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Dear Sir or Madam

IOSCO/BCBS Consultation on Margin requirements for non-centrally-cleared derivatives July 2012

Standard Life Investments would like to thank you for the opportunity to respond to such a significant market development.

In this response, we represent the **interests of our investors** across an international business. Standard Life Investments has managed assets for UK institutional pension fund clients, including government authorities, corporates, charities and insurance companies, since the 1930s and headquartered in Edinburgh, we maintain a presence in a number of locations around the world and manage over £157.6 billion of assets on behalf of clients worldwide.

We broadly support the intention of global regulators to minimise counterparty risks associated with derivative transactions and, since the events associated with Lehman, clearing certainly simplified the post default management of positions.

As a global asset manager we do utilise derivatives across a number of asset classes and fund types, and for many years have operated under relatively conservative engagement terms with our selected counterparties, including management of two way collateralisation on a daily basis.

In compiling our response, we have provided some comments of our own, but also included a number of comments that represent the views of the wider UK investment management community as expressed by a separate response by the UK Investment Management Association (IMA) which we support.

I have summarised below some of our key feedback as you prepare this proposed regulation for the marketplace;

- Consideration needs to be taken in terms of the cumulative impact of total margin requirements across current global regulatory initiatives (CRD IV, Bi-Lateral Margin, Central Clearing) and the compound impacts upon market liquidity – we believe that global regulators need to work in harmony to ensure implementation does not create new risks which generate greater concern than the risks mitigated.

- Legislation must ensure that those asset rich and low probability of default market investors (pension schemes, UCITS or other regulated funds) do not subsidise the riskier participants.

- Foreign Exchange (FX) transactions should not be covered by the margin requirements proposed. We do not believe that the risks associated with FX contracts are comparable to other OTC derivative contracts and note that the FX market has already found ways to mitigate settlement and other risks.

- Overall risk reduction should be appropriate and equitable. 'Market Makers' should not be allowed to dominate how participants protect against default.

In conclusion, we feel that the most important consideration is that of the end investors who ultimately carry the costs and risks. Again, collective market participants and regulators should take caution to ensure that the overall cost of the suite of legislation to reduce risk and improve transparency does not stifle efficiency of global financial markets or end up costing more than the risk which is mitigated.

Once again, thank you to the Working Group on Margin Requirements (WGMR) for the opportunity to provide feedback.

Please feel free to contact myself should you wish to discuss our feedback further or should we be able to assist in any way.

Yours faithfully

Mike Everett
Head of Risk & Compliance
Standard Life Investments

Basel Committee on Banking Supervision & Board of the International Organisation of Securities Commissions

Margin requirements for non-centrally cleared derivatives

Response provided by: Standard Life Investments Limited September 2012

Q1. 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?

Given the objective of mitigating systemic risk, it is key that the requirements are not implemented in any jurisdiction prior to the implementation of any related mandatory central clearing regime. Where contracts or suitable alternatives are not centrally cleared this should be taken into account and the application of the requirements should not be mandated in respect of such contracts until this is the case.

The phase-in should allow regulators to assess the liquidity impact at each stage and also allow firms to spread the cost and burden of the changes to their systems and documentation over a reasonable period.

The implementation time frame should be set as far as possible in a consistent fashion, on a global basis.

Q2. 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?

We believe that FX transactions should not be covered by the margin requirements proposed. We do not believe that the risks associated to FX contracts are comparable to other OTC derivative contracts, and note that the FX market has already found ways to mitigate settlement and other risks.

The FX market has already attained, under its current regulatory structure, the goals of transparency, liquidity, financial security and efficiency, due largely to the proliferation of electronic trading platforms where market participants can view real time pricing data and facilitate straight through processing and confirmation of trades.

In addition, the inclusion of FX forward contracts would have a significant impact on certain retail investment offerings, such as hedged share class products.

Q3. 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?

We believe that all FX transactions / swaps / options should be exempt from the margin requirements.

The lack of an appropriate counterparty default component in the determination of the amount of initial margin which should be posted, may introduce an imbalance of risk favourable to lower credit counterparties. Unlike in the centrally-cleared world, initial margin in the bi-lateral

world has a key role to play in relation to counterparty risk management and as such should also reflect the likelihood of default. The key cost not covered by initial margin is replacement cost. Replacement cost will not be an issue if counterparties do not default.

Q4. 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?

We support the proposal for two-way variation margin by all counterparties across all trades covered by the regime but do not support the application of universal two-way initial margin.

We do not agree that non-systemically important and highly capitalised counterparties such as most pension schemes, insurance vehicles and regulated collective investment schemes should be required to post initial margin where the likelihood and consequences of default by such entities is relatively low. Such entities are not currently required to lodge initial margin with bank counterparties. This recognises the extremely low risk of default given the extensive degree of regulation applied to such funds, their underlying investment profile, historically low leverage levels and their focus, which is investment rather than trading.

The impact on funds and investors of the regulations will be a net drag on investment returns, operational costs & fees of introducing this new process and the performance drag associated to margin requirements will largely be borne by the end investor. We must be certain that those with an extremely low risk of default are not subsidising market participants with higher risk of default.

The effect on fund performance can be substantially mitigated if appropriate models using security over segregated accounts, with a broad range of eligible collateral assets are allowed. We therefore welcome some of the proposals further on in the consultation paper. The costs associated to the operation of these models should not be overlooked versus the risk mitigation provided.

Q5. 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?

We consider that initial margin thresholds are an appropriate tool for managing the liquidity impact of the proposals.

However, we do not think that the various approaches outlined are sufficiently flexible or reflect the reality of the underlying counterparty risks.

The impact of several transactions needs to be considered between the same parties and whether the threshold will be introduced at the transaction level or some aggregated level.

If at an aggregated level, then the potential for reducing the liquidity impact to large market players is reduced e.g. from 10,000 to 9,990. However, if introduced at a transaction level, thresholds would change market behaviours so that large transactions would be broken down into several smaller transactions that would each attract very little initial margin. e.g. A transaction that would raise 100 initial margin (90 after threshold), might be broken down into 5 transactions of 20, raising only 50 after thresholds are used on each transaction (zero if broken down into 10 transactions).

Therefore, there is a risk that thresholds would have minimal impact on liquidity for large market participants or change market behaviours to more but smaller trades to optimise the use of initial margin by the same large players. The positions associated to equal & opposite trades also needs to be carefully considered.

Q6.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?

See question 5 response.

We believe that the initial margin should largely reflect the likelihood of counterparty default, regardless of status or outstanding amounts.

Systemic risk posed could be a factor and may mean that margins should be both collected and posted by such entities to protect their own position in the event of severe market stress, but also to protect the impact of their failure on others.

We support the suggestion to use thresholds in relation to initial margin, in order to provide flexibility in the regime, but we do not think that the options proposed are sensible nor that the key risk of counterparty default has been taken into account appropriately.

Notional derivative amounts outstanding are unlikely to truly reflect risks inherently run by entities unless the exemptions in Q4 are implemented.

Q7. 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?

Many non-prudentially regulated financial counterparties are nonetheless subject to stringent regulatory requirements designed to protect their capital base, such as UCITS funds in the EU. Such funds are subject to stringent regulatory requirements including restrictions on investment, counterparty concentration limits and the use of leverage and derivatives (including the "cover rule" which requires a UCITS at all times to be capable of meeting all its payment and delivery obligations under financial derivatives transactions). The assets of such funds are held in safe keeping with custodians and depositaries, who will themselves be prudentially regulated.

The investors in such funds also include pension funds and insurance companies who are themselves prudentially regulated (and whose underlying beneficiaries are individuals), as well as direct retail investors. Distinguishing between prudentially and non-prudentially regulated entities does not actually capture the true position in terms of exposure between market participants, nor does it take account of the stable and robust nature of many clients, including UCITS. If the use of initial margin thresholds is limited to prudentially regulated entities this would result in UCITS and other funds being used to bolster the capital position of prudentially regulated entities, in particular bank counterparties, at the expense of individual investors, savers and pensioners.

The application of thresholds for initial margin should not be based on broad counterparty categories, but should reflect the credit quality of the counterparty in question and the risk of

default. This should be based on an assessment of each individual counterparty.

Q8. 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?10 Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

We believe that any threshold should reflect the credit quality and therefore the likelihood of default of the counterparty.

Counterparties such as pension funds, insurance companies and regulated funds which have a low risk of default should in a threshold model generally have a high threshold applied.

We do not believe that it is practical to mandate models, rather they should be agreed between counterparties (or their agents/investment managers) and should be flexible. However, caution should be applied in terms of the historic sell side bias and address the imbalance of risk mitigation supplied by the buy side. We believe that regulated counterparties (and their agents) should agree their models with regulators; and that models should reflect the different types of counterparties and the underlying credit quality and risk of default of each.

Q9. 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?

We believe that the requirement to post initial margin will have a significant market impact in terms of global financial market liquidity, which may in fact outweigh the potential benefits of the margining. A reduction in general liquidity, as the last 5 years have evidenced, can be the pre-cursor to counterparty default.

We believe that the requirement to post initial margin will have the following impacts on the clients of investment managers, with a subsequent impact to the market more generally:
(i) Lower investment returns, in particular for pension funds, insurers and investment funds, as counterparties will be required to move away from assets that provide higher returns to those that provide greater liquidity, such as cash or near cash assets.
(ii) A reduction in the volume of OTC derivatives trading and consequently less risk management of funds, and liabilities, where such contracts are used for hedging and investment purposes.
(iii) The move to more liquid assets such as cash will have the unintended consequence of reducing demand for equity and fixed income products making it more difficult for corporate and government bodies to raise funds in the capital markets.
(iv) Greater pension fund shortfalls with increased pressure on sponsor companies, greater volatility in the solvency of pension schemes and the financial performance of corporates, with a negative impact on the funds available to fund a pension scheme’s benefits.
(v) A further squeeze on the availability of eligible collateral assets as the cleared and un-cleared OTC derivatives markets compete for the same pot of assets.

It should also be noted that the addition of initial margin will be operationally complex, particular in terms of managing disputes on agreed initial margin amounts, given inevitable differences in approach to calculating initial margin across firms.

Q10. 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?

We believe that initial margin can be an important factor in stabilising markets in stress conditions by providing additional security in a post default scenario. We support the posting of initial margin for non-centrally-cleared transactions based on the systemic importance and underlying financial stability of each counterparty, as well as the risks posed by the relevant product.

This requirement should not depend on whether an entity is regulated or unregulated. However we appreciate that the structure of capital models for some prudentially regulated entities actively work against the posting of initial margin model.

These rules should be amended to ensure that there is symmetry in treatment for capital purposes between initial margin posted and initial margin received and/or sufficient flexibility to take into account segregation structures which provide security and bankruptcy remoteness for margins posted. Capital models should encourage the posting of margin where this is sensible to protect other market participants.

Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

Recent market experience would suggest that blanket exemptions would not protect investors from participant default. Many sovereigns and non-financial entities have a higher probability of default than some funds.

Exemption for some major market players may also create an imbalance in the market makers' ability to cope with margin calls on the other side of their trades. So, this could in fact increase financial stress on financial institutions.

Neither, due to the lack of alignment between regulations, are exemptions practically likely to work, those exempt pension funds that not choose not to clear OTCs will face a higher cost of trading for an alternative route due to capital requirements on sell side organisations being passed on directly.

Any per se exemption should also be linked to the exemptions from central clearing provided in each jurisdiction.

Q12. 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?

No Comment

Q13. 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?

See question 8 response.

We believe that a key factor which should be taken into consideration is the credit quality and probability of a particular counterparty defaulting. That is the critical risk in each bilateral contract.

We believe that the most flexible solution is to allow counterparties to agree the methods that

will be used and to have full transparency of methodologies & calculations and robust dispute resolution processes.
We agree that any internal quantitative models should be pre-approved by the relevant supervisory authority and also that there is complete transparency for counterparties who accept the use of the model.

We also agree that such models should be subject to an internal governance process to assess, test and validate the model on an on-going basis.

Q14. 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?

We do not think that initial margin calculations on a portfolio basis should be limited to specific asset classes but should be permitted across asset classes here transactions are covered by the same legally enforceable netting agreement.

We believe that the proposals in this respect are therefore too restrictive.

Q15 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?

We agree that it is sensible to have the fall-back of a standardised schedule, but this should not be taken as the baseline for any internal model. In particular, the model cannot take into account the risk of a particular counterparty defaulting. In this regard, we believe that such a standardised approach should only ever be used alongside an appropriate margin threshold model.

In terms of risk sensitivity, a standardised model based on very limited variables can never really be risk sensitive. If the object is to achieve risk sensitivity then a more sophisticated model should be used. The model proposed is a very blunt instrument especially when related to notional rather than real exposure levels. This however has benefits, in that the amounts required to be posted will remain more stable and less prone to procyclical effects.

The model proposed is far too simplistic to be a sensible working option for most market participants. For example it captures only a limited range of instrument types and underlying assets/elements (different interest rates, currencies and equity and bond markets will be subject to different levels of volatility and liquidity which are not factored into the percentages proposed) and does not cater for complex derivatives or combinations of instruments.

We agree that market participants should not be allowed to pick and choose between models to suit their purpose or increase the amount of initial margin to be posted to them.

We agree that rigorous and robust dispute resolution procedures will be required whatever the model adopted by counterparties and that the parameters of this should be agreed up-front to avoid unnecessary periods of uncertainty, especially in stressed market conditions.

Q16. 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?

No Comment

Q17. 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?

We believe that collateral should move between counterparties on a daily basis to reflect movements in variation margin requirements and collateral valuations, subject to any agreed minimum transfer amount.

Q18. 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?

We support the proposition that cliff-edge triggers should be avoided as far as possible and that initial margin should be built up over time in order to mitigate procyclical effects. However, models should not be so conservative as to discourage activity and adversely impact liquidity in period of market calm.

Q19. What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?

Minimum Transfer Amounts should be flexible and based on the financial status and probability of default of the counterparty.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

We support the second approach to eligible collateral outlined in the consultation paper which allows a broader set of eligible collateral but imposes haircuts to reflect the perceived liquidity in stressed circumstances of a particular asset type.

We think that list of collateral is sensible. Would also like to see money market funds and units of other highly regulated funds such as UCITS in Europe.

Q21. 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?

We support utilising concentration limits, with the option to use standardised haircuts and internal models so market participants can decide.

Applying a large haircut to an instrument with lower liquidity will potentially further impact the liquidity of that instrument, to the extent that it is used for collateral purposes

It is difficult to assess whether haircuts are sufficiently conservative in stressed conditions when the value of some individual securities is likely to fluctuate widely. On the other hand, the market itself may not be so severely affected and some securities may not lose value but may gain is they are seen as a safe haven.

The haircuts are not sufficiently risk sensitive. There is no definition of what is meant by "high quality". i) How is this to be assessed? ii) What happens when an issuer falls out of the eligible pot?

Q22. 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?

We agree with the desire to improve end investor protection, where practically a default position would be that cash and non-cash assets should not be re-hypothecated or re-used. We acknowledge that post Lehman and MF Global the investor interest in reducing risk and improving investor protection may mean that fully secured models are the only viable option to deliver these ambitions.

However note, that the marketplace is reliant upon the ability to re-use assets in the system, as such a segregated or protectionist approach from asset rich clients such as UCITS or pension funds would result in a further significant drain in global liquidity which would in turn increase widespread counterparty default probability.

We support the proposals that initial margin should be posted on a net rather than gross basis where there is an exchange of margin and also the proposition that cash and non-cash assets posted as initial margin should be segregated in such a way as to fully protect the posting party in the event of the collecting party's bankruptcy. Counterparties should also be free to choose whether such assets are also segregated from the cash and/or non-cash assets of other counterparties of a market participant.

As the asset protection regimes in each jurisdiction vary, it is difficult to state with certainty whether the proposed requirements are appropriate and inappropriate to promote only one approach or structure. However, we believe that the proposals capture the main principles that should form the core of any structure used for holding initial margin.

In addition, where assets are held at a custodian or with a depositary chosen by the receiving party, certain duties should be placed on the receiving party regarding the appropriateness of that choice, the custody arrangements in place and the on-going monitoring of the custodian, as well as ensuring that segregation is effective and maintained.

Q23. 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?

A large percentage of the assets proposed as eligible collateral will already be held by custodian banks so we do not believe there will be a material increase in concentration risk.

Q24. . 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?

See question 22 response.

Rehypothecation is a significant global market activity which needs to be re-assessed, recent IMF research by Manmohan Singh should be considered.

As regard initial margin, we consider that the default position should be that such amounts/assets are not re-used or re-hypothecated by the receiver, even though we understand that this could create pressure on the liquidity of certain instruments. To provide otherwise would undermine the principles behind segregation and bankruptcy protection.

However, re-use or re-hypothecation of initial margin assets could be permitted by counterparties on a case by case basis if tight restrictions were placed around such practices

in terms of types of re-use, segregation and protection of assets obtained as a result of re-hypothecation/re-use for the posting party and any other benefits were shared.

We consider that the re-hypothecation or re-use of variation margin should be allowed, although market participants should be entitled to restrict this by agreement to the extent it does not conflict with the security interest being given. Where re-use is allowed, market participants should still be entitled to receive assets of the exactly the same type and value as those posted.

Q26. 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?

No Comment

Q27. 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?

Financial markets operate globally. Any developments need to be implemented so that they can operate in this environment and do not impinge on the efficiency of the markets.

We support the proposals to ensure that there is consistency in approach and that no transaction be subject to more than one set or rules on margin requirements. However, we do not think that the proposals achieve this. Allowing local regulators too much leeway in how they implement the proposals set out in the paper could have an unduly restrictive effect on the way in which transactions are collateralised.