ALFI comments

on

Basel Committee on Banking Supervision (“BCBS”)
&
Board of the International Organization of Securities Commissions (“IOSCO”)

Consultative Document

Margin Requirements for Non-Centrally Cleared Derivatives

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ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers. According to the latest CSSF (Commission de Surveillance du Secteur Financier) figures, on January 31, 2013, there are 3 840 undertakings for collective investment in Luxembourg (UCITS and non-UCITS), representing 13 436 active compartments representing a total, in terms of net asset value EUR 2 405.928 billion.

ALFI welcomes the BCBS IOSCO Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (hereafter, the “Consultative Document”) and welcomes the opportunity to provide its comments and expertise to the BCBS IOSCO work stream on this issue.

Regarding the questions raised in the Consultative Document.

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?

We would generally concur with the exemption criteria under the Dodd-Frank Act as issued by the US Secretary of the Treasury on 16 November 2012. Counterparty credit risk prior to settlement can be generally regarded as low for short-term fx transactions. A counterparty to such a transaction is mainly exposed to settlement risk. Introduction of a new operating regime would potentially introduce additional operational risks and challenges to the current settlement process. Furthermore, we also believe that a two-side initial margin requirement would significantly increase systemic risk due to the liquid capital backing of a very large number of currencies and volumes.

However, we believe that such a full exemption should only be permitted for transactions with a short-dated maturity such as three months and less longer-dated transactions increases, ceteris paribus, the settlement risk. Therefore, we would recommend that each counterparty to such a transaction should assess whether, at which point in time and to what extent it deems necessary to request collateral as it also depends significantly on the currency under consideration when and to what degree settlement risk becomes material beyond the three-months period.

Physically settled FX forwards and swaps with maturities of more than three months should be generally included in an individual collateral programme of a counterparty. We do not believe that the current proposed regime for other non-centrally cleared derivatives should be systematically applied for physically settled fx forwards and swaps. We would rather strongly recommend requiring any counterparty to establish its own collateral management policy and procedures in this respect. Those could consider currency and market specific properties such as volatility or liquidity. We believe it is more appropriate to have a principle based framework for the – predominately – settlement risk as different exposures to different currencies are exposed to market risks to different degrees subject to the specific nature of the different currencies. Considering the very specific nature of the various fx-markets, but also appreciating that physically settled fx swaps and forwards may inherently bear some sort of risk, such transactions should be subject to a counterparty's individual collateral management programme backed by a strong own risk management.

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 of the opinion that cash must be re-invested or re-deposited in any case as cash cannot be segregated for legal and operational reasons. Thus, if there is no re-investment possibility for cash, the posting party faces significant default risk as regards the collateral collecting party.

Re the re-investment of cash and re-hypothecation of non-cash collateral, we suggest to apply the rules set forth in the Chapter XII of ESMA-Guidelines 2012/832 (replacing Box 26 of CESR-Guidelines 10-788). These are rules applicable to the UCITS on the European level and seem to be well elaborated and covering all relevant points re re-hypothecation. From our perspective, it can also be expected that these rules will be transferred into the national laws more or less uniformly. These rules need, however, to be applied on both buy and sell sides.

In a nutshell: The re-hypothecation, re-pledge or re-use of collateral should be allowed under the rules specified in the above ESMA-Guideline.

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?

We would recommend aligning the phase-in periods for initial and variation margin requirements. We agree that a certain variation margin system is currently in place, but it will take some time to effectively implement and adopt the new specific requirements, particularly developing and testing new internal models, which enhance the current regime. We believe 1 January 2015 should be the earliest starting date, but we would rather prefer a later phasing-in aligned with the phasing-in for the initial margin system.

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

The large difference between the two model approaches, which suggests that the standardized approach requires some refinement. The potential significant difference in margin between model-based and scheduled-based approaches makes it very difficult for an entity to compete if it does not have the ability to work with model-based margins. This is a particular concern for smaller financial entities. Given the difference in IM margin requirement between using (i) quantitative portfolio model or (ii) standardized schedule model as defined in Appendix A in terms of a multiple of 5.9x to 11.1x with zero or 50 million EUR threshold it would be advisable to reduce the IM requirement values by an equivalent scale in order to ensure a level playing field between smaller and larger financial entities.

Contact

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