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

BVI[1] welcomes the opportunity to comment on the second consultative document on margin requirements for non-centrally cleared derivatives.

BVI supports the initiative by the G-20 to regulate the derivative market infrastructures (e.g. central counterparty (CCP), trade repositories) and to require risk mitigation techniques for OTC derivatives not cleared by a CCP. However, we remain concerned about the overall liquidity impact of the proposals and question if the proposal of the revised consultative document could contribute to reduce liquidity.

We would like to make the following comments:

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 agree. Physically-settled FX forwards and swaps should be exempted from initial margin (IM) requirements. As explained in our position paper on the first consultative document, BVI strongly supports an exemption for foreign exchange forwards and swaps independently from the maturity of such foreign exchange instruments. We believe that BCBS/IOSCO should not put up regulatory barriers in order to prevent the hedging of foreign exchange obligations through the use of OTC derivatives.

We believe that the requirements to collect and post IM for foreign exchange swaps and forwards and the high costs involved in order to implement the process of IM by the investment fund management companies outweigh the benefit to mitigate the counterparty credit risk. In case of swaps and forwards with very short maturity it is in practice virtually impossible to post collateral as the collateralization process takes longer than the term of the contract.

The implementation of the proposed initial margin requirements could increase existing risks and legal uncertainty in the financial market due to arrangements that fully protect the posting party in the event that the collecting party enters into bankruptcy to the extent possible under applicable law.

However, if initial margin for non-centrally-cleared derivatives is introduced, the German investment fund management companies would require at least two years for the implementation of the IM after the enactment of the relevant legislation due to the following reasons:

- Currently, the investment fund industry does not exchange IM. Therefore, new technical processes need to be developed.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 78 members currently handle assets of EUR 2 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. BVI's ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit www.bvi.de.

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- According to principle 5 the IM shall be segregated from the regular collateralization process of variation margin (VM). This process can take place only via the pledge of collateral or by appointing a trustee. The coordination of the arrangements needs to be in line with the relevant insolvency laws applicable to the counterparties which take additional time to negotiate.

- A market standard documentation for IM needs to be developed which takes additional time. An audit process also has to be developed in order to ensure that it is in compliance with the different national insolvency laws.

- To the extent that IM is posted by the means of pledge, there is legal uncertainty regarding the applicable law of property when the pledged security is certified in a collective safe custody. The arrangements also need to be developed which takes additional time.

BCBS/IOSCO should be aware that there will be not a “one covers all” solution for the implementation of the initial 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.

In Europe, re-hypothecation is not allowed for regulated investment funds. Re-hypothecation undertaken in a prudent way, with effective transparency is important to the financial system and a key part of the optimization of collateral to minimize reinvestment risk and cost of funding. We support any balanced approach to allow the re-use of collateral.

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 disagree. The proposed phase-in arrangements are not appropriate. For the reasons given in our answer to question 1, we think that market participants require more time for establishing market standards which are compliant with the multiple national laws and regulations applicable in this matter.

We believe that in the light of the current regulatory tsunami, market participants and all regulators will not have sufficient capabilities (e.g. human resources) to develop robust market standard for the initial margin requirements in time.

A phase-in approach proposed firstly for the largest and most systemically-risky covered entities could not mean any benefit for other entities. As soon as one of the parties of OTC derivatives transactions is obliged to exchange initial margin requirements it will demand all other counterparties to agree on initial margin requirements too, independent of the counterparties size or trade volume.

We think that the definition of “covered entity” requires further clarification and should incorporate how regulated investment funds will be legally handled. The proposals to calculate margin requirements and threshold at a group level could introduce new complexity, increase legal and operational risk and negate the benefits of introducing the IM threshold of EUR 50 million to a large extent. We think that the implementation of the definition of “covered entity” should be made in close consultation with all relevant market participants. Furthermore, if BCBS/IOSCO insists on proposing the application of standards at group level, a consultation on how this could operate in practice should be undertaken.

However, it should be clarified how the **(a)** minimum level of non-centrally cleared OTC derivatives activity (EUR 8 billion gross notional outstanding amount), **(b)** the EUR 50 million threshold and **(c)** the de-minimis minimum transfer amount of max. EUR 100.000 work together. We believe that BCBS/IOSCO needs to clarify how the mentioned three thresholds could be incorporated in the overall margin requirement framework.

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

We think that the results of the QIS study do not represent the true effect on market liquidity. For example, the original QIS was undertaken at the legal entity and not at the group level. The figures will lead to a potential shortfall in liquid and eligible collateral even in the phase-in approach time. We think that the figures that are summarized in the executive summary under 1. (f) and (g) in terms of IM depending on notional amount and unencumbered assets are underestimated. In a market which accounts for approx. $640 trillion and where future exposure has to be collateralized with IM and VM an estimate of 0.5% of gross notional exposure for IM seems to us very low.

Our members expect an average of 2-3% IM of notional amount of derivatives based on risk models provided by different CCPs for their portfolios. In some cases the IM was calculated even as high as 6% in the case of the portfolios constructed in a directional way and which therefore could not benefit from offsetting effects.