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Re: Second consultative document on margin requirements for non-centrally cleared derivatives

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to provide comments on the BCBS-IOSCO consultative document on margin requirements for non-centrally cleared derivatives.

We support the core objectives of the BCBS-IOSCO proposals, to encourage central clearing and reduce systemic risks. We welcome the ideas in the second consultation designed to address market participants' original concerns and the efforts of the working group to reach an internationally consistent approach.

However, the modifications contained in the proposals and the speed at which phase in is proposed to take place, are not yet sufficient to adequately address these concerns. The impact of the proposals remains disproportionate to the objectives that are sought and create new risks such as increased procyclicality. We would encourage BCBS-IOSCO to consider other policy options that meet the overall objectives but with a lower risk of unintended consequences, and where relevant have made suggestions in our response.

We trust you find these comments helpful. Please let us know if we can provide further information.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

Summary

We support the core objectives of the BCBS-IOSCO proposals, to encourage central clearing and reduce systemic risks. The industry is on a path towards central clearing for a large number of products and globally the financial sector has deleveraged significantly. The revised proposals made by BCBS-IOSCO contain a number of elements designed to reduce implementation costs and the liquidity impact, which are to be welcomed. However, a number of other modifications included in the proposals work to offset these changes.

Impact of the proposals

- The reduction in impact resulting from the introduction of a €50m IM threshold is likely to be significantly offset by the requirement to calculate the requirements at the group level rather than at the individual counterparty level, which also introduces legal and operational challenges.

- The four year phase in period and grandfathering of existing positions is of limited benefit as designed, given that many derivatives contracts are typically under five years in duration, much of the IM required is likely to be exchanged in the first years of the phase in and the implementation costs necessary to implement VM will in any case be required for all counterparties from 1 January 2015.

- The conditions that must be met in order to allow rehypothecation to be undertaken appear to be designed such that very limited rehypothecation may be possible in practice.

Therefore, even with the modifications proposed, the proposals are likely to go beyond what is necessary to achieve the core policy objectives.

Objective 1: Reducing systemic risk at the expense of other risks

- The dynamic nature of the initial margin (IM) requirements would increase procyclicality through rapid increases in IM requirements in future periods of financial instability creating new liquidity risks to the financial system which are not addressed in the current proposals.

- The proposed IM threshold, for example, will only reduce the impact by the size of such threshold, but does not help with collateral calls that may be many times greater during periods of stress.

- Users of non-centrally cleared derivatives are generally those with a genuine need for a product tailored for their specific needs that cannot be centrally cleared. Rigid

proposals thus risk penalising genuine users without offering alternative risk management choices.

- At present, prudentially regulated counterparties are able to manage their credit risk to more risky counterparties by requiring IM and not posting IM. Requiring two way IM in potentially large amounts can increases risk, particularly in periods of volatility, and especially with the strict model assumptions contained in the proposals.

Objective 2: Encouraging central clearing in the absence of clearing solutions

- Some non-centrally cleared products will not be operationally clearable within the time frames being considered. Therefore margin requirements cannot act as a direct incentive to clear for those products. For other products, clearing will be mandatory in any case. IM requirements as an incentive to clear are therefore only relevant for a limited set of products. Counterparties affected by these proposals are dependent on third party readiness and, importantly, their willingness and ability to centrally clear derivatives.

- Measured by notional amount, most derivatives activity can be cleared. Measured by transaction type, most cannot be cleared. Bespoke derivatives or derivatives that have low volume are not likely to be able to be cleared. For example, a currency swap in a non-major currency that a corporation may need to make investments in emerging markets, or single name CDS on a reference entity that is not traded frequently that financial institutions might use to hedge their credit exposure. These are all important to economic activity and growth.

Foreign exchange swaps and forwards

- We welcome the proposal that physically settled FX swaps and forwards may be exempted from IM, since they do not generally generate significant counterparty risks and are typically short dated and highly liquid. To the extent that a risk mitigation regime is required, it should be consistent with principle 3 of the supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, published by the BCBS in February 2013.

Further assessment needed and alternative proposals should be considered

- Given the uncertainties over the benefits from a systemic risk perspective and the procyclicality risks, a further quantitative impact study should be undertaken following publication of the final BCBS-IOSCO proposals and alternative approaches to phase which generate a smoother introduction of requirements or which focus on particular products linked to the availability of clearing solutions should be considered.

Element 1: Scope of coverage – instruments subject to the requirements

Question 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?

For deliverable foreign exchange transactions in particular, the most significant risk remains settlement risk, which is addressed by means of appropriate risk controls, such as enforceable netting arrangements and systems. Such netting arrangements also reduce counterparty risk, and diminish the need for mitigants such as collateralisation. While supervisory guidance can provide principles for management of mitigants, the history of both systemic and counterparty stress scenarios does not provide any evidence that would indicate that prescriptive VM requirements would have provided any material additional mitigant. The mitigation afforded by margin should not be confused with implementation of effective risk controls that diminish or limit exposure in the first place.

Regarding IM, there is no evidence to suggest that counterparties were impacted negatively or systemically by IM not having been exchanged in previous years. The nature of physically-settled FX forwards and swap contracts make initial margin disproportionate from a risk mitigation standpoint. These types of transactions are typically short dated, particularly in comparison to other asset classes.

In the case of a physically-settled FX swap, an actual exchange of principal (in the specified currencies) occurs at the inception of the contract. These exchanges are akin to a fully collateralised transaction and therefore broadly risk neutral from a counterparty credit risk perspective.

FX forwards and swaps play an important role in international trade and global cash management activities, tending to be demanded as a result of real economy cash flow needs. For example, corporations that issue debt in a particular currency and need to meet costs in a different currency would enter into a physically-settled position for basic hedging requirements. FX forwards and swaps are typically traded in highly transparent and liquid markets. The risks that measures such as mandatory clearing requirements are intended to reduce or eliminate for other types of derivatives does not therefore apply to the same degree to these instruments.

IM and VM requirements for FX forwards and swaps would impose significant liquidity costs on the contract participants, and is likely to lead to a reduction in the availability of those instruments, an undesirable outcome from a wider economic viewpoint.

To the extent that a risk mitigation regime is required, it should be consistent with principle 3 of the supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, published by the BCBS in February 2013.

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

Any kind of maturity differentiation is likely to create market distortion, including the potential bifurcation of markets on contracts which may only be days apart. Longer dated contracts would become more expensive and this in turn may encourage participants with longer dated hedging needs to enter into shorter dated contracts at higher frequencies, potentially creating maturity mismatches. Furthermore, given that FX forwards and swaps are typically short dated, it seems disproportionate to require the build out of a significant IM infrastructure across the industry for the number of products that are longer dated.

Element 2: Scope of coverage – scope of applicability

IM thresholds

The change in calculation method to cover consolidated groups as opposed to individual legal entities largely negates the benefit of the introduction of the €50m IM threshold. Therefore the threshold should be increased and/or be allowed to vary with the riskiness of the counterparty.

Scope of coverage

The steady state notional amount of non-cleared derivatives used for the threshold to deem systemic relevance (€8bn) should exclude strictly defined hedging transactions. It is also not clear whether the thresholds apply for the purposes of exchange of VM or solely for IM. To avoid unnecessary implementation costs which would carry little benefit from a systemic risk reduction perspective, the scope should be aligned for IM and VM based on the €8bn steady state threshold.

Definition of consolidated group

The introduction of the consolidated group concept on which the rules would apply introduces new complexities into the regime that are disproportionate to the objective of preventing avoidance. We recommend the threshold be maintained at the level at which margin management occurs today - between the distinct legal entities that are party to the trade and the legal collateral arrangement.

The concept of a "shared IM threshold" for a consolidated group may risk transforming a purely bilateral negotiation of legal documentation between two parties into a process that involves multiple parties located in different jurisdictions and subject to different regulatory rules. Using the scenario described on page 9 of the paper, if any single entity (among A1, A2, A3, F1, F2 and F3) discovered itself to be a "covered entity", it is likely that all six entities would need to renegotiate existing documents and/or enter into new agreements to comply with the shared threshold. Assuming that each of the entities is incorporated in a different jurisdiction, up to six different sets of local margin requirements would also be relevant.

In practice consolidated groups have many more legal entities than three. It would also need to be clarified how the definition of consolidated group is applied to investment firms that manage legally separate funds. Given the assets and obligations of such funds are discrete, with distinct ownerships, the calculation of notional amounts for phase-in purposes would need to be performed at fund level.

Furthermore, counterparties may be required to undertake diligence on entities other than the counterparty to the transaction and with which they do not have a contract. This would require a detailed understanding of how the counterparty is structured at a group level and monitoring of such entities. It is difficult to see how this could be maintained and documented in practice.

Element 3: Baseline minimum amounts and methodologies for IM and VM

Use of models/schedule

We strongly support the ability to use model based approaches, both to ensure the liquidity impact of the proposals is minimised, but moreover to increase the risk sensitivity of the proposals and encourage counterparties to improve risk management. However, given the two way nature of the proposals, it is unclear how a model approach could work in conjunction with a schedule based approach. This might in practice mean that more sophisticated counterparties using a model may be required to post higher levels of IM to potentially less sophisticated and sometimes less creditworthy counterparties, which is likely to increase risk rather than reduce it. The reduction in the number of counterparties in scope, via the €8bn threshold, will help to minimise these issues, but it does not go far enough to avoid them (see our comments on element 8 for further detail).

Model assumptions

It is not necessary to require the holding period of 10 days and confidence interval of 99 per cent for each individual bilateral pool of non-cleared OTC derivatives. There are multiple pools of non-cleared derivatives for which there is no netting benefit, meaning the aggregate amount of capital required will be much more than required for central clearing even using a lower holding periods and confidence intervals.

Such a proposal applied across all asset classes irrespective of liquidity will penalise more liquid products and potentially underestimate the gap risk for less liquid and more risky products. In addition, regarding the 10-day horizon, usually, non-cleared transactions can be closed out quicker than those managed by CCPs. We would recommend allowing the period to vary depending on the product characteristics.

We would propose initially requiring a lower confidence interval and holding period and gradually phasing in higher requirements while monitoring the effect on liquidity and progress towards central clearing.

Use of multiple margin methodologies

Models will need to be risk based, transparent and consistent (including in terms of input parameters) to avoid disputes. Furthermore, it is unclear whether multiple margin methodologies could be used for a particular transaction. The introduction of different models could lead to a mismatch in the collateral requirements between counterparties and a substantial increase in disputes. It is also not clear as to whether models can be used in jurisdictions where netting is not enforceable.

Application on a per asset class basis/netting

Cross margining arrangements based on overall credit risk to a counterparty should be allowed and should more accurately reflect actual close-out provisions. The assumption embedded in the proposals, that derivatives with fundamentally different characteristics may not be netted, runs contrary to the single agreement concept upon which many industry netting agreements rely. Netting is an important risk mitigation technique that is supported by insolvency law and has worked successfully in many defaults. The introduction of margin rules should not impact the ability of a party to rely on appropriate netting.

Frequency of exchange

Further clarity would be welcomed on the expectations around frequency of exchange of IM & VM. In places, the proposals suggest a daily requirement; in others it is suggested flexibility for less frequent exchange may be permitted.

Element 4: Eligible collateral for margin

We agree with the range of eligible collateral proposed, but are however concerned that the proposal to allow jurisdictions to set their own list of eligible assets may encourage regulatory arbitrage.

Furthermore, requiring that highly liquid foreign currencies are subject to haircuts for FX risk is not appropriate without a detailed study of the impact. For a small number of highly liquid currencies no, or at most a small haircut would be appropriate.

The requirement that collateral should not be correlated to the counterparty or the underlying risk is sensible; however it is not clear what the minimum thresholds for determining correlation should be. We would propose that this is handled by prudential risk management and the use of standard CSAs.

Element 5: Treatment of provided initial margin

Question 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.

Rehypothecation undertaken in a prudent way, with effective transparency, is important to the financial system and the real economy and is a key part of the optimisation of collateral to minimise reinvestment risk and cost of funding.

Under current market and legal practices the proposal would not strike an appropriate balance between ensuring sufficient liquidity and protecting clients:

- rehypothecation of client assets is effected via the mechanism of title transfer, which operates on an absolute basis; any attempt to introduce priority for particular creditors would impact on the securities financing industry globally;
- it would require a change in national laws to accommodate and would be difficult to implement practically; and
- some client asset regimes protect the value of the asset not the asset itself.

The requirement to segregate initial margin would also have a direct impact on the ability of prudentially regulated institutions to manage the implementation of the liquidity coverage ratio (LCR) under Basel III. The BCBS estimated in its April 2012 quantitative impact assessment on Basel III implementation that group 1 and 2 banks faced a €1.76tn shortfall meeting the LCR and subsequent revisions were made. However, the mandatory segregation of margin for non-cleared transactions would add to that shortfall.

We would propose that the pledgee be allowed to rehypothecate if the pledgor has given their consent. This is consistent with Principle 6 of the IOSCO Consultation Report "Recommendations Regarding the Protection of Client Assets" issued in February 2013.

Element 6: Treatment of transactions with affiliates

Affiliates should be able to be fully or partially exempted from the requirements to exchange both variation and initial margin where their risk management procedures are adequately sound, robust and where there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the affiliates. This would imply in many cases that IM should not be required, since it does not make sense to guard against potential future exposure if the exposure is purely between entities within the same group.

However, it is unclear how the principle as drafted (with discretion left to national jurisdictions) would operate in practice. For example, if one jurisdiction were to determine that a particular transaction type may be exempted and the other does not, it is unclear whether this would result in a two-way exchange of margin or simply a one way transfer.

A harmonised global approach to determining initial and variation margin requirements for intra group transactions should be sought. Principles for exempting transactions between affiliates should be agreed globally and then implemented by local supervisors in a consistent way.

Element 7: Interaction of national regimes in cross-border transactions

We welcome key principle 7. However, the use of the terminology 'to the extent permitted' in the examples provided, suggests that jurisdictions would be able to determine the extent to which another jurisdiction has implemented the principles, which risks creating an uneven playing field and undermining the benefits of a global approach to margin rules. There should be a centralised, BCBS/IOSCO/FSB led approach to assessing adherence to the principles.

By leaving covered entities entirely to national regulators, there is a risk that there is a mismatch in entity types per jurisdiction to which these requirements apply. For example, if one party is required to collect margin under its local regulations but its counterparty is not required to post margin pursuant to its local regulations it is unclear which regime would prevail.

Finally, careful consideration is needed of the implications of imposing margin requirements on financial firms that trade with counterparties incorporated in jurisdictions where the legal validity and enforceability of close-out netting is in doubt. Typically, the uncertainty arises because of certain aspects of the bankruptcy laws in the jurisdiction, which may give the liquidator "cherry-picking" powers if the counterparty has gone bankrupt.

Element 8: Phase-in of requirements

Timing of assessment

In order to ensure the readiness of market participants when they reach the threshold it appears that the timing of the calculation to determine their requirements (the end of the relevant year) and the implementation date being the start of the following year (i.e. 1st January), are too close together to be practicable and insufficient to allow market participants the ability to prepare themselves both operationally and from an infrastructure stand point for compliance. We would suggest the assessment is undertaken at least six months before implementation, and the list of covered entities is made transparent well in advance of requirements entering into force.

Ongoing assessment

It is unclear whether an entity is able to move in and out of scope of the regulations from year to year or whether the assessment is 'once and for all'. It should also be clarified whether an existing transaction would continue to require margin to be posted when a counterparty moves out of scope.

Cost-benefit analysis

Consideration of the costs and benefits of various phase in options should be carefully assessed. For example, to avoid the cliff effects outlined in our response to question 3, further consideration of alternatives which generate a smoother introduction of requirements or which focus on particular products linked to the availability of clearing solutions should be undertaken.

Question 3: 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?

The proposed phase in model is not sufficient to smooth the liquidity or transition costs. From a liquidity perspective, since, a large percentage of notional contracts are dealer to dealer, the liquidity impacts of the proposals are effectively frontloaded in 2015. Requiring VM for all in scope counterparties in 2015 negates many of the operational/transitional benefits of delaying IM until 2019 for some smaller market participants.

Regarding the start date, the detail necessary to complete the amendment process, industry protocols and modelling will not be fully known until each jurisdiction's rules are finalised. In order for the proposal for cross-border transactions to be workable, jurisdictions will need to coordinate and converge as to substance (e.g. definition of financial entity, swap, treatment of affiliates, treatment of segregation) which may take time. Implementation should therefore only be required from 1 January 2016 or two years from the publication of final rules in an individual jurisdiction, whichever is the later.

A later start date would also help to reduce overlap with the introduction of the Basel III Liquidity Coverage Ratio in 2015.

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?

See above. There is a risk of cliff effects from businesses just under the threshold benefiting from a lower cost of funding and able to gain market share at the expense of others above the threshold.

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?

VM requirements should be phased in a similar way to IM. Otherwise, counterparties will be subject to a series of amendments to CSAs instead of a single amendment. As dealer to dealer and a considerable number of financial institutions are already two-way margining for VM, there is no additional systemic risk arising from the phasing in VM in the same way as IM.

Question 4: Accuracy and applicability of the QIS

The data referenced in the QIS to assess the liquidity impact of the proposed rule with a €50mn threshold assumed that the thresholds were applied at legal entity level, not consolidated group level. The required collateral taking into account this change will be substantially higher.

The proposal that variation margin would be called per each legally enforceable netting agreement is a significant change from current market practice where variation margin is usually called assuming full netting. This change could imply a substantial amount of variation margin would need to be exchanged, as the netting sets for counterparties will not always match (also, for many emerging market countries there are no netting opinions). This will have substantial impact on market liquidity and was not considered in the previous QIS. The paper also indicates that models can only be used for IM where there is legally enforceable netting – it is not clear whether this means that the grid approach must be used where netting is not enforceable. If that is the intention, this was also not reflected in the QIS.