Aviva Investors' response to the BIS, BCBS and IOSCO joint consultation on Margin requirements for non-centrally cleared derivatives

March 2013

Aviva Investors welcomes the opportunity to respond to the BIS, BCBS and IOSCO joint consultation on Margin requirements for non-centrally cleared derivatives. Aviva provides 34[1] million customers with insurance, savings and investment products. We are one of the UK's largest insurers and one of Europe's leading providers of life and general insurance. We combine strong life insurance, general insurance and asset management businesses under one powerful brand.

Aviva Investors is the global asset management business of Aviva plc, managing assets in excess of £274[2] billion across a range of real estate, equity, fixed income, money market and alternative funds. The business operates under a single brand with over 1,200 employees in 15 countries[3] across North America, United Kingdom, Continental Europe, and Asia Pacific. We are dedicated to building and providing focused investment solutions for clients that range from large corporate and institutional investors including pension schemes and local government organisations to wealth managers to individual investors.

Please note that we ask for our submission to remain private and therefore, not be made available for public inspection.

Please find attached our responses to the specific questions raised.

1 As at 31 December 2012
2 As at 31 December 2012
3 As at 31 December 2012

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General Comments

Aviva Investors welcomes the proposals to require exchange of variation margin from 1 January 2015 and for the requirement to apply only to those contracts entered into after this date. We also welcome the phase-in approach to the exchange of initial margin requirements for new contracts entered into after 1 January 2015 and believe this will allow firms some time to prepare. Furthermore, we support the proposals not to apply margin requirements to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party to.

However, we have the following additional comments:

Scope

Whilst we support the proposal for two-way variation margin by all counterparties across all trades covered by the regime, we do not support the application of universal two-way initial margin.

Whilst we recognise that an initial margin threshold has been proposed, we do not believe that non-systemically and highly collateralised counterparties such as pension schemes, insurance vehicles and regulated collective investment schemes should be required to post initial margin where the likelihood and consequence of default by such entities is relatively low. Such entities are not currently required to lodge initial margin with bank counterparties, in recognition of their credit standing. This recognises the extremely low risk of default given the extensive degree of regulation applied to such funds, their underlying investment profile, historically low levels of leverage and their focus, which is on investment rather than trading.

In addition, the provision of initial margin is likely to affect returns for such counterparties and, as their positions will generally be directional, netting of exposures will rarely be possible resulting in significant initial margin requirements which will increase liquidity risk and may increase counterparty risk. By contrast, credit institutions such as banks providing services to clients will have multiple exposures which are likely to net off and reduce the level of initial margin required. We therefore believe that thought should be given to providing an exemption to authorised retail funds and pension funds, whose investment restrictions and diversification result in them posing low default risk to the counterparty.

The impact on fund performance will also be increased to the extent that the list of eligible collateral assets is restricted, as this will affect the extent to which a fund will need to transform assets for collateral purposes.

The effect on fund performance can be substantially mitigated if appropriate models using security over segregated accounts, with a broad range of eligible collateral assets are allowed. It should be noted however, that these models will, in turn, still have associated custody, legal and other operational costs, although these are likely to be a fraction of returns on assets foregone.

It is also worth noting that, to the extent that pension funds are able to net cash flows and other risks with their counterparty on a portfolio basis, the costs of posting initial margin may also be reduced if margin requirements were applied to the portfolio after netting across all OTC derivative contracts rather than restricted on an asset class basis.

Finally, a requirement to post and collect initial margins will require many participants to set up new or improved systems and custody or tri-party structures which will incur upfront systems and legal costs and mean increased on-going administrative costs. It is difficult to quantify the amount exactly although, from the research we have undertaken, the cost will be significant.

Gross Initial Margin

We disagree with the proposal that initial margin should be exchanged on a gross basis as we believe the liquidity impact of posting gross margins would be significant for a number of our clients and the directional nature of their portfolios means that the liquidity impact is also likely to be significant. In our view, the perceived benefits of posting gross margins are disproportionate compared to the costs and we would therefore advocate that initial margins are exchanged on a net basis.

In addition, we believe that exchanging large amounts of initial margin would lead to initial margin being held by a potentially small number of custodian banks, thereby creating concentration risk.

Collateral

In our view, the proposed list of eligible collateral is too narrow and we therefore suggest that the list be defined as widely as possible and that bi-lateral negotiation is permitted. There is a significant difference between a clearing house and a bank in terms of the respective ability to transform less liquid assets into more liquid ones, albeit with haircuts. Another consideration is that UCITS funds are restricted in terms of the types of assets that are deemed eligible to hold. For example, gold is not an eligible asset and therefore could not be received as eligible collateral.

We also consider the proposed haircuts of 8% for posting 'non trade currency' cash or assets as collateral as extremely punitive, particularly when the assets or cash may only be posted on a short-term basis. Our other concern is the potential unintended consequence of increasing counterparty risk for our clients, as they would be required to post 8% more assets than they do today.

We have set out, below, our comments on the specific questions raised.

Response to 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?

In our view FX forwards and swaps should not be subject to margin requirements, as is the case in the United States. We do not believe that FX contracts are directly comparable to other OTC derivative contracts and note that the FX market has already established industry wide mechanisms to mitigate settlement risk through Continuous Linked Settlement (CLS) and other risks, such as replacement risk, through the use of an ISDA Credit Support Annex (CSA).

Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

Whilst there could possibly be an argument for imposing margin requirements on long dated FX forwards and swaps, the market volume of such long-dated instruments is low and therefore unlikely to be a source of systemic risk. Given that the vast majority of FX forwards and swaps have short average maturities and are, therefore, also unlikely to be a source of systemic risk, we would advocate that FX forwards and swaps with a tenor of less than one year should, as a minimum, be exempt from margin requirements.

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 not supportive of initial margin being re-hypothecated or re-used and instead prefer that it is properly segregated to ensure that it is readily available to protect the posting party in the event of the collecting party's bankruptcy.

We have no particular concerns with the re-hypothecation or re-use of variation margin as this is typically posted on a full title transfer basis and represents the mark-to-market exposure of the particular contracts.

Q3. Are the proposed phase-in arrangements appropriate?

We welcome the proposals to require exchange of variation margin from 1 January 2015 and for the requirement to apply only to those contracts entered into after this date. We also support the phase-in approach to the exchange of initial margin requirements for new contracts entered into after 1

January 2015. However, we have concerns in respect of the proposed thresholds that will be applied on a consolidated group basis. We believe this will be extremely difficult for ‘non-banking’ entities such as Aviva to effectively monitor, particularly where the primary business purpose is to manage non-derivatives related activity across a number of international locations. In our opinion, this will require complex operational systems and processes to be built which don’t exist today.

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?

Without conducting detailed margin analysis based on our client base, it is difficult to establish whether the proposals appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transaction 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?

The proposed triggers and dates for the phase-in of the requirements appear reasonable.

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?

Given that variation margin is already a widely adopted practice, we see no reason why it should not be required as soon as the margin framework becomes effective.

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 agree that there should be some flexibility in the proposals to reflect the readiness and relative volume of transactions undertaken by certain participants.

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

We have no comment.