European Banking Federation

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EBF comments on BCBS- IOSCO consultation on "*Margin requirements for non-centrally cleared derivatives*"

Key Points

- Mandatory two-way Initial Margin (IM) posting should be reconsidered in view of the serious negative effects that this would have. A better and equally effective approach would involve exemptions, the exchange of Variation Margin (VM), regulatory capital requirements, larger thresholds and only one-way IM where one of the counterparties is not prudentially supervised. In addition we assume that the posting of IM results in an equivalent reduction in capital in order to avoid double counting counterparty risks and exacerbating a liquidity drain. This should be made more explicit in the proposal.
- We support a full exemption from margin requirements for physically-settled FX forwards and swaps. The FX markets should not be subject to significant margin requirements that might interfere with a market that is already transparent, liquid, and has a well-functioning settlement process.
- Re-hypothecation should be allowed for both VM and IM. Without the possibility of re-hypothecation, liquidity will be strongly impacted and raise transaction costs and potentially funding levels for end users. Legal differences need to be recognised and fully understood: Requirements or exemptions must not presuppose a specific legal system but be open enough in order to prevent competitive disadvantages.
- To prevent an uneven playing field, the phase-in should not be staged solely on the trade volume of institutions but should be more risk-sensitive and also factor in other necessary prerequisites (legal framework for protection of netting and collateral arrangements, approval of models).
- We suggest that IM is introduced only after a thorough review of the cumulative impact of Basel 3 rules and mandatory clearing on global market liquidity, including an assessment to make sure that risks are not over-collateralized. In this way, 2020 seems a far more prudent and realistic timeframe than 2015, especially given the operational challenges with the implementation of the IM requirement. Consideration should be given to phasing-in for VM.
- The QIS greatly underestimates the amount of capital required in a stressed market situation. Consequently we believe that a new QIS should be carried out to design appropriate thresholds and calibrate the overall proposals.

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GENERAL COMMENTS

- OTC derivatives serve an important role in allowing companies to manage risks arising from their commercial activities. Setting a "universal two-way margin" requirement for non-centrally cleared derivatives represents a one-size-fits-all solution and presents challenges for effective liquidity and cash management.
- Initial margins on un-cleared OTC derivatives cannot be calibrated and implemented properly before regulators and the industry have a clear view on the scope of clearable derivatives by CCPs. This depends on CCP capability to offer adequate clearing solutions. OTC derivatives end users should not be penalized because clearing solutions have not been found yet or will never be found in some cases.
- 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 and which significantly negate the benefits of introducing an IM threshold of 50 million Euro. 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 current QIS underestimates the costs and impacts of the Basel Committee on Banking Supervision (BCBS) and IOSCO proposals. Some changes in the proposals (calculation of threshold at consolidated group level instead of netting set level) are not reflected in the QIS. These changes would result in higher IM requirements.
- Importantly, the EBF is concerned that the proposed IM regime is unworkable from a dispute resolution standpoint. There is no guidance on what is the appropriate resolution mechanism for a scenario where two firms are using completely different prudentially approved IM models. Here, it needs to be recognised that even generally identical models may come to very different results since different data will be used as a basis (e.g. differing historical data). Unless the process is designed upfront in such a way as to eliminate or minimize disputes – which may mean both firms using a single model with a few key inputs that are transparent to both parties - the disputes process will fail. This is of particular concern to banks given the punitive capital impact of outstanding collateral disputes. Additionally, it is unclear as to how it is envisaged that cash posted as IM would be segregated as this is not currently possible given contemporary market and legal practices: Any requirements in this respect must take into account the differences between legal systems and the requirements must therefore be open enough to cover a variety of solutions without prejudice or preference to a specific legal system.
- A requirement to exchange IM should not exist where the relevant collateral arrangements and netting agreements are insufficiently protected under applicable law. Otherwise, mandatory two-way margining would in fact increase risks significantly for the counterparties as covered entities may be required to post margin without knowing whether it could recover it in the case of the other party becoming insolvent.
- Furthermore, a common set of criteria or guidelines should be developed by the BCBS and IOSCO to further define what entities are to be considered to be Financial Entities

and/or Qualified Non Financial Entities. This applies both to the definition and the threshold. Otherwise, there is a clear risk that the scope of covered entities will differ significantly between jurisdictions.

- The EBF queries the arbitrary nature of the 10-day horizon for an estimated wind down period. In practice, 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 highlight that the proposed 99 percent confidence interval seems very demanding. Especially when combined with the higher capital requirements for derivatives users. The EBF would like to stress the difficulty in counting value at risk for complicated derivatives. With the current set up, the proposal in 3.1 of the consultation paper may mean that smaller actors are not able to hedge their positions.
- Some of the margin requirements in appendix A (standardised initial margin schedule), might be too high, considering the fact that they might deter companies from hedging, thus creating additional risks. As an example, the 6 percent IM requirement for foreign exchange/currency and 15 percent for commodities should be lowered.
- We fully support the general approach to allow for a phase-in, however, to prevent an uneven playing field, the phase-in should not be staged solely on the trade volume of institutions (thereby granting considerable competitive advantages to institutions with a trade volume just below the relevant thresholds). A better, more risk-sensitive approach would be a phase-in based on a combination of counterparty and transaction based thresholds. Furthermore, the availability of approved models, a sufficient degree of legal certainty and other aspects such as the risk management capabilities of counterparties should also be factored in. In addition, it should be explicitly stated in the principles that when one party to the contract is under the threshold for the phase-in, the exchange of margin will start only when the margin requirements apply to both parties. Moreover, any phase-in or extension should be measured from the date the rules come into effect.
- Regarding the QIS we would remark that the potential big difference in margin between model-based and scheduled-based approaches makes it very difficult for an institution to compete if it does not have the ability to work with model-based margins. This strengthens the case for longer phase-in in order to facilitate the development of appropriate models approved by regulators in an internationally consistent way.
- We would invite the BCBS and IOSCO, when drafting their final recommendations, to take into consideration the specificities of covered bond derivatives just as European Regulators have done so in the Regulation[1] (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR). Covered bond issuers are not allowed to post collateral and the fact is that preferential claims are given to counterparties of covered bond issuers and this provides equivalent protection against counterparty credit risk as noted in recital 24 of EMIR. If these qualities are not taken into consideration there could be serious implications for the covered bond market and for the European banking industry in

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF

particular. We emphasise that this could be generalised to exclude hedging, in line with EMIR.

- Furthermore, the EBF believes that derivatives facing SPVs in the context of securitisation and structured finance transactions (as defined by local regulators by reference to their own legal frameworks and market conditions) should be exempt from these requirements (and not just covered bond-related derivatives) on the basis that: (1) these transactions perform an important role in providing finance to the real economy and act as an important source of liquidity for banks, (2) such SPVs are limited recourse vehicles and exposure to them is, therefore, necessarily limited to their assets; (3) the creditors of these structures are limited in number; (4) these kinds of structures generally benefit from a security package (created in favour of all secured creditors including any swap banks) and are already collateralised – to require additional collateral would mean that such structures would become prohibitively expensive.
- We also ask the BCBS and IOSCO to examine alternative proposals that would achieve more effectively the shared objective of reducing systemic risk, while mitigating liquidity drain and limiting operational complexity. For example, examining the possibility for each covered entity to post all IMs (as calculated for its whole un-cleared derivatives portfolio, across all its counterparties and based on a multilateral netting) to a custodian/ fund may be useful if such a proposal would offer adequate protection to the financial system from the default of the covered institution, while mitigating the liquidity drain and improving the workability of the requirements.
- Overall, we stress that current proposals would not reduce risk but transfer it within the financial system. The current proposals will require additional positions in certain type of assets increasing most probably exposures to sovereign risks, additional repos transactions to collect collateral while creating counterparty risk or additional credit risk on the third party entity receiving the collateral. They will also deter careful analysis by covered entities of their counterparties' financial soundness.
- Finally, we ask for clarification as to whether the counterparties should collect IM either on a pre-trade basis or after the transaction. When specified in 3.10 in the consultation paper that IM "should be collected at the outset of a transaction", we think that it refers to a post-trade requirement. This would clarify the circumstances under which IM re-calculation for an existing portfolio of transactions has to be performed even if no changes have been made to the trade population. Further, it would clarify when a change in calculated IM for the portfolio would require the counterparties to actually collect additional IM (or pay back excess IM).

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 support the proposal to exempt margin requirements for physically-settled FX forwards and swaps regardless of maturity. This exemption should apply to all such transactions.

As noted by the U.S. Department of the Treasury in its proposed determination to exempt FX swaps and forwards from mandatory clearing, the risk profile of these instruments is quite different from other derivatives classes because of existing market price transparency, liquidity, and a well-functioning settlement processes.

While the requirement to exchange the full principal amounts and the short time to maturity concentrates the risk profile of an FX Swap or FX Forward on settlement risk, this risk is mitigated by transacting FX Swaps and FX Forwards in a well established secure infrastructure – CLS.

Small open economies (which are numerous in Europe) - more dependent on FX markets than larger economies - will suffer a more profound cost impact relative to the size of their economy than larger ones, especially when one considers their smaller systemic risk threat. Furthermore, these derivatives are essential for the risk management of corporates.

Moreover, FX spot, forwards and swaps are exempt under the Dodd-Frank Act. In order to ensure a level playing field and foster international trade and competition, exemptions for FX swaps and forwards should be aligned across jurisdictions and harmonized to a maximum extent.

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.

The EBF believes that re-hypothecation should be allowed for both VM and IM.

In the case of VM this is indispensible. As VM covers the current exposure due to the mark to market valuation of the derivative contract, it is crucial to transfer VM in full ownership (full title transfer) with re-use or re-hypothecation right directly to the counterparty , already from a

mere operational perspective. Exchange of VM (which may have to be adjusted on a daily or even intraday basis) can only be achieved in the requisite time frame and with sufficient legal certainty by way of full title transfer. Such full title transfer necessarily entails re-use rights. Any restrictions regarding full title transfer of VM would have extremely serious and far reaching consequences. A transfer of ownership should be possible for all counterparties regardless of national differences in tax legislation – especially in jurisdictions that have traditionally used pledge. For example, in some jurisdictions in Europe the use of transfer of title collateral is practically impossible as the tax laws have not been aligned with the Financial Collateral Directive 2002/47/EC.

As regards IM, we do not agree that there should be mandatory segregation or restrictions on the re-use right of IM (whether placed on a title transfer, or pledged, basis). Re-hypothecation of IM should also be permitted as far as a prior transfer of ownership has occurred in accordance with the applicable local law or with the prior consent of the counterparty. The liquidity squeeze that would arise would mean that it may simply not be possible for entities to hedge exposures at an economically feasible cost, once the cost of posting such collateral is taken into account. At least, re-use should be permitted within in a certain limit (cap or threshold). We acknowledge that insolvency regimes may not be able to handle re-hypothecated IM in some jurisdictions.

While supporting the re-hypothecation of IM where appropriate, we note that counterparty credit risk management will be challenging given different insolvencies regimes across jurisdictions. Thus, certain requirements regarding the protection of IM appear to be necessary.

However, we would also stress that any such requirements regarding the legal protection need to take into account the differences between legal systems and thus need to be stated in such a way that they do not prejudice certain legal systems or favour a certain jurisdictional approach over others as this would result in an uneven playing field globally.

In view of the above, we would strongly argue that the proposals should be accompanied by an initiative to harmonise insolvency regimes and the legal protection of netting and collateral arrangements.

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operation-al and transition costs associated with implementing the requirements? Are the pro-posed 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 introduction of mandatory margining for a significant portion of transactions will pose considerable operational challenges to all market participants. These challenges will be acerbated by the challenges resulting from the expected impact of regulatory changes on liquidity of assets qualifying for margining purposes.

We therefore generally welcome the proposal of staged implementation and an extended phase-in period in order to permit market participants to adjust their internal operations, IT-systems and contractual documentation to the new requirements.

However, we believe that the approach to stage the implementation solely in accordance with the total transaction volume of counterparties will result in market distortions. A better, more risk-sensitive approach would be a phase-in based on a combination of counterparty and transaction based thresholds. Furthermore, the availability of approved models, a sufficient degree of legal certainty and other aspects such as the risk management capabilities of counterparties should also be factored in. This would allow for a better calibration of the phase-in, result in a level playing-field and prevent regulatory arbitrage by counterparties.

In addition, we believe that the phase-in regime, which is currently restricted to initial margining, also has to cover variation margining. For many counterparties the introduction of mandatory variation margining will be almost as challenging as initial margining. For example, even though the exchange of VM 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 VM in all cases.

In view of the complexities of the new margining regime, the phase-in periods should be considerably extended. Also, it needs to be ensured that all counterparties affected will be able to

assess with sufficient time in advance at what point in time they will be covered by the new requirements (that is, which of the phase-in waves they will be included in).

We suggest that IM is introduced only after a thorough review of the cumulative impact of Basel 3 rules and CCP requirements on global market liquidity, including an assessment to make sure that risks are not over-collateralized. In this way, 2020 seems a far more prudent and realistic timeframe than 2015.

In any event, any phase-in or extension should be measured from the date the rules come into effect as the final rules must be known before systems can be developed to meet these new requirements.

Further to our remarks in our general comments section regarding the treatment of covered bonds under EMIR, we would like to again point out that covered bond issuers are not allowed to post collateral and the fact is that preferential claims are given to counterparties of covered bond issuers and this provides equivalent protection against counterparty credit risk. We urge the BCBS-IOSCO to fully consider recital 24 of EMIR.

Additionally, the EBF has concerns regarding the definitions (or lack of) and how practically some of the recommendations would be implemented, which may lead to substantially different outcomes (in terms of in-scope and out-of-scope clients). The primary concern is with the term "consolidated group" and how this is to be applied, as this is key for the purposes of calculating thresholds for phase-in periods. 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 EBF does not support a threshold determined by reference to a group rather than an entity. There are certain exceptions that ought to be applied in the event that regulators adopt this inappropriate approach however:

1. There should be the flexibility for regulators to recognise regulatory ring-fences within a group, such that the threshold for the ring-fenced part of the group is calculated independently of the rest of the group.

2. Uncleared OTC derivatives between members of the same group should not be included in the calculation of the threshold. If not, back-to-back transactions to transfer risk from the group member who faces a client to the group member who holds the market making book may cause a group to exceed a threshold when such back-to-back trading does not represent incremental systemic risk.

3. There needs to be the scope for regulators to exempt certain covered entities from the IM and VM requirements. Derivatives entered into by such exempt covered entities should not be included in the calculation of the phase-in thresholds. The EBF response picks out covered bond swaps entered into by covered bond issuers or regulated covered bonds[2]. These perform an important role in providing finance to the real economy (residential and commercial mortgages, credit cards, auto loans etc.) and act as an important source of liquidity for banks.

An example of the problem with reference to a group is in relation to investment firms that manage and/or advise a number of legally separate funds. We would expect that this calculation would be performed at individual fund level, but if the expectation is that it would be done at the investment firm level this would cause a problem.

Secondly, we are concerned with who would be responsible for providing the threshold details and what if any remedies would exist if this information was not provided.

Thirdly, a concern is the time period allowed from calculation of threshold to implementation date i.e. it is overnight. This does not give firms time to prepare to comply.

When considering threshold and phase-in periods, and put in the context of what is driving systemic risk, we would argue that other factors should be considered beyond those proposed in this 2nd consultation.

We would recommend a broad exemption for trades entered into for hedging (i.e. risk mitigating) purposes, or that the thresholds for such trades be set suitably high. OTC derivatives serve an important role in allowing companies to manage risks arising from their commercial activities. If a product type is made too expensive for the end user, due to additional margin requirements, the end user may shy away from doing any hedging, or alternatively use less suitable products that leave certain risks un-hedged. At an overall economic level this would increase the systemic vulnerability as hedging levels could generally decrease.

In addition, there are some types of OTC derivatives that may not be viewed as sufficiently liquid to be deemed eligible for clearing, but where the risks associated with these products are not of systemic significance. It is therefore important not to base the margin/collateral requirement (including threshold calculations) solely on what is cleared vs. non-cleared. This could, for example, unfairly penalize smaller markets where for liquidity reasons products are not clearing eligible and yet do not give rise to higher systemic risk.

[2] In line with our comments under our general comments section, this should extend to securitisation SPVs which equally perform an important role for the real economy.

Finally, we do have some other concerns on which we would appreciate further clarification:

- At present the requirements for intra-group transactions have been left to the discretion of local supervisors. This is a source of uncertainty for us, and potentially could lead to an uneven playing field across jurisdictions.
- We would also like to see more detail in the rules governing transactions between qualifying and non-qualifying entities during the phase-in timeline. Our primary concern here is that despite the phasing-in timeline we may see a sharp increase in transaction costs or decrease in market liquidity for non-cleared transactions as qualifying entities reflect the new regime.
- For clarity we would ask the BCBS and IOSCO to explain how a threshold of 50 million Euro has been set, e.g. why 50 million Euro as opposed to 70 million Euro?

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

While we understand the difficulties of such a QIS we do not know how far the participants' answers were made on a comparable basis so it is difficult to comment on the scientific robustness of the study. We have heard comments however that some respondents took as a basic assumption that the 50 million Euro IM threshold was to apply *vis-à-vis* each legal entity and not at consolidated group level while other comments we picked up questioned if the 8% figure representing what is supposed to be the "available unencumbered assets" is already used by banks mainly to comply with the LCR and thus not available at all. Clearly there was confusion in some quarters and this may have distorted the results it has been suggested.

One comment the EBF has relates to the large difference between the two margin model approaches, which suggests that the standardized approach warrants some refinement. The potential big difference in margin between model-based and scheduled-based approaches makes it very difficult for an institution to compete if it does not have the ability to work with model-based margins. This is a particular concern for smaller institutions. Given the documented difference in IM margin requirement between using (i) quantitative portfolio model or (ii) standardized schedule model as defined in Appendix A in terms of a multiple of 5.9x to 11.1x with zero or 50 million Euro threshold it would be advisable to reduce the IM requirement values by an equivalent scale in order to ensure a level playing field between smaller and larger financial institutions.

In this regard clarity is needed on how the IM exchange will work operationally in case of discrepancies. e.g. one party is using model (i) - quantitative portfolio margin model - and another is using model (ii) - standardized schedule model as defined in Appendix A. Which one of the IM amounts should be exchanged bilaterally – the largest or smallest IM number, or should different IM amounts be posted between counterparts? Since using model (i) as opposed

to model (ii) would reduce the IM amount by a multiple of 6-11 in accordance with the QIS study as stated in Appendix C, section 8, table 8, a failure to harmonize the IM amount to be exchanged would create an uneven playing field between the larger and more advanced financial institutions versus the smaller financial institutions where operational costs in developing or buying the appropriate model framework would be prohibitively high.

As a study into the cumulative impact of this proposal, when added to other regulatory initiatives covering risk, liquidity and capital, we strongly believe additional, more robust analysis is needed. For example, while supporting the concept of a phase-in period, we note that the period seems to simply mirror a similar phase-in period for LCR, but has the cumulative effect of these parallel phase-ins been calibrated? Also, should the proposal go ahead, then as previously stated in our response to question 3 , a start date of 2015 may not be realistic given the time needed to make required regulatory changes in national laws on the basis of new regulations, such as EMIR in Europe , and that market participants may need to undertake significant system development and work to be ready to meet all the requirements, e.g. to calculate IM, update or agree upon legal agreements, dispute resolution procedures, make changes to collateral management infrastructure, etc. We are further concerned that the QIS greatly underestimates the amount of capital required in a stressed market situation. As such, industry specifically requests that the BCBS and IOSCO undertake another, more robust QIS given the importance of this issue and the relatively weak formulation of this one.

Furthermore, the study presents a set of figures and assumptions on a global level, based on the input of major market participants. It therefore does not adequately assess the impact on smaller markets, where as previously mentioned for liquidity reasons products are not clearing eligible and yet do not give rise to higher systemic risk. We would like to stress the importance of analyzing this further and updating the proposal to ensure that smaller markets are not unfairly penalized.

The details of how an IM regime would be offset against already agreed Basel III capital requirements for counterparty and CVA risks also needs to be clarified. If no offset is anticipated then the relevant counterparty risks appear to be substantially double counted by introducing these two independent regimes.

In addition to the answers to the specific questions we recommend that when it comes to appendix B on the standardized haircut schedule, the BCBS and IOSCO should consider a further expansion of eligible asset classes with reference to the LCR definition of level 1 and level 2 (a and b) assets as specified in the Basel III document.

- General Observation regarding PARAGRAPH 4.1:

  We would refer you to the paragraph which begins "The illustrative list" and to the final sentence in that paragraph. This wording does not reflect current practice. Eligible collateral should either be denominated in the underlying trade obligation, or denominated in a liquid currency. However, such collateral can only be used subject to an appropriate haircut. Although, we are unsure about the 8% figure where there are other mitigating factors. Also, would this assume a double haircut 1) to compensate for the use of a currency that is not the same as the underlying obligations and 2) for the actual collateral type itself? Furthermore, it is not always clear how market participants should apply any additional haircut, for example with cross currency elements and when using a quantitative model.

  The currency haircut also suggests that there will be no netting between VM in different currencies, as is done in most cases today. This confirms once again that a longer phase-in period is needed also for VM, as this will result in many operational challenges.

- General observation regarding PARAGRAPH 4.4:

  Haircuts will become subject to either internal regulator approved models or standard haircut models as set by the BCBS and IOSCO. As each counterparty is free to apply either of the model types, it is likely that there will be many margin disputes resulting from the use of different models (as noted above, disputes which could also have a punitive character under Basel III). Can the BCBS and IOSCO provide further guidance on the use of different models by two counterparties to a trade, as current market practice is that a haircut model is agreed upon in the bilateral CSA thus eliminating the risk of disputes resulting from haircuts models? Shouldn't this established market practice (and existing agreements) be allowed to continue to operate?

- General observation - Extra-territoriality. Requirement 7 :

  We strongly believe that the issue of the treatment of branches needs to be closely coordinated with other regulatory initiatives and take into account the current international discussions on the coordination of the implementation of the new international framework for OTC derivatives.