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Re: Margin requirements for non-centrally cleared derivatives consultative document

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions for the opportunity to comment on the consultative document on 'Margin requirements for non-centrally cleared derivatives'. Please find attached our response to the paper.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein on +41 44 234 4486.

Yours sincerely,
UBS AG

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UBS Response to the Joint
Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' Consultative Document on Margin Requirements for Non-centrally Cleared Derivatives

INTRODUCTION

UBS would like to thank the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) for the opportunity to comment on the consultative document on 'Margin requirements for non-centrally cleared derivatives'. Please find below our response to the overall content, as well as the specific questions set out in the paper.

The proposal contains, in our view, four elements which we consider to create significant costs to the industry and which are likely to disincentivise the use of OTC derivatives for risk management purposes: (i) the requirement for two-way posting of the full amount of initial margin (IM) on a gross basis (ii) mandatory full IM segregation without the possibility to re-hypothecate or re-use the collateral posted (iii) restrictions on collateral eligibility (iv) the proposed treatment of transactions with affiliates.

The requirement for two-way posting of the full amount of IM on a gross basis is likely to have a number of considerable impacts: (i) a significant legal impact resulting from the need to renegotiate existing legal contracts (ii) an operational impact resulting from parties who currently do have to post or receive margin having to develop the processes and infrastructure to do so and (iii) a highly significant liquidity impact resulting from the need to collateralise considerably higher margin requirements than are currently required.

The liquidity impact is likely to be further exacerbated by the proposed mandatory full IM segregation without the possibility to re-hypothecate or re-use the collateral posted as well as by the restrictions on collateral eligibility which will create a situation where significant amounts of high quality collateral is tied up and is not available for other uses. We are concerned that these requirements, coupled with the proposed Basel III liquidity requirements, will require banks to have significant levels of liquid assets and are likely to contribute to a global liquidity drain. Based on ISDA estimates, the liquidity

impact at a global level could be as large as $12 – 16 trillion. The impact is likely to be significantly greater still should firms not be permitted to use internal margin models but rather be required to rely on standardized margin schedules.

So whilst the systemic risk resulting from counterparty credit risk is likely to be materially reduced by the proposals, we believe the corresponding increase in liquidity and operational risk could offset this, with the overall impact on systemic risk being ambiguous. We also believe this could materially undermine the ability of the banking sector to provide funding to the real economy.

The proposed treatment of transactions with affiliates will reduce the flexibility groups have to manage risks on a centralized basis which may actually increase rather than reduce systemic risk. Equally important, it is of upmost importance that any exemption from the clearing obligation is mirrored in the bilateral margining of uncleared trades in order not to render the clearing obligation exemption ineffective. We would emphasize our view that we consider the proposals to be inconsistent with the European Market Infrastructure Regulation (EMIR) which provides for an exemption for intra-group trades from bilateral margin requirements under certain specified conditions.

In light of this, we propose that the following key amendments are made to the proposals which will, in our view, strike a more appropriate balance between the mitigation of different types of risk and in turn most effectively strengthen the resilience of the global market:

- There should be a careful phasing-in of the final proposals to give parties adequate time to develop systems, processes and infrastructures given that many of the proposed obligations are likely to be entirely new for many types of market participants
- There should be no requirement for mandatory two way exchange of IM when a Sophisticated Prudentially Regulated Entity (SPRE) is a counterparty to the trade for reasons set out in this response
- It should be permitted for internal margin models to net i) within asset classes ii) between asset classes and iii) between cleared and non-cleared products
- A wide range of collateral should be permitted to back margin requirements with risks addressed via haircuts and other risk mitigation techniques
- BCBS/IOSCO should work with relevant standard setting bodies to improve global harmonization of bankruptcy and asset protection laws

- Exemptions from the non-cleared derivative margin requirements should be aligned with exemptions from OTC derivatives central clearing requirements such as those in EMIR and Dodd-Frank

In additional, we consider it crucial that a fully comprehensive impact study is undertaken on the proposals before they are finalised in order to quantify the potential liquidity and operational costs generated. Such assessment should also consider the aggregate impact of the proposals read in conjunction with the Basel III requirements for the leverage ratio and capital requirements for derivative exposures and general liquidity.

Please find below our responses to the specific questions set out in the consultation.

IMPLEMENTATION AND TIMING OF MARGIN REQUIREMENTS

BCBS and IOSCO note the importance of the sequencing, timing and implementation of margining requirements and seek comments on issues related to the timing and implementation of margining requirements.

Q1: What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the initial margin (IM) 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?

Significant phase-in period and coordinated global approach

We believe that a sufficiently long phase-in period is required as the proposals not only will likely require firms to renegotiate all legal documentation but to undertake changes to their infrastructure due to the fact that many financial entities do not currently collect or sometimes pledge IM and will be required to do so should the exchange of two-way bilateral IM be mandated. Some entities will be also required to establish relationships with third party custodians. Furthermore, we anticipate material practical issues in getting portfolio margin models signed off by relevant supervisors in a timely manner which would need to be factored in when determining an appropriate phase-in period for the implementation of margining requirements. In this context, we would propose that existing IM models are grandfathered until the supervisory review is completed to

avoid the potential temporary use of less risk sensitive standardised margin calculation approaches.

The initial margin implementation timeline should, however, not be set independently from other related regulatory initiatives. We advocate a co-coordinated consistent global approach due to the global nature of derivatives and propose that the new bilateral requirements are only introduced **once clearing has been introduced across all of the G20 jurisdictions.** In other words, the proposals should not be a precursor to clearing, but rather clearing must already have started within the various countries across all financial institutions. New bilateral requirements should not be imposed on firms without them having a viable clearing solution as they have been developing their infrastructure to a clearing timeline set by their own regulatory bodies.

Furthermore, **capital and margins should be viewed as complementary,** and as such, the timetable for agreeing margin requirements should be co-ordinated with the timetable for global implementation of Basel III. This will ensure that the aggregate impact of margins and capital are proportionate to the risks they seek to mitigate.

Nature of the phase-in approach

We consider that a potential phase-in could be arranged i) according to type of industry participant or ii) by volume of trading activity between particular counterparties with largest volume relationships being subject to the requirements first (e.g. implement for the relationships with greater than X notional outstanding exposure first).

Clarification of transactions with scope

It is not clear whether it is proposed to apply the requirements retrospectively (i.e. to trades agreed before the new requirements come into effect). We would strongly disagree with a retrospective application as it completely changes the economic terms under which the contracts were agreed. We firmly believe that any new requirements should only apply to transactions entered into on, or after, the bilateral margining start date. However, when a party is using portfolio margining, it should be possible to include historic trades to the extent they are included in ISDA netting agreements.

ELEMENT 1: SCOPE OF COVERAGE – INSTRUMENTS SUBJECT TO THE REQUIREMENTS

According to BCBS/IOSCO, all non centrally-cleared derivatives should be subject to margining requirements. This covers all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardised and bespoke). The BCBS and IOSCO have considered the US proposal to exempt foreign exchange swaps and forwards from the US mandatory central clearing regime and seek comments to what degree an exemption from global margining requirements should equally apply.

Q2. Should FX 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 other arguments to support an exemption for FX swaps and forwards?

We believe that FX swaps and forwards should be exempt from the margin requirements for the following key reasons:

Transparency: Unlike many other derivatives, FX swaps and forwards already trade in highly transparent, liquid, and efficient markets. Also, FX swaps and forwards are heavily traded on electronic platforms and market pricing information is readily available from a number of sources.

Contract duration: FX swaps and forwards are predominantly short-term transactions (68 percent of the market matures in one week or less and 98 percent in one year or less) whilst many other derivatives have much longer average maturities. The short duration of contracts means FX swaps and forwards pose significantly less counterparty credit risk than other derivatives. Consequently, margin that mitigates counterparty credit risk is not the appropriate mechanism for addressing the main risk posed by these products.

Settlement risk versus counterparty risk: Because FX transactions involve the actual exchange of currency, settlement risk (the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought), is the main source of risk. At a global level, there is a well-functioning settlement process that effectively

addresses this risk. There is extensive use of payment systems that permit the transfer of one currency to take place only if the final transfer of the other currency also takes place.

Fixed terms and physical exchange: In contrast to other derivatives, FX swaps and forwards always require both parties to physically exchange the full amount of currency on fixed terms that are set at the outset of the contract. Market participants know the full extent of their own payment obligations and their exposure to the other party to a trade throughout the life of the contract.

The overwhelmingly short dated nature of FX transactions, in contrast to many other asset classes, provides FX market participants with considerable greater flexibility in managing their counterparty exposures, as was demonstrated during the financial crisis. Therefore a "one size fits all" regime that mandates a high level of margin be collected even from financially strong counterparties whose creditworthiness is highly unlikely to deteriorate during the lifetime of an FX contract is a disproportionate response that will impair both the FX market and, given the ubiquity of currency conversion, the real economy. Similarly, mandating two-way margining may create an unnecessary barrier to entry for many FX market participants who need to do FX transactions occasionally but have little appetite to invest in the capability required to manage the collateral they will be forced to receive.

We do not consider it appropriate to limit the exemption to transactions below a specified maturity. We note that if a specific maturity is prescribed, it is likely to result in transactions being specifically structured to fall below the threshold in order to avoid the requirements, disincentivising participants from hedging FX risk properly.

As noted by BCBS/ISOCO, the US has proposed exempting FX Swaps and forwards from mandatory central clearing. We consider it important not only to have global alignment in the bilateral margining exemption to maintain a level playing field and reduce opportunities for regulatory arbitrage, but also that, where derivative contracts are exempted from central clearing, they are equally exempted from bilateral margining in order not to render the clearing exemption ineffective.

Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

We believe that the FX exemptions are the most important.

Again, we emphasise that we would strongly disagree with a retrospective application to any products.

ELEMENT 2: SCOPE OF COVERAGE – SCOPE OF APPLICABILITY

The proposal broadly exempts from the margin requirements non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that such transactions are (i) viewed as posing little or no systemic risk and (ii) are exempt from central clearing mandates under most national regimes. Sovereigns and central banks are not required to either collect or post margin.

With respect to other non-centrally-cleared derivatives, BCBS and IOSCO propose margin requirements that would involve the mandatory exchange of both IM and VM among parties to non-centrally-cleared derivatives ("universal two-way margin") in mandatory minimum amounts.

Two options are considered for implementing universal two-way margin:
Option 1: require the exchange of the full amount of IM and VM for all types of derivative market participants.
Option 2: provide for an IM threshold ("threshold") that would specify an amount below which a firm would have the option of not collecting IM. In cases where the IM requirement for the portfolio exceeded the threshold, the firm would be obligated to collect IM from its counterparty in an amount that is at least as large as the difference between the initial margin requirement and the threshold. The BCBS and IOSCO note that this approach would not apply to VM, as the exchange of VM represents a net transfer between derivative counterparties, meaning the net liquidity impact associated with its exchange is not likely to be material in the ordinary course of business.

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

We strongly disagree with the requirement that all financial institutions call for two-way IM and do not believe it is appropriate for the reasons set out below:

Significant legal and operational cost implications: The legal and operational cost implications of a mandated two-way margining are likely to be considerable for many firms. Many current OTC market participants would be required to make considerable investments in infrastructure covering margin calculation, account segregation, dispute management policy and procedures. The imposition of IM and VM will also lead to significant incremental liquidity and operational requirements for the majority of firms using OTC derivatives. Many funds are unlikely to have the resources (or want to bear the expense) of having to calculate and collect VM and IM. Forcing them to do so imposes significant costs on the industry and would increase the barrier to entry and concentration in the market. In terms of legal documentation, it is important to take into account that the length of time spent to negotiate each CSA could extend to 3 months per contract. This is because current CSAs only cover VM and not IM, and for the latter, a different legal set up is required as it needs to be placed in custody and pledged. As it is not common market practice today to have two-way exchange of IM, we believe that the complexity of posting IM between counterparties which have never done so should not be underestimated.

In summary we are very concerned that the cost implications of the proposed requirements are likely to reduce the extent to which firms use derivatives for risk management purposes which will increase the overall risk of the financial system.

Increase in counterparty credit risk: Posting VM and IM to funds is likely to create significant additional counterparty exposure for dealers, particularly where the funds are located in countries with weaker regulatory frameworks (e.g. emerging markets) or ones domiciled in jurisdictions that present higher country or regulatory risk. Dealers will seek to mitigate the risk via segregation which implies that margin posted by dealers to

clients would almost exclusively have to go into tri-party accounts. There are two significant consequences of this: (i) additional significant cost implications which are likely to disincentive the use of derivatives for hedging even further and (ii) a likely significant increase in concentration risk and systemic risk given that there are only two main tri-party providers globally (i.e. JPM and Bank of New York). We also note that this concentration risk should be considered in conjunction with the additional concentration risk in CCPs resulting from the central clearing requirement of the G20 mandate.

Need for differentiation between approach for cleared and non-cleared trades: As an overall comment, we would like to emphasize our view that initial margining is a risk mitigation technique used by CCPs which is less suited for replication for non-cleared trades. CCPs require IM because they typically lack the necessary level of capital to absorb potential losses without recourse to the default fund. By contrast, in the uncleared OTC derivative space, firms are not at risk that their capital will be depleted by absorbing the mutualised losses of others (in contrast to how the CCP default fund distributes losses). Furthermore, for cleared OTC derivatives, the CCP must guarantee a contract's performance should one of the two counterparties default. This guarantee requires the CCP to perform a close-out process with the defaulting party and replace the defaulting contract with a new one. The new contract's cost should theoretically equal the VM already collected. If the close-out occurs over a longer time period, any adverse movement in the replacement contract's cost can be covered by IM. In contrast, a non-defaulting counterparty in a bilateral situation has no obligation to replace the defaulted contract with a new one, thus reducing the rationale for IM.

Due to the reasons outlined above, we do not believe that the proposed requirements appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact. The proposals are likely to reduce one important source of systemic risk (i.e. counterparty credit risk) but at the expense of introducing significant additional liquidity risks and reducing the extent to which risks are hedged. The overall impact on systemic risk is therefore ambiguous. To more appropriately balance the goals, we suggest the specific adjustments outlined below.

Cross-margining flexibility: We believe greater flexibility should be allowed for cross-margining. Many firms allow counterparties to have a single margin call covering netted and offsetting positions across all trading activities including both cleared and non-cleared derivatives, exchange-traded and securities financing activities. This maximizes

efficiencies and minimizes costs and operational risks. We believe netting should be permitted to the full extent it is legally enforceable (existing ISDA agreements allow cross-asset hedging) but parties should be able to demonstrate the robustness of their netting approach if requested by competent authorities.

Different application of margin requirements based on a differentiation between Non-Prudentially Regulated Entities ("NPRE"), Prudentially Regulated Entities ("PRE") and *Sophisticated* Prudentially Regulated Entities ("SPRE"): We would advocate a distinction between Non-Prudentially Regulated Entities ("NPRE"), Prudentially Regulated Entities ("PRE") and Sophisticated Prudentially Regulated Entities ("SPRE").

We consider that an SPRE should be defined as one that, as well as being subject to specific prudential requirements, has been granted supervisory approval to use an internal model for the purposes of calculating IM. As such, this approach would also have the benefit of creating incentives for PRE to develop more risk sensitive modelling approaches to calculate margins in order to qualify as SPRE.

In our view, SPRE should not be mandated to post or receive IM. This is because:

i) **With regard to SPRE collecting IM**: SPRE are capable of closely evaluating the market risk of derivatives and the creditworthiness of counterparties in order to determine whether to take IM, and if so, the appropriate levels of IM. SPRE are able to adequately protect against default without collecting IM through termination options, tight credit limits and CDS, among other credit mitigants. Thus SPRE are capable of managing their derivative counterparty credit risk without the need for mandatory receipt of IM. Furthermore, the Basel III counterparty credit risk requirements create significant incentives for SPRE to collect IM at their own volition as uncollateralised derivative trades attract materially higher capital charges than collateralised trades. So, in cases where an SPRE chooses not to collect IM, its systemic risk will not increase as it will be required to hold more loss absorbing capital against the exposure.

ii) **With regard to SPRE posting IM:** SPRE are subject to robust capital requirements which provides significant protection to their counterparties against the risk of the SPRE defaulting on their obligations. The daily exchange of VM will also protect the system against the undetected accumulation of

undetected risks. Crucially, we believe a requirement that a) SPRE post IM in all cases with b) all posted collateral segregated and unavailable for re-use and c) restrictive standards for posted collateral quality and liquidity will significantly weaken the liquidity positions of banks as previously available liquid assets will be locked up. Consequently, the liquid assets will not be available during market shocks and this is likely to make such institutions more susceptible to liquidity shortages. This could have a significant detrimental market impact if solvent banks are unable to meet immediate liquidity needs as their liquid collateral cannot be accessed. Thus the posting of IM by SPRE could increase overall systemic risk by making large systemically important institutions less able to withstand liquidity shocks.

Q5. Are IM thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of IM 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?

As previously noted, we do not support mandatory two-way posting of IM. Our comments on the use of thresholds should be read in this context (i.e. that whilst we accept that they are a potential mitigant to some of the concerns raised by the proposed approach, we still do not consider the overall approach to be appropriate).

IM thresholds can be an appropriate tool to mitigate the potential liquidity impact and to ensure that the margin requirements are not too punitive for an instrument class to the extent the cost may affect the actual investment decision.

It is, however, important that counterparties are granted a certain level of flexibility to determine the thresholds bilaterally and we strongly advocate against mandating set thresholds. Different instruments within the same product class may have different levels of risk, and therefore is difficult to set a consistent level for all. Firms should have flexibility to set the appropriate thresholds for IM by reference to counterparty type, credit quality and the type of transaction. For any approach to thresholds, we would stress the importance of developing a granular approach to setting the thresholds that

would more accurately distinguish between the risk of different counterparties and different products.

Q6. Is it appropriate for IM 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?

We are not supportive of thresholds by counterparty type as such a static approach is unlikely to appropriately reflect the individual risk posed by specific counterparties. Any thresholds should reflect the specific creditworthiness of the counterparty, as within a broad grouping of counterparties by entity type, the actual credit risk of any given counterparty within the group could differ significantly. As an example, for counterparties with issued bonds, thresholds may be best linked to public credit ratings or CDS spreads, while for other counterparties, thresholds may be best linked to NAV or defined financial ratios. Or it may not be possible to identify suitable criteria for other counterparties at all. Where thresholds are linked to credit ratings or CDS spreads, there would need to be a flexible mechanism for adjustment to reflect a potential change in ratings or spreads. It is important to note that the appropriate level of IM also depends on the type of contract.

Hence as noted in our response to Q5, we would reiterate our view that there should be sufficient flexibility for counterparties to assign thresholds in a manner which reflects their specific characteristics and also the credit appetite of the parties. We would also stress the fact that the core competency of SPRE (as defined in our response to Q4) is to manage credit risk and they should be allowed to use their expertise to determine the right threshold level in order to mitigate risk in an appropriate manner.

Approach for G-SIFIs

We would furthermore like to emphasize that we are not supportive of higher margin requirements for G-SIFIs. This is because their systemic risk is already addressed via several targeted measures including higher capital requirements, additional risk management, liquidity and organizational requirements and initiatives such as Too Big To Fail. As noted in our response to Q4, we believe imposing disproportionate collateral posting requirements on SIFIs will weaken their liquidity positions, make them less able to withstand market shocks, and consequently actually increase systemic risk.

Q7. Is it appropriate to limit the use of IM 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?

It is not entirely clear how limiting the use of IM thresholds for prudentially regulated entities would work in practice but we understand this to mean that prudentially regulated counterparties would have the option of not collecting or posting margin below the threshold, while other counterparties would have to collect/post it in full. If this interpretation is correct, it might increase trading costs for non-regulated entities, because they would have higher IM requirements than a regulated entity, so counterparties would not want to deal with them, even though the non-prudentially regulated entity may be a small user of derivatives and present no systemic risk.

Approach to SPREs: To avoid the above unintended consequence and referring to our response in Q4, we would advocate that for transactions involving SPREs, IM should not be mandated for the counterparties involved. Where IM is mandated (despite our opposition to such an approach), SPREs should be allowed to use their expertise to determine the right threshold level in a bilateral negotiation in order to mitigate risk in an appropriate manner.

Margin thresholds do not need to be symmetric: In this context we would also emphasize our view that margin requirements do not need to be symmetric as proposed. Thresholds should be set by one counterparty based on the risks posed by the other counterparty which could result in asymmetric thresholds where the creditworthiness of the two counterparties differs. Also, given that prudentially regulated entities are subject to specific capital requirements, consideration of the nature of these capital

requirements and the loss absorbency it provides must be taken into account when determining margining requirements to ensure duplicate requirements are not imposed that are disproportionate to the risks being addressed.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the IM 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 believe both model based and standardised options are needed to ensure the necessary flexibility. Overall, the thresholds should be based on the creditworthiness/counterparty risk of the relevant parties and the specific characteristics of the transaction. We support the ability of firms to use internal models where they are able to satisfy robust modelling standards and agree that a more simplistic approach should be available for firms who are unlikely to have the appetite or resources to internally model in a robust manner. We also believe scope should be provided for a smaller counterparty in a transaction with a SPRE to use the SPRE's model to calculate their IM provided there are clear rules in place to address potential conflicts of interest.

It is very important that internal margin modelling is allowed on a netted basis across instruments and is not required on a transaction by transaction basis. We also reiterate that existing internal margin models should be grandfathered until the relevant supervisory authority has reached a decision on the model, otherwise, firms currently modelling margins could be faced with a very significant, temporary, capital cliff if they are required to use less risk sensitive standardised margin schedules for an interim period.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities?
How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

We refer to our response to Q4 for our key comments.

Some additional points are set out below:

Significant potential for IM calculation disputes: We believe there will be significant practical difficulties associated with the calculation of two-way margin. It is important that the final proposal clarifies whether there is any flexibility to determine who makes the margin calculation, for example, i) whether both counterparties to a trade would be required to separately calculate margin or ii) whether it would it be possible for one party to calculate on behalf of both parties. If both counterparties make their own calculations based on separate methodologies, we believe there would be significant scope for disputes as to the margin required. Such disputes can trigger defaults under current ISDA arrangements which could have significant practical implications.

Operational impacts: As per our response to Q1, we note that two-way bilateral margin will have significant operational impacts as a significant proportion of OTC participants are not set up to collect or pledge IM, or keep it segregated, and having to develop this capability will impose huge process, technology and infrastructure costs onto market participants. Resultant operational consequences are likely to require greater resources dedicated to trade monitoring, life cycle events and reconciliations.

Liquidity impact: The proposed requirement for collateral to be segregated and the prevention of rehypothecation could have highly significant liquidity implications. The likely collateral drain will have a materially negative impact on banks' ability to provide funding to the real economy.

Potential for pro-cyclical systemic impacts: We also note that the proposed approach is likely to be procyclical given that, under stressed market conditions, IM requirements are likely to increase materially, particularly under VaR based internal modelling approaches. Combined with the increase in VM calls in times of market stress and the proposed restrictions on collateral eligibility, many firms are likely to be forced to liquidate assets during such periods in order to meet their increased IM and VM requirements with a resultant systemic impact.

We note however that any risk sensitive approach to calculating IM will be pro-cyclical to some degree and we strongly believe the appropriate solution to mitigating pro-

cyclicality is not to set margins at a very high level in all market conditions. Rather, we consider the pro-cyclical impact to be a justification for not mandating two way exchange of IM when the risks of a transaction can be mitigated in other more appropriate ways such as via capital (a "survivor pays" approach as an alternative to the "defaulter pays" nature of IM), termination options and tight credit limits.

Please also see our response to Q23. for details of the impact on the Basel III leverage ratio for banks mandated to collect IM.

Q10. What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post IM to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

We believe requiring regulated entities to post IM to unregulated counterparties is likely to reduce the contribution of counterparty credit risk to overall systemic risk but only to a marginal degree.

As per our response to Q4, we believe that there are significant credit risks associated with the posting of IM from prudentially regulated entities to non-prudentially regulated entities which would need to be mitigated via segregation. To the extent prudentially regulated entities cannot get comfortable with the level of protection and segregation provided by the non-prudentially regulated counterparty (likely in cases where such party has no previous experience of segregating collateral and where local bankruptcy laws are weak), margin posted by dealers to non-prudentially regulated clients would almost exclusively have to go into tri-party accounts. There are two significant consequences of this: (i) significant cost implications which are likely to disincentive the use of derivatives for hedging (see our response to Q23 for further details) and (ii) a likely significant increase in concentration risk and systemic risk given that there are only two main tri-party providers globally (JP Morgan and Bank of New York). We do not believe this increase in concentration risk was the intention of the proposal.

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

We agree that exempting non-systemically important institutions, sovereigns and central banks from the margin requirements would be appropriate.

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?

We strongly believe that any exemptions from the requirement to centrally clear OTC derivatives, such as the pension fund or intragroup exemptions under EMIR in the EU, should also be applied to non-cleared OTC derivatives. We refer to our response to Q25.

ELEMENT 3: BASELINE MINIMUM AMOUNTS AND METHODOLOGIES FOR INITIAL AND VARIATION MARGIN

BCBS/IOSCO states that the methodologies for calculating IM and VM that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the proposed requirements and reflect the potential future exposure IM and current exposure VM associated with the particular portfolio of non-centrally-cleared derivatives at issue and (ii) ensure that all exposures are covered fully with a high degree of confidence.

For purposes of informing the IM baseline, BCBS/IOSCO propose that the potential future exposure of a non-centrally-cleared derivative should reflect an extreme but plausible estimate of an increase in the value of the instrument that is consistent with a one-tailed 99 percent confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress. The IM amount is to be calibrated to a period of financial stress to ensure that sufficient margin will be available when it is most needed and to limit the extent to which margin can be procyclical. The required IM amount may be calculated by reference to either (i) a quantitative portfolio margin model or (ii) a standardised margin schedule. IM models may account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit and commodities, but not across such asset classes.

BCBS/IOSCO note that, whilst quantitative, portfolio-based IM models are useful and desirable if monitored and governed appropriately, there are some instances in which a

simpler and less risk-sensitive approach to IM calculations may be warranted. Accordingly, the BCBS and IOSCO have provided a proposed IM schedule.

For purposes of informing the VM baseline, the full net current exposure of the non-centrally-cleared derivative must be used. VM should be calculated and collected for non-centrally-cleared derivatives subject to a single, legally enforceable netting agreement with sufficient frequency (eg daily). In addition, minimum transfer amounts (MTAs) should be set sufficiently low so as to ensure that current exposure does not build up before variation margin is exchanged between counterparties.

The BCBS and IOSCO recognise that national supervisors may wish to alter margin requirements to achieve macroprudential outcomes.

Q13. Are the proposed methodologies for calculating IM 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 IM would be preferable and practicable, and why?

Overall, and as highlighted in our previous responses, we believe that where a SPRE is a counterparty to a trade, the requirement for, and level of, IM should be determined on a bilateral level. Different methodologies may be appropriate for different type of counterparties. We therefore object a one size fits all approach and advocate that the parties maintain choice over the method, based on an analysis of credit risk of the counterparty. No specific approach should be mandated.

Although we strongly support the use of risk sensitive internal margin models, we note that a requirement for mandatory two-way exchange of IM, coupled with an approach under which counterparties use VaR models to calculate IM, may result in significant pro-cyclical impacts during periods of stress.

Potential for high levels of disputes

We again highlight that current market practice is for firms to bilaterally agree the terms of any IM requirements. This ensures that both firms value the IM amount in the same manner and avoids any collateral disputes over IM. Moreover, existing dispute resolution procedures are designed to resolve collateral disputes associated with VM only. Given that the proposal would allow two counterparties to an OTC derivative contract to use two different prudentially approved models for the calculation of IM, we are concerned

that the approach may significantly increase the number of collateral disputes, as previously highlighted in our response to Q9. In the case of a dispute, it is unclear how resolution could be achieved as both firms are likely to argue that their calculation methodology is appropriate if it has been approved by their supervisor.

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?

As per our response to Q4, we strongly believe that **initial margin models should be allowed to i) account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit and commodities ii) across such asset classes and iii) between cleared and non-cleared instruments**. Diversification benefits exist between different asset classes and these should be taken into account within the proposals. Netting and diversification effects should also be recognized when calculating exposures used to determine margin levels. The onus should be on firms to demonstrate to their supervisors that their approach is robust.

Q15. With respect to the standardised margin schedule, are the parameters and methodologies appropriate? Are the IM 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?

Need for more risk sensitive calibration of the schedule: We consider the standardised margin schedule to be a sensible approach for parties lacking the resources to robustly use internal models but we believe the proposed approach lacks risk sensitivity. For example, the proposed CDS margin levels don't take into account buy / sell, spread levels, or type of product (e.g. super senior tranche vs. equity tranche, main index vs. HY single name). As a consequence, we consider the proposed levels to be too high for some products which will remain uncleared (e.g. super senior tranches).

Need for flexibility to address specific risks of counterparty: Our general preference is to have a standardised schedule that sets margin at a relatively low level so firms would not be locked into paying disproportionate amounts but to allow flexibility

for counterparties to require higher margin levels where justified by the specific characteristics of the derivative in question.

We would support the use of a standardised valuation approach (i.e. OIS) in addition to the standardised margin schedule.

Q16. Are the proposed methodologies for calculating VM appropriate? If not, what approach to the calculation of baseline VM would be preferable, and why?

As per our response to Q14 with regard to IM, we are of the view that all netting and diversification effects should be taken into account in margin calculations, both with regard to IM and VM.

It would be preferable for VM to potentially be collateralised by bonds as well as cash in order to mitigate the impact on investment strategies of funds.

Q17. With what frequency should VM payments be required? Is it acceptable or desirable to allow for less frequent posting of VM, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating IM?

While we support the daily exchange of VM in principle, we believe that in some cases this may be onerous for certain smaller firms. We would also re-emphasize that only sophisticated financial institutions have the infrastructure in place to manage daily trade and collateral valuations, and the operational means to manage cash payments.

We also note that whilst daily exchange of collateral is useful when underlying positions can be meaningfully re-valued on a daily basis, this may not be realistic in markets which are lacking robust observable price data. There should be some flexibility in the proposals to reflect this

Q18. Is the proposed framework for VM appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional IM due to "cliff-edge" triggers sufficiently discouraged?

We are supportive of measures that seek to mitigate pro-cyclicality. But we are of the view that the requirement for two way exchange of IM, potentially calculated using VaR methodologies, combined with the increase in VM calls under stressed conditions and the proposed restrictions on collateral eligibility, may result in firms having to liquidate assets in order to meet their increased IM and VM requirements during periods of stress with a resultant systemic impact.

However, as per our response to Q9, we do not believe that margin levels should be calibrated at an inappropriately high level during times of low market volatility just to mitigate pro-cyclicality given the negative liquidity impact (and additional systemic risks) this will have. We also note that any risk sensitive approach is likely to introduce some degree of pro-cyclicality as effective risk management will result in higher requirements as volatility increases. Rather, we consider the combined pro-cyclical impact of IM and VM to be a justification for not mandating two way exchange of IM when the risks of a transaction can be mitigated in other more appropriate ways such as capital, termination options and tight credit limits.

Q19. 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 a daily VM call with an MTA of $100,000. This will significantly mitigate counterparty risk as well as ensuring a practical and efficient operating model is in place.

ELEMENT 4: ELIGIBLE COLLATERAL FOR MARGIN

The BCBS and IOSCO have considered the types of collateral that should be deemed eligible for use in meeting the margin requirements. Two options are considered:
Option 1: limit eligible collateral to only the most liquid, highest-quality assets, such as cash and high-quality sovereign debt.
Option 2 (proposed option): permit a broader set of eligible collateral, including assets like liquid equity securities and corporate bonds, and address the potential

volatility of such assets through application of appropriate haircuts to their valuation for margin purposes.
Examples of types of eligible collateral that satisfy the key principle are considered to generally include (non-exhaustive list): Cash; high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices; and gold.

Additional assets and instruments that satisfy the key principle may also serve as eligible collateral. Potential methods for determining appropriate haircuts could include either internal or third-party quantitative model-based haircuts or schedule-based haircuts. The BCBS and IOSCO have proposed a standardised schedule of haircuts for the list of assets appearing above.

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

Scope of collateral: We consider the proposed scope of eligible collateral, as set out in the guide list in the consultation, to be too narrow. However, we note that the list is not intended to be exhaustive and **we strongly support a non-exhaustive approach in order to provide flexibility to firms depending on the range of collateral available to them**.

We believe it should be a matter of agreement between the parties to take a range of collateral for which they have the systems in place to adequately model and risk manage. For example, parties that invest in equities often provide these as collateral for derivatives. There is no obvious reason why those parties should not be able to continue to provide a wide range of equities (potentially beyond those included in major indicies) as collateral for derivatives. If equities were not to be permitted collateral, then holders of shares that wanted to provide cash collateral would need to borrow cash by lending shares in the stock loan market and then providing the cash received under the stock loan as collateral for derivatives. In our view, this would lead to a needless doubling of transactions and one that would increase rather than decrease risk if the stock loan was done with a different party to that which the derivatives were entered into with.

An example of what we believe would be a prudent approach to collateralising IM whilst mitigating some of the liquidity impact are "Less Liquid Initial Margin Trades" in

which two dealer counterparties pledge assets to a third party custodian in order to reduce close out risk on collateralised derivative contracts.

Using UBS as an example, in such a trade, UBS and a counterparty both pledge assets, drawn from a bilaterally agreed eligibility set, to a third party custodian. In the event of default, the non-defaulting party receives its own assets and the counterparty's assets thus improving its close out position.

Under executed transactions, each with Globally Systemically Important Financial Institutions, UBS has used Euroclear as the third party custodian and leverages the Euroclear Triparty process to deliver select and transfer eligible collateral. Security is achieved in existing transactions under a Belgian Law pledge. No right to rehypothecate, sell, assign or otherwise transfer assets exists.

Transactions are documented under a Collateral Transfer Agreement which references ISDA documentation between UBS and its counterparts. A default under the CTA constitutes a default under the ISDA agreement with attendant consequences. The relationship between UBS and Euroclear is captured under a Euroclear Security Agreement; Triparty operations are governed by standard Euroclear Triparty documentation.

Collateral provided is market to market on a daily basis using third party pricing and a market standard dispute provision is embedded in the CTA documentation. Haircuts are agreed (with the provision to revise and add) within the initiation phase and again captured within CTA documentation. The haircuts agreed are the result of commercial negotiation based upon input and examination from Trading Desks and Credit Risk departments on both sides.

Eligible collateral is agreed and structured within a hierarchy. The hierarchy considers the ability of the firm to use the inventory within its secured funding operations. Less liquid inventory is individually agreed between counterparts and then underpinned, to the extent necessary, by more traditional forms of collateral such as investment grade bonds and sovereign inventory.

The primary consideration for eligibility within a transaction is the assets liquidity in the event of counterparty default. Assets with a perceived correlation to the derivative counterparty will be rejected.

Operation of the asset selection and valuation processes achieves the important objectives of (i) ensuring that the asset holds its value in a period of financial stress and (ii) minimizes the market liquidity impact and allows an organization to maximize its secured funding impact whilst reducing close out risk.

We therefore believe the proposals should provide flexibility for such approaches provided the counterparties can demonstrate, on request, to their supervisors that the approach is robust and prudent.

Potential consequences of an overly narrow scope of eligible instruments: The consequence of a narrow approach to eligible collateral is that it will make certain end users reliant on collateral transformation services offered by banks. We expect the costs of assets considered eligible for collateral to increase significantly due to an increase in demand. Accepting non-standard collateral for IM could alleviate funding pressure. A narrow approach may increase the likelihood of bubbles in the assets that are eligible as demand for such assets will be artificially increased by the requirements. This can create significant systemic impacts.

Existing incentives for prudentially regulated entities to take a prudent collateral approach: For PREs, the prudential regime already differentiates between different types of collateral as more risky collateral receives less credit in reducing capital requirements. We consider this to already create incentives for such firms to take a prudent approach to collateral as firms can choose to either i) accept higher quality collateral in order to minimise their capital requirements or ii) accept lower quality collateral and hold additional capital instead.

We also note that consideration should be given to the correlation between the collateral and the derivative exposure. Collateral which is typically perceived as being very high quality/low volatility may be a less effective risk mitigant than lower quality collateral that is less correlated with the derivative exposure.

Use of collateral haircuts: Our overall view is that the list of eligible collateral should be as broad as possible with firms addressing the risks of the collateral by using haircuts. However, similar to our comments on Q9 regarding calculation of margin, we are concerned that it may not be workable for two counterparties to a transaction to make their own calculations of collateral haircuts based on separate methodologies as

we believe there would be significant scope for disagreement as to the appropriateness of the respective haircuts. We believe this is further justification for not mandating two way exchange of IM.

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

We are not supportive of prescribed concentration limits and/or other diversification requirements. Rather, we believe firms should have the flexibility to impose such requirements on a case-by-case basis so that firms can use their own risk management judgement rather than having a blunt and potentially non-risk sensitive framework imposed upon them.

Rather than a schedule with specific haircut percentages at product level, we propose that haircut ranges should be provided which allow the two parties to determine an agreeable haircut percentage at the time of execution. This will then provide the flexibility to agree different requirements for trades within the same product class, but with varying degrees of complexity.

ELEMENT 5: TREATMENT OF PROVIDED MARGIN

BCBS/IOSCO state that IM collected should be held in a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law. IM should be exchanged on a gross basis and held in a manner consistent with the key principle above. Cash and non-cash collateral collected as initial margin should not be re-hypothecated or re-used.

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?

Potential impact on liquidity: We do not believe the proposed requirements with respect to the treatment of provided margin to be appropriate. In our view, a requirement to exchange gross IM on a segregated basis will place huge additional demands for collateral on the market, have significant impacts on funding / liquidity for banks and impose significant systems costs. Therefore, whilst we fully support giving counterparties the option to have their IM segregated, we do not believe this should be a mandatory requirement.

Segregation of IM is likely to result in a reduction in market liquidity as eligible assets become locked into pledge accounts. The shortage of highly liquid instruments suitable for use as collateral is already resulting in clearing houses expanding eligibility to collateral classes that would not be acceptable under current standard bilateral CSA agreements, for example corporate bonds. **With lower trading volumes of assets that are segregated and unavailable for rehypothecation, the potential for price volatility in such instruments is likely to increase**, which in turn will require larger haircuts and create a downward spiral which will worsen the collateral shortage.

We refer to the impact analysis included within the ISDA response to this consultation as evidence of the potential liquidity impact of the proposals ($ 12- 16 trillion). .

Approach to IM segregation

Need for harmonisation of bankruptcy laws: The effectiveness of measures to protect posted margin via segregation depends on the local law and insolvency regulation in each jurisdiction. For effective collateral segregation, it is necessary to enhance the harmonization of bankruptcy legislation at a global level. Mandatory posting of IM will increase credit risk for those required to post collateral unless all jurisdictions have laws and regulations to ensure the effective supervision and enforcement of segregation requirements and timely recovery of collateral by non-defaulting parties. **Segregation without hypothecation will be very expensive but with no practical benefit if local bankruptcy laws do not provide effective protection.**

Need for choice between level of segregation: If IM collateral segregation is mandated by the proposal (and again, our strong preference is to allow parties to request collateral segregation but not to mandate it for all parties), where collateral is posted to a counterparty, we believe the poster of collateral should have the option to (i) post collateral by opening a custody account with the counterparty or (ii) post collateral to a segregated third party custodian. The need for such flexibility is to find an appropriate balance between the two key concerns previously raised with the proposed segregation requirement: i) the reluctance of parties to post IM to counterparties in circumstances where the segregation and bankruptcy requirements applicable to the counterparty are not robust ii) the consequent concentration of collateral and risk into a small number of tri-party custodians

In cases where a party chooses to hold collateral in the custody account of its counterparty, the approach has two key advantages: (a) Cost: placing collateral with a third party custodian tends to be time-consuming and expensive to set up so posting to the counterparty account direct is likely to be cheaper (please see our response to Q23 for further details) (b) Reduced concentration risk: if the third party custodian defaults then the pledged collateral will be stuck in the insolvency of the custodian and would need to be replaced since it is temporarily useless as collateral and the beneficiary of the collateral would be unable to access it if the poster of collateral then defaulted. As only a few institutions offer third party collateral services, entities posting collateral will have a significant liquidity exposure if one of those custodians defaults.

By contrast, if the party holding the collateral as custodian is the counterparty being collateralised and that counterparty defaults, there is typically no liquidity impact since there will not be an obligation to provide new collateral to the defaulted counterparty. While the problem that the securities collateral might take some time to be released from custody exists, this is not a credit exposure since the securities are segregated. Further, if the collateral due to a party were placed with a third party custodian then the counterparty to that party has two sets of default liquidity risk to contend with: (i) the default of the custodian and (ii) that the party defaults and the insolvency official of the party refuses to let the collateral be released by the third party custodian until the insolvency official has confirmed that the party is not exposed to the client asking for its collateral back. The risk in (ii) is identical to the risk if the collateral were placed directly with the party as custodian. Therefore the use of a triparty custodian does not eliminate but creates a potentially significant liquidity risk concentrated in the few triparty custodians.

Approach to VM segregation

We do not support the mandated segregation of VM. This is because if the recipient of the VM defaults, the value of the VM will net with the exposure that the VM is collateralising, meaning that there is no net exposure other than the market moves since the last time that the collateral call was made and met.

Approach to cash collateral

Cash collateral can generally not be legally segregated, consequently, initial margin as cash needs to be held at a third party custodian.

Cash always has a credit risk to the institution that holds it as a deposit, so it is unsuitable to be placed with a bank with a low credit rating. In this regard, it is worth noting that some schemes that protect client cash from the beneficiary of the collateral, such as the UK Client Money regime, still involve a credit risk for clients on the banks that hold the Client Money so they diversify credit risk but do not remove it.

We also note that it is not clear under Basel III how cash collateral posted to a non-CPP counterparty would be treated for capital purposes. It is very important that this is clarified.

Treatment of IM under the Basel III leverage ratio

Cash IM that is collected by banks and required to be segregated with no possibility of rehypothecation would have the impact of grossing up the balance sheet for the purpose of calculating the Basel III leverage ratio. Since the proposal seems to prohibit recycling of the cash into a bank's internal funding process, this is a dollar-for-dollar uplift. It is not permitted to net cash collateral vs negative replacement values (out-of-the money OTC positions) for leverage ratio purposes, so there's no permissible offset. **Consequently, we consider that cash IM should be exempted from the leverage ratio calculation, otherwise the mandatory collection and segregation of IM (when the collateral provided is cash) would artificially restrict the maximum size of a bank’s balance sheet and consequently restrict its ability to fund the real economy.**

Q23. Is the requirement that IM be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of IM being held

by a potentially small number of custodian banks and thus creating concentration risk?

We do not support the requirement for IM to be exchanged on a gross basis. We believe IM should be exchanged on a net rather than gross basis with netting permitted across other products which have an offsetting benefit either bilaterally or cleared. Reducing exposures in cases where positions offset each other is a fundamental concept and should not be prevented.

As per our response to Q4, we believe that the requirement will result in large amounts of IM being held by a potentially small number of custodian banks and thus creating concentration risk. The practical problems associated with this are threefold: (i) a process has to be built out for collateral to be moved and managed in a Tri-Party agency (ii) there would be an increase in the number of operational reconciliations (iii) reliance on a small number of Tri-Party agents to transfer and collect collateral which we believe would result in huge concentration and systemic risk.

Costs and practical implications of the use of third party custodians: The current cost to a dealer of setting up third party custody arrangements for pledging IM is in the order of EUR 15,000 -20,000 per counterparty in external legal costs alone, although it can stretch to EUR 50,000 for parties unfamiliar with the documents. The agreements (around 3 or 4 are required) can take up to 3 months to negotiate. The costs for a client would typically be as high as for the dealer. The setup cost to the third party custodian would be lower, but still material. Our third party custodians estimate that it takes up to 2 weeks of dedicated lawyer time to negotiate the package of agreements. If third party custodians were to be required for each PRE then each PRE would need to do this hundreds, if not thousands, of times for all of its counterparties that traded derivatives that could not be cleared.

In addition to the setup costs, there is an ongoing cost in the order of EUR 20,000 per year in custody costs and additional process requirements when taken across all three parties to the agreement. This level will vary depending on the value and type of securities. In consequence, we see the overall implementation costs to be extremely high.

If the majority of IM was held with third party custodians, we do not believe it would be possible for those custodians to accommodate all firms seeking to use their services in a timely fashion. The existing legal teams within those custodians would be too small to

accommodate the high volume of requests for triparty custody. Even if we assume that the time to negotiate decreased to a matter of days, the custodians and other market participants would still need to employ thousands of additional lawyers and other support staff to get the agreements set up in the course of several years. During this time, normal derivatives users would be unable to transact uncleared derivatives with a significant number of counterparties, causing material dislocation in the market as many parties would lack the ability to hedge risk appropriately. We also note that the cost per agreement is likely to have a disproportionate impact on the less-sophisticated parties, as their low level of familiarity means that the cost of negotiation is typically far higher than for more experienced parties.

If a third party custodian is not used but rather a PRE is permitted to act as custodian, we would expect set-up costs across the two parties to the agreement to drop to approx. EUR 20,000 per relationship, with an ongoing cost in the order of EUR 5,000 per year. The costs we estimate are therefore lower than compared with exclusively using third party custodians, but still material as we expect them to be billions of Euros in aggregate.

If a gross two-way IM requirement is imposed generally, we believe that the costs and inability of custodians to process the requests for setup of tri-party accounts will mean that the majority of clients that wish to trade anything other than clearable derivatives will either have to trade with the unregulated derivatives market or let the exposure run unhedged. The cost of setup may mean that parties that trade derivatives infrequently will never choose to incur the initial setup cost as the cost for the initial trade outweighs the benefit for that trade, even though the benefit may be greater than the cost when taken over a longer-term relationship.

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, we believe that rehypothecation of collateral posted for both VM and IM should be permitted, subject to agreement between the counterparties, in order to mitigate the otherwise highly significant liquidity impact of posting collateral and also because it reduces transaction costs in arrangements providing full title transfer. At a minimum, we would expect to be permitted to rehypothecate VM.

We consider that rehypothecation works effectively today but would support the introduction of tighter controls to ensure it only takes place with creditworthy institutions and when clearly agreed between the two counterparties.

ELEMENT 6: TREATMENT OF TRANSACTIONS WITH AFFILIATES

BCBS/IOSCO proposes that transactions between a firm and its affiliates should be subject to appropriate VM arrangements. Full VM should be exchanged between affiliates. In terms of IM, local supervisors should review their own market conditions and put in place requirements as appropriate.

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?

Proposed IM requirements for non-cleared derivatives between affiliates: We do not believe that the requirements proposed in the Paper are appropriate. We would draw the attention of BCBS and IOSCO to the fact that the legislative text in EMIR provides for an exemption for intra-group trades from bilateral margin requirements.[1]

[1] In the EU, EMIR implements the G20 requirements for mandatory clearing of standardised OTC derivatives. EMIR also sets out requirements for risk mitigation techniques for OTC derivative contracts not cleared by a CCP, including the need for the timely, accurate and appropriately segregated exchange of collateral (EMIR Article 11, 3.). EMIR Article 11, 5. and 6. then exempt intra-group transactions from the collateral requirements for non-cleared OTC derivatives under specified conditions. We therefore consider the proposals in this consultation to be incompatible with EMIR as EMIR expressly permits the exclusion of intra-group transactions for bilateral margin requirements.

As a general note, we would emphasize our view that any exemption from the clearing obligation should be equally mirrored in the bilateral margining of uncleared trades in order not to render the clearing obligation exemption ineffective. More specifically, we believe intragroup transactions should be exempted from the clearing obligation and, where this is the case, also from bilateral IM and VM requirements, for the reasons outlined below.

Derivative transactions between entities within the same consolidation group do not pose systemic risks as they do not create additional counterparty exposure outside of the group and do not increase interconnectedness between third parties. Rather, inter-affiliate trades allow institutions to manage and reduce risks and to increase the scope of netting with individual counterparties by allowing counterparties to transact with a single group entity across a broad range of underlying asset classes. This flexibility would be undermined when imposing IM requirements on affiliated entity transactions. The amount of collateral tied-up would reduce firms' ability to manage risk on a centralized basis and would increase, rather than decrease, the level of risk within the financial system. Losses incurred by one affiliated entity should be completely offset by gains to the other affiliated entity so the group exposure is flat.

We would also stress the fact that PREs frequently collateralise intra-group exposures to minimise regulatory capital. This regulatory capital benefit is sufficient to encourage PREs to collateralise intra-group trades, if deemed appropriate, without the need for further obligations.

Clarification of scope of "affiliated entities": We would furthermore welcome clarification of the definition of "affiliated entities" and "transactions with affilitates" and to what extent it differs from the term "intragroup transactions" under EMIR. We emphasize our view that branches should not be considered affiliated entities.

Potential for local supervisor discretion to impose IM: As set out above, we do not support any requirement for mandatory exchange of IM between affiliated entities. We do not consider giving discretion to local supervisors to set IM requirements would mitigate our concerns and we note that providing local supervisor discretion may also result in an un-level playing field and create regulatory arbitrage opportunities. We therefore do not propose the setting of IM at a national level.

Q26. Should an exchange of VM 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 VM among affiliates within the same national jurisdiction?

We do not support mandatory exchange of VM between affiliated entities for the reasons set out in Q25. If groups believe it is appropriate to exchange VM between group entities for internal risk management purposes, they should be free to do so, but the requirement should not be mandatory as firms may legitimately and more effectively seek to mitigate intra-group risks in an alternative manner.

ELEMENT 7: INTERACTION OF NATIONAL REGIMES IN CROSS-BORDER TRANSACTIONS

BCBS/IOSCO propose that margin requirements in a jurisdiction should be applied to legal entities established in that local jurisdiction, which would include locally established subsidiaries of foreign entities, in relation to the IM and VM they collect. Home-country supervisors should permit a covered entity to comply with the margin requirements of a host-country margin regime with respect to its derivative activities, so long as the home-country supervisor considers the host-country margin regime to be consistent with the proposed margin requirements. A branch is to be treated as part of the same legal entity as the headquarter, thus subject to the margin requirements of the jurisdiction where the headquarter is established.

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 support a globally consistent approach because of the global nature of OTC transactions. This will help minimise regulatory arbitrage opportunities.

It is important to have clarity on which jurisdiction's rules will apply to a trade, so that an entity can be clear in advance of trading which rules its counterparty will be applying when calling for collateral. It is important to ensure that firms do not end up having to comply with many different sets of regulatory regimes as this could lead to increased costs, decreased liquidity and a reduction in the overall availability of capital.