TCX

the currency exchange fund

Basel Committee on Banking Supervision
Bank for International Settlements
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CC: International Organization of Securities Commissions

27 September 2012

Comments on the Consultative Document on Margin Requirements for non-centrally-cleared derivatives

TCX Investment Management Company B.V. (TCXIM) appreciates the opportunity to comment on the Consultative Document on Margin Requirements for non-centrally-cleared derivatives published on 6 July 2012.

The Currency Exchange Fund N.V. (TCX) is a tax-exempt unregulated private limited liability company incorporated in The Netherlands, exclusively managed by TCXIM. TCXIM is also incorporated in The Netherlands and is located in Amsterdam. Commencing operations in 2008, TCX's business objective is the promotion of long-term local currency financing for borrowers in emerging and frontier markets that do not have hard currency income. TCX achieves this development objective by acting as currency swap counterparty to international financial institutions providing local currency loans in developing countries, and by acting as currency swap counterparty to emerging market borrowers which have hard currency liabilities. TCX's has USD 660m in capital provided by leading International Financial Institutions (IFIs) and bilateral development banks, including the African Development Bank (AfDB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IDB), International Finance Corporation (IFC), Agence Française de Développement (AFD & Proparco), Belgian Investment Company for Developing Countries (BIO), Deutsche Investitions und Entwicklungsgesellschaft (DEG), Development Bank of Southern Africa (DBSA), Japan Bank for International Cooperation (JBIC), KfW Entwicklungsbank (KfW), Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO), and the Norwegian Investment Fund for Developing Countries (Norfund). In addition, TCX benefits from a Subordinated Convertible Loan provided by the Dutch and German governments.

Our concern relates primarily to the potential negative impact the proposed scope will have on the ability of financial institutions and other derivative users based in emerging markets and developing countries (EMDCs) to fairly access global derivative markets. Financial inclusion is a prominent priority on the international development agenda and is widely recognized to not only include access to credit products, but also access to financial risk management products in a fair and cost effective manner.

There is a substantial risk that the proposed mandatory margining rules may exacerbate systemic risk in cross-border transactions, given that the need for high quality collateral will effectively increase the prevalence of FX lending. In this regard, we kindly refer to the European Systemic Risk

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Board, which published its recommendation on lending in foreign currencies in the Official Journal of the European Union on 21 September 2011.[1] In our discussions with international market participants active in EMDCs, major swap participants have indicated they will only accept collateral in a limited number of highly liquid global currencies. As such, financial institutions outside of these currency jurisdictions (including affiliates of globally active banks) will be dependent on foreign funding sources for collateral purposes. Mandatory rules may exacerbate these practises. This issue is of particular concern in cross border transactions such as FX Swap and forwards.

We are strongly in support of allowing thresholds to mitigate the above concerns. Further, we believe initial margin and threshold rules should remain flexible as per current market practise and in particular be sensitive to credit profiles in addition to the tenor and type of transactions being traded rather than the proposal of having different rules for different types of entities (e.g. prudentially regulated vs. non-prudentially regulated). We understand that margin rules subject to credit profiles may promote "Cliff edge triggers" but nonetheless prefer credit sensitive margining rules rather than arbitrary rules based on type of counterparty. Further, the definition of covered entities should be subject to a size threshold in order to remain consistent with Dodd-Frank and EMIR. The size threshold should be net of hedging transactions. Government entities and its affiliates should not be exempted from the rules as they are major players in some markets.

The proposed principle for determining eligible collateral combined with the proposed interaction between national regimes may significantly limit EMDCs ability to develop secondary government bond markets and establish acceptable local currency collateral for utilization in their own jurisdiction where country ratings prevent local collateral from being deemed high quality by international participants. In this regard, we note recent papers by the Financial Stability Board on the potential impact of global reforms on emerging markets, confirming that domestic money and government securities markets in EMDCs "tend to be constrained by perceptions of high counterparty risk and often a limited supply of high quality collateral, contributing to high spreads."[2] To the extent that proposed margining rules create additional demand for an already constrained supply of collateral, a negative impact may result for many EMDCs development agenda.

We find the proposed interaction between national regimes appropriate to ensure cross-border consistency but would stress the need to resolve the potential conflict in the definition of eligible collateral in different jurisdictions. Non-investment grade countries stand the real risk of being cut off from global markets with the proposed interaction of national regimes.

The proposed relaxing of margining rules for Affiliates may be a source of systemic risk as there is a significant global channelling effect through affiliated entities. This practise is especially prevalent in EMDCs forward and FX swap markets. We believe this market structure to potentially prevent fair competition and prevent the development of a more balanced interbank network. Allowing this key channel linking onshore and offshore markets to trade on better collateral terms may exacerbate this problem and undermine efforts to reduce systemic risk.

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[1] ESRB/2011/1 2011/C 342/01.

[2] Financial Stability Board. (2011). *Financial Stability Issues in Emerging Market and Developing Countries.* Available at www.financialstabilityboard.org.

Attached to this letter we provide further detail in response to the specific questions raised in the consultative document. Please feel free to contact us at your convenience with any questions. We would be delighted to discuss these issues in person with appropriate officials of BIS and IOSCO.

Sincerely,

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TCX Investment Management Company B.V.

Philip Buyskes
Vice President
TCX Investment Management Company B.V.

Detailed response to questions

Implementation and timing of margin requirements

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?

Depending on the final detail of the requirements, it could trigger the need to renegotiate thousands of ISDAs which will be time consuming and costly for all market participants to undertake simultaneously, as such a phased implementation period of at least 5 years should be considered. Given that the key goal of the margining requirements is to promote central clearing, coordination with central clearing mandates is required. Central clearing rules should already be well-established and implemented prior to the margining time-line deadline in order to facilitate market participants switching to exchange-based trading and centrally cleared products where feasible. A possibility is to align the phase in over a period which is consistent with the implementation of the Net Stable Funding Ratio (1-1-2018).

It would be prudent to coordinate implementation with the on-going development of standardised CSA (SCSA) documentation by ISDA which conforms to the broad requirements in order to avoid duplicative efforts by individual market participants. ISDA is currently working on the development of a standard Credit Support Annex which is compatible with novation to central clearing counterparties.

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?

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?

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?

Given the stated policy goals, any derivative product where counterparty credit risk (i.e. concern that counterparty may default whilst contract is outstanding as compared to failure prior to settlement on expiry date) should be considered for margining rules. In this regard, and as argued further below, if mandatory margining rules take credit profiles into account a case can be made that no exemption of any product class is required.

However, the cost-benefit analysis to be undertaken by BIS/IOSCO should carefully weight up the pro and cons of exemption of FX swaps and forwards, especially short dated instruments which are critical to linking global money markets and primarily face settlement risk rather than credit risk. Whilst there are good arguments to exempt short dated FX swaps and forwards we are primarily concerned this would negatively incentivize participants to avoid longer dated trades, thus increasing roll-over risk. As such, if the mandatory margining rules allow for thresholds which are sensitive to the tenor of the FX transactions (as discussed further below) and credit profile of the counterparty, a specific exemption may not be required. Further, the potential negative impact of mandatory margining on EMDCs could be mitigated by including a size threshold in the definition of covered entities. The size threshold should be net of hedging transactions.

Below we summarise the pro and cons in our view. The case against exemption is:

- In our discussions with market participants active in Emerging Markets and Developing Countries (EMDCs), counterparty risk is a key issue preventing the orderly development of interbank FX swap and forward markets, however notably with tenors longer than 1-3 month. Margining could serve to reduce the credit risk concerns in this instance, thereby supporting the development of liquidity for longer tenors in these markets, enhancing competition in the banking sector by ensuring a level playing field, and thus promoting economic growth in EMDCs. If shorter tenors are formally excluded from all margining requirements it may incentivize market participants to trade short term instruments, thus increasing funding / roll over risks in interbank markets and promoting maturity mismatches. This is an undesirable outcome given the importance of long term lending to economic growth.
- FX Futures, being the natural alternative exchange traded and centrally cleared product, are traded on initial margin and settled daily. If the policy goal of mandatory margining rules is to promote central clearing in the FX market, FX swaps and forwards should require margining.

The case for exemption:

- The impact of counterparty credit risk concerns during the crisis on FX Swap markets has been a topic of debate, for instance see Baba and Packer (2008),[3] but is at best uncertain. Whilst there is some evidence that credit risk concerns impacted the market, the overall conclusion seems to be that the FX Swap and forward markets continued to perform appropriately during the crisis and continued to play their critical role in linking global pools of liquidity across borders. As such, the inclusion of this large market in mandatory margining rules is likely to substantially increase the liquidity impact of the rules without any meaningful systemic risk reduction.

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[3] Baba, N. and Packer, F. (2008). *Interpreting deviations from covered interest rate parity during the financial market turmoil of 2007-08.* BIS working Papers Bo 267.

- Further, extensive mandatory margining in this market may even increase systemic risk given the cross-border nature of the market. We expect that international market participants will only accept collateral in global currencies which implies local institutions in EMDCs will be dependent on foreign funding sources of collateral which can quickly disappear in times of stress.
- As such, mandatory rules may trigger dollarization of EMDCs given the additional cost of margining rules and the impact of this on transaction costs in interbank markets, thus negatively impacting the capital market development agenda of EMDCs.

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?

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?

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?

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?

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?

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?

As per the points raised in answering questions 2 and 3 above, our concern relates primarily to potential negative impact the proposed broad scope will have on institutions based in EMDCs access to global derivative markets. Financial inclusion is a prominent priority on the international development agenda and is widely recognized to not only include access to credit products but also access to financial risk management products in a fair and cost effective manner.

In our discussions with market participants, major swap participants have indicated they will only accept collateral in a limited number of highly liquid global currencies. As such, financial institutions outside of these currency jurisdictions will always be dependent on foreign funding sources for collateral purposes. In our view, this will exacerbate existing FX lending practises and thus increase systemic risk in the global market. The systemic risk issue of FX lending practises was recently highlighted by the European Systemic Risk Board, which published its Recommendation on lending in foreign currencies in the Official Journal of the European Union on 21 September 2011.[4] It may furthermore have an impact on the real economy to the extent financial institutions in EMDCs divert hard currency resources from lending to collateral.

We broadly find that the proposed key principle and requirements balance the policy goals in that it is all encompassing but strongly support the use of thresholds to overcome the issues raised. Further, we would support that threshold are driven by counterparty credit profiles, as well as the type and tenor of derivatives being traded, rather than by the nature of the counterparty. In addition, we would propose that covered entities be defined by a size threshold in order to be consistent with the US and EU regulations and thus to limit the definitions of covered entities to only systemically significant financial institutions. However, once the size threshold is breached we propose that margining rules NOT be established by type of counterparty (example whether or not an entity prudentially regulated) but universally by credit profile, tenor and type of transactions.

Other points regarding on thresholds:

- Mandatory variation margin rules will naturally limit the amount of leverage possible and promotes market transparency by acting as an early warning system. Mandatory variation margin would thus already go a long way towards mitigating systemic risk.
- Initial margin does not necessary reduce all residual risk at default, as potential financial losses arising from replacement risk could outweigh the losses of not having initial margin.

[4] ESRB/2011/1 2011/C 342/01.

Initial margin is costly from a credit, legal and operational perspective and it is not clear that the benefits of initial margin to reducing systemic risk outweigh these costs, especially when compared to the benefits of variation margin. Further, in our view the systemic risk arising from the financial crisis was due to lack of transparency, not due to a lack of (initial) margin. The increased transparency required by global reforms combined with variation margin will already substantially reduce potential systemic risk from OTC derivatives.

- We support the proposal that thresholds be determined based on internal quantitative models, and should furthermore be sensitive to counterparty credit risk profiles (in particular the PFE should be adjusted for LGD and PD of counterparties), transaction types, and transaction tenors.
- We furthermore would propose that collateral terms should remain definable as per existing ISDA CSA documentation.
- We are concerned about the potential for market distortion and regulatory arbitrage of any proposal to distinguish initial margin rules by counterparty type (as for instance proposed by EMIR[5]). It is likely that many non-prudentially regulated entities (e.g. insurance companies, pension funds, development finance institutions, hedge funds) categorised as key market participants may have superior credit standing to some prudentially regulated entities, why should they still be subject to more onerous initial margin requirements?
- Basel III capital calculations and CVA charges will naturally promote the lowering of thresholds as counterparties to banks will be required to trade off the impact on pricing of bank's holding capital against counterparty risk versus the liquidity cost of posting initial margin. As such, if mandatory initial margin rules are flexible to allow market participants to set levels to account for actual risk (credit risk, tenor, transaction type) and cost of capital it should broadly promote the goals of the margining rules.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. 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?

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 do not believe so. Allowing thresholds implicitly implies that capital can be held against the credit exposure on the counterparty up to the threshold amount. Taking on credit risk backed by capital, when well-managed, does not automatically lead to unacceptable levels of systemic risk.

[5] Here we refer to the Joint Discussion Paper on Draft Regulatory Technical Standards published by the EU authorities and available on www.esma.europea.eu.

TCX, as a non-prudentially regulated entity, has prudently utilised capital to mitigate counterparty credit risk to support access to risk markets for financial institutions based in EMDCs:

- TCX has supported the establishment of MFX Solutions LLP,[6] a US based entity which supports access to derivative markets by the microfinance sector on an uncollateralised basis. This is made possible through the provision of a credit guarantee by the Overseas Private Investment Corporation (OPIC), facilitating TCX's ability to trade with MFX on an uncollateralised basis. Without MFX, a significant proportion of the global microfinance sector would not have access to currency hedging markets and thus remain exposed to risk;
- FMO,[7] the Dutch Development bank, has provided TCX with a partial guarantee to support trading with their emerging market based clients. Whilst TCX still collects variation margin under this structure, the guarantee allows TCX to trade with emerging market entities with a threshold instead of requiring a significant initial margin, thus alleviating some pressure on the counterparties hard currency liquidity requirements (TCX's only accepts hard currency cash collateral). The guarantee is made possible because FMO holds capital against its credit exposure up to the threshold/guarantee amount.

We don't see an impact on systemic risk of regulated entities posting initial margin to unregulated entities if collateral terms are determined by counterparty credit profiles and transaction type and tenors.

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.

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?

Netting across asset classes in bi-lateral margining can bring substantial reduction to the liquidity impact of the proposed margining rules. The concerns highlighted on model risk are also prevalent in calculating PFE within asset classes e.g. the PFE for fixed-fixed cross currency swap is a function of modelling FX, interest rates and correlations between them. This holds especially for level II and III assets as we have seen with credit derivatives.

The concerns raised could be mitigated by disclosure rules and by requiring models to be approved by regulators and/or by external auditors.

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?

[6] www.mfxsolutions.com.
[7] www.fmo.nl

As discussed in our response to question 2 and 3, we would propose initial margin for FX to also be sensitive to the tenor of the fixed rate duration of the transaction to account for the increased risk of longer dated FX products. The standardised schedule should be sensitive to credit risk profile of the entity for all asset classes.

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?

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?

The proposed methodology is appropriate and less frequent valuation should be allowed. This allows market participants to trade off operational and transaction costs of frequent valuation and collateral transfers versus increased liquidity cost of a higher initial margin or lower threshold. This may be especially relevant for users with only limited OTC transactions for hedging purposes and for financial institutions based in EMDCs. These institutions do not have the operational capability to post collateral on a daily basis due to, for example, local regulatory constraints and cost considerations. As such, these entities may have limited access to risk management solutions if variation margin must be exchanged daily.

Q18. Is the proposed framework for variation margin appropriately calibrated to prevent unintended pro-cyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?

We are concerned that the pro-cyclical effects of mandatory universal margining may be substantial in times of stress given the global nature of OTC trading and the expectation that acceptable collateral will be limited to a small set of highly liquid currencies. This exacerbates the potential systemic risk of FX lending and may place substantial additional pressure on global money and FX markets in times of stress. Nonetheless universal variation margin requirements may be prudent given the stated policy goals. Our proposal that initial margin is sensitive to credit profile may increase "cliff-edge" triggers. Nonetheless sensitivity to credit profiles is preferred to more arbitrary rules based on counterparty type.

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

This question can only be answered on a case by case basis and is sensitive to the counterparty credit profile, liquidity risk (e.g. size of transaction relative to asset base) and the operational cost of collateral management (e.g. an institution based in a EMDCs may incur significant transactions costs of frequent collateral posting to offshore market participants). As such, we would not be supportive of placing formal limits on minimum transfer amounts. MTAs are standard market practise and higher MTAs can substantially reduce the cost of collateral management for market participants, notably for cross border transactions.

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

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?

A broader pool of eligible collateral should be allowed for initial margin compared to variation margin requirements. We are concerned that the key principle will substantially limit acceptable collateral to assets denominated in global currencies, and that access to these assets may be limited in times of stress for market participants located outside of these jurisdictions and especially for those located in EMDCs. Thus, for cross-border transactions the proposed collateral rules are likely to be particularly onerous to implement.

The principle may significantly limit EMDCs ability to develop government bond markets and establish acceptable local currency collateral for utilization in their own jurisdiction where country ratings prevent local collateral from being deemed high quality by international participants in their jurisdiction. In this regard, we note recent papers by the Financial Stability Board[8] on the potential impact of global reforms on emerging markets, confirming that domestic money and government securities markets in EMDCs "tend to be constrained by perceptions of high counterparty risk and often a limited supply of high quality collateral, contributing to high spreads."[9] To the extent that proposed margining rules create additional demand for an already constrained supply of collateral, a negative impact may result for many EMDCs development agenda.

We would thus propose to include (unfunded) highly rated guarantees and commercial letters of credit to be included as eligible collateral. This could potentially alleviate demand concerns.[10]

We would caution the use of prescribed diversification requirements and allow market participants to determine acceptable collateral and haircuts subject to the key principle. In times of stress, assets presumed to be low risk and very liquid may become high risk and illiquid. If the market was held to set rules which can quickly become out of date, this may exacerbate liquidity risk and thus systemic risk.

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[8] For instance, see Financial Stability Board. (2012). *Identifying the effect of regulatory reforms on emerging countries*. Available at www.financialstabililityboard.org. Financial Stability Board. (2011). *Financial Stability Issues in Emerging Markets and Developing Economies.* Par. 48, pg 27. Available at www.financialstabilityboard.org.

[9] Financial Stability Board. (2011). *Financial Stability Issues in Emerging Markets and Developing Economies.* Par. 48, pg 27. Available at www.financialstabilityboard.org.

[10] We note for instance, the success of international finance institutions such as the World Bank in supporting global trade finance in the face of counterparty risk concerns through the use of guarantees.

The standardised proposed schedule should better define the term "high quality" to be effective and allow for greater haircuts depending on the quality of the collateral. The standardised schedule should allow a broader set of acceptable collateral for initial margin.

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?

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?

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?

Initial margin should be posted on a gross basis and segregated to a legally remote company from the counterparty. Re-hypothecation should also be prohibited but we would note the potential cost and infrastructure required if implemented universally and would encourage the impact study to consider the costs and benefits, again noting the benefits of thresholds based on credit profiles to alleviate these concerns.

Cash collateral should be investable in order to generate income to compensate of interest payable and the mitigate credit risk on banks. We note that the proposed limits would substantially limit the use of cash for initial margin (given the credit risk this would create on the 3rd party custodian).

Re-hypothecation of variation margin should be allowed given that the counterparty has a legally offsetting market value on the portfolio of derivatives.

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?

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?

In answering this question, we understand affiliates to include subsidiaries and branches of globally active banks in various jurisdictions. The proposed requirements may introduce a competitive advantage for regional and global financial entities compared to local banks in EMDCs. In our interviews with market participants, global banks with local affiliates often act as a key interbank channel where the international parent entity (based in London, New York, Singapore) trades with offshore entities, whilst the onshore affiliate trades with onshore banks (since offshore banks often have limited credit appetite for local banks who also have limited and expensive access to acceptable collateral). There is thus a significant global channelling effect through affiliated entities and thus they may be a source of systemic risk. This practise is prevalent in EMDCs forward and FX swap markets. We believe this market structure to potentially prevent fair competition and prevent the development of a more balanced interbank network, helping to maintain the dominance of international and regional entities to the disadvantage of local banks and local interbank markets. By allowing this key channel linking onshore and offshore markets to trade on better collateral terms may exacerbate this problem and undermine the policy goals.

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?

We find the proposed interaction appropriate to ensure cross-border consistency but would stress the need to resolve the potential conflict in the definition of eligible collateral in different jurisdictions. Non-investment grade countries stand the real risk of being cut off from global markets with the proposed interaction of national regimes. For example, if our understanding of the proposal is correct, the local subsidiary of an international bank – where the home regulator does not recognise the local regulators rules to be compliant – would be required to enforce the mandatory margining rules if it wishes to trade with other local financial entities. In this case, would this subsidiary be allowed to receive local government bonds which may not meet the eligible rules of the home regulator? If not, dollarization may result and the financial markets development agenda of EMDCs impaired.