Annex - 1

Saudi Banks Comments on the BCBS Consultative Document "Margin Requirements for Non-Centrally-Cleared Derivatives"

BANK # 1

Comments

We have reviewed the consultative document from the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements (WGMR).

- We think that the proposals to establish minimum standards for margin requirements for non-centrally cleared derivatives develop in consultation with the Committee on Payment and Settlement Systems (CPSS) and the Committee on the Global Financial Systems (CGFS) will add strength to the global markets. As a bank, we currently have mutual margining requirements with some major financial counterparties dealing in OTC derivatives, where threshold limits, minimum transfer amounts, eligible collaterals (currently USD cash margin only), etc. are clearly agreed, we endeavor to have this arrangement with all our OTC derivative financial counterparties. For non-financial counterparties we establish risk limits before we enter into an OTC derivative transaction. The proposed minimum standards will also provide a guideline for margin requirements, if any, with other non-financial counterparties.

- We note also that certain jurisdictions may not specifically recognize the concepts of netting and its impact in the event of bankruptcy. Alignment in local jurisdictions with respect to this issue would be an enabler if the margining concept was to be rolled-out on a larger scale.

Instituting margin requirements for all non-centrally controlled derivatives will reduce systemic risk/risk of default of derivative counterparties and will enable financial institutions to better manage their risks. Potential impact of margin requirements on us and other financial institutions is required to be assessed (through the QIS), specifically its impact on liquidity. This should be considered with other parallel regulatory initiatives of BCBS impacting liquidity example. LCR, NSFR and central clearing of standardized derivatives.

BANK # 2

COMMENTS

1. The local market currently does not have any Central Clearing system or experience in operating one. Therefore the requirement to set up a margining mechanism for non-centrally cleared derivatives will be a substantial challenge.

2. The proposal does not provide details on how the process will work. It only provides a broad policy framework. A process map of how the proposed guidelines will be implemented locally is required for us to comment on likely impact on the banks and inter- bank market place.

3. In principle, the margin requirement would cover all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardized and bespoke) that are not centrally cleared by a central counterparty for any reason. The clearing and collateral requirements should not apply to markets such as FX, where trades are mostly short-dated and the principal concern is settlement, not counterparty. Derivatives with respect to SWAPS for example should therefore exclude FX Swaps.

4. The proposed margin requirements on non-centrally cleared derivatives could have a significant effect on the following:

   a. Liquidity of the banks and could cause a drag on the funding reference as in SIBOR. This in turn could lead to increase in the cost of borrowing and thus have a negative impact on economic growth.

   b. Given the relatively lower volume of derivative trades in Saudi Arabia, the margin requirements are likely to increase the bid/ask spread, consequently leading to lower volumes and liquidity in the derivatives market.

5. Initial margin refers to the amount of collateral exchanged at the outset of a transaction to protect the parties from potential future exposure, while variation margin refers to collateral exchanged during the course of a transaction to reflect the current exposure arising from changes in the value of the contract. The proposal recommends the mandatory exchange of initial and variation margin among transacting parties. In order to address the impact on liquidity, the proposal suggests that initial margin should be required only if it exceeds a threshold amount, depending on the risk profile of the counterparty. The proposal is to not net the initial margin. This means each counterparty would be required to post margin based on the gross position.

It is the bank's view that the potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties' need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as result of an increasing demand for such collateral in the aggregate.

Financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. It is important to recognize ongoing and parallel regulatory initiatives that will also have significant liquidity impacts; examples of these initiatives include the BCBS's Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

6. Appendix B provides proposed haircuts for asset classes. For "cash in different currency" the haircut is shown at 8%. This would be excessive for dollar margin posted through a Saudi Riyal denominated collateral or vice versa.

7. Appendix B -Clarity is required as to what is a "high quality" security or bond.

8. The proposal requires that "collateral assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress". Given lower volume of activity in the Saudi and regional markets, even in the regional sovereign bonds, it may be difficult to find assets which would fit this definition.

BANK # 3

Our views on the proposed framework and its impact are presented below.

The recent financial crisis, where there was excessive and opaque risk-taking through OTC derivatives, demonstrated weaknesses in the resiliency of banks and other market participants to financial and economic shocks. CPSS-IOSCO has issued several consultative documents on various aspects of market governance and infrastructure – notably in the area of ensuring maximum trading of OTC derivatives in as standardized format in electronic platforms in exchanges and to be cleared through central counterparties (CCPs). Through this document, BCBS-IOSCO have proposed a G20 mandated requirement on margin requirements for non-centrally-cleared derivatives. The key objectives of margin requirements are firstly reduction in systemic risks originating through OTC derivatives, and secondly to promote mandatory central clearing of standardized derivatives.

This consultative document lays out the framework for margin requirements on non-centrally-cleared derivatives but does not propose a specific process for implementation. The BCBS and IOSCO has rather outlined a series of issues and proposed solutions and have sought comments on the questions they have raised to address specifics of the margining framework. We recognize the importance of the proposed changes and have the following response to the key questions.

Scope of coverage – Subjected Instruments and Scope of Applicability

The key market participants in derivative markets are banks and financial institutions, sovereign investment agencies, and corporate. In principle, we believe everyone should be under the purview of the margining regime and exceptions like sovereign entities or multilateral financial institutions should be mandated by regulators based on universally accepted criteria.

We believe that OTC derivatives should as far as possible be traded in a transparent and standardized manner to reduce systemic risk. Towards this end, regulators may initially promote and implement the program of central clearing mandates. Once that is established, margining requirements for non-centrally cleared derivatives should be phased in. In the meantime, IOSCO should strengthen mandatory reporting of trade deals in derivatives and promote public disclosures of non-centrally cleared derivatives.

FX forwards and swaps are one of the most important products for non-financial corporate to manage their day to day cross-border payments, funding and investment needs, and manage their cash-flows. It is at the heart of the global payment system, and as such any disruptions to its operations could have serious and negative economic consequences. We welcome the recognition in WGMR that decisions on the application of the margining obligation to specific classes of OTC derivatives should into account the particular characteristics of each class. FX forwards should be exempted from margining requirements s FX markets have functioned very well in times of

high systemic risks and there is strong oversight of the market promoting well-functioning payment systems.

Any product class which demonstrates universality, promotes in economic sectors, and has not exposed financial systems to systemic risk, should not be regulated as stringently as others which have been adverse on the above stated factors. In this regard, the issue of Islamic finance/derivative products may have to be addressed specifically in view of their growing importance in some markets.

With respect to non-centrally-cleared derivatives, we support a mandatory and bilateral exchange of initial and variation margins among parties. However, the thresholds and extent of margins should have some relevance to their systemic impact as well as their credit rating. Initial margin thresholds is a very important tool in minimizing liquidity impacts for prudentially governed entities and maybe linked to their commitment to full disclosure of risk takings.

On the issue of specification of thresholds, we believe that clear and simple guidelines on these eligibilities promotes a bias free trading environment, and therefore regulators should uniformly apply globally and well publicized and scrutinized best practices towards it.

These requirements will, however, raise liquidity requirements and lock up scarce capital which could reduce innovations in derivatives. It may push the financial system towards a liquidity trap as institutions in derivatives. It may push the financial system towards a liquidity trap as institutions will rush towards acquiring highly liquid assets and thus not promote the same objectives as regulators may have in mind.

Baseline minimum amounts and methodologies for initial and variation margin

The proposed methodologies seem appropriate but not as practicable as not every institution can ensure robust and scientific use of internal models and thus promote audit arbitrage and other malpractices. We recommend that country regulators develop standardized internal models and regulate local margining activity accordingly.

On the proposed standardized schedule for margins, credit and interest rate products are prescribed appropriate margin requirements while it appears very high for FX products. Further, rather than classifying margins broadly by asset class only, further dimensions of product complexity should be considered as all products in one asset class are not similar and some may contribute more systemic risk than others (as demonstrated by barrier options in the past).

The variation margin should be collected frequently and should be based on full net current exposure and the minimum transfer amount should be set sufficiently low to ensure the least build up of current exposure. The frequency should be standardized as far as possible by asset class. We believe more

frequent posting promotes less risky behaviors while the proposal for using higher initial margins without variation margins will only accentuate liquidity problems. In this regard, care has to be taken to deter originators from pushing risk illiquid products with opaque risk features (as was clearly the case in the CDO markets).

Eligible Collateral for Margin

On the scope of eligible collateral, we believe it is too stringent and is developed from the perspective of only developed markets, while in less developed markets regulators may consider locally prevalent collaterals and recommend accordingly.

Treatment of provided margin

We support the proposed requirements on protection and ring fencing of margins, but a final view can only be taken once clear cut guidelines are formulated. We recommend that margin amounts should be secured with independent custodians who are under the purview of regulators. It is important that margin terms must allow the collateral to be immediately available to exposed parties in the event of counterparty default. Also, if regulators can ensure strict segregation and an effective insolvency regime, collateral should be allowed to be re-hypothecated or re-used by the collecting party.

Treatment of transactions with affiliates

The proposed requirements of derivative treatments with affiliates is a reasonable requirement, and local regulators should be given discretion in setting up margin requirements for non-centrally cleared derivatives between affiliates.

Consistency in Interaction of national regimes in cross-border transactions

BCBS-IOSCO has recommended an appropriate practice of national jurisdiction to be applied to legal entities in that jurisdiction. Once a final detailed framework is developed, we expect interactions are clearly defined and do not promote a litigious conduct among entities based in different jurisdictions.

In summary, given the importance of OTC markets and the need for their effective regulations, the future of the OTC derivatives industry critically hinges on whether the regulation strikes an appropriate balance between greater systemic stability while preserving the benefits of vibrant derivatives markets. This BCBS-BIS consultative document seems to have found that balance – as long as WGMR reckons the above critical points when finalizing implementation measures.

Finally, we believe that the proposed document needs to address the structural uniqueness of the Saudi Arabian economy which has traditional as well as Islamic products, which is not addressed in this revision. Therefore, the proposed framework may be validated by the empirical analysis of the Saudi Arabian banks derivative business.

BANK # 4

Overall comments

The issue of margin requirements for non-centrally-cleared derivatives is intricately linked to the derivatives market reforms as per the G20 declaration and specifically the proposal to move most derivatives trades to a central clearing platform. It has to be noted that the derivatives market in Saudi Arabia is very small (and less complex) in comparison to other G20 countries and so regulations designed for other countries may not always be suitable for the local market.

- The size of the local market does not warrant central clearing in the near term for smaller banking system. Hence, margining requirements that closely mimic the central clearing proposal may be a good way for such smaller authorities to ensure stability of the local derivatives market without having to implement a CCP.
- However, the proposed margining requirements can have a significant impact on the liquidity in the system by setting aside large amounts of liquid collateral as margins which will discourage active trading in the markets and hinder the development of deep capital markets in smaller system. Further, the funds and securities set aside as margins may not be available for credit creation and hence restrain economic growth.
- Besides, there are certain legal hurdles in making the proposals work in certain jurisdiction especially related to netting. Without the applicability of netting rules, the impact on liquidity will be severe as margins will need to be posted on a gross basis.
- It will be very useful for the regulator to consider the impact on trading volumes, liquidity and legal framework and determine a very gradual approach to implementation of any rules.

Question # 1: *What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Bank's response: Implementation of margining requirements should ideally be coordinated with central clearing proposals. For smaller jurisdiction, the conclusion is that central clearing is not immediately required – margining can be looked at independently.

Question # 2: *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Bank's response: FX swaps and forwards with short tenors should be excluded from the margin requirements. Most such transactions are

conducted for genuine funding purposes as opposed to speculation or even hedging FX movements since some currencies maybe is a pegged currency. Margins will impose an unnecessary burden on customers for little benefit in terms of risk mitigation.

Question # 3: *Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

Bank's response: No other exemptions are required in the local markets

Question # 4: *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's response: The proposals to apply the margining requirements similar to the requirements for central clearing as appropriate. It is also fair to require all covered entities to exchange initial and variation margins (with thresholds).

A major concern in certain is the lack of netting rules. Without this, all variation margins will need to be posted on a gross basis resulting in huge amounts of liquidity being consumed to support trades. Given that such liquidity is to be held in segregated accounts and is not available for use by the collecting party, this may strain the liquidity in the system.

A further concern in the smaller markets is the lack of sufficient quantities of liquid, high quality collateral in terms of Government securities.

Question # 5: *Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?*

Bank's response: Thresholds are appropriate to manage the liquidity impact. The inconsistency with central clearing is justified because under margining collateral is posted to several counterparties resulting in larger amounts of collateral as compared to central clearing where only one consolidated collateral is posted to the CCP (assuming netting).

Thresholds could be set based on the capital position of the counterparty as is usual practice for CSAs. Small threshold amounts may not result in regulatory arbitrage.

***Question # 6**: Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?*

Bank's response: It is appropriate for thresholds to reflect the riskiness of the counterparties. Besides the capital position of the entity, it is appropriate to take into account the systemic risk based on the level of the entities' derivatives trading activity.

***Question # 7**: Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

Bank's response: Yes it is appropriate. The benefit of prudential regulation may be reflected in higher thresholds that such entities benefit from. Given that there are separate proposals to increase the capital requirements for trading activities by banks, there is a risk of doubly penalising banks with both higher capital and a higher margin requirements that needs to be avoided.

***Question # 8:** How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?*

Bank's response: Thresholds may be based on approved models or standardised amounts depending on the sophistication of the entity. In either case it is important that netting of risks (where suitable – same underlying and similar maturities) is allowed to mitigate the liquidity consumption.

***Question # 9:** What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?*

Bank's response: Universal two-way margin requirements will result in higher liquidity requirements and must be factored into all the reforms being considered in relation to liquidity. Consumption of liquidity will for sure constrain the asset balances and so may result in a small improvement in capital position but at reduced profitability.

Margining will augment the current CSA type arrangements that enable bilateral collateralising of credit exposures.

Question # 10: *What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's response: Ideally, only variation margins should be exchanged with non-regulated entities such as systemically important corporates. Initial margins should be posted by non-regulated entities to regulated entities and not vice versa.

Question # 11: *Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?*

Bank's response: It will be ideal if there are no exemptions for such entities since exemptions will create asymmetry in the margin posting resulting in much higher liquidity costs to the market making banks. This is because the market maker may be posting collateral on one side but not receiving any collateral from the exempt entity.

Question # 12: *Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?*

Bank's response: No exemptions are required.

Question # 13: *Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?*

Bank's response: The proposed methodologies are appropriate. However, there needs to be sufficient time and resources available with the regulatory authorities to review model based methodologies proposed by banks. The standardised approach which does not allow for netting benefits is likely to be too onerous and consequently result in a major contraction of trading volumes as banks try to reduce funds consumed for initial margins.

Question # 14: *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Bank's response: Diversification should be mainly allowed within asset classes and for products that have clear inter-linkages such as FX and Interest Rates.

Question # 15: *With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?*

Bank's response: The proposed standardised margins seem appropriate but need to be compared against model based outputs used by major CCPs to ensure that they are consistent. A major concern will be the applicability of netting rules for using standardised initial margins.

Question # 16: *Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?*

Bank's response: They are appropriate.

Question # 17: *With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?*

Bank's response: Daily exchange of variation margins is appropriate. However, for small market participants and for the local markets where volumes are lower, it may be suitable to consider a less frequent exchange of variation margins such as weekly.

Question # 18: *Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?*

Bank's response: Frequent exchange of variation margins will reduce any procyclical or cliff edge effects.

Question # 19: *What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?*

Response: Depending on the size of the entities, MTA of around USD 0.5m would normally be effective in reducing the risk without causing a huge operational burden.

Question # 20. *Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

Bank's response: The proposed scope is appropriate. However, national regulators should take the main lead in establishing the range of acceptable collateral and the haircuts for such securities. A broad range of acceptable securities will mitigate the liquidity burden of the margining rules.

Question # 21: *Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

Bank's response: There may not be any need for further diversification criteria for collateral eligibility as long as the types of the collateral and the haircuts are determined by the authorities and reviewed on a regular basis to allow for changes in market conditions.

Question # 22: *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?*

Bank's response: The proposed requirements are quite conservative and provide adequate protection of the margin amounts. However, there need to be local enabling laws for such rules to be effective in jurisdiction in relation to bankruptcy.

Question # 23: *Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

Bank's response: Requirement for the initial margin to be on a gross basis is highly conservative and will result in large amounts of margins set aside for trading. Although, it is prudent to use a gross basis rather than a net basis at an overall level, there needs to be allowance for netting at least across similar risks between the counterparties. For example, if Bank A has done two equal and opposite transactions with Bank B, it is appropriate for the risks to be netted and no initial margin exchanged as the banks have no net market risk and credit risk to each other.

Question # 24: *Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's*

bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

Bank's response: Depending on the total liquidity impact of these proposals on the system, it may well be needed to consider the collateral as available liquidity for the institution that is holding such funds. Otherwise, we may be creating a large pool of funds that cannot effectively be used for credit creation and drag on economic growth.

Question # 25: *Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

Bank's response: They are appropriate. It is prudent to exchange variation margins between affiliates.

Question # 26: *Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?*

Bank's response: There are no systemic risk benefits in margin exchange between affiliates within the same jurisdiction.

Question # 27: *Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?*

Bank's response: The proposed approach leads to entities mainly following the local regulatory rules which is appropriate. It will be desirable for Saudi regulators to work with other major countries to ensure that all countries accept Saudi regulations are being suitable for cross border transactions.

BANK # 5

General observations

The aims of introducing initial margin requirements for non-centrally-cleared derivatives are stated to be two-fold: (1) to encourage a greater proportion of transactions to be centrally cleared and (2) to reduce systemic risk.

- As regards the first point, we believe the introduction of margin requirements to non-centrally-cleared derivatives may be somewhat successful in meeting this aim. However, this raises the issue of creating massive concentrations of systemic risk in central clearers (which history shows are not immune to failure) and, in some jurisdictions, is problematic since there is, as yet, no central clearing arrangement for local currency derivatives.

- With regard to the second motivation, the paper starts from the premise that OTC derivatives in general have been problematic in terms of causing unhealthy levels of systemic risk and that this was evidenced during the recent crisis. We would argue that it is less than clear that that was the case, rather the problems occurred overwhelmingly in credit derivatives and like instruments, rather than in, say, plain vanilla interest rate swaps.

  Accordingly, the proposals raise the prospect of "throwing the baby out with the bath water" – making it more expensive for all derivative contracts to be executed and potentially reducing liquidity in all derivative markets, when the crux of the problem relates to a subset of the overall derivative market. These costs would be passed on to the end consumer, for example making fixed rate mortgages in the nascent smaller mortgage market more expensive for the aspirant home buyer, as well as acting as a disincentive for corporations and banks to properly manage their risks.

- In addition to having a material negative effect on derivative contracts that might widely be considered to be beneficial to individuals, corporations and the economy as a whole, there is also doubt whether initial margining is a particularly effective tool to mitigate the risk of those derivatives that did give rise to systemic risk issues, most obviously with the collapse of AIG.

- Credit derivatives are, in essence, deep out of the money options, initial margins on this kind of contract, calculated along the lines suggested in the paper (99%, 10 day move) would have resulted in negligible initial margin on the majority of credit derivatives written in, say 2006, when credit spreads where very low. Even the proposed standardized initial margin requirements contained in appendix A to the document suggest

only a 5% initial margin on a 5 year CDS. Given the gap risk of these contracts, this seems inadequate to provide material comfort in the event of a new financial crisis of systemic proportions.

- Furthermore, as the paper suggests, systemic risk from these contracts is concentrated in a few large institutions. Accordingly, it seems to us inequitable to impose general requirements, raising costs for all participants and end users. Greater targeting of regulation – be it margin requirements or otherwise – on the institutions that pose the systemic risk seems to us fairer. Indeed, perhaps by requiring that systemically important institutions need to post substantially more margin than other entities one would reach a scenario where - to the extent they have posted adequate margin - their failure will become less unthinkable: in short they could continue to be big, but would tend to cease to be too big to fail.

Specific questions raised in the paper

Question # 1: *What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Bank's response: We feel an answer to this question is dependent on the completion of our own and wider market Quantitative Impact Studies.

Question # 2: *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Bank's response: Exempting short dated FX transactions would certainly ease implementation and reduce unintended consequences. But it is not clear that these transactions pose less systemic risk than say (vanilla) IRS, so why should not also be excluded? Exclusion criteria could be based around a (regulatory or internal) PFE calculation, over the life of the transaction or a shorter term based on the (variation) margining documentation it is subject to. An intent (hedging, speculation) criterion might also be imposed.

This does rather come back to our opening observations that (1) lower risk transactions do not need initial margining and (2) there is limited meaningful risk reduction in applying initial margin to the much higher risk instruments.

Question # 4: *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's response: Exchanging initial margin creates delivery risks. It also increases the counterparty risk run by the party that is out of the money, who would otherwise have no counterparty risk. Imposing initial margin requirements could even make it harder for an institution seeking to de-risk its positions to do so, given the liquidity burden it would impose if positions were closed other than with the original counterparty.

Questions would also need to be answered about the implications of non-receipt of initial margin. Would this result in trade cancellation? Default of the entire portfolio? How long would be given to receive?

Question # 5-8: *the suitability of margin thresholds in respect to managing liquidity / differing levels across entities (SIFIs) / prudentially regulated entities / evaluation basis.*

Bank's response: In our view the "appropriate" magnitude of thresholds is likely to fall out of the proposed QIS.

Again we would argue that banks and other entities engaged in modest levels of derivative activity for commercial purposes, driven by customer requirements, and which activities pose no systemic risk, domestically or internationally, should be exempted from posting initial margin. Setting thresholds at a sufficient level may be a way of achieving this.

Question # 11: *Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?*

Bank's response: A blanket exemption of sovereigns and central banks, in the context of e.g. the EU crisis, seems unduly generous to some of these entities.

Exempting end-users, does not really exempt them - they will still have to pay for the cost of the liquidity.

Question # 12: *Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?*

Bank's response: We believe thought should be given to "exempting" smaller banks whose derivative activities do not pose systemic risks.

Question # 14: *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Bank's response: Given that the intent is to reduce systemic risk, we should be examining possible outcomes *given that a potential systemic risk event is occurring* diversification benefits should therefore be viewed very sceptically.

Question # 22: *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?*

Bank's response: The principle is sound. The difficulty of achieving this with legal certainty in all relevant jurisdictions should not be under-estimated.

In closing, we would like to emphasise regulator's critical role in discussions with the BCBS on this subject and like topics. These proposals will no doubt receive a great deal of attention and lobbying from the major international banks, predominantly from the G7 countries. We believe it is vital that the implications for the banks and wider economies of other countries, be considered and that countries with smaller banking system are not penalised under the guise of "level playing field" concerns.

<u>BANK # 6</u>

Comments

Question # 1: *What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Bank's response: In our view, the implementation of these recommendations should be coordinated with CCP mandates to ensure that there are no regulatory arbitrages. The phase-in period should be at least two to three years to allow all stakeholders enough time to change their business practices and systems and it should be coordinated with CCP mandates.

Question # 2: *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Bank's response: FX swaps and forwards market is highly liquid with settlement risk eliminated through CLS. Net open positions are well monitored by central banks and warrant higher capital allocation under the BIS rules. Hence there is a strong case to exempt them from margin requirements especially when the remaining tenor is less than one year.

Question # 3: *Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

Bank's response: Products with rights but not obligations, e.g. bought options, should be exempted for the buyer from two way initial margin requirements i.e. only the seller should post initial margin.

Question # 4: *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's response: Yes. It reduces the systemic risk and eliminates regulatory arbitrage for non-centrally cleared derivatives. We feel hedge funds which conduct significant derivative business should also be included in the scope.

Question # 5: *Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?*

Bank's response: Initial margin thresholds are appropriate to reduce the operational burden. We consider that in case the total initial margin is below $ 1 million, it may be exempted to reduce operational burden. We also believe that initial margin should be managed on a gross basis for it to be comparable to the CCP mandate. We believe that $ 1 million is too small an amount for the big players to consider for any regulatory arbitrage purposes.

Question # 6: *Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entitity's systemic risk level?*

Bank's response: Initial margin threshold should depend on credit rating of the entity. and entity's systemic risk contribution. This will also be in line with the CVA practice which covers the counterarty risk by seeking different charges for different rated counterparties. Standardized initial margin requirements on outstanding notionals can serve as a proxy for the systemic risk contributed by that entity.

Question # 7: *Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

Bank's response: We believe that it is appropriate to limit the initial margin thresholds to prudentially regulated entities and systemically important non-financial entities including hedge funds.

Question # 8: How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

Bank's response: We believe that models should not be allowed since they will create arbitrage opportunities and arguments over assumptions. Rather simpler standardized initial margins should be used.

Question # 9: *What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?*

Bank's response: Universal two-way margining, while reducing the counterparty and systemic risk, will also severely impact the liquidity position of active market participants. In times of market distress, forced liquidation of derivative positions due to insufficient margins will feed a chain reaction exacerbating the market distress. It will also increase of cost for end user since banks will price the cost of capital on margin requirements into derivative pricing, especially when the collaterals are segregated and not useable. Hence we suggest that initial margin should be posted on a net basis. In addition, daily margining process will put enormous pressure on Operations unit of the bank leading to higher operational risk.

Question # 10: *What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's response: Regulated entities posting initial margin with unregulated counterparties should not create any systemic risk as long as the collaterals are segregated with a custodian and not controlled by unregulated counterparty.

Question # 11: *Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?*

Bank's response: Proposed exemptions for sovereigns and /or central banks are appropriate. However, other non-financial entities who are actively trading in derivatives e.g. hedge funds should be subject to margin requirements. The criteria should be the systemic risk contributed by those entities as measured by standardised initial margins on outstanding notionals.

Question # 12: *Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?*

Bank's response: In keeping with the above reasoning, any entity which has a very low systemic contribution can be exempted from these requirements. This systemic risk contribution based on standardized initial margins on outstanding notionals should be recalculated at least quarterly.

Question # 13: *Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?*

Bank's response: The proposed methodology is appropriate. Coupled with adjustments for non-daily frequencies, legally valid netting and threshold amounts, the approach can be put into practice.

Question # 14: *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Bank's response: Diversification across asset classes is of limited benefit due to weak links and hence should not be allowed for diversification benefits.

Question # 15: *With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?*

Bank's response: We suggest a weekly frequency for close out horizon and hence the suggested haircuts which are based on daily frequency should be suitably adjusted for weekly frequency. Alternately two schedules i.e. one for daily and another for weekly frequency can be prescribed.

Question # 16: *Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?*

Bank's response: We consider the proposed methodology to be appropriate with suitable adjustment to frequency i.e. weekly.

Question # 17: *With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?*

Bank's response: Weekly frequency is appropriate with suitable adjustment to close out horizon.

Question # 18: *Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?*

Bank's response: Proposed framework will create a procyclical effect since mandatory liquidation of derivative positions will be triggered during market distress when additional collaterals are not posted. The suggested frequency for variation margin should discourage "cliff-edge" additional initial margin calls.

Question # 19: *What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?*

Bank's response: USD 500,000 on a net basis.

Question # 20: *Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

Bank's response: Proposed eligible collaterals are appropriate.

Question # 21: *Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

Bank's response: We suggest a weekly frequency for close out horizon and hence the suggested haircuts which are based on daily frequency should be suitably adjusted for weekly frequency. Alternately two schedules i.e. one for daily and another for weekly frequency can be prescribed.

Question # 22: *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key*

principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Bank's response: Proposed requirements are not appropriate since they don't protect the collaterals from bankruptcy of collecting party. Even if it protects, it will make the repossession cumbersome. Hence third party e.g. CCP or Custodian along with related regulation should be considered.

Question # 23: *Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

Bank's response: We feel calculating initial margin on a net basis is sufficient to reduce the systemic risk and it should be reviewed frequently or when new positions are added. If gross initial margins are held by custodians, it will create concentration risk. Posting initial margin on net basis will also bring parity with CCP practices and eliminate any regulatory arbitrage. Net basis will also reduce the systemic impact on collateral requirement and improve liquidity.

Question # 24: *Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?*

Bank's response: No. Given the several instances of customer assets comingled with firm's assets, it is preferable that collaterals are not re-used or re-hypothecated.

Question # 25: *Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

Bank's response: We consider it appropriate. Discretion on initial margin requirements are not required since affiliated parties are already linked and initial margin will not protect either firm in a bankruptcy situation.

Question # 26: *Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?*

Bank's response: Yes.

Question # 27: *Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?*

Bank's reply: We consider it appropriate.

BANK # 7

Comments

Margin requirements for non-centrally-cleared derivatives have two main benefits:

Reduction of systemic risk. Only standardized derivatives are suitable for central clearing. A substantial fraction of derivatives are not standardized and will not be able to be cleared. These non-centrally-cleared derivatives, which total hundreds of trillions of dollars of notional amounts, pose the same type of systemic contagion and spillover risks that materialized in the recent financial crisis. Margin requirements for non-centrally-cleared derivatives would be expected to reduce contagion and spillover effects by ensuring that collateral are available to offset losses caused by the default of derivatives counterparty. Margin requirements can also have broader macro prudential benefits, by reducing the financial system's vulnerability to potentially de-stabilizing procyclicality and limiting the build-up of uncollateralized exposures within the financial system.

Promotion of central clearing. In many jurisdictions central clearing will be mandatory for most standardized derivatives. But clearing imposes costs, in part because Central Counterparty (CCPs) require margin to be posted. Margin requirements on non-centrally-cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing, making the G20's original 2009 reform program more effective. This could, in turn, contribute to the reduction of systemic risk.

Following are TROPS comments on operational aspects of these requirements and overall theme of main document:

The document requires following actions to monitor the OTC derivative activities:

1- Trading of all standardized OTC derivatives through exchanges or electronic platform

2- Establishing a CCP where all OTC trades could be cleared

3- Concept of trade repositories where trade could be reported for better monitoring of margin requirements

4- In case of non-centrally cleared trades, the imposition of higher capital requirements

Future requirements as per proposed implementation plan:

i) all NCC OTCs (interest rate, credit, equity, foreign exchange and commodity) are to be subject to margin requirements without exception;
ii) all firms using NCC OTCs must exchange initial margin (IM) and variation margin (VM) on a gross, two way basis, with some adjustment to standardized threshold amounts, based on the risks posed by counterparty. For example, a higher threshold is proposed for transactions between two regulated entities subject to prudential regulation, with more aggressive thresholds proposed where one or more parties to a transaction is subject to little or no regulation;
iii) tolerance for firms wishing keep their own margin calculation models (as opposed to using the proposed standardized threshold amounts), provided: (i) these are verified by national regulators; and (ii) firms do not switch between models to "cherry pick" favorable calculations;
iv) intra-group transactions should be subject to full VM, with national regulators having discretion to impose IM requirements on intra-group transactions;
v) collateral posted must be highly liquid (cash, government bonds, high quality corporate bonds, covered bonds, equities and gold). Firms should be prohibited from accepting securities issued by its counterparty or one of the counterparty's related entities;
vi) firms receiving collateral will be prohibited from re-using/re-hypothecation, and it must be segregated to protect counterparty interests in the event of a bankruptcy; and
vii) implementing jurisdictions should ensure consistency in the application of the above-mentioned requirements as far as possible in an effort to prevent regulation arbitrage and reduce duplication.

In order to implement above mentioned requirements, following would need to be considered:

i) Defining the rules on standardization of OTC derivatives so that the same could be traded on local or overseas exchanges or electronic platform
ii) Defining the working methodology of Central Counterparty (CCP) which could be based on a local or overseas standing
iii) Creation of repositories where the trade could be reported for margin monitoring

Standardizing legal terms is the first condition for central clearing. It provides the basis for establishing trading relationships between counterparties and sets forth the contract specifications through common legal documentation including master agreements, definitions and confirmations. The **ISDA Master Agreement**, **Customer Treasury**

Agreement (CTA) and related asset-specific documentation which have become industry standards might require further review by relevant bodies.

Standardization of legal terms will be a required step towards central clearing. Novation by the CCP cannot take place in its absence. The CCP has to be certain that trades are conducted on the same terms to facilitate netting and risk management.

Current market practice applied in local trading environment.

b. For standardized transaction (exchange trade activities) market participants systematically provide margins (initial and variation) to the exchanges through their brokers and keep proper segregated records of such margin balances.

c. For OTC transactions, margin is exchanged between the counterparts on case to case basis as per the demand of the trade counterpart who does not want to take any risk on other party of the transactions. In this scenarios, financial institutions (FI-A) that provide the margin to the demanding party of the transactions (FI-B) from their own funds (in case of their proprietary transactions) but for back to back transactions in some scenarios they also demand the similar margin amount from the counterpart (CPT-1) whose transactions has been covered in the market with (FI-B) and against which the margin had been demanded by (FI-B).

d. Financial institutions that do not have sophisticated system to calculate the variation margin on outstanding position very much depend on their counterparts who have such system capability to calculate the margin and demand for submission of required margin from their corporate counterparts on the other side of the transaction. In this scenario, to apply the above required actions, market participants would be required to upgrade their system to handle above mentioned requirements. Similarly the corporate counterparts whose transaction has been covered in the market will have operational hurdles to manage the movement of margin every now and then.

   We consider that Foreign exchange contracts (forward and swaps) should be exempted from margining requirements. The reasons for such exemptions are:

   - they are high in volume and might be difficult to manage the margin movements on those deals
   - most of the forwards are done against corporate customer for their commercial activities and
   - Swaps are mostly used for liquidity and balance sheet management purposes.

Business Constraints:

In case of standardization of contracts eligible for trading on exchange clearance through CCP, it will restrict development of advance / new generation of derivative contract that are created every now and then to meet specific needs of customer i.e. TRF, structured IRS with rate protection (caps / floor) options embedded etc.

Operational Constraints:

Lack of operational process without straight through processing (STP) will require more manual efforts in monitoring and managing margin management

Straight-through processing is the key to margin management. It reduces risk from the otherwise manually intensive nature of post-trade processing and the potential for significant market disruptions in closing out positions following a member default. STP therefore facilitates novation and ensures that trades can be processed safely.

We also consider that following should be used as eligible collateral for margin management:

- Cash;
    - High quality government and central bank securities;
    - High quality corporate bonds;

Above are easy to handle and less expensive on account of hair-cut.

<u>BANK # 8</u>

Bank's Comments

Question # 1*: What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Bank's Response: Given that banks are involved from the consultative phase and there will also be a QIS, a phase-in period of 1 year, from the time that respective national supervisor adopts the final BIS requirements, should be reasonable.

Question # 2: *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Bank's Response: Yes, foreign exchange swaps and forwards upto a certain tenor should be exempt.

Question # 3: *Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

Bank's Response: Currency pairs that follow a policy of fixed exchange rates, need to be considered for exemption for fx options. The fixed exchange rate regime leads to low volatility in the currency pairs and precludes the need for margin requirements.

Question # 4: *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's Response: Yes, the proposed key principle and proposed requirement appropriately balances the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact.

Question # 5*: Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?*

Bank's Response: Yes, initial margin thresholds are an appropriate tool for managing the liquidity impact of the proposed requirements. The thresholds should also be set at a level that promotes dealing through CCPs or incentivizes the establishment of CCPs in jurisdictions that have not established them to date. To help avoid regulatory arbitrage, thresholds should be consistent across all jurisdictions.

Question # 6. *Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?*

Bank's Response: It is desirable to apply different threshold amounts to different types of derivative market participants for the reasons mentioned. However, the number of types of market participants should be limited so as to not over-complicate the framework.

Question # 7: *Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

Bank's Response: Yes, it is appropriate to limit the use of initial margin thresholds to entitities that are prudentially regulated.

Question # 8: *How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?*

Bank's Response: A two pronged approach is reasonable; those entities that are unable to implement an approved internal model or third party model should have the option to utilize a standardized method.

Question # 9: *What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?*

Bank's Response: Other than the demand-supply dimension of collateral eligible assets and its knock-on consequences on LCR and NSFR which can be better assessed after the QIS study, the financial health of market participants should be better after universal two-way margining ("defaulter-pay" versus "survivor-pay"). Not only will it decrease risk appetite of market participants but it will also curb excessive (and in some cases) reckless speculation using non-centrally cleared derivatives.

Question # 10: *What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Bank's Response: Requiring regulated entities to post initial margin to unregulated countperties will reduce systemic risks since it will decrease the ability/ risk appetite (due to collateral posting) of the regulated entities to increase the size of their derivatives books.

Question # 11: *Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?*

Bank's Response: It should be the discretion of the bank to have an internal policy on margin requirements for non-financial entitities, sovereigns and central banks.

Question # 12*: Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?*

Bank's Response: No comment.

Question # 13: *Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?*

Bank's Response: Yes, further guidance may be needed from the national supervisor for the calibration to a period of significant financial stress.

Question # 14: *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Bank's Response: Yes

Question # 15. *With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?*

Bank's Response: The initial margin levels prescribed in the standardised schedule can be better assessed for appropriateness after the QIS study.

Question # 16: *Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?*

Bank's Response: Yes, the proposed methodologies for calculating variation margin are appropriate.

Question # 17: *With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?*

Bank's Response: Daily variation margin payments should be required subject to minimum transfer amounts (MTAs) set at a sufficient level so as to ensure that current expsoure does not build up.

Question # 18: *Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?*

Bank's Response: Yes, with daily variation margin requirements and MTAs set at at reasonable level so as to prevent unintended procyclical effects during market stress.

Question # 19: *What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?*

Bank's Response: This can be better assessed after the QIS study.

Question # 20*: Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

Bank's Response: Yes the scope is appropriate.

Question # 21: *Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

Bank's Response: No, it is in the bank's interest to manage concentration risk in collateral by itself. National supervisors should develop their own list of eligible collateral assets and respective haircuts based on the key principle taking into account own market conditions, etc.

Question # 22: *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key*

principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Bank's Response: Yes, the proposed key principle and requirement are adequate.

Question # 23: *Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

Bank's Response: Initial margin should be exchange in gross; there is a possibility of concentration risk with custodian banks. This needs further assessment post QIS study.

Question # 24: *Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?*

Bank's Response: No, collateral should not be allowed to be re-hypothecated or re-used by the collecting party.

Question # 25: *Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

Bank's Response: This should be established at the discretion of national supervisors. There will be more visibility on this after the QIS study.

Question # 26: *Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of bnot requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?*

Bank's Response: This should be established at the discretion of national supervisors and there will be more visibility after the QIS study.

Question # 27: *Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?*

Bank's Response: Yes, it is appropriate.