RESPONSE TO BCBS/IOSCO CONSULTATION PAPER BY

TELEFONICA, SPAIN (NON –FINANCIAL COUNTERPARY)

Margin requirements for non-centrally-cleared derivatives

Issued July 6th, 2012

Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel, Switzerland
Attn: Secretariat

28 September 2012

Thank you very much for the chance to answer the consultation paper. We support the objectives of the G20 regulatory reform agenda and its effort to ensure derivatives reforms are globally consistent. We also we would like to emphasize that non financial entities represent a small portion of the OTC derivatives. Non Financial Counterparties use derivatives to reduce risks and through hedging the hedge and the hedged risks almost net each other out. Derivatives accounted for less than 10% of total losses incurred by banks as a result of the crisis.

In general we would like to point out these different points

a) Margin can be seen as offering enhanced protection against counterparty risk but its excessive cost can have a negative impact in the liquidity needed by non financial counterparties to ensure their required investments in the real economy.
b) Applying margining in addition to CVA costs may result in duplicity and again excessive additional hedging costs.
c) It is not possible to guarantee an uniform margin requirement across products, companies or markets since counterparty risk is not uniform at all and depends among other things on relative positioning between counterparties.
d) Any additional margin between a firm and its affiliates should not be considered since risk is already in the main firm.
e) Simplicity in the calculation and of course in the implementation is key.
f) Excessive additional hedging cost might produce the undesirable effect of non-financial counterparties stop their hedging policies which we believe should increase systemic risk and not decrease it as the regulation desires.
g) Any non financial counterparty that under EMIR is exempt from clearing should be exempted from direct margining. The problem is that it will be affected by indirect margining (via price/cost transfer) through its financial counterparties.

Please note all comments on questions attached:

Q1. We believe that the timeline has to be aligned with all regulatory initiatives in order to guarantee consistency, and to avoid any regulatory gap that might create possible arbitrages. This coordination has to be achieved by a constant dialogue between all regulatory bodies involved so that all timelines are set at the same time. The phase-in period should be aligned with EMIR and its regulation for OTC derivatives.

Q2. Yes, forwards should be exempted since they do not pose systemic risk. Also non financial counterparties might use these products for various purposes, on one hand for hedging short term liabilities, both commercial and operational, and also as part of their short term hedging strategy that implies cash in or cash out at the time of the roll of the hedges therefore the risk is more on the liquidity position on the company. Imposing collateral requirements on either short or long dated FX forwards will do little to reduce the risk in the FX market. Instead, it would introduce new risks by creating incentives for end-users to refrain from hedging in an attempt to avoid collateral requirements.

Q3. We believe that a general exemption should be granted for all non centrally traded derivatives on the basis of the liquidity tensions that excessive costs might bring forth. As stated before these liquidity tensions might force non financial counterparties to either reduce their investment in the real economy or partially reduce their hedging strategies. Both outcomes are undesirable and we believe mainly the last one it goes against the spirit of the proposal which is to reduce systemic risk. Even if this exemption is clear, when a non financial counterparty that does not pose systemic risk transacts with a non prudent regulated counterparty, then at the end the non financial counterparty will be indirectly charged this margin costs.

Q4. The principle and scope are not appropriate since although the exemption for non financial entities is clear, there will always be a price transfer from the covered entities, financial firms, to the non financial counterparties. The use of margin does not balance appropriately reducing risk and limiting liquidity. The proposal neither poses or exacerbates systemic risks and the implementation would be rather hard approaching the model used to a centrally cleared world. Also for the examples provided normally transactions take place between prudentially regulated and not prudentially regulated entities therefore the possible margin reduction when transactions take place between two prudentially regulated entities is not applicable.

Q5. As Basel III capital also demands for capital are sufficient (or excessive) to ensure banks are protected against potential losses, margin requirements should not be needed to achieve the same target. By applying margin and Basel III Capital Requirements (CVA) NFC will be deterred from using OTC derivatives for hedging due to high costs.

Q7. More entities than the prudent regulated entities should be included and eligible for marin requirements.

Q8. Thresholds should be evaluated in an individual basis.

Q9. As of today a lot of counterparties have two way CSAs that are similar to Two Way Margining therefore this does not really change the way markets participants that have these kind of agreements operate. It is different if it is universally required and we are strongly against since this bilateral CSA or two way margining can have the same effect as using a CCP to clear all trades with the inconvenient that the risk using a CCP is centralized and bilaterally is individualized. The effects in liquidity and financial health are adverse.

Q11. Yes. We support that margin requirements should not apply to transactions executed by non-financial entities whose derivatives use is not systemically important.
The exemptions are appropriate, but in practical terms the price or cost transfer between banks and non financial counterparties will yield an effect in the non financial counterparty almost as if it were not exempt.

Q13. Yes

Q14. The model should be applied within broad asset classes and analyzed this way to avoid cross class stress and also to alienate this proposal to the one made to EMIR with regards to the clearing margin definition to be set per asset class.

Q17. Frequency can be a major obstacle for non financial counterparties that might be forced to post bilateral margin since a daily margin posting might not be operational therefore if applied should be more on a monthly basis.

Q20. Broader eligible collateral might be used: from cash to high quality covered bonds to equities in major indices to gold and this approach is desirable.

Q23. A net approach to margin exchange is more appropriate than to use a gross approach since normally exposures are analyzed on a net basis. Also, although we do not approve, if bilateral margining is imposed then the net approach is implicitly used.

Q24. No, since this in turn might have the effect of “false diversification” of risk. Also for non financial counterparties it has to be clearly stated how this collateral will be treated under accounting frameworks.

Q25. Neither initial margin nor variation margin should be required with respect to inter affiliate transactions.

Only in the case that affiliates do not share the same appropriate centralized risk evaluation and controls, are not included in the same consolidation and if there is a material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities maybe it should be considered.