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ABI response to BCBS/IOSCO second consultative document on margin requirements for non-centrally cleared derivatives

The UK Insurance Industry

1. The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

2. Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

3. The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

4. The ABI's role is to:
   - Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
   - Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
   - Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
   - Promote the benefits of insurance to the government, regulators, policy makers and the public.

5. The ABI welcomes the opportunity to respond to the BCBS/IOSCO second consultative document on margin requirements for non-centrally cleared derivatives

Executive summary

- The ABI urges regulators of derivatives to recognise the differences between the business models of insurers/pension funds/asset managers and banks. Insurers/pension funds often use derivatives to hedge liability risk rather than for speculative purposes and there is limited default risk for counterparties. If this distinction is not adequately recognised, the unintended consequence could be additional cost or risk for end-investors. The ABI supports the exemption from clearing requirements for pension arrangements in the EU Regulation EMIR, which is not referenced in this consultation paper.
- We welcome a number of the proposals in the consultation paper including the exclusion of FX forwards/swaps from the initial margin requirements. The indicative list of eligible collateral assets appears sensible, although we agree that it should be non-exhaustive.
- However, we suggest inflation and interest rate/currency derivatives should be categorised in the same asset class for the purpose of netting margins because the risks are closely aligned.

- We welcome the proposed phasing-in of the initial margin requirements and the application of minimum thresholds. We urge BCBS/IOSCO to confirm that the requirements apply at the fund level rather than the underlying beneficial investor level.

Specific questions

Q1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

The ABI agrees that FX forwards and swaps should be exempt from the initial margin requirements. As BCBS/IOSCO recognise, these types of transactions are not a source of systemic risk, and industry-wide mechanisms such as Continuous Linked Settlement (CLS) and the ISDA Credit Support Annex (CSA) help to mitigate settlement and replacement risk respectively. If margin requirements were to be applied, it would add significant cost to FX forwards and swaps, reducing their usage and exposing end-investors to additional currency risk. It should also be recognised that some market participants only make use of FX forwards and swaps and do not trade in other types of derivatives, so it would be disproportionately expensive to require them to establish arrangements for managing daily movements in variable margins.

No clear rationale has been provided for taking a different approach to FX forwards and swaps with longer maturity values, which are limited in volume and are therefore unlikely to be a source of systemic risk. However, if BCBS/IOSCO adopt such an approach we believe it should not apply to FX transactions of less than a year.

We are concerned that BCBS/IOSCO are proposing to restrict the product exemption to FX forwards and swaps. EMIR includes a specific exemption for pension arrangements, and we suggest that BCBS/IOSCO should also give due consideration to the way in which the insurance business model differs from the banking model. Insurers/pensions funds (including annuity funds) use derivatives to hedge against their liabilities and they pose limited default risk to their counterparty. The margin requirements should not involve disproportionate costs in these circumstances, whether or not the derivatives are centrally cleared. We do not support the application of universal two-way initial margin to these contracts.

We do, however, welcome the proposed exemption from the margin requirements for non-financial entities which are 'not systemically-important'.

Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

We are encouraged by the BCBS/IOSCO guidance on the types of collateral assets eligible for margin, including high-quality corporate bonds and equities on major indices.

Insurance/pension funds do not hold high levels of cash so it is important to permit the use of other asset types as collateral.

We agree that the list should be viewed as non-exhaustive, and national supervisors should permit other assets and instruments that satisfy the key principle of high liquidity. In the EU, we would expect the Liquidity Coverage Ratio developed within CRD4 to be of relevance here.

The ABI does not support the proposed scope for re-hypothecation of initial margin, which could make it difficult for the posting counterparty to retrieve the collateral in the event of a collecting counterparty's default. We suggest that if re-hypothecation is permitted it should only be possible if both parties to a contract explicitly agree on the terms and potential limits of re-hypothecation.

The consultation paper states that initial margin models may allow for offsets within well-defined asset classes but not across assets classes, but it doesn't define the asset classes. We urge BCBS/IOSCO to recognise that inflation rate and interest rate/currency swaps are closely related so it should be permissible for margining requirements to be netted across inflation and interest rate/currency hedging instruments.

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that:

(i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and

(ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk?

Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

The ABI supports a phased approach to the introduction of the new margin requirements, but urges a clearer link to the systemic risks involved in a derivatives transaction. We also emphasise the importance of taking account of the impact of the development of central clearing, which is still at its early stages, and is likely to raise many operational and financial challenges.

In addition, the definitions of 'covered entity' and 'consolidated group' are unclear and will be important in fully evaluating whether the requirements are appropriately calibrated. We urge BCBS/IOSCO to make clear that the covered entity and the margin requirements for funds should be determined at the fund level rather than at the level of end investors.

The proposed gradual approach to introducing the requirements is welcome, although we note a significant extension in scope is proposed between 2018 and 2019 (when the relevant level of non-centrally cleared derivatives business will fall from €0.75 trillion to €8billion) and we suggest this may need to be reassessed nearer the time. We agree that a flexible approach should be adopted for emerging markets, and add that should also be applied to other markets/products where there are small volumes of derivatives trading.

We agree that the proposed requirements to exchange variation margin from 1 January 2015 should apply only to contracts that are entered into after that date. However, a differential approach to the phasing of the initial margin and variation margin requirements will involve additional operational cost so it may be better to require consistent phase-in arrangements.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

The ABI doesn't have detailed comments on the accuracy of the QIS results although we note it provides evidence of the significant costs associated with the new margin requirements. However, in considering the applicability of the results, it should be recognised that the data only includes three insurers and three pension funds. This may have caused the consultation to focus on the use of derivatives by banks which have quite different business models.

We also urge regulators to give greater attention to the impact upon end-investors of the new requirements for both centrally cleared and non-centrally cleared derivatives. We fear consumers may incur extra costs/reduced returns if pension funds, insurers and asset managers are required to move away from assets that offer higher returns in order to meet the new collateral requirements. A full impact analysis should also take account of the 'dynamic' impact of the new requirements – additional margin requirements for both cleared and non-cleared derivatives is likely to lead to a reduction in the aggregate use of derivatives, including economically useful hedging activity.