BBVA | CORPORATE & INVESTMENT BANKING

March 15, 2013

BBVA response to the second Consultative Document on "Margin Requirements For Non-Centrally-Cleared Derivatives"

Dear all,

BBVA appreciates the opportunity to respond to the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) second Consultative Document on "Margin requirements for non-centrally-cleared derivatives" of February 2013.

EXECUTIVE SUMMARY

BBVA position on the BCBS and IOSCO Consultative Document on margin requirements for non-centrally-cleared derivatives can be summarised in the following bullet points:

- A deeper analysis of the impact on the liquidity on the financial market of the global margin requirement on derivatives should be performed before setting the definitive margin requirements for non-centrally-cleared derivatives.
- Such requirements should be applied globally and consistently through different jurisdictions in order to maintain a level playing field and prevent regulatory arbitrage.
- Fx forwards and swaps should be fully exempt from margin requirements, as the Fx market is liquid, transparent and has a well-functioning settlement process.
- Thresholds on initial margin should be recalibrated considering the requirement to be applied on a consolidated basis.
- The scope of consolidation for the calculation of initial margin thresholds should be limited to entities in the same jurisdiction and supervised and regulated by the same national authorities.
- Quantitative models should be simple and homogeneous, and supervisors should avoid the proliferation of models using inconsistent methodologies.
- The Standardized schedule should be reviewed for them to produce initial margin amounts more in line with the outcome of quantitative models.
- In cross-boarder transactions, entities should be allowed to post collateral with assets that are included in the eligible list of collateral assets developed by their own national supervisors.
- Haircuts should not be prohibitive when posting assets that receive a 0% weight in calculation of RWAs for the banking group of the posting entity, even in cross-border transactions where the national supervisor of the collecting entity may treat the same asset in a different way. For these assets no wrong-way risk should be included in the haircut.
- Re-use and re-hypothecation of collateral: Collateral collected as
    - variation margin should be allowed to re-use or re-hypothecate
    - initial margin should be permitted when the posting counterparty has first priority claim on the asset

- Variation margin requirement should be phased-in to give time to local authorities to adjust their laws and regulations, for the institutions to renegotiate CSA agreements and for less sophisticated parties to adjust systems and procedures that would allow them to manage collateral.
- Neither initial nor variation margin requirement should enter into force until both parties' legal frameworks are mutually recognised and the collateral mechanisms are legally recognised. Until such time, as an appropriate legal framework is developed in each country, a form of "grandfathering" or phase-in approach must be in place in order to avoid that the posting of collateral actually exacerbates risk rather than mitigating it.

OVERVIEW

General remarks

BBVA congratulates the initiative of the BCBS and IOSCO and supports the main objectives of this document, i.e. the reduction of systemic risk and the promotion of central clearing for derivatives. BBVA considers essential that the new margin framework promotes and ensures consistency in the application of margin requirements among different jurisdictions and maintains a level playing field for all market participants.

The new margin framework will have huge implications for the financial markets as it imposes requirements beyond current market practices. This comes together with other regulatory initiatives that require enhanced liquidity standards for financial institutions. BBVA considers that before establishing the definitive margin framework for non-centrally-cleared derivatives it is necessary to perform a deeper analysis on the aggregate impact on liquidity in the financial system of the whole set of new regulatory initiatives, and on a potential availability or scarcity of highly liquid high quality assets.

BBVA is concerned on the impact of this framework in cross-border transactions. Potential problems may arise from:

- an inconsistence approval of quantitative models across national authorities
- different treatment assets used as collateral may receive form the collecting party national supervisor with respect the way the same collateral is treated by the posting party national supervisor
- different legal frameworks in terms of insolvency figures, recognition of close-out netting and treatment of margin posted
- different objective and scope on the legislation across countries (e.g., derivatives covered margin requirements, definition of financial firms, definition of systemically important non-financial firm)

BBVA regards fundamental that margin requirements do not end-up increasing disputes among parties, discriminating entities depending on their home country, or increasing counterparty risk due to different legal treatment of collateral posted.

Initial margin calculation

BBVA thinks that there is a too large incentive to the use of quantitative models for the calculation of initial margin. This gives an unfair advantage to big institutions that can deploy large resources to optimize their internal models. This also encourage less sophisticated derivative users to use quantitative models even if they are not well prepared to handle those models.

The use of quantitative models may give rise to the following problems:

- Conflict of interest; even when two parties agree in advance on the models to use for the calculation of the initial margin they will exchange each other, there may still be disputes on particular details of the model or on the data that may give rise to disputes on the final amount of the initial margin.
- In cross-border transactions, as models would have to be authorized by national supervisors, entities may be forced to use several models at the same time; the models to use for derivatives held with each counterparty may depend on the models approved by their national supervisor.
- Some national supervisors could be tempted to favour their home entities by approving models which would not be acceptable by more rigorous supervisors, thus contributing to an unlevel playing field and, eventually, to regulatory arbitrage.

To minimize all the issues that may arise in the initial margin calculation, BBVA proposes that:

- Standardized tables to be recalibrated in order to produce an outcome more in line with quantitative models.
- Only one quantitative model to be available for all counterparties across the world, and to be used without the authorization of the national supervisor.
- The quantitative model should be simple and well defined.

BBVA considers that initial margin should only be required for exposure between counterparty that may give rise to systemic risk. In this sense, it welcomes the setting of thresholds under which entities are not required to exchange each other initial margin, however, it considers it should be recalibrated for initial margin only to kick-in in large counterparty's exposure. BBVA is also concerned that the QIS may over-estimate the effect of thresholds as many participants may not have applied the thresholds on a consolidated basis. BBVA considers that a deeper QIS analysis should be performed in order to analyse the whole impact of the new regulatory initiatives in the liquidity profile in the system, before setting the definitive threshold level.

BBVA understands that the purpose for the requirement to apply the thresholds on a consolidated basis is to avoid the incentive entities may have to distribute its non-centrally-cleared derivative among different group entities to diminish the exchange of initial margin. However, the application of thresholds on a consolidate basis may give rise to issues when entities are supervised by different national authorities and may affect the competitive position of particular entities with respect to its local market. To avoid these unintended consequences, an anti-evasion provision could be sufficient.

Additionally, BBVA proposes the perimeter of consolidation to be limited to include only entities:

- established in the same jurisdiction
- supervised by the same national authority
- performing the same business in the same market (e.g. do not include in the same perimeter entities performing banking activities with entities in the insurance business)

<u>Collateral</u>

It is essential that the new margin framework maintains a global level playing-field in the derivative market, and that it does not distort the global competitive landscape. The treatment of collateral to be posted by entities established in non top-rated countries is fundamental to allow the continuation of derivatives business. To not force entities established in non top-rated countries out of the derivative market, BBVA proposes the framework to include the following points:

- Assets included in the eligible list created the national supervisor of the posting entity should be accepted for all collecting parties, irrespective of their location.
- The haircut an entity would face when posting government bonds in which in place a 0% weight in the calculation of the RWAs for the banking book should not be prohibitive; this requirement includes the no application of wrong-way risk for such assets.

Entities should not face significant divergent treatment of the conditions to be applied to the same asset by different pieces of regulation; Basel III calculation RWAs in the banking book, Basel III LCR definition of high quality liquid assets (HQLA) and conditions required to collateral in this framework.

If a fair treatment of home country government bonds is not assured for cross-border transactions, the new margin framework will increase the volatility in government bond markets, magnify the impact of sovereign downgrades and substantially impair the competitive profile of financial institutions established in lower rated countries.

BBVA considers that efforts should be made to reduce the global liquidity drag that this framework will represent. In this sense, BBVA considers that no prohibition on the re-use or re-hypothecation of collateral should be applicable to collateral the covers variation margin, as this represent receiver's profit, and it covers and amount the receiver would maintain in case of the cancelation of the derivatives. BBVA agrees that more protection should be given to collateral that represents initial margin, it also considers that there is scope for some flexibility; measures such us the re-use of re-hypothecation of collateral when the posting party has the right of first priority claim on the asset.

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 foreign exchange (FX) market one of the oldest, largest and more liquid markets in the world. It is a well developed market that has characteristics that reduces the risks incurred by entities dealing in this market:

- settlement risk is considered to be the main risk from FX trading activities. With the creation of the Continuous Linked Settlement ("CLS") and the CLS Bank, settlement risk has been eliminated for most major participants
- the depth and liquidity of the market allows for quick and efficient closing of counterparty exposures when necessary

FX forwards and swaps are fundamental for the currency risk management for end-users. Harsh margin requirements on these instruments may reduce ability to manage currency risk in an efficient way and make end-users more vulnerable to foreign exchange fluctuations.

The US Treasury Department on November 2012 recognised the characteristics of the Fx forwards and swaps instruments and exempted them from the requirements of the Title VII of the Dodd-Frank Act.

BBVA considers that the regulatory treatment of these instruments should be similar across the world and recommends for them a full exemption of margin requirements. Imposing different margin requirements for physically-settled FX swaps and forwards with differing maturities will bifurcate the FX market and reduce liquidity for long-dated FX derivatives

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.

BBVA believes that the new margin requirements on non-centrally-cleared derivatives may have a huge impact on liquidity in case all collateral collected by counterparties in non-centrally-cleared derivatives is banned from being re-used or re-hypothecated.

It considers that it is important to distinguish between collateral collected as variation margin or as initial margin:

- Variation margin: It is the receiver's profit, and it is the amount it would retain in case contracts are cancelled; it should be allowed to be re-used or re-hypothecated.
- Initial margin: It covers potential risk, no an actual profit. It should have a larger degree of protection as receiver would have to return it to the counterparty in case of cancellation of the derivative agreements. However, some flexibility should be give to the prohibition to re-use, re-hypothecate or re-pledge assets collected to cover initial margin. In this sense, BBVA is in favour of allowing the re-use or re-hypothecation of collateral when the posting party has the right of first priority claim on the asset. Finally, BBVA considers that restrictions for re-use or re-hypothecation of collateral should also apply when collateral is posted on a third party.

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?

BBVA believes that a phase-in period should be provided for the variation margin. Although, the exchange of collateral to cover the mark-to-market is a common market practice, there is still a substantial number for smaller market participants that do not exchange collateral.

Time should be given to:

- allow local jurisdictions to adjust their laws and regulation to these margin requirements
- review and negotiate new CSA contracts with all counterparties that would be subject to this margin requirement
- allow smaller and less-sophisticated institutions to improve their systems and process in order to be prepared to manage collateral

BBVA considers that neither initial nor variation margin requirement should enter into force until both parties' legal frameworks are recognised and the collateral mechanisms are legally recognised. Until such time, as an appropriate legal framework is developed in each country, a form of "grandfathering" or phase-in approach must be in place in order to avoid that the posting of collateral actually exacerbates risk rather than mitigating it.

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

BBVA is concerned that the QIS performed last September may have substantially underestimated initial margin:

- Entities may have applied thresholds not on a consolidated basis.
- The quantitative models used may not be available for all market participants, and may not be accepted by all national supervisors.

BBVA considers that given the huge joint impact on the liquidity profile on the financial system of the new margin framework on non-centrally cleared derivatives and the other regulatory initiative, a larger study should be performed before a final decision on the margin requirements.

This new study should include:

- An analysis of the full impact of margin requirements that entities will face in the future. This analysis should include:
  - Margin requirements for all transactions that will be cleared through CCPs.
  - Variation margin
- An analysis the problems that may arise in the margin requirements on cross-border transactions due to:
  - inconsistencies in quantitative models approval by national authorities
  - different eligible collateral asset pool designed by national supervisors
  - haircut requirements on assets issued in the counterparty home country
- A new calculation initial margin that takes into account:
  - the perimeter of consolidation for the calculation of thresholds
  - more specific guidelines of the type of quantitative models that would be accepted by supervisors