TOWERS WATSON

Towers Watson response to the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions on margin requirements for non-centrally-cleared derivatives

Towers Watson is a leading firm of investment consultants to a wide range of institutional asset owners globally. In the UK our predominant client base is the trustees of large occupational pension schemes. We would be happy to meet with the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) to discuss this topic further and expand on the points made below.

We would also be happy to provide the BCBS and IOSCO with further background and evidence with regard to the points made in our response.

Key Points

We are supportive of the intent to avert systematic risk in the OTC derivatives market and promotion of the use of central clearing when appropriate. However, we are concerned about possible undue and unintended consequences of increasing the existing margin requirements on market participants. In particular, the amount of capital long term creditworthy investors, such as funded pension funds, using derivatives for risk mitigation are required to contribute under margining requirements should be representative of the risk they pose and hence not excessive.

We have concerns over the liquidity implications and therefore cost implications on market participants only involved in the buy-side of derivatives. We are supportive of the risk reduction provided by margining of derivatives, however if the resultant costs of doing so are very high, this may result in institutions potentially taking more risk as the cost of using derivatives to hedge its risks are too high: by this we mean that either hedging transactions are not executed, or that additional risk is taken elsewhere in the portfolio to manage the overall level of return net of costs.

Part 1

Question 1: 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?

- The phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives should take a long term approach to ensure the smooth running of the markets and allow sufficient time for market participants to understand the margin requirements for non-centrally-cleared trades. Sufficient time should be allowed for the development of services when the proposed rules come into force to provide a more diverse and competitive range of services for managing market participants margining requirements.

- Sufficient time should be given to allow market participants such as pension funds to understand and set up the operational infrastructure. In particular, most pension funds do not hold significant levels of cash required to meet the potential variation and initial margin requirements under the proposed margining framework. For pension funds that have a temporary exemption from central clearing it is counterintuitive to require pension funds to implement the margining requirements of non-centrally-cleared derivatives in advance of this.

- A period of perhaps 3 years would be appropriate.

Part B

Element 1: Scope of coverage – instruments subject to the requirements

Question 2: 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 support the margining and clearing of derivatives to reduce systemic risk and counterparty risk. However, we believe that these margining requirements should be measured against the increase in capital requirements and hence costs for margining these derivatives. If the capital requirements/ costs associated with margining foreign exchange swaps and forwards that have a short tenor are such that it would result in market participants not transacting these derivatives to control risk, then we would support exempting these transactions.

Question 3: 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 note that some derivatives that are transacted have related positions such as paired interest rate and inflation swaps. Requiring initial margin on both the interest rate swap and inflation swap separately may result in excessively high liquidity levels and hence burdensome costs associated with counterparties hedging real rate risk. In addition incurring an initial margin requirement on the interest rate swaps through one counterparty bank and the inflation swaps from another counterparty bank would almost double the initial margin requirements. We recommend under such paired / related transactions allowing for the netting of these transactions when calculating initial margin requirements to reduce excessive amounts of initial margin being posted. See comments in relation to Question 14 and Question 15.
- Transactions such as longevity swaps which typically have a long tenor and opaque market pricing should not be subject to additional margining requirements. We recommend that longevity swaps and longevity related instruments are exempt from the additional margin requirements of non-centrally-cleared derivatives.

Element 2: Scope of coverage – scope of applicability

Question 4: Is the proposed key principle and proposed requirement for scope and 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 margin requirements of counterparties should depend on the risk they pose in totality and the margin requirement for the same position from a high-risk counterparty and a low-risk counterparty should not be the same. Only considering the position and not the counterparty does not fully address systemic risk and invites cross subsidy. The risk measure used should be appropriate to the true risk posed to a party if its counterparty were to default.

- We are concerned about the additional costs due to the expected increased margining requirements that may be incurred by market participants whom contribute little or no systemic risk.

- We have concerns around the operational structures envisaged for bi-lateral initial margin. Segregation of assets is an essential element in the protection of market participants in the event of default. Assets should be segregated not only from the counterparty's assets but from those of any of its clients.

Question 5: 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 significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

- We are supportive of the use of thresholds to make a distinction between the various market participants based on risk they pose to the market. However, sufficient time would need to be given to market participants to source the appropriate levels of liquidity for its derivative transactions and set up the operational framework for managing the margining requirements.

Question 6: 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 be considered? Can an entity's systemic risk level be meaning fully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFs, 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 effective determine an entity's systemic risk level?

- See comments in Question 5.

Question 7: 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? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

- We consider pension funds to be prudentially-regulated entities. As per our previous comments, we would support pension funds being subject to no/lower initial margin given their limited contribution to systemic risk.

Question 8: 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?

- We have no comments to make.

Question 9: What are the potential practical effects of requiring universal two-way margin on 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 note that in some markets the framework for posting variation margin already exists through the International Swaps and Derivatives Association documentation. Therefore for the majority of our clients who transact derivatives such as interest rate and inflation swaps, the main change to the existing collateral framework would be the requirement to post initial margin and potential use of more restrictive variation margin controls.

- High initial margin requirements are likely to significantly impact investors such as pension funds who do not typically hold high levels of very liquid assets such as cash. Please note our comments in relation to the initial margin requirements and calculations in answer to Question 4, Question 13 and Question 15.

- As per the comments above, requiring variation margin in the form of cash is likely to significantly impact pension funds. We are supportive of a moderately wide range of high quality collateral for margining.

- Whilst our clients typically collateralise their interest rate and inflation swaps position, in line with market standards the collateralisation of FX contracts is less common. We note that this will

significantly impact on the liquidity of our clients who primarily use these instruments for derisking. This may result in clients foregoing managing their risk if costs are excessively high.

Question 10: 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 have no comments to make.

Question 11: Are the proposed exemptions from the margin requirements for non-financial entities that are no systemically important, sovereigns, and/or central banks appropriate?

- We have no comments to make.

Question 12: 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?

- We do not believe that pension funds using derivatives for risk mitigation purposes pose the same systematic risk as other financial counterparties so ask that consideration is given to expanding the exclusion to include pension funds, particularly for existing transactions.
- Overall we urge that pension funds are not inappropriately forced to bear excessive and unexpected costs from margining existing contracts and future derivative exposure and that at the very least the additional margining requirements are not made mandatory for pension funds until a full range of services suitable for pension funds is available from market participants.

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

Question 13: 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?

- We are supportive of the use of models to set appropriate levels of Initial Margin subject to the adequate parameterisation of the model with respect to volatility measures (in particular relating to correct identification of 'stressed volatility') and horizon for liquidity. A 99% confidence limit is logical, but so would 97.5% or similar.
- We are concerned that certain hedging strategies might be unjustifiably penalised if the methodology is not sensibly applied – a good example is the paired use of inflation and interest rate swaps to manage risk – demanding Initial Margin for both swaps would clearly be an over prudent requirement
- The disapplication of full Initial Margining for certain low risk clients via thresholds (again we raise pension funds) is logical.

Question 14: 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 are supportive of allowing initial margin models to account for diversification, hedging and offsetting risks within broad asset classes. We assume that inflation linked instruments would be grouped in the same asset class as interest rate derivatives.
- We would support setting an overall minimum base level of initial margin to ensure adequate initial margin is posted by counterparties.

Question 15: 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 are in favour of the transparency of the proposed standardised schedule and its simplicity for calculating the required amount of initial margin in respect of each transaction. However, by not allowing for the netting, hedging and diversification benefits, given the main end users of this approach are likely to be less sophisticated and lower risk market participants, we believe that they would be penalised with potentially excessive margining requirements.
- We recommend that additional controls are added to the standardised schedule to allow participants to benefit from netting, hedging and diversification of risks within broad asset classes.

Question 16: 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?

- We are supportive of the proposed variation margin methodology which is in line with that described.
- However, please note our comments above on Question 3.

Question 17: With what frequency should variation margin payments be required? Is 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 are supportive of daily margining for the majority of derivative contracts. However, we note that this would not be suitable for exotic contracts or for counterparties with a limited level of derivative exposure and so a longer margining period may be acceptable. For example, the valuation frequency of longevity transactions is likely to be more like annually or quarterly. Please see our comments in Question 3 with regards to these transactions.

Question 18: 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 have no comments to make.

Question 19: What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?

- We support setting a minimum transfer amount to reduce the burden and operational effort of transferring insignificant sums of collateral between counterparties. We would support setting a minimum transfer amount in the region of £250,000 to £500,000 is appropriate.

Element 4: Eligible collateral for margin

Question 20: Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

- We are supportive of having a moderately broad range of high-quality eligible collateral. However we note that for low risk / risk-averse counterparties, some of the proposed assets such as equities included in major stock indices may be inappropriate.
- As per the existing International Swaps and Derivatives Association documentation framework set out in the Credit Support Annex (CSA), we recommend that the scope of eligible collateral is agreed between the counterparties prior to trading.

- We would not be supportive of applying a single standardised schedule for all counterparties if the range in eligible collateral results in increasing the costs associated with closing out transactions (eg the inclusion of multi-currency denominated assets).

Question 21: Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific 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?

- For some of the proposed assets set out in the Proposed Standardised Haircut Schedule, we would recommend incorporating additional constraints on the level of collateral provided by a single stock or issuer (excluding government bank and central bank securities) to incentivise diversification and less concentrated collateral portfolios. For example, setting limits such as restricting the amount high quality corporate bonds from a single issuer that can be posted to be a maximum of 30% of the overall posted collateral.

- However, we note that the diversification of collateral is likely to depend on the underlying investment strategy of the counterparty. We recommend that as similar process is applied as currently used within CSAs and the counterparties agree the concentration limits and other restrictions in advance in a document such as a CSA.

- The suggested haircut for equities at 15% is too low. A figure of at least 30% would be more sensible.

Element 5: Treatment of provided margin

Question 22: 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?

- If initial margin is required, we agree that this should be held on a fully segregated basis at a third party approved custodian.

Question 23: 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 potentially small number of custodian banks and thus creating concentration risk?

- We recommend that initial margin is exchanged on a gross basis in line with central counterparty clearing standards.
- We have concerns around the use of a small number of custodians which may result in increased risk.

Question 24: 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?

- We have reservations around how re-hypothecation of collateral would work in the case of initial margin. We recommend that initial margin is not allowed to be re-hypothecated by the collecting party.
- We understand that re-hypothecation aides in managing the costs of transacting derivatives. However typically our clients do not re-hypothecate under their existing derivative arrangements.
- If there are adequate safeguards then the re-hypothecation of Variation Margin could be supported.

Element 6: Treatment of transactions with affiliates

Question 25: 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?

- We are supportive of the proposed requirements by the BCBS and IOSCO with respective of the treatment of non-centrally-cleared derivatives between affiliated entities.

Question 26: Should an exchanged 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?

- We have no comments to make.

Element 7: Interaction of national regimes in cross-border transactions

Question 27: 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 are supportive of clear guidelines on the interaction of national regimes in cross-border transactions. We recommend that these guidelines are structured to ensure that there is an overall minimum standard for margining to remove/reduce the risk of market participants using regulatory arbitrage to reduce their overall margining requirements.

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