Comments

of the German Insurance Association

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on BCBS - IOSCO's Second Consultative Document regarding Margin requirements for non-centrally cleared derivatives

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Summary

The German insurance industry appreciates the opportunity of contributing its views on the BCBS-IOSCO working group's second consultative document regarding margin requirements for non-centrally cleared derivatives.

As a general comment we would like to observe, that variation margining seems to us the effective and sufficient way to mitigate risks of non-centrally cleared derivative transactions. Initial margining in the case of bilateral OTC-derivatives may on the contrary lead to new, additional risks.

With respect to specific questions arisen in BCBS-IOSCO's consultative document, we would like to summarize the German insurers' positions as follows:

1. Physically-settled FX forwards and swaps transactions should be exempted from the initial margin requirement. Different maturities should not lead to different treatments.

2. German insurers are not in favor of the possibility to re-hypothecate initial margins.

3. The proposed phase-in arrangements seem appropriate to German insurers.

4. We would estimate the figures of the model-based bilateral margin requirements average higher than summarized in the executive summary.

1. Introduction

German insurers appreciate the opportunity to respond to BCBS-IOSCO's second consultative document on margin requirements for non-centrally cleared derivatives. We support the international regulatory community's efforts to promote international standards for the margining and regulation of non-cleared OTC derivative transactions.

German insurers do not expect to face problems as regards the introduction of variable margins. Many Insurers already have corresponding internal guidelines in place in order to cover counterparty-risks arising from derivative transactions with external counterparties.

Variation margining is the appropriate, effective and sufficient way to mitigate risks of non-centrally cleared derivative transactions through the transfer of values. On the contrary, initial margining may be counterproductive to the objective of risk reduction. In fact, bilateral initial margining increases counterparty-risks instead of reducing it. The document itself confirms this under 5 (a) on the top of page 18:

> *"Although a firm has received initial margin as collateral, the firm also now bears the risk of additional loss on the initial margin that it has provided to the counterparty if the counterparty defaults, which may offset some or all of the benefits of the initial margin received."*

This statement in our view points into the right direction, but the subsequent conclusion is not made: Bilateral initial margining doesn't make sense as long as the collateral is posted with the counterparty of the transaction. We believe it would only make sense if the collateral were posted with an external third party - just like required for centrally cleared derivative transactions.

Finally, we would like to reiterate that transactions concluded between counterparties belonging to the same group (intragroup transactions) should not be subject to any margin requirements. Intragroup transactions are concluded for risk management purposes within the group. They do not change the group's overall risk profile, nor do they have any market impact outside the group.

2. Physically-settled FX Forwards and Swaps

As a consequence of our statements made in the introduction above, all non-centrally cleared derivatives should be excluded from initial margining. However, physically-settled FX forwards and swaps are special cases of derivative transactions from a risk point of view and should be exempted a fortiori, as the notional of these transactions will be exchanged between the counterparties at trade inception.

As regards different maturities, one variation margin requirement for all seems sufficient to cover the risks from currency fluctuations.

3. Re-Hypothecation

German Insurers are not in favor of the possibility to re-hypothecate initial margins. No or lower initial margin requirements seem more appropriate and advisable from a risk perspective point of view. In this context we are referring to our statements made in the introduction. Additionally, we would like to point out that German insurers almost exclusively enter into derivative contracts for purposes of protection or hedging their commitments against policy holders. The insurers' concept of using derivative transactions strongly differs from the banking sectors' business. We therefor strongly suggest the BCBS-IOSCO working group to exempt insurers from the duty to post upfront initial margin, at least where derivative transactions are entered into for reasons of asset liability management.

4. Phase-In

In general, the proposed phase-in arrangements seem appropriate to the German insurers.

The latest stage of the levels introduced (2019 and beyond with EUR 8 billion from EUR 0.75 trillion in 2018) might lead to the effect that a broad range of not systemically important firms will be affected by the regulation in a short period of time. This might have a negative effect on the quality of collateral then available to these entities.

5. QIS Study

We would like to note, that the results of the QIS study do not seem perfectly feasible to us. The figures introduced will lead to a potential shortfall in liquid and eligible collateral even when implementing the phase-in approach. That said we would see the figures higher than summarized in the executive summary (see Appendix C, clause 1, lit. f, g) in terms of initial margin depending on notional amount and unencumbered assets.

In a market which accounts for approximately USD 640 trillion and where future exposure has to be collateralized with initial margin and variation margin an estimated average of only 0.5 % of gross notional exposure seems to be very low (for initial margin). Some German insurers have evaluated an average of 2 - 3 % based on risk models provided by different CCPs. In some cases the initial margin was calculated up to 6 %.

Berlin, 15th March 2013