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2nd Consultation on “Margin Requirements for Non-Centrally-Cleared Derivatives”

Dear Sir or Madam,

This letter contains our input for consideration in the standard setting process for requiring margin on non-centrally-cleared derivatives in response to the consultation document “Margin requirements for non-centrally-cleared derivatives” jointly issued by the BCBS and the IOSCO in February 2013.

Commerzbank AG supports its more than 100,000 corporate clients in Germany and around the globe in managing their risks related to changes in exchange rates, interest rates and commodity prices and thus enabling them to concentrate on growing their business. The bank's Corporates & Market segment is an active participant in OTC derivative markets and has been at the forefront of adopting central clearing for its interest rate swap books.

We welcome the significant changes from the first consultative document. In particular, the exclusion of existing positions from the initial margin regime reduces the risks of a liquidity cliff effect and economic losses on positions for which the cost of margining had not been known and therefore not priced when the transaction was concluded.

We still feel though that the introduction of bilateral initial margin requirements will introduce an unnecessary element of systemic liquidity risk in financial markets as well as impact the availability of long term financing as locked-up initial margins operate equivalently to minimum reserve requirements. In addition, given the existing differences in international insolvency law, the arrangements may not even result in a reduction in counterparty risk in all scenarios in addition to introducing considerable complications in the administration of a failed company.

We therefore hope that the joint evaluation of the standards by the BCBS and IOSCO scheduled for 2014 will, in the spirit of a regulatory cost-benefit analysis, contain a quantitative framework for the evaluation of the proposed model as well as of alternative models to address the key objective of a reduction of contagion risk, without an undue increase in other risk factors. A multilateral facility for calculation of margins and posting of collateral in our view would offer considerable potential to alleviate operational and liquidity problems inherent in a bilateral framework.

Yours sincerely,

Commerzbank AG
Corporates & Markets

I. Introduction, Key Concerns – and an Alternative Model

Prior to addressing the four questions asked by the joint committees, we would like to re-iterate our concerns regarding the use of bilateral margins. Even where cliff effects are avoided due to a phase-in period, such a system will still result in large amounts of liquidity being tied up for most internationally active financial institutions. Bilateral margins are significantly less efficient in mitigating risks than margins posted in a multi-lateral framework. This follows directly from the results of the QIS, which suggest that for an expected notional which is about 80% of that of currently centrally cleared interest swaps ¹, the initial margin required, after allowing for differences in close-out times, are about 15 times as high² as in a centrally cleared framework, a ratio equally applying to liquidity costs.

We believe this comparison underlines the value provided by a quantitative impact analysis – and highlights the disproportionate effects the proposed regime would have on liquidity. The estimated aggregated initial margin requirements, although only a fraction of the numbers resulting from the initially proposed standard formula, should also be considered in relation to available market liquidity: The estimate of € 700bn provided in the QIS compares to €529bn provided by the ECB's LTRO in February 2012 – suggesting that such an amount of tied-up liquidity would impact the functioning of the monetary transmission mechanism.

We otherwise refer to the comments we made in our response to the joint committees in September 2012, but would like to re-iterate a proposal for an alternative margining scheme, which would in our view achieve the stated objectives, without the risk of creating macro-economic and systemic effects due to severe constraints on liquidity.

An alternative model to achieve the regulatory objectives of “limitation of contagion” and “defaulter pays”

One of the objectives listed in the consultation documents is to ensure that the defaulter in an OTC transaction bears a higher share of the associated costs. Following this line of thought, initial margin in a bilateral context actually resembles the default fund in a multilateral framework. Most of the proposals indeed would fit better in such a framework, and hence from a terminology point it would be preferable to think about “bilateral default funds”. Consequently a better way to achieve the desired outcome may be the use a central, multilateral collateral facility (MCF) for non-cleared trades”. In such a framework, counterparties would maintain independent funds in a mutual, bankruptcy-remote facility – e.g. with an established CCP or CSD or with central banks. Amounts posted there would be a function of total OTC counterparty exposure, largely following the calculation mechanics employed for portfolio margining in established CCPs.

Rather than multiplying funding arrangements with hundreds of counterparties, resulting in a potential severe problem for any administrator and non-trading creditors of a defaulted, margin posting entity, such a centralised MCF would allow an efficient use of funds reserved for settling close out differences – which, over a number of counterparties, are very likely to balance. A centralised MCF also allows for the development of an infrastructure facilitating the fair calculation of initial margin requirements, as is the case for a CCP. This could avoid disputes which would otherwise be likely occur frequently, given the large number of parameters which can influence the risk content ascribed to a particular portfolio.

The current proposal does not prevent an institution to function as de-facto central counterparty in certain markets and build up undue systemic risk. A central MCF would allow for transparency as total initial margin posted and received in relation to total available capital could be easily monitored. The perceived risk posed by SIFIs could therefore be alleviated further. A MCF arrangement could be easily extended to other market participants in analogy to client clearing models. In addition, MFCs would provide a workable framework to mitigate liquidity constraints in markets. A MCF would contribute to a truly level playing field between OTC transactions and central clearing, and would allow a natural and organic transition path to a central clearing model.

¹ LCH.Clearnet, Annual Statements 2012; USD 339,900 bn of cleared IRS notionals

² LCH.Clearnet, Annual Statements 2012, Footnote 13 – Initial margin and other clearing member balances € 39.06bn

II. Response to the Consultation Questions

Q 1	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?
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We strongly support the exemption of physically-settled FX forwards and swaps from any form of initial margin requirements. With regard to variation margining, which we consider a suitable form of mitigation of counterparty risks when applied on a portfolio level, we would welcome an initiative to ensure international consistency. FX transactions are an inherently international activity, where natural suppliers of one currency are facing natural suppliers of another currency. National differences in variation margin regimes would result in distortions in markets and pricing and increase the operational risk in the international financial architecture. It should also be noted that the systemically relevant institutions in the focus of the present proposals had only accounted for 47%³ of the turnover in this market segment in 2010 – suggesting that an initial margining system in this product category would only result in a much smaller reduction in systemic risks than in other categories, where global dealers are difficult to replace. This resilience was underscored during recent crisis periods. Even while benchmark rates were distorted by counterparty risk concerns, technically simple and robust FX markets functioned comparatively smoothly.

It also remains the case that close-out risk, which would be addressed by initial margins, is only a small component of risks resulting from physically settled FX transactions where the major risk results from settlement failures – referred to as “Herstatt risk” – which are adequately mitigated by the CLS system, often quoted as a role-model for other instances where settlement risk plays a significant role.

The largely short dated nature of FX forwards and swaps, and the large number of transactions is another distinct feature of this product category. The short maturity profile is obvious from the triannual BIS survey, but also evident in the QIS results. The ratio of gross market value (without netting) and notional of FX forwards and swaps according to the BIS survey⁴ is just 2.77% - consistent with an average time horizon of about 2 months and an underlying volatility of 6%. Operationally, this particular deal profile along with a 24 hour market means frequently changing exposure profiles, resulting in a high likelihood of disputes and calculation issues in a bilateral IM model.

Demanding the posting of independent amounts on positions which in a Treasury context are usually employed to manage liquidity balances in different currencies would also have the additional effect of creating the need to re-adjust currency exposures on an ongoing basis, paradoxically resulting in an increase in trading activity.

Treating the small portion of physically settled FX transactions which extend beyond two years differently from the shorter maturity segment would have no obvious advantages in terms of systemic risk reduction – in particular as time to maturity is rendered largely void thanks to variation margin requirements, while interest sensitivities are small even for transactions with a two year horizon.

All these arguments have been recognised by the recent decision of the US Treasury to exempt FX forwards and swaps from the clearing requirement. Apart from the fact that the amount of extra protection afforded by posting initial margins for FX transactions would hardly justify the substantial operational and liquidity costs involved, this also means that for these products there wouldn't be the issue of a need to create a level playing field between cleared and non-cleared products.

³ BIS Triannual FX survey 2010, p. 10

⁴ BIS Triannual FX survey 2010, tables E.25 and E.26 – “Forwards and FX swaps”, Total

By analogy to the case of FX forwards and swaps it should generally be considered to reserve the use of any kind of initial margining regime to those instances where both counterparty and closeout risks are significant systemic factors and thus can be potentially addressed through the posting of additional independent amounts.

Q 2 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 welcome the proposals to find a solution to mitigate the impact of the proposed regime on the liquidity of markets in instruments used as collateral and general funding pressures.

For the established bilateral collateral framework, the aggregate effect on liquidity is generally considered as manageable. Posted collateral is channelled from one end point of a transaction chain to the other, regardless of how many intermediaries and changes in notionals etc. occur along the chain. The party for which an instrument constitutes an un-hedged liability thus posts collateral directly or indirectly, and therefore largely mitigates counterparty risks, to such a party which has an un-hedged asset.

This system only creates liquidity risks where some large counterparties with largely similar positions, like government sponsored entities or central governments, do not participate in the collateral chain, since they are exempted from the collateralisation requirement and subject intermediaries to additional funding requirements.

In the established collateral framework the ability to re-utilise collateral is undisputed, and serves to ensure continuing liquidity in the markets for instruments used as collateral, as well as to ensure positions do not create liquidity strains in the system.

By contrast, bilateral initial margin, as proposed by the joint committees, is “locked away” and economically dead: it can’t be utilised by the recipient to satisfy own liquidity requirements, as it has only been pledged, not transferred. This “vault” property at the one hand renders an initial margin system fail-safe at first sight – but it also turns the system into a monetary liquidity drain, equivalent to the working of minimum reserve requirements.

The proposed bilateral system also differs from the working of a CCP. The difference is not only one of magnitude (efficiency of multilateral clearing is between 3 to 15 times as high, s. also Q4), but also one of legal certainty thanks to a larger degree of standardisation, and use of a common legal framework for a CCP.

The consultative document touches on the issue of differences in the treatment of initial margin provided and received between jurisdictions both under insolvency law as well as from a regulatory perspective. It has to be emphasized that the interplay between national insolvency laws and capital rules currently can make the use of independent amounts unattractive. This holds in particular in situations where already for normal collateralisation no satisfying legal certainty can be obtained. In such a scenario of legal uncertainty, received collateral may have to be returned in the case of the insolvency of a counterparty, thus not reducing an existing exposure. In the case where collateral was posted, it may not be returned in the case of an insolvency of the recipient, therefore creating a new exposure for the posting party.

Except in the context of client-clearing concepts or trades conducted by an agent, we do not see an obvious way how the proposals for re-hypothecation could result in a situation which at the one hand ensures the legal certainty

of being able to use the pledged assets in a default scenario, while at the same time alleviating the liquidity drain effect inherent in the bilateral initial margin concept.

One way to partially alleviate the liquidity impact on instrument markets would be to allow the pledgor to substitute posted securities, which is established practice in many collateral frameworks. This could be extended to also give the right of substitution to the pledgee, which in most jurisdictions would require an adjustment of the legal framework. Ensuring economic equivalency of collateral in such a scenario may be difficult, potentially resulting in adverse effects for the pledgor.

— An alternative avenue would be to make IM a priority claim in insolvency law, akin to the client money concept. This would entail the need to change insolvency laws in more than 30 jurisdictions, in order to allow for a common application across G20 countries and the EU. It appears doubtful that such changes, giving far-reaching preferred treatment to OTC counterparties over other creditors in an insolvency, would gain wide support.

None of the above approaches would effectively work for cash posted as IM with the counterparty, requiring a bankruptcy remote 3rd party. Generally, while most legislative frameworks allow for the use of pledges instead of transfer of full rights, re-hypothecation generally requires a title transfer.

— While the re-hypothecation of collateral is highly desirable from a liquidity management point of view, it seems questionable if the desired protection effect could be achieved under any bilateral framework without resulting in some form of multilateral collateral scheme – which in our perspective is the preferable solution in the first place, as it addresses liquidity concerns beside providing an adequate protection to all counterparties.

<p>Q3.</p>	<p>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?</p>
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— We strongly support the application of initial margining requirements only to new trades. Any other solution would result in significant change in the economics of trades. Using the QISs results for uncleared notionals after the introduction of mandatory clearing and the resulting initial margin we arrive at a funding requirement of on average 0.33% of notional. Using a very conservative normalised cost of funding of 3%⁵ would result in a running cost of 1bp p.a. for positions subject to initial margin requirements. This seemingly small number would create annual costs of 31bn €, or 155bn € over an assumed average remaining life of the currently outstanding derivative portfolios of 5 years, which is most likely underestimating the reality. These costs could not have been originally considered in a transaction and therefore change the economics of transactions. The result would be unmanageable losses in the portfolios of institutions subject to the IM requirement, depleting capital buffers otherwise available to increase stability of institutions.

⁵ Current low interest rates should not be considered to be the norm in the future. Normalisation assumes short term rates around 2pct and the recognition of capital funding costs. 3 % in our view is at the lower end of a range of reasonable estimates for weighted average capital costs (WACC).

Nevertheless, introducing the requirement for bilateral posting of initial margin between international counterparties subject to different insolvency laws and regulatory regimes, and with significant differences in their ability to access eligible collateral assets will likely result in distortions in competition and the functioning of international wholesale markets for derivatives. As discussed in our answer under question 2, the provision of initial margin amounts can in some cases result in an increase in counterparty risk. Even where collateral is deposited with a bankruptcy remote depository, no institution can be considered completely remote from bankruptcy or operational risks – a thought taken up when applying a non-zero risk weights to CCPs. Just about the only fail-safe way to provide collateral would be actually to use vault-gold and even that mechanism is subject to some risks.

- A necessary condition before the introduction of any initial margin regime thus is a viable mechanism to exchange such independent amounts within at least all G20 insolvency regimes, and to ensure an equal treatment of such exposures in these countries capital regimes. Lacking this, even posting variation margin to a counterparty located in a country without a legally enforceable close out netting scheme can not be reasonable mandated.

The need for an internationally consistent approach pointed out also in the consultative document has to be stressed again in this context: the risk transformation function of derivative markets is dependent upon the ability of large market participants to interact with each other, but also of second tier institutions to interact on an equal footing with systematically important institutions. Different treatments in different jurisdictions would therefore result not only in competitive distortions but could undermine the working of markets in general.

- The stated start date for an IM regime of 2015 therefore should be considered as the earliest possible start date after the necessary pre-conditions are fulfilled. As pre-conditions we consider (1) the need to achieve legal convergence regarding insolvency treatment of margins and (2) time for a review of existing risk models regarding treatment of initial margins by the institution and by the regulator. No current template for a system like the one proposed exists. As pointed out before, multilateral IM regimes on CCPs are entirely different, both due to the difference in magnitude in liquidity required (s. above) but also to the reduced complexity thanks to the use of a central model, single legal framework, and usually largely homogeneous risks. The introduction of mandatory clearing has taken several years, despite the existence of a working and proven clearing model which users gained experience with for more than a decade. This suggests that the introduction of a robust initial margining framework within less than 2 years, even if applied only to about 20 global firms, is a very challenging objective. The experience gained from current bilateral collateral management setups would also suggest that in the envisaged final implementation stage, where about 3,500 bilateral initial margin sets have to be calculated and agreed, disputes will occur on a regular basis despite best efforts.

The alternative model of a MCF as described in the introduction would significantly reduce the operational difficulties, by reducing the number of managed relationships to about 150 to 300 rather than 3,500.

As nothing can be gained from introducing a completely new regime over too short a time horizon with potentially adverse consequences for both the market and individual institutions we would strongly recommend to adopt a series of milestones instead of fixed dates. Such milestones could be the finalisation of an IM regime; a legally robust and equitable regime of posting collateral in all G20 areas; proven readiness of at least 80% of initial adopters and 30% of second wave adopters, etc.

Given that there is no obvious need to link the phase-in schedule to that of Basel 3 we would recommend to consider this an independent project. Indeed, given the acknowledged duplication of incentives provided by the two concepts, it would seem more appropriate to unbundle these two regulatory workstreams in terms of time of adoption. If any overlap at all should be sought it would be with the fundamental review of the trading book which may result in adjustment to quantitative models.

The principle of multiple waves of adopters should be maintained. To ask institutions with high systemic relevance, which usually will have the most developed risk and operational systems, to spearhead such a regime also is a valid concept.

Instead of re-calibrating the adopter waves on an annual basis, waves though should be fixed at the outset. This provides banks with the required legal certainty to price transactions accurately and plan their investments in IT systems and address the necessary bilateral legal framework. A revision of the initial wave assignments should only be possible due to a significant change in the business of an institution (merger or discontinuation of activities resulting in un-cleared OTC exposures).

— A complete implementation plan should also consider and set out the possible consequences of the ongoing quantitative surveillance of an IM regime, including its postponement or abolition should market structures change significantly or evidence become available that the regime does not, as intended, result in a reduction of systemic risks.

— Part of the required calibration should also be a review of the proposed haircut schedule. In particular the role of cash should be reconsidered. In many intercontinental netting sets it is difficult to determine one currency which should have the benefit of a zero haircut. Beside the home currency of the two counterparties, the calculation currency for exposures or a currency underlying a number of individual trades could be equally argued to earn a zero haircut. In addition, the proposed rules may create a distortion in international funding conditions considering that many collateral agreements use the USD or the EUR as their numeraire.

Q 3/2 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?
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The introduction of VM, where frameworks are mature and less contentious, and benefits are less likely to be outweighed by undesired effects, should be seen as largely independent from the significantly more challenging establishment of an initial margin regime.

— To avoid the creation of split netting sets between pre-introduction trades and transactions under the new regime, while avoiding cliff effects, we would ask to consider a sliding convergence scheme over 7 to 10 years, after which pre-regime trades could come under the same collateral arrangements as transactions entered under the new regulation.

Q3/3 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?
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We agree that different thresholds should apply for countries where the operational and liquidity impact of a mandatory collateralisation and margining scheme could have an even larger impact on stability and the ability to provide long term credit than in mature markets. Any exemption benefits though should be subject to an institutional threshold. A globally relevant financial institution active in global financial markets should be subject to the uniform regime, even when domiciled in an 'emerging' market.

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

Firstly we would like to thank the BCBS and IOSCO for the effort spent on conducting a quantitative impact study. Given the multitude of parallel and overlapping regulatory initiatives, more studies of this kind would be welcome, ideally incorporating network effects on monetary policy, long term lending capacity and market liquidity.

Results arrived at by the QIS agree broadly with economic reasoning and expectations. In particular the results show the severely reduced efficiency of a regime of bilateral margin posting compared to multilateral initial margin employed in clearing houses. Using only the data for the QIS firms for the “all clearing achieved” scenario the estimated IM (€ 558bn) is 0.33% of the aggregate notional (€171,733bn). Comparing this to numbers of LCH.Clearnet published for end of year 2012 clearly shows the difference: there, cleared notional was \$339,000bn, while member firms had posted initial margins of €39bn, i.e. 0.015% of notional, resulting in a ratio of 0.021% after scaling up to a 10 day close out period. Put differently, *bilateral margin requirements result in 15 times higher liquidity needs and costs than central clearing.*

Benefits in terms of counterparty risk reduction are at best the same as for central clearing. More likely, benefits should be considered lower, due to the need to rely on bilateral arrangements and currently existing impediments to legal and regulatory risk reduction of margining frameworks. A regulatory cost benefit analysis would have to consider also the increase in liquidity risk, which in an optimistic case should be a linear function of encumbered assets. But depending on pre-existing asset encumbrance, such a function could also reasonably be expected to show above-linear growth beyond a critical point.

Given this evidence from a real life example, the factor between the sum-of the parts and the total-portfolio results shown in Table 7 for the subset of 19 respondents managing to calculate numbers for a completely netted portfolio seems surprisingly small. Even for the category of FX and interest rate products, which is not too dissimilar from the situation on LCH.Clearnet, the simulation suggests a ratio of margin to notional of 0.05% in the 5-day closeout situation, i.e. 3.5 times higher than observed in an actual clearing house. While the presence of option products could account for some of the difference, it should also be considered that most respondents would have had to use systems differently from how they had been designed, potentially impacting results.

The results also display the expected bias to a concentration of risks between globally active market participants (“G30”). Exposures between such institutions generally have a high degree of netting efficiency as this is in practice a prerequisite for the ability to extend business, which would otherwise result very quickly in a depletion of bilateral credit lines.

Results for the standardised margin approach signal that a broader adoption of this approach would result in a huge impact on aggregate liquidity drainage – about 10 times the amount of the February 2012 LTRO in the example in Table 8, even after application of the 50 million threshold. A broader adoption of this fall-back approach should therefore be strongly discouraged. At the same time, the complexities involved in creating a robust portfolio based initial margin model should also not be underestimated – even for just one asset class. A larger than expected number of market participants may therefore be tempted to opt for the seemingly cheaper to implement infrastructure –resulting in too many adopters and a subsequent systematic liquidity drawdown. This observation is therefore tied to the statement in Q3 where we suggested to make the start for one “wave” of adopters subject to the availability of approved systems, as this would prevent the effect described in this point.

The proposed MFC solution would alleviate also this issue by providing a standard infrastructure, allowing the majority of firms required to provide independent amounts to employ a suitable quantitative model, thus ensuring fair competition across the market.

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