty's portfolio an internal model will result in lower margin requirements than a standard model. Building, obtaining approvals for and maintaining and internal model will be beyond the financial and operational capabilities of all but the most sophisticated users.

- Ultimately, these higher costs will be borne by end users by impacting fund performance.

<u>Credit sensitivity</u>

The proposed approach to Initial Margin is not sensitive to counterparty credit quality and thus may increase moral hazard by incentivising certain firms to assume more credit risk and reduce the robustness of credit processes. Banks are in the business of assessing counterparty credit risk and de-emphasising the process of credit management is a very punitive form of credit risk mitigation. It is unclear why Initial Margin is required to support derivatives transactions with a particular counterparty while lending to the same counterparty could theoretically be done on an unsecured basis.

In attempting to impose a cleared model on bi-lateral transactions, the proposed approach ignores the key differences between parties to a bilateral and a cleared transaction. Bilateral risk management is often more evolved, particularly when one party is a Prudential Financial Counterparty (PRFC) or Non Prudential Financial Counterparty (NPRFC). Moreover, for many significant financial institutions, a robust and conservative prudential regulatory framework is in place that requires sufficient and stable equity to be held to cover the risk of potential losses.

Conclusion

Until the results of the Quantitative Impact Study with respect to Initial Margin are more clearly understood and a proportionate and non-disruptive initial margin framework formulated, we believe that an appropriate policy response would be to progress with a robust mandatory Variation Margin regime with exemptions limited to non-systemic non-financials and inter-affiliate transactions. Variation Margin is much better understood, with $4 trillion "VM" (CSAs) in circulation today.[2] Such a regime would formalise and globalise a pre-existing process without the concomitant liquidity drain. Variation Margin can be safely re-hypothecated as it serves as partial settlement of the corresponding derivative and does not materially increase counterparty credit risk. In this respect we endorse voluntary moves by the Bank of England, other Central Banks, sovereigns and supra-nationals to enter into two way Variation margin arrangements allowing them to access improved terms of business.

[2] ISDA Margin Survey 2012