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Group Governance and Assurance

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Standard Bank submission on BCBS and IOSCO Consultative Document: Margin requirements for non-centrally-cleared derivatives

Please find attached Standard Bank's submission on the BCBS and IOSCO Consultative Document: Margin requirements for non-centrally-cleared derivatives. The submission contains Standard Bank's responses to the questions posed in the document. A copy has also been sent to the South African Reserve Bank.

Yours sincerely

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BCBS and IOSCO Consultative Document: Margin requirements for non-centrally-cleared derivatives

General Remarks

Standard Bank appreciates the opportunity to provide a submission on the Consultative Document "*Margin requirements for non-centrally-cleared derivatives*". Standard Bank fully supports the goal of reducing systemic risk and building a safer financial system. It is critical that regulators, policy-makers, and market participants work together to find the appropriate regulatory framework to bolster financial stability without generating unintended consequences that have a deleterious impact on the real economy.

In this regard, Standard Bank believes that a comprehensive and holistic view of the emerging regulatory framework needs to be considered, and as such the proposals on margining requirements for non-centrally cleared derivatives cannot be considered in isolation from the Basel III requirements or the moves towards central clearing and reporting for OTC derivatives in the G20 countries. Meeting the LCR and NSFR requirements in Basel III will become more difficult if the proposals regarding Initial Margin and Variation Margin are introduced, especially where re-hypothecation is not available. Further, the effects of the proposals on Initial Margin and Variation Margin will be negatively pro-cyclical, counteracting other measures introduced in Basel III aimed at minimising pro-cyclicality.

These two major regulatory reforms, in conjunction with a focus on macro-prudential supervision and oversight by regulators; structural reforms in many jurisdictions (for example, the Volcker Rule); as well as the requirements for financial institutions to develop recovery and resolution plans, provide an extensive regulatory framework for the management of systemic risk. Standard Bank's view is that the proposed margining requirements for non-centrally-cleared derivatives will not enhance this framework. Rather these proposals are likely to undermine other reforms aimed at managing systemic risk given the pro-cyclicality of margining as well as a shifting of risk into the commercial sector as non-financial entities choose not to hedge their risks as hedging instruments become too expensive. In this regard, it is essential that non-financial entities which are using derivative instruments to hedge commercial risks, rather than for speculation and proprietary trading, must be exempted from the margining rules. For the same reason, foreign exchange derivative instruments should also be excluded from the ambit of the proposed regulations; and as should buyers of options.

The economic role of banks is to serve as intermediaries, channelling funds to businesses. The safety of the banking system is managed through an effective set of prudential regulations and proper prudential oversight. Prudent management of exposures is at the heart of banking, and in-principle there is no fundamental difference between loan exposures and derivative exposures. The business of a bank is built on the transfer and intermediation of risk, whereas a clearer simply serves as a buffer, on a mutualised basis, in the event that a counterparty defaults.

Standard Bank's views on this consultative document are in line with those of the International Banking Federation, and the International Swaps and Derivatives Association.

Response to the specific questions

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?

Derivatives that remain OTC after the implementation of CVA capital charges are likely to do so because they are not suitable for clearing: either because they are not standardised, or because a counterparty to the derivative is not subject to the CVA capital regime and prefers not to clear centrally, or is unable to meet the clearing requirements. As a result, the regulatory framework for OTC derivatives is likely to become more complex than that for standardised and/or centrally cleared derivatives. So although coordination and harmonised timelines for implementation are desirable to reduce regulatory arbitrage, this is likely to be difficult to achieve in practice.

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor as one month or one year b 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?

Yes.

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?

N/A

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?

The proposed principle and scope of applicability are logical. However, a question that must be answered is whether or not the envisaged shift towards central clearing is needed if a comprehensive OTC margining framework and a comprehensive trade reporting regime are in place. A comprehensive OTC framework provides the advantage that collateral will be held in a far more diversified manner, avoiding substantial concentrations in entities or instruments that clearers may use for the investment of IM. Further, if OTC derivatives are subject to IM and VM to the same extent as centrally cleared derivatives, then OTC derivatives should enjoy the same capital relief.

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?

The widened use of IM, whether in an OTC or centrally-cleared framework, will create a substantial liquidity drain as the implementation of Basel III requirements will already have created substantial pockets of ‘dead’ money. IM thresholds would mitigate the liquidity impact to an extent, but this is difficult to quantify until there is a better understanding of the zero-threshold liquidity impact and the appropriate size of the threshold needed to still achieve a reduction of systemic risk.

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?

The principle of different threshold rules for different types of counterparties is theoretically sound, but is likely to be very difficult to enact. While systemic importance is a valid consideration, there is a question has to whether this consideration applies to the local financial system, or the global financial system. Additionally, systemically-important banks and financial entities are required to hold additional capital buffers in terms of Basel III.

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?

Yes.

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

It is difficult to model thresholds. It is not a scientific process, more of an accommodation to what would otherwise be a substantial liquidity drain.

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?

For prudentially-regulated entities, it would represent a material and permanent withdrawal of liquidity from the economy. However, it is unlikely to change trading patterns other than to perhaps move more activity to cash markets and away from derivatives. For non-prudentially regulated entities, it will be a further disincentive to use derivatives to hedge, and may further stimulate a move of risk into non-regulated sectors.

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?

Such a requirement will exacerbate systemic risk. Operationally, unregulated counterparties are less well-equipped to return money when required, and less able to establish segregation mechanisms.

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

Yes. Corporates and pension funds hedge in order to obtain certainty of cash flow; requiring these entities to post IM/ VM defeats that purpose.

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?

Extending credit to corporations is a fundamental function of banks. Some of that credit extension is through un-margined derivative products. As long as the aggregate across primary exposures (loans, etc.) and derivative exposures is measured and considered under a bank's prudential regulatory regime, credit policy, and large exposures policy, exempting non-financial, non-systemically important entities should not increase systemic risk.

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?

It is suggested that clearer IM's could be considered as the baseline alternative to internal models. The margin schedule proposed in the consultative document does not differentiate within asset classes, and implies an incorrect assumption that liquidity and tenor are positively correlated. It is not clear what the proposed schedule is based on. A material problem with the implementation of an internal model approach is that two counterparties to a trade may calculate IM differently. This is likely to be a course of considerably more debate and dispute than VM.

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?

If correlations are demonstrable across asset classes, diversification benefits should be taken into account.

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?

The standardised schedule is too blunt. The methodology used to determine the proposed IMs needs to be clarified and debated.

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?
Yes. A counterparty may be axed from trading with certain other counterparties, creating counterparty optimisation and a reduction in overall liquidity. This will be more in relation to IM. VM in bilateral trades between financial counterparties is well-established and is unlikely to be problematic. However, VM will be more of a problem with centrally–cleared trades when the value of each trade becomes unique to the counterparty and the clearer has to find some version of 'market value'.

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?
Requiring daily VM payments is correct between financial counterparties. Margining for non-financial counterparties is not supported, as it removes certainty of cash flow which is the primary reason for such entities to hedge.

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?
Yes.

Q19. What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?
Between financial counterparties, the minimum transfer amount could be relatively small, perhaps $50 000.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?
These proposals are contradictory to a move towards standard CSA within ISDA agreements. A choice of collateral can impact the curve against which derivatives are discounted and can alter values mid-trade if collateral changes. It also impedes easy transfer of OTC trades to centrally-cleared trades. Cash collateral in currency relevant to the trade is a more sensible approach. The repo market can b used to generate the cash in part, and if counterparties have unencumbered assets. A repo test is a good proxy for liquidity and hence theoretical eligibility.

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?
N/A

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?

Segregation of IM is sensible in principle. However, there will concentrations in custodian banks (and clearers), and if an economic return needs to be earned on the collateral, there is a risk that additional layers are created but the money still ends up somewhere. With bank capital adequacy ratios increasing under Basel III, a form of two-tiering and internal segregation is preferred.

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?
Yes, it would create substantial 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?
Yes, if the principle of segregation is maintained.

Q25. 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?
Yes.

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.

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?
Yes.