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

Dear Secretariats,

Shell International Trading and Shipping Company Limited ("**Shell**") appreciates this opportunity to respond to the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") with respect to the Consultative Document "Margin requirements for non-centrally-cleared derivatives" (the "**Consultation**").

A. Introduction

Shell understands the objective expressed by the G20 nations to require over-the-counter ("**OTC**") derivatives to be cleared and for uncleared trades to be subject to robust operational processes and capital requirements including with regard to margin. As such, Shell is supportive of the Consultation's three main stated aims of:

- creating systemic resiliency,
- promotion of central clearing; and
- the preservation of market and collateral liquidity.

Shell applauds and welcomes this initiative as a positive step towards tackling these important issues on a global basis, so minimizing the potential for regulatory arbitrage among regions that would be exacerbated by parallel development of differing standards to cover similar issues.

In this letter we have provided a narrative of our most important points in the interests of submitting a response by the relevant deadline. We can, if requested, follow up with with a version of our response separating out the answers to each of the questions in the Consultation, for ease of reference.

B. Executive Summary

- **1. Introductory Statement**

- As a starting point, we would reiterate that we support establishment of a level playing field for all non-banking entities who carry out regulated activities as part of their business (as contrasted with hedging the commercial activity or treasury financing requirements of their own majority-owned group companies). Any measures that seek to draw an arbitrary line between those non-banks who operate in the regulated space for these purposes on the basis of size alone could have adverse consequences in terms of market stability and would almost certainly lead to a two tier market. Those falling just under the line would not be subject to the same regulatory requirements as those who fall just above the line and so would be able to offer uncleared products more cheaply to end users who, in the interests of avoiding expensive hedging costs (particularly where there is no cheaper cleared alternative available), would either choose not to hedge or would choose the least costly (and also the least regulated) alternative.

- This level playing field only can be effectively facilitated by the development and implementation of internationally harmonised rules, and the consistent interpretation and application of those rules, by all regulators (wherever located) to all market participants in different regions. Divergent, overlapping or inconsistent standards, or differing constructions or understandings of how such standards should be applied by different legislative and regulatory bodies, will lead to commercial uncertainty and will create the potential for regulatory arbitrage. It also may have the effect of putting parties that are subject to more stringent regimes at a competitive disadvantage to those that are subject to more flexible, less onerous requirements. Overall, this could lead to an economic shift from those regions where more stringent (and so more expensive) requirements apply.

- Furthermore, to achieve the objective of attaining market stability in a risk-appropriate and proportionate way, it is crucial that the key criteria upon which any differentiation between market participants is applied should be related to their objective creditworthiness.

2. Key Points

a. Process:

Timing:

- Shell echoes the calls from other market participants for BCBS and IOSCO to conduct a thorough impact study before imposing mandatory margin requirements. We believe, as set out in more detail below, that the requirements if implemented as proposed would have a detrimental effect on the market as a whole. The effects in terms of liquidity drain, collateral demand and increased transaction costs may well outweigh the actual benefits of such measures.

- There should be a long phase-in period for any margin requirements to provide affected market participants with adequate time to prepare and, if thought necessary, adjust their business model accordingly. This should take into account that some (particularly non-banking) Covered Entities will require additional time to implement changes to their systems, operations and working practices to comply with the relevant requirements. Phase in should also provide regulators with

enough time to properly gauge the impact of the rules and eliminate potential problems that may result from a premature application of such proposals.

Existing OTC derivatives:

Margin requirements should only apply to uncleared OTC derivatives executed on or after the effective date of the relevant requirements, and not to pre-existing transactions.

Link to Clearing Requirements:

Mandatory margin requirements for any class of uncleared OTC derivatives should not apply until the clearing mandate for such class is implemented.

b. Posting Requirements:

Mandatory Initial Margin ("IM"):

- As a general principle we do not agree with the imposition of mandatory IM requirements. At the very least, these should not be imposed without further in depth study of the potential impacts.
- If BCBS and IOSCO are wedded to the idea of mandatory IM being applicable to at least some section of the uncleared OTC derivatives market, one-way mandatory IM posting is not acceptable, as it is contrary to the establishment of a level playing field.
- If a party is regarded as either a financial firm or a systemically important non-financial firm (each a "**Covered Entity**" and together the "**Covered Entities**"), and so subject to the margin requirements, then it should be treated on a level playing field to all others that fall within scope, whether they are prudentially regulated or not, with the only potentially differentiating factors being the risk profile and purposes of the relevant transactions and the creditworthiness of the party.
- This means if Covered Entities are required to collect IM, then they should also be required to post it to other Covered Entities. The requirement to post and collect IM should be two-way as between all Covered Entities and IM posted on this basis should be segregated and not permitted to be reused/ rehypothecated.

Posting Variation Margin ("VM"):

- Shell endorses the collection of VM between Covered Entities as a means to promote systemic resiliency. The exchange of VM is a practical way to avoid the accumulation of unrecognized losses with counterparties that, left unchecked, could become a source of instability to the system.
- VM exchange alone with no thresholds should address systemic resilience concerns and, for that reason, we can live with a zero threshold for VM exchanged between Covered Entities if the quid pro quo is either not having to post and collect mandatory IM or, if mandatory IM is required between Covered Parties, if a threshold can be applied that takes into account creditworthiness.
- Any mandatory exchange of VM between Covered Entities should be subject to a minimum transfer amount to ensure that the requirement to exchange VM frequently is not unnecessarily onerous or administratively burdensome. We suggest that mandated minimum transfer amount should be USD500k, particularly if a zero threshold is applied to VM. The parties should be free to agree to a lower minimum transfer amount if this is appropriate and workable.

Thresholds:

- If Covered Entities that are prudentially regulated entities (PREs) are allowed to apply thresholds to reduce the amount of IM they need to collect from other Covered Entities subject to an aggregate cap based on regulatory capital cover, then if non-prudentially regulated entities (non-PREs) are also included within the Covered Entities, they should be allowed a similar threshold.

Scope of Coverage – Exclude Deliverable FX:

- Deliverable FX should be excluded from the scope of the requirements altogether. At the very least it should be excluded from the IM requirement as the usual risk is settlement risk rather than credit exposure risk with regard to the counterparty.

Scope of Coverage – Type of Entity:

- If a company is not a Covered Entity then it should not be subject to any mandatory margin requirements, either with regard to Initial Margin (IM) or Variation Margin (VM).
- The simplest answer would be for Covered Entities to be limited to prudentially regulated entities (PREs), however, BCBS and IOSCO have proposed that Covered Entities also include "systemically important non-financial firms", which appears to follow the trend amongst regulators to recognize that some non-prudentially regulated entities (non-PREs) may be systemically important.
- If the intention is that certain non-financial firms (i.e. non-PREs) are included within the scope of the margin requirements as "systemically important non-financial firms" then it is vital that this term is both clearly defined and consistently applied internationally in the interests of commercial certainty and a level playing field. We would argue that, if this is the intention, this term is of sufficient importance to the market as a whole that it is vital it is clearly defined in a consistent way in primary legislation to avoid the difficulties and inconsistencies that would occur if regulators in different regions sought to superimpose this concept upon different defined terms that may appear in their own regional or national legislative texts. We would strongly urge BCBS and IOSCO not to implement any such requirements until this point is settled in primary legislation in an internationally consistent way.
- Systemic importance of non-PREs should not be assessed by reference to any group-wide test that also includes PREs (as they will be caught separately and be subject to requirements as a PRE on an entity basis) and, even across non-PREs in a group, such a test should not be applied so as to automatically designate each individual external market-facing entity within a group as a "systemically important non-financial firm" on an individual entity basis if they themselves should properly be classified as an end user on an entity basis by virtue of the purposes for which they trade (e.g. for hedging or treasury financing purposes as a customer of a PRE) and should be outside the scope of the mandatory margin requirements (to post or collect margin) altogether.
- SPVs should not be included as Covered Entities – they are usually non-PREs and they enter into swaps for risk mitigation purposes with regard to their activities and are generally not in a position to post collateral (or clear). The consequence of asset-backed SPVs being subject to mandatory clearing or bilateral margining would be to essentially undermine the economic viability of the asset-backed securitized market.

c. **Margin Calculation:**

Models:

- Allowing some parties to use their own internal approved initial margin models to calculate how much IM they need to take and requiring others who do not have their own internal approved models to use the standardized model calculation schedule as proposed could create an uneven playing field between Covered Entities. Any approved models should be available for use by all Covered Entities, with a Covered Entity being permitted to use a third party calculation agent to apply such a model where it cannot do so itself in order to facilitate a level playing field. This has the benefit of not allowing more sophisticated Covered Entities to utilize less regulatory capital and have to collect less IM against it and so to effectively gain a competitive advantage over less sophisticated Covered Entities that would enable them to take on more risk and offer products more cheaply, thus concentrating more of the market in the hands of a very few entities, making them even more systemic and increasing the risk to the market as a whole. To avoid disputes between parties that may arise by application of different models by counterparties to a trade, whatever methodology is used should be agreed at the outset.
- If the above is not possible, then a standardized schedule should apply equally to all Covered Entities for the purposes of determining the required amount of IM, however, the percentages set out in Appendix A to the BCBS IOSCO paper as being appropriate for each asset class are unrealistically high and should be recalibrated accordingly with appropriate consideration being given to the credit risk weighting of the relevant entity being required to post IM. This may also reduce the incidences of disputed IM calculations between counterparties.
- Requiring IM at 99% confidence level with a 10 day horizon is very high, because IM is intended to cover the credit risk for the period between exchanges of VM. Particularly if the VM threshold is zero, consideration should be given to the frequency of the recalculation and exchange of VM when calculating the required time horizon for the calculation of IM.
- We do not agree that internal model based margin calculations should be permitted to take into account diversification effects across broad asset classes without restriction. They may be permissible provided any correlations upon which cross-asset class benefits are based are calculated using a standardized, transparent methodology and are conservative enough to be robust during market stress.
- Use of internal models (predominantly, if not exclusively, by larger banks) to calculate IM may also mean that many less sophisticated parties will not be able to check or verify these calculations. Any contractual right to dispute such calculations and any attendant dispute resolution procedure would then effectively become redundant, making counterparties fully dependent on the larger banks' calculations. A standardised, transparent calculation methodology is preferable for this reason or, at the very least, disclosure to the relevant counterparty of the inputs, methodologies and assumptions forming a basis of the relevant calculations.

Frequency of VM Determination:

- The Consultation recommends that VM be collected and calculated with "sufficient frequency". Shell supports this, and given the importance of VM exchange to systemic resiliency, proposes that BCBS and IOSCO allow "sufficient frequency" to be determined by a Covered Entity,

based on the type and liquidity of the collateral, taking into account the operational capabilities of the relevant counterparty.

- Whilst most sophisticated parties could probably manage daily VM calculations and exchange of collateral, depending on the width of the class of Covered Entities, it may not be appropriate or possible for some parties to margin on a daily basis.

d. Collateral:

- At least non-banks should be able to use letters of credit (LC) or bank guarantees as collateral in respect of uncleared derivative trades. This would assist Covered Entities in non-banking groups who may have significant less liquid assets but who have less ready access to highly liquid collateral by the nature of their business than banking groups. If non-banks could not post LCs as collateral they may be forced to obtain collateral transformation facilities/ liquidity facilities from banking groups in any event (who may themselves need to access central bank liquidity/ facilities such as the LTRO to source that additional required liquidity). This would tie up more liquid collateral that would in fact be required if, for example, a non-bank was able to post an LC (which may either be backed by less liquid collateral posted to the LC issuing bank or by means of utilization of a credit line with the LC issuing bank, dependant on the creditworthiness of the non-banking party in favour of whom the LC was issued) as IM. Posting an LC as IM would have the added advantage of being, by its very nature, bankruptcy remote and structurally segregated from the proprietary assets of the party to whom it is posted. A realistic haircut we could suggest would be 20%.
- We welcome a broader class of collateral that may be posted to satisfy uncleared margin requirements generally, but would caution against extending them too far, especially in the area of commodities (including gold). Permitting too wide a class of eligible collateral may give large banks with sophisticated operating systems and models for calculation of the value of posted collateral on an ongoing basis, and complex custody and security arrangements for the holding of such collateral, an unfair competitive advantage over those non-banking entities who are not able operationally to do so. This could lead to a further concentration of systemic risk (with a rush-to-the-bottom effect as regards collateral cover quality) with the biggest banks, making them even more systemically important, so increasing systemic risk, reducing overall liquidity and the availability of affordable hedging options for end users.

e. Treatment of Margin – Segregation and Re-hypothecation:

- It is very important that parties are offered the option to have any collateral they post as IM segregated (i.e. subject to arrangements that fully protect the posting party if their counterparty goes bankrupt).
- Where the requirement to post and collect IM is two-way then this should be properly segregated and, if necessary to protect this segregation, such collateral should not be permitted to be reused/ rehypothecated.
- VM should not be required to be segregated. Non-cash collateral posted as VM should be allowed to be reused/ rehypothecated and cash collateral provided as VM should be able to be exchanged by means of outright title transfer, as is the current market practice under the English law governed ISDA CSA which is widely used throughout the uncleared OTC derivatives market.

f. Inter-affiliate OTC derivatives:

- IM should not be required to posted/ collected between entities within the same group of companies.
- In the case of non-bank Covered Entities which are part of non-banking groups (whether made up entirely of non-PREs or a majority of non-PREs and a small number of PREs) with limited external OTC derivative market facing group entities and pre-existing cash management group treasury arrangements, the exchange of bilateral VM between companies within the same group is not appropriate and serves no market stability function. The operational differences and differences in risk profile between the restricted number of external market-facing entities structure and internal centralized treasury operations of non-banking groups (wheel spokes intra group OTC derivative structure shape) and the multiple external market contact points, where each external-facing node needs to be appropriately capitalized to meet its individual obligations on an entity basis, of banking groups (honeycomb intra group OTC derivative structure shape) should be taken into account when assessing what is appropriate in terms of any IM or VM requirements applicable to non-banking groups (whether made up entirely of non-PREs or a majority of non-PREs and a small number of PREs). A one-size requirement for banking and non-banking Covered Entities will not fit all.

g. Cross-Border OTC derivatives:

- The implementation and timing of margin requirements should be coordinated and consistent across jurisdictions. Duplicative and potentially inconsistent margin requirements should be avoided at all times and we suggest that a mechanism be adopted from the outset that will facilitate this and will not result in a case-by-case analysis by relevant regulatory authorities to try to work out which of the competing requirements should be applied. This uncertainty of application could endanger market stability and orderly market function.

The above response is based on our understanding and assessment of the effect of the regulatory landscape as it is, and as is currently proposed. Given that this landscape is changing as the regulatory reform agenda develops across different jurisdictions, we reserve the right to revisit, and if necessary amend, any of the comments we have made based on the position as it currently stands. On that basis, we hope that our response is of assistance. We would be happy to discuss any aspect of this response further with you. Please do not hesitate to contact us in this regard.

Yours faithfully,

Joanna Williams
Legal Counsel

On behalf of **Shell International Trading and Shipping Company Limited**