Comments

on the BCBS/IOSCO Second Consultative Document "Margin requirements for non-centrally cleared derivatives"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Comments - **BCBS-IOSCO Second Consultative Document – Margin requirements for non-centrally cleared derivatives**

I. Introduction and summary of key concerns

The German banking sector welcomes the opportunity to comment on the second consultative document of the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) regarding margin requirements for non-centrally cleared derivatives (second consultative document).

We support the initiative to harmonise the regulatory framework for margining requirements in respect of non-centrally cleared derivatives (bilateral transactions) across jurisdictions. A set of common standards for margining requirements as well as close coordination between regulatory authorities with a view to a consistent implementation of the standards is of paramount importance to ensure safe and functioning financial markets and to avoid diverging or even conflicting regimes which would not only significantly impede cross border transactions but also distort competition.

However, while we agree with the general objective and also share the view that collateralisation of transactions is a very important and effective instrument for the reduction of counterparty risks in bilateral transactions, we continue to have very serious concerns over a central element of the proposal, namely the proposal to introduce a general requirement to exchange initial margins (mandatory initial margining) in respect of transactions between covered entities:

- Mandatory initial margining will have a severe impact on liquidity with fundamental and far reaching negative consequences for all market participants. Some of these consequences are described and evaluated in the qualitative impact study (QIS). However, we are convinced that this study actually understates these, not least because it does not sufficiently take into account the dynamic and self-amplifying effects of this approach: In the event of extraordinary market developments, the models for the calculation of the amount of required initial margin (both external and internal) will necessarily and automatically result in a continuous and ever-increasing need to improve or increase the initial margins to be posted and demanded by the relevant covered entities so that the overall total amount of initial margin required by counterparties in such extraordinary situations will be a multiple of the total initial margin set referred to in the QIS. The proposed threshold of 50 million EUR is significantly too low to have any meaningful effect on liquidity, in particular in view of the fact that the threshold is intended to be applied on group level. Likewise, the proposed minimum level of non-centrally cleared activities subject to the initial margin requirements (eight billion EUR) is significantly too low and could have very negative effects for the markets, in particular if it were to include hedging transactions.

- We also believe that the proposed initial margin requirement might increase existing risks, if BCBS/IOSCO deem cash collateral eligible for initial margin contributions. Receiving cash collateral as initial margin only replaces a limited counterparty risk (a potential gap of variation margin) by a full (initial margin amount) default risk regarding the bank maintaining the account the initial margin received is booked to.

- Moreover, we also believe that the potential legal and operational risks associated with mandatory initial margining in case of international transactions have not yet been taken into account to a sufficient degree: In case of international transactions, mandatory initial margining will require counterparties to subject a significant portion of their assets to a number of different jurisdictions with very different insolvency regimes and concepts for the protection of collateral. This will not only result in considerable operational and legal risks for the counterparties but will also significantly affect

the ability of resolution authorities to resolve or reorganise financial institutions under any future resolution regime. Thus, further harmonisation of the legal framework for netting, the protection of collateral and the insolvency as well as resolution regimes should be a necessary prerequisite before contemplating the introduction of an obligation to exchange initial margins.

- As regards the issue of client protection (addressed in the context of re-use rights) the significant differences between legal systems need to be taken into account. Before introducing any requirements regarding the level of client asset protection as a perquisite for re-use, it thus appears to be necessary to analyse in greater depth the various possible solutions under the differing legal systems and the effectiveness of the protection the various solutions actually afford to clients.

- In addition, we are concerned over the approach of BCBS and ICOSO to utilise initial margin requirements as incentive for CCP-clearing: A significant portion of transactions will always remain to be ineligible for CCP-clearing, in particular hedging transactions. Initial margining requirements can thus not have this desired effect. Rather, they may work as a disincentive to hedging transactions.

In the event that key elements of the proposal, in particular mandatory initial margining, will not be reviewed despite the above fundamental concerns, we would have a number of further observations to make on individual aspects of the proposal. In the following briefly summarize those which we consider to be of particular relevance:

- Key principle 2 – covered entities

  Should the concept of mandatory initial margining between counterparties qualifying as financial entities (FEs) or systemically important non-financial entities (qualified non-financial entities – QNFEs) be pursued despite the above described general concerns, such exchange of initial margins should at least not be required in all cases under all circumstances: In view of the fact that the exchange of variation margin in combination with capital requirements will be more appropriate in many circumstances, there should at least be an exemption with regard to a certain portion of the transaction volume of a counterparty. In addition, FEs and QNFEs should not be forced to exchange collateral where the relevant collateral arrangements and netting agreements are insufficiently protected under applicable law. In this case, mandatory two-way margining would in fact increase risks significantly for the counterparties.

  Furthermore, a common set of criteria or guidelines should be developed to further define what entities are to be considered to be FEs and/or QNFEs. Otherwise, there is a clear risk that the scope of covered entities will differ significantly between jurisdictions.

- Key principle 8 – phase-in

  We of course very much welcome the general idea of a phase-in regime with a four year period for a staged introduction of the initial margin requirements beginning in 2015, both in view of the significant operational and legal challenges the implementation of margining requirements will have as well as the expected negative impact this will have on market liquidity. However, we believe that the approach to stage the phase-in regarding initial margins solely based on the absolute transactions volume of an entity should be reconsidered. A better, more risk-sensitive approach would be a phase-in based on 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 an even playing-field and prevent regulatory arbitrage by counterparties.

Considering the above mentioned challenges the new margining regime will pose to all market participants and its expected impact on liquidity, it should also be considered to expand the timeframe for the proposed phase-in period.
In addition, we believe that the phase-in regime, which is currently limited to initial margining, should also cover variation margining: For many counterparties the introduction of mandatory variation margining will be almost as challenging as initial margining. A staged phase-in process along the lines of that for initial margining would greatly help to ensure an efficient implementation process.

We also believe that the timeframe for the phase-in period should be expanded in view of the complexity of the issues involved and the operational challenges involved, including, for example, the necessary assessment of the legal framework and review and adjustment of the entire contractual documentation for all transactions to be covered.

- Standardised initial margin and haircuts schedules

The proposed schedules are overly conservative and thus may discourage counterparties to rely on these.

- Impact Study

We very much welcome the fact that an impact study has been undertaken. We, however, believe that the study understates the impact of mandatory initial margining on liquidity (see comments above on the self-amplifying effects of the models for the calculation of initial margins) and overstates positive effects of the use of internal models (which may not be used in practice as much as anticipated)

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II. Comments on key principles and requirements / responses to questions

- **Key principle 1 / Requirement 1/ Question 1 (material scope/exemption for physically settled FX transactions)**

> 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 concur with the assessment that the primary risk connected with physically settled FX forwards and swaps is the settlement risk ("Herstatt risk") and that therefore an exemption from margin requirements would be justified where the delivery obligations under a physically settled FX forward or swap have been included in a settlement system that ensures simultaneous exchange of payment. Such settlement system and the products covered by it would also determine the scope of any such exemption: A differentiation on the basis of maturity as such would thus not be merited.

As to the overall effects of such exemption, the following has to be considered: Such exemption from mandatory margining requirements may, in most cases, apply to initial margin only: Where counterparties do enter into both physically settled FX transactions and other types of derivatives, these transactions will generally be subject to the same close-out netting agreement which combines all such transactions into a single portfolio. This makes it operationally difficult, if not impossible, to distinguish between individual transactions. An exemption from variation margining as well as initial margining would, however, of course benefit counterparties which exclusively enter in to physically settled FX transactions.

- **Key principle 2 / Requirements 2.1 and 2.4 (mandatory margining for covered entities)**

Should the concept of mandatory initial margining between counterparties qualifying as financial entities (FEs) or systemically important non-financial entities (qualified non-financial entities – QNFEs) be pursued despite the above described general concerns, such exchange of initial margins should at least not be required in all cases under all circumstances:

For one, other methods of risk mitigation, in particular capital requirements in combination with variation margins may often be more appropriate and equally effective. We would therefore urge the BCBS and IOSCO to permit a certain degree of flexibility in this respect. One possible approach may be the introduction of a threshold or cap permitting covered entities to enter into in respect of a certain portion of their transaction volume without having to exchange initial margin (subject to the proviso that variation margin is posted by both counterparties and that the relevant capital requirements are being observed).

In addition, margining requirements can under certain circumstances actually increase risks for a counterparty and thus be counterproductive. This is the case where collateral were to be exchanged with a counterparty subject to the laws of a jurisdiction which does not sufficiently protect collateralisation of derivative transactions or close-out netting agreements. Thus, margining (initial and variation margin) should not be mandatory in relation to transactions where the legal protection of collateralisation and netting agreements is insufficient. In this connection we do note that the consultative document

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addresses the issue of the legal protection of netting and collateral arrangements in a number of places. However, the consultative document does currently not provide for an exemption where the requisite legal certainty does not exist (as to the fundamental concerns this issue raises, in particular regarding operational risks and the challenges this poses to resolution and reorganisation measures, see also our comments in the introduction). In this context, it also needs to be noted that in the case of cash collateral, mandatory exchange of initial margin replaces a limited counterparty risk (a potential gap of variation margin) by a full (initial margin amount) counterparty default risk – or in the event of a third-party custodian account – a counterparty risk of the third-part where the accounts are maintained.

Furthermore, it should also be considered to limit the requirement for providing two-way initial margin to transactions where both parties are prudentially supervised FEs. Where one party is a prudentially supervised FE and the other party is either a FE neither subject to capital requirements nor subject to regulatory limits on the amount of non-centrally cleared OTC-transactions or a QNFE, only the relevant FE or QNFE should post initial margin. This would significantly reduce the negative impact of initial margin requirements on liquidity and also recognise to some extent the interplay between capital requirements or other regulatory requirements regarding OTC-derivatives on the one hand and collateralisation on the other hand.

- **Key principle 2 / Requirements 2.1 and 2.4 (definition of the scope of covered entities)**

The consultative document does currently not provide for any guidelines or set of criteria to define more clearly what entities would have to be qualified as NFEs, QNFEs or FEs and leaves this to the jurisdictions. However, in order to avoid inconsistencies and an uneven playing field, - both of which would invite regulatory arbitrage - it needs to be ensured that the definitions do not diverge significantly across jurisdictions.

It should therefore at least be considered to set out general criteria or guidelines and require the jurisdictions and supervisory authorities to coordinate their approaches in advance.

- **Key principle 2 / Requirement 2.2 (initial margin threshold / amount)**

Thresholds for initial margins - just as minimum transfer amounts for variation margins – serve to prevent unreasonable effects. We therefore welcome that the proposal provides for this instrument. However, the threshold amount proposed (in the form of fixed uniform amount) is too low to achieve the desired objective and thus should be increased.

- **Requirement 2.2 - application of initial margin threshold on group level**

The proposed implementation and monitoring of the application of the threshold for the requirement to exchange initial margins on a group level will be virtually impossible in practice, not only for the group-wide risk management and may result in unavoidable unreasonable effects: In order to make group-wide margining management operationally reliable, it would be necessary to sub-allocate thresholds to individual group members (supported by a formal credit approval). These sub-allocated thresholds would need to be monitored continuously on a group level. In the event a sub-allocated threshold is exceeded by one group member, the initial margin requirement of such member would be triggered irrespective of whether the group-wide threshold is actually triggered or not since a readjustment or reallocation of thresholds would require a new credit approval and this will in most cases not occur on a daily basis.

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The proposal as it stands would also not distinguish between groups where individual members are subject to different and potentially more demanding prudential requirements on the one hand and groups where no prudential requirements exist or where these are applied uniformly at group level. The existence of such capital requirements applicable to group members should be adequately reflected, i.e. by giving rise to an exemption from the application of the initial margin requirement on group level or at least result in an adequate adjustment of the relevant threshold to account for this fact.

In view of the above we believe that the application on group-level needs should not be adopted.

In order to prevent uncertainties and also a distortion of competition between jurisdictions, it should be considered to set out guidance on the definition of a group. Such guidance should also address the very specific challenges posed by investment management companies and other structures which may be classified as a group to some extent but are not comparable to a group of companies.

- **Requirement 2.3 - Minimum transfer amount**

A minimum transfer amount reduces the costs of exchanging collateral and determines the maximum uncollateralized amount. It is an indispensable instrument to ensure that variation margin does not need to be adjusted where the amounts involved are disproportionate to the considerable operational costs and risks any exchange of collateral entails.

However, the amount proposed under item 2.3 of the second consultative document (100,000 € is, is significantly too low to achieve this objective. A minimum transfer amount of in the area of 300,000 € would be more appropriate and also risk adequate.

- **Requirement 2.5 – Minimum level of activities subject to initial margin requirements**

The proposed minimum level of non-centrally cleared activities subject to the initial margin requirements (eight billion EUR) is significantly too low and could have very negative effects for the markets, in particular if it were to include hedging transactions: Although CCP-clearing will expand in the next years, a significant portion of transactions will nonetheless remain to be ineligible for CCP-clearing, in particular hedging transactions. The proposed minimum level would direct impact

It should therefore at least be considered to exclude hedging transactions and/or adjust this level in line with the development of CCP-clearing.

- **Key principle 3 / Requirements 3.1 to 3.12 – Methodology for the calculation of initial and variation margin**

We welcome the fact that the proposals aim at ensuring consistency with the corresponding requirements under the new capital requirements framework as such consistency is an essential element to prevent distortive effects, conflicts and also regulatory arbitrage.

However, 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.

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As regards the reliance on internal models, we fully support the approach to permit counterparties to rely on internal models. However, in practice, internal models may eventually be relied upon to a lesser extent than anticipated because of the inherent difficulties associated therewith: Even where counterparties use similar models, the calculations may nevertheless differ simply because the historical data will always differ between institutions. Reliance on internal models may therefore often require extensive negotiations. . As to the implications for the impact study, see our comments below.

- **Key principle 4 / Requirements 4.1 to 4.5 (eligibility criteria for collateral)**

We agree with the approach to set out a non-exhaustive list of illustrative examples for eligible collateral thereby potentially permitting reliance on a wider range of collateral. This approach especially allows market participants such as UCITS (which are subject to very strict requirements and restrictions regarding collateralisation).

However, the impact this will have on the overall liquidity of eligible collateral should not be overestimated: In practice, counterparties will primarily rely on a limited range of collateral for margining purposes in view of their risk management policies and also operational requirements. Variation margin will, for example, largely be posted in cash.

In addition to restrictive or rigid rules regarding the manner in which such additional types of collateral can be posted (i.e. in respect of gold or other precious metals) would greatly reduce any positive effects.

Specifics regarding covered bonds
Derivative transactions for covered bond cover pools are collateralized bilaterally, however only the counterparty posts collateral. The cover bond issuer on the other hand is obliged to ensure that the counterparty's claims under the derivative transaction - along with the claims of the covered bond holders - are covered by the very high quality assets of the cover pool at any time.

Under the applicable legal frameworks to covered bonds, the cover pool assets must fulfill restrictive legal requirements with regard to asset types, asset matching, etc. In addition, it is common practice and in some member states (i.e. Germany) even required that cover pools of covered bonds are over-collateralized. In the event of the covered bond issuer's insolvency, the counterparty has a preferential claim on the cover pool, ranking pari passu with the other covered bond holders. This preferential claim should be considered by BCBS and IOSCO as an equivalent and appropriate collateralization.

Against this background two-way margining in respect of transactions for cover pools would effectively constitute a second level of privilege and represent an unmerited additional benefit for the counterparty which ranks pari passu with the covered bondholders. In some jurisdictions, covered bond cover pools are therefore not permitted to post margins.

Hence, we urge the BCBS and IOSCO to duly take into account the impediments faced by covered bonds issuers or cover pools in posting collateral as already done by the European legislator in recital 24 of EMIR, which states that "[…preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk]".

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- **Key principle 5 / Question 2 (re-use, re-pledge/re-hypothecation)**

> 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.

We understand the proposal to discuss potential restrictions on re-use, re-hypothecation or re-pledge (re-use) only in respect of 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 (which entails a re-use right). Any other understanding would have very serious consequences for liquidity by far exceeding those addressed in the qualitative impact study.

As to the potential restrictions on re-use in respect of initial margins we do share the view that such re-use should be permissible 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 result in 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 or priority claims in respect of client assets in insolvency proceedings. Any requirement based on the concept of priority claims could thus necessarily not be met by a large number of jurisdictions. It also may raise questions regarding the equal treatment of creditors. Before introducing any requirements regarding the level of client asset protection as a perquisite for re-use, it thus appears to be necessary to analyse in greater depth the various possible solutions under the differing legal systems and the effectiveness of the protection the various solutions actually afford to clients. Ultimately it is questionable whether the negative consequences of any requirements effectively restricting the use of full title transfer arrangements may not outweigh the limited positive effects.

In this context the particular issue of cash collateral would have to be taken into account: Cash collateral can generally only be transferred by way of full title transfer. Other forms of collateralisation of cash, such as pledges regarding the claims against the account where the cash is deposited or third-party accounts are very cumbersome and/or may actually entail other risks or only replace risk (i.e third party custodian accounts effectively only exchange the credit risk of one party with that of the third party).

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- **Key principle 8 / requirements 8.1 to 8.10/ Question 3 – phase-in**

> 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 very much welcome the general idea of a phase-in regime, both in view of the significant operational and legal challenges covered entities will face in connection with the implementation of margining requirements as well as the expected negative impact the increase of margining will have on market liquidity.

However, we believe that the approach to stage the phase-in regarding initial margins solely based on the absolute transactions volume of an entity needs to be reconsidered as it is too simplistic thereby potentially distort competition while inviting arbitrage.
A better, more risk-sensitive approach would be a phase-in based on a combination of counterparty and transaction related thresholds. In addition, 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 (as to the considerable risks resulting from insufficient legal protection of collateral and netting arrangements, see our comments above). Such a combination of thresholds and other factors would allow for a better calibration of the phase-in. This would not only ensure a more risk-sensitive implementation of the new requirements but also result in an even playing-field between the covered entities and prevent regulatory arbitrage by counterparties.

Furthermore, 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.

We also believe that the timeframe for the phase-in period should be expanded in view of the complexity of the issues involved and the operational challenges market participants face, including, for example, the necessary assessment of the legal framework and review and adjustment of the entire contractual documentation. Experience with other similarly fundamental structural changes to the financial market infrastructure have demonstrated that these are significantly more complex and time consuming than originally anticipated.

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Furthermore, it is still unclear how the (a) minimum level of non-centrally cleared OTC derivatives activity (EUR 8 billion gross notional outstanding amount), (b) the EUR 50 million threshold and (c) the de-minimis minimum transfer amount of max. EUR 100.000 are intended to work together in this context (as to our general concerns over the amounts proposed, see our comments above).

In any event, all potentially affected counterparties need to be able to assess with sufficient time in advance at what stage they will become subject to the new margining requirements. Thus, the phase-in needs to be structured in such a manner that all covered entities are aware from the outset of the point in time from which they will be covered (that is, which wave they will belong).

- **Appendix A – standardized initial margin schedule**

We believe that the proposed schedule is overly conservative and rigid.

A readjustment and slightly less conservative approach would also encourage counterparties to rely on the schedule instead of electing reliance on internal models.

- **Appendix B – standardized haircut schedule**

As in the case of Appendix A the proposed haircuts appear to be overly conservative. In addition, certain clarifications regarding the practical application would be helpful. For example, it is currently not entirely clear what haircut would have to be applied in a situation where the currency of the notional amount is not the currency of the place where one or either of the counterparties is established or the currency of the close-out amount payable in the case of a default of one of the counterparties.

- **Appendix C /Question 4 – Quantitative impact study**

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

We very much welcome the fact that an impact study has been undertaken. The impact study is an extremely helpful instrument to point out potential unintended consequences and explore interrelations of the proposal with other regulatory measures. In particularly, we welcome the focus on the issue of liquidity and fully recognise the difficulties and challenges the study faced.

However, we nevertheless believe that the study understates the impact of mandatory initial margining on liquidity (see comments above on the self-amplifying effects of the models for the calculation of initial margins) and overstates positive effects of the use of internal models (which may, in view of the complications this may entail, not be used in practice as much as anticipated). We also would have welcomed a further analysis of the implications the fragmentation of assets across jurisdictions resulting from mandatory initial margining would have on an operational and default risk management level (see our comments above on the legal risks resulting from insufficient legal protection of collateral and netting arrangements).