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European Fund and Asset Management Association

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

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 59 corporate members about EUR 14 trillion in assets under management of which EUR 8.9 trillion managed by 54,000 investment funds at end December 2012. Just over 35,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

Thank you for giving us the opportunity to submit evidence on the BCBS-IOSCO second consultative document on "Margin requirements for non-centrally cleared derivatives. EFAMA welcomes as very positive and fully supports the initiatives aimed at enhancing safety and transparency in the over-the-counter derivatives market.

Although we agree with many key ideas, principals and requirements, we wish to submit the following general remarks (see section I) before providing our answers to the consultation (see Section II).

We would also like to remind you of the intervention made at the roundtable on margin requirements held on 7 September and of the answer that we gave to the first consultation on margin requirements for non-centrally-cleared derivatives.

Section 1 – General remarks

We thank BCBS-IOSCO for listening to several of our comments made in response to the first consultative paper published last year.

We believe that the proposed way forward is coherent and brings clarity to the outstanding issues.

Specifically, we support:
- the principle of a phase in of the requirements;
- the application of minimum thresholds before the requirements apply: this is a proportionate response to the risks presented;
- the use of 2-way margin for variation margins ("VM")

However, we would also like to highlight some areas of concerns:
- The use of a "group" approach to aggregating notional derivatives exposure needs further clarification. Many funds are set up as umbrella structures in line with UCITS (and AIFM) regulation, and beneficially each sub-fund is maintained separately from its fellow sub-funds. In many jurisdictions, including the UK, Belgium, France and Luxembourg, additional legislation has been introduced in the form of "protected cell" regimes to keep the sub-funds legally segregated from

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each other in the event of an insolvency of one of them. As mentioned before, most of EFAMA members are of the opinion that it is important that the margin requirements are handled at the level of the sub-fund.

- As expressed in the answer to the previous consultation, EFAMA is in strong disagreement that asset managers should post and collect initial margins (IM). Funds (especially UCITS or other regulated funds) are subject to stricter rules than other financial institution and will not materially contribute to systemic risk.

All assets managed by an investment manager ("portfolio manager in MiFID terminology) are segregated and held by an independent depositary/trustee (e.g. as required by EU law) or custodian. In the event of the failure of an investment manager, these assets would remain segregated and held by the custodian. Consequently and due to their very low risk of default, the funds should be exempted from posting initial margins ("IM").

- Currently, the investment fund industry does not exchange IM. Therefore, new technical processes need to be developed which takes time, resources and will reduce revenues for investors.
- According to principle 5 the IM shall be segregated from the regular collateralization process of VM. This process can only take place 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 of the counterparties which take additional time to be set in place
- 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

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

<u>Section 2 – EFAMA's answers to the consultation</u>

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 with BCBS/IOSCO approach. We believe that physically-settled FX forwards and swaps should not be subject to initial margin requirements at all.

As explained in our answer to the first consultative document, we even support an exemption for foreign exchange forwards and swaps independently from the maturity of such foreign exchange instruments

Unlike many other derivative instruments whose payment obligations fluctuate daily in response to changes in underlying variables, such as interest rates, the payment obligations of FX swaps and forwards are fixed at the outset of the agreements and involve the actual exchange of full principal for settlement.

Further, the vast majority of FX swaps and forwards have short average maturities, posing significantly less counterparty risk than other derivatives. Trades are largely cash backed, and market risk of transactions will be reflected in the P&L of the respective counterparties. 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 impossible to post collateral as the collateralization process takes longer than the term of the contract.

Considering those elements, we believe that the biggest risk in FX relates to settlement. Consequently, we would recommend to exempt FX instruments from IM.
Additionally, should the counterparties have dealt with these instruments and have been using formal settlement systems such as CLS, we believe that no time restriction should be foreseen at all and that no IM should be required when the counterparties use one of the existing cash settlement system (e.g. CLS) that eliminates counterparty risk.

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.

Notwithstanding the potential impact on liquidity, for initial margin, most of EFAMA members believe that re-hypothecation of client assets should be allowed but only under even stricter conditions then the one set out, as it could leave too much autonomy in the hands of the bank counterparty that could be detrimental to final investors.

Re-hypothecation should only be allowed if:
(1) the reuse of margin would be used as an effective risk mitigation technique; and
(2) the customer has entered into a binding contractual agreement that allows re-hypothecation ; and
(3) express permission for re-hypothecation is granted in this contract, ahead of any trading; and
(4) the contract is permitting a wide range of eligible collateral with appropriate haircuts if necessary, thus supporting a more counter-cyclical approach to collateral management and reducing asset concentration risk.

The exchange of variation margin should also be considered as an effective tool to address product specific risk and prevent the build-up of large uncollateralized current exposures.

The combination of the two should be sufficient to deal with the risks presented.

We believe that those changes will also require a more harmonized legislation with respect to re-hypothecation and collateral use in general.

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 believe that the principle of a phase-in arrangement is appropriate and helpful.

However the deadlines foreseen are too short according to our analysis. We believe that in the light of the current large number of regulatory initiatives, 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.

Additionally, firms that present no apparent systemic risk to the market shouldn't be urged to achieve unnecessary and heavy or urgent changes.

Moreover, we believe exceptions should be granted based on hedging transactions as in EMIR and in Dodd-Frank.and the low liquidity/ low systemic risk the derivative itself
In relation to pension funds which are in receipt of the pensions fund exemption, we suggest it would be proportionate to phase in any requirement to post margin to align with the timing of the temporary exemption from clearing.

We believe that it would indeed be simpler and more efficient to set the required formal framework from an effective date but that 1 January 2015 is too early.

Even though exchange of variation margin is widely adopted as market practice, there are a large number of substantial participants in local markets that have not got the automated systems and legal support to handle variation margin in all cases. These market participants will have extreme difficulties in being able to be compliant by 2015.

A phase in period is needed for variation margin, too. There is huge operational complexity related to the implementation of the current BCBS-IOSCO proposals, even in the most advanced jurisdictions. The industry will need to agree on new relevant documentation, risk metrics and dispute protocols, under adequate monitoring –by regulators to secure international consistency. Models will need to be approved by regulators in an internationally consistent way.

We would also like BCBS/IOSCO clarifying some principles:
(1) will the entity exemptions (such as for occupational pension schemes and intra-group transactions) be clarified and aligned according to EMIR or similar legislations; and

(2) will the definition of systemically important non-financial counterparty and the threshold therein be defined in more detailed manner; and
(3) will the hedging transactions exempted from threshold calculations as they are under in EMIR and in Dodd Frank; and
(4) will the phase-in period start on the application of the last party to be due to exchange collateral according to the threshold limits; and
(5) Will clear rules be set to resolve any difference that might appear between the different margining models? Especially, some alignment of calculation method is required as the margin requirements under the standardized model are still too high when compared with internal models. The higher level of standardized models would unfairly affect smaller markets and smaller actors; and
(6) will the definition of "covered entity" be further clarified and will it incorporate how regulated investment funds will be legally handled in this context?

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

EFAMA believes that the implementation needs monitoring to prevent arbitrage, loss of competitiveness etc.

a. Segregation and asset safekeeping

The segregation requirements for initial margin may require the use of third-party custodians. However, there is a limited number of global custodians that would be able to provide such services on a global basis. This may lead to increased concentration risk on custodians.

b. Scope of applicability

Regulators intend margin requirements to apply to all financial firms and systemically-important non-financial entities ("covered entities"), when they deal with each other, but not when they deal with other parties.

Under the BCBS/IOSCO principles, covered entities would not need to take margin when dealing in non-cleared OTC derivatives with "non-financial counterparties under the clearing threshold". The position with regard to third country firms when those firms are systemically important is not clear and requires clarification.

Implementing this principle will be a matter for local regulators. In Europe, this raises the issue of the interpretation of article 11 (3) of EMIR. When will "financial counterparties" and "non-financial counterparties over the clearing threshold" be required to exchange margin? This will need to be clarified in the expected technical standards.

c. Intra-group transactions

The consultation leaves it to local regulators whether non-cleared intra-group transactions should be subject to margining requirements.
This allows local regulators to take different approaches, increasing uncertainty and the potential for regulatory arbitrage, with some requiring margin and others providing for straightforward

exemptions. It would seem to expose large groups unduly to the risk of conflicting treatments in multiple jurisdictions. At the same time the approach appears to skirt round the treatment of potentially quite large exposures being held in institutions which present systemic risk, which could be problematic and not on the face of it in alignment with G20 intentions.

Consequently, BCBS/IOSCO should be aware that there will be not a “one covers all” solution especially for the implementation of the initial margin requirements and should set a date for applicability later than 1 January 2015.