via email to: baselcommittee@bis.org and wgmr@iosco.org

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EAPB comments

BCBS-IOSCO Second Consultation on Margin requirements for non-centrally cleared derivatives

The European Association of Public Banks (EAPB) represents the interests of 40 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

The member institutions of the European Association of Public Banks (EAPB) welcome the opportunity to participate in the BCBS-IOSCO consultation on margin requirements for non-centrally cleared derivatives. As a result of the nature of public banks, non-centrally cleared derivatives are mainly used to hedge the interest rate risk and FX-risk of the bank. Using derivatives first and foremost to hedge long-term loans many public banks operate as end-users in the derivatives markets. Consequently, derivative portfolios are structured in a very directional way. This is in contrast to derivatives dealers that generally have a more non-directional portfolio. Additional collateral requirements will hence have a much higher impact on institutions with directional portfolios. The EAPB believes that therefore, the proposed requirements are not in line with the overarching political goal of reducing systemic risk in the financial system.

Furthermore, the consultation document does not sufficiently take into consideration banks with a low-risk business profile. For banks specializing on funding local and regional governments or supporting their responsible state or public authority with promotional funding a very good credit rating is much more essential than for commercial banks. To prevent low-risk business activities from being extraordinarily punished BCBS and IOSCO should develop margin requirements based on the risk profile and the business activities of a counterparty. This can take effect through applying the proposed threshold for the initial margin in a more differentiated way, e.g. by setting a higher threshold for banks with a higher rating.

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In addition, we would like to make the following comments on the different questions and elements described in the consultative document.

[Question 1: Scope of coverage]
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 EAPB supports the exemption of FX forwards and swaps from the initial margin requirements if the delivery obligations under a physically settled FX forward or swap have been included in a settlement system that ensures simultaneous exchange of payment.
An exemption of these products for variation margin is, however, not appropriate. We understand that the majority of FX swaps and forwards traded have a maturity of less than a year. The potential future risk associated with such transactions comparing to the mark-to-market values or the settlement risks can be neglected as FX swaps and forwards are standard products which could be easily recovered from other counterparties in case of default. Moreover, the gross exposure of each institution could significantly exceed the net exposure since many long and short positions are held during a day. In case of a counterparty default, only net exposures need to be traded. This would allow banks to more easily come back to the pre-default position than if gross exposures were traded.

In addition, there is one item in the consultation where the EAPB believes that more clarity is needed. It concerns the question of which physically-settled FX forwards and swaps will fall under the scope of the requirements (initial margin/variation margin). In particular, it is not yet clear whether the requirements will concern a number of products which are actively used for risk management purposes to reduce mainly the FX-risk, for example if:
(1) The counterparties bilaterally agree on a cross currency swap given nominals of USD 100 and EUR 130. The nominal at the beginning and the end of the transaction are the same and are exchanged at both times. Party A pays a fixed coupon on the USD 100 nominal, party B pays a floating coupon on the EUR 130 nominal based on the 6m EURIBOR.
(2) Given the same preconditions as provided for in example 1, party A pays a floating coupon on a USD 100 nominal which is based on the 3m USD LIBOR. Party B pays a floating coupon on the EUR 130 nominal based on the 6m EURIBOR.

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[Element 2: Scope of coverage – scope of applicability]

In the end, and despite all efforts to harmonize margin requirements, firms will calculate initial margins on the basis of an individual transaction. Hence, margins will be different for each transaction also in case the counterparties use the same methodology but have a highly diversified portfolio. In order to avoid a conflict on the margin requirements the EAPB recommends the provision of further guidance on the use of initial margins.

[Question 2: re-hypothecation]

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.

The EAPB believes that these questions are very valuable and therefore encourages BCBS and IOSCO to carefully consider their final recommendation. The EAPB also believes that the proposal to discuss potential restrictions on re-use, re-hypothecation or re-pledge (re-use) only targets initial margins and would not apply to variation margins. Such an understanding would correctly reflect the fact that the posting and adjustment of variation margin can only be operationally managed if the relevant collateral is provided by way of full title transfer.

As to the potential restrictions on the re-use of initial margins we do share the view that such re-use should be permitted in certain circumstances to a certain extent, not least in view of the positive effects this would have on liquidity. However, we also believe that such permission to re-use must be designed in such a way that it does not lead to distortions of competition as it would for example be the case if it were based on a particular concept of client asset protection. Thus, to the extent the legal regime would be a factor in determining the permissibility of re-use, the differences between jurisdictions would need to be taken into account. For example, many jurisdictions do not recognise the concept of preferential claims in insolvency proceedings and apply other concepts. In addition, it would be important to analyse whether the protection formally afforded under a law is effective in practice: For example, preferential claims are of no practical value if there are insufficient assets available to the creditors to satisfy the preferential claims.

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[Question 3: Phase-in arrangements]

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?

The EAPB believes that BCBS and IOSCO have carefully considered market concerns raised in the first consultation. The phase-in periods are carefully balanced between the goal of making the financial markets safer and more robust and the institutions ability of implementing the new standards. Nonetheless, the EAPB has a couple of remarks to the proposals:

(1) It is absolutely necessary that market participants can understand how their counterparties calculate the initial margin in order to avoid disputes between the counterparties. A neutral third party could help find a solution between the conflicting counterparties.

(2) Concerning the variation margin, the EAPB believes that the current market practice between financial institutions allows the exchange of the mark-to-market value on a portfolio level on a frequent basis even though the mark-to-market values are very often calculated on a single currency basis. According to key principle 4,"...eligible collateral should not be exposed to excessive FX risk". This implies a multi-currency exchange of variation margins. In a multi-currency portfolio, this could result in the exchange of multiple cash collaterals, which leads to a build-up of Herstatt risk if one counterparty posts Euros and receives US-Dollars. Currently, the market infrastructure is not yet prepared to allow for an exchange of collateral through the CLS Bank infrastructure. As a result, we propose the introduction of a variation margin on a single currency basis but we do not support a phase-in of these requirements. However, for the implementation of further standards appropriate phase-in periods are required.

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