BCBS242: Margin requirements for non-centrally-cleared derivatives (Second Consultative Document)

HSBC Response

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General Remarks

HSBC welcomes WGMR's decision to issue a second consultation document and to continue working with the industry on developing these important rules.

The consultation document investigates a number of potential ways to mitigate the extreme liquidity impact of bilateral segregated exchange of initial margin (IM), such as permitting limited rehypothecation, allowing netting in the standardised schedule, setting thresholds and providing a phase-in schedule. Recognition of the need to manage liquidity in the system is extremely important and we agree it is also logical to exempt physically settled FX forwards and swaps.

We are concerned however that these measures don't go far enough, that the liquidity impact would still be too high, and also that risk management using derivatives would no longer be economically viable for our clients. We also note that our concerns about systemic risk have not been addressed: in particular the combination of requiring high levels of margin, to be posted in a largely untested operational environment, whilst generating new financing requirements and systematic drains on liquidity. Nor have the unintended consequences of a move to such a procyclical and liquidity intensive regime been assessed.

HSBC supports universal exchange of variation margin (VM) between covered entities. As detailed in our first response, universal VM together with a capital framework strengthened by Basel 3 form a key systemic risk mitigant.

HSBC have contributed to the ISDA response and support the points made there. In this response we will concentrate on topics not covered by the industry response or which particularly affect HSBC. These include:

- Calculation of thresholds on a group basis is operationally difficult, legally unworkable and puts firms with a subsidiary structure at a disadvantage
- Calibration of threshold driven by arbitrary limits of the initial QIS (see answer Q4)
- Margin rules will incentivise participation from firms with poorer credit quality at the expense of those with better credit quality
- Margining should be linked to the availability of clearing solutions, encouraging clearing where this is available, but not penalising the offering of products which are not clearable
- Instead of allowing limited rehypothecation, margin levels should be reviewed to reduce the liquidity impact
- VM should be cash in the relevant trade currency only
- Credit rating triggers should not be permitted
- The consultation paper does not address non-netting jurisdictions
- Margin rules don't leave flexibility for prime brokerage-style business models or cross-product margining
- Derivatives with SPVs should be exempt

Thresholds on group basis

HSBC appreciates the efforts to reduce the overall liquidity impact of the new regulations by allowing thresholds. However, we do not believe these are operationally or legally viable.

Each legal entity contracts separately with each other legal entity and thresholds form part of this contractual relationship. So it is not possible to have a threshold spanning these entities without fully defining how they interact, or more particularly splitting the threshold between these entities, thereby dismantling the group threshold concept.

Further, thresholds at group level put financial groups operating in a subsidiary model, like HSBC, at a disadvantage to firms operating a branch model. A subsidiary model is more expensive to run, but it is widely acknowledged to give local regulators the safeguards of separately capitalised local entities, making the group easier to resolve, and strengthening financial stability. More robust structures should not be penalised by regulation.

If IM is to apply to intra-group transactions then it is inconsistent to set the threshold on a group basis.

Clarification is needed on the definition of a "group" in the context of asset managers. Would such a threshold apply on the level of the asset management company, covering all of its funds? Or will the threshold apply on the level of the end-client, i.e. one client having multiple funds with multiple asset management companies? Should the

threshold apply on the level of the asset management company, the costs of margining could not accurately be allocated back to individual sub-funds as IM by definition is a portfolio calculation. Unless the trading costs attributable to a sub-fund are a result of its specific trades, there is potential for the fund manager to violate the mandate given to it by each of the sub-funds.

Thresholds at group level will also pose operational challenges. It is not clear how the collecting party can verify that the intake of IM is correct. Relying on data provided by the counterparty who needs to post IM will introduce, due to the information asymmetry, a moral hazard.

HSBC would like to propose that IM thresholds are introduced for each separate legal entity and not on any basis associated with connectivity. The level of the threshold will be a function of credit worthiness. This will reduce operational complexity and ambiguity. The connectivity constraints are already effective through large exposure regimes operational in most jurisdictions.

Good credit quality will be disincentivised

Current proposals for margining do not differentiate between financially sound, robust organisations and weaker ones. Expensive and penal margining requirements will mitigate the overall loss potential of a default of a market participant, but do little to make the overall financial system safer, because there is no incentive for market users to deal with stronger organisations.

If weaker market participants take a substantial market share, material reliance is placed on the effectiveness and sufficiency of the collateral posted. HSBC strongly believes that a sound financial system is a function of the credit worthiness of its material market participants. The stronger the participants, the sounder the financial system will be. This is the driver of our proposal that the level of the IM should reflect the credit worthiness of each participant. Limiting the capital requirement from non-cleared OTC derivatives to a percentage of tier one capital as described in our initial response would fulfill this aim, as the capital framework would take account of counterparty quality.

Margining should be linked to the availability of clearing solutions

An objective of the margin rules is to incentivise central clearing. The industry is already incentivised by the capital framework to clear centrally, demonstrated by the amount of transactions now cleared between dealers. However, if margin rules are to penalise uncleared transactions, such a disincentive should at least be restricted to product types where market participants are actually able to clear. For example, it makes little sense to penalise uncleared cross currency swaps or FX options while there is no viable clearing solution available.

Lower margin levels instead of limited rehypothecation

Limited rehypothecation has several drawbacks:

- There is a limited number of jurisdictions where limited rehypothecation could work. Imposing it would lead to a materially distorted playing field.
- Firms generally do not hedge exposures one-by-one
- Limited rehypothecation would operationally be very difficult.

A simpler and more direct approach would be to analyse whether the systemic risk would be mitigated sufficiently through lower levels of IM. This could be effected, for example, by application of the 50th percentile, or a shorter VaR period or both.

VM should be cash in trade currency

Trade compression and incentives to move to central clearing are important policy tools to reduce complexity and linkage in financial markets. HSBC believes that the current proposals for VM margining in bilateral CSA are in conflict with achieving these goals.

We believe that these aims can only be achieved by putting much more emphasis and scrutiny on valuation dispute resolution. This can be improved by either eliminating or disincentivising the posting of other collateral than cash in the trade currency. The multi-currency option within the existing CSAs, i.e. the option to post collateral in a different

currency than the trade currency, is one of the biggest sources of valuation disputes. The availability of this option with the resulting valuation differences not only creates uncovered credit exposure, but also makes trade compression less likely, undermining the aim of moving more business to central clearing.

HSBC strongly supports valuation principles within the bilateral world to mirror those of the CCP. We believe that any valuation which would not follow CCP principles should be ruled out or discouraged. It is for this reason that HSBC gives very strong support to the inclusion of haircuts on collateral other than cash in the trade currency for VM, as this is the only effective tool to achieve the aims of trade compression and bring the business to the CCPs. The proposed haircut of 8% in the BSCS 242 for posted collateral in a currency other than the trade currency should not be watered down, or this will surely undermine the efforts of establishing central clearing as the future venue for most derivatives business.

In this context, special care needs to be applied to cross currency products which by definition have two trade currencies. As a consequence, a common valuation can only be achieved if all cross currency products have one global uniform discounting currency for all currency pairs. Any deviation in collateral posted from the one global discounting currency should result in haircuts being applied to the posted collateral. One negative implication of this is that the currency of the collateral can be different from the two trade currencies. However, not following this principle will lead to a valuation imbalance in the market and will make trade compression more burdensome and potentially impossible without friction.

For IM, counterparties will have to agree a currency in which the IM is calculated (calculation currency). By doing that, potential movements of the calculation currency against currencies of underlying trades is already included in the VaR calculation. If the counterparties then exchange collateral in this calculation currency no FX mismatch collateral should be applicable. The calculation currency will not always be the same as the underlying currencies, but by calculating the VaR in the calculation currency any currency movements are already taken into account at the appropriate percentile. This treatment is also in line with CCP practices.

Rating triggers should be disallowed

Rating triggers are common risk mitigants in lending agreements. In loan agreements they offer protection to the lender as he can terminate the loan early upon a worsening of the credit worthiness of the borrower. Typically, they protect the bank against an idiosyncratic risk in its credit portfolio.

Although the rationale to include rating triggers in derivatives contracts is similar to the loan case above, rating triggers within derivatives contracts can create a dynamic of their own in certain markets, which can result in cliff effects and therefore increase systemic risk.

At the height of the financial crisis, big institutional investors used their market power to renegotiate CSA with their bank counterparties to include a rating trigger upon a bank's downgrade. Banks, in their status severely weakened by the financial crisis, could only protect market share by accepting rating triggers.

The fiduciary role of many institutional investors makes them ask for the same protection from each bank and the competitive environment of institutional investors makes more of these investors ask for similar protection so they can compete on equal terms.

In liquid markets in products with little credit constraints a rating trigger may not be that harmful, as both the investor and the bank can rehedge without too much frictional cost.

However, in illiquid markets (with few market makers) with credit sensitive systemic flow (one-way from bank to investor base), which is very common in the institutional insurance and pension space, a rating event is a disruptive event and can cause a cliff effect when the affected bank has large positions. The derivatives flow is at risk of disruption when remaining market makers and investors have credit constraints in dealing with each other and where the investor can also choose to go long on the equivalent cash instrument (e.g. a bond). In such a situation the bank might not only need to pay the credit transformation price at the wrong time, but might not find a price at all. This issue will become a concern the more rating triggers there are on the same side of the market (in systemic markets it will be on one side).

Non-netting jurisdictions

In some jurisdictions netting agreements are not enforceable and exchanging collateral might actually increase risk.

Unfortunately the second consultation paper is silent on how to deal with such non-netting jurisdictions. These margin rules would leave no room for transactions between a jurisdiction applying the margin rules as defined in this consultation paper and a jurisdiction without the necessary legal framework. This would lead to further fragmentation in markets and might affect international trade.

HSBC suggests exempting such jurisdictions at least for a longer phase-in period to allow them to change their legal frameworks. During this period firms would be covered by the large capital requirement that stems from having to calculate risk on a gross basis without taking any netting into account.

No flexibility for prime brokerage-style business models or cross-product margining

The proposed rules do not explicitly allow for a prime brokerage-style business model where exposures and collateral are evaluated together on a portfolio basis. Nor do they provide clarity with respect to whether cross product margining between ETD, cleared and un-cleared derivatives and securities financing transactions will continue to be permitted. Counterparties routinely hedge across traditional product silos and across different legal entities of a bank to reduce portfolio volatility. These activities should be allowed / encouraged under proposed regulations. Proposed rules should be clarified to state that cross-product margining and the prime-style business model should be allowed where legally enforceable.

Generally prime brokers take a holistic approach to margining a given client's outstanding transactions against the prime brokerage entity and the collateral supporting such transactions. The risk of the portfolio, inclusive of collateral, is considered as a whole to determine an appropriate margin requirement. These practices are well-established across the industry, have been tested through the most recent crisis and others preceding it, and are backed up by legally-enforceable cross-product netting agreements.

In many cases netting within the calculation of margin is carried out across product types within a specific asset class. For example, equity collateral, stock borrowing, OTC equity derivatives, exchange-traded equity derivatives and equity-linked notes might all be considered together in a portfolio margin calculation, with recognition given to basis risk and varying liquidity between products. Consideration of such portfolios within one portfolio margin calculation does not undermine risk management standards, but rather it allows margining to reflect more accurately the exposure faced by a prime broker. Being able to recognise the offset between client assets and derivatives used to hedge any unwanted exposures in those assets is not only central to prime brokerage, but it also ensures that firms are able to manage their market risk exposures effectively without a detrimental impact on their liquidity.

The rules, as they are currently contemplated, do not provide sufficient guidance on whether the margin calculations applicable to non-cleared OTC derivative transactions and any collateral applicable to such transactions can be considered on a holistic basis along with other products in the same asset class. It is feasible for prime brokers to ensure under such a framework that the margining standards applicable to non-cleared OTC derivatives as envisaged under BCBS242 are maintained. Many prime brokers already employ margining models that consider both through-the-cycle scenarios and recent market volatility and are subject to similar confidence level and risk horizon assumptions as those under BCBS242. However, as drafted, the rules create ambiguity as to whether current practice in prime brokerage can continue in its current form despite the fact that it has been shown to be robust and consistent with best practice in risk management and the spirit of BCBS242.

Explicit consideration should also be given in the rules to recognition of FX, rate, and credit hedges to exposures embedded within other instruments either within the same or other asset classes. Such recognition does not constitute margining across asset classes since it relates solely to margining on a portfolio basis of these specific risks only. However the rules as drafted create an ambiguity as to whether such practices could continue. Not permitting recognition of such hedging practices within the calculation of IM would have a detrimental impact on the liquidity of asset managers seeking to manage currency, rate and credit exposures embedded in their portfolios.

We also believe risks within a counterparty's cleared and non-cleared portfolios should be assessed jointly when determining IM requirements. With appropriate documentation in place, banks retain a perfected legal interest in collateral / proceeds held at clearing venues following a counterparty liquidation. This lien effectively integrates the risks of a counterparty's cleared and non-cleared portfolios for close-out purposes. We support that counterparties should post the minimum initial margin required by clearing venues. We feel, however, that the risk of cleared transactions should then be assessed jointly with a counterparty's non-cleared positions/transactions when determining total IM required. Counterparties should be allowed to commit margin based on the net risk of their portfolio, subject to the minimum requirements (floor) calculated / collected by the relevant clearing venues.

Derivatives with SPVs should be exempt

SPVs for the purpose of repacking assets should be exempt from the margining rules. Typically, but not exclusively, the SPV route is chosen for creating covered bonds and ABS, which are very important refinancing tools for banks and corporates. Derivatives in this context are typically being used to smooth and match the cash-flows of the assets vs the liability of the SPV. Usually risk is mitigated by the structure of these transactions and additional mitigation by margin would be inefficient and duplicative.

The swap provider typically ranks super-senior or pari-passu with the assets in the SPV and as such already has a safety net.

If the SPV is rated, over-collateralisation structures to protect the SPV/note-holder are already in place today. The risk remaining is the replacement upon rating downgrade of the swap provider. To reduce this disruptive risk, it might make sense to reconsider this part of the contract. However, HSBC believes that the majority of this framework is robust to protect the SPV/note-holder in the event of an unwanted default of the swap provider and that they do not need further protection. As such HSBC would promote an exemption for SPVs from the margining requirement.

Questions in the consultation document

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 contributed and concur with the GFMA Global FX Division response:
- Initial margin (IM). Physically-settled FX forwards and swaps should be exempted from any regime which requires the exchange, collection or posting, of IM between transacting parties on a mandatory basis. Further, the market for such products should not be split based on tenor for the purpose of applying any such requirement.
- Variation margin (VM). Replacement cost risk associated with physically-settled FX forwards and swaps is appropriately mitigated today without the need for a requirement to exchange VM between transacting parties on a mandatory basis. If, however, physically-settled FX forwards and swaps are not exempted from a mandatory VM requirement, VM for these products should only be required as a result of supervisory guidance and not national regulation.
- Cross currency swaps are a combination of FX forwards. If one promotes the exclusion of FX forwards, there is no reason not to promote the exemption of cross currency swaps, especially as these products are a tool mainly used by the real economy for bringing their longer term foreign funding back to their functional currency. An exemption for FX forwards only would lead clients to remain exposed to basis risk fluctuation and would lead to unwanted increases in their PL volatility, as their hedge will be imperfect. Many clients will want to avoid this risk. The most effective way to achieve this is for corporates to rely much more on shorter term funding. This is surely in contrast with the overall goal to boost longer term funding to stabilise the real economy.

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 are opposed to limited rehypothecation for several reasons:
- Limited rehypothecation would be workable in a only a few jurisdictions. A global framework cannot allow more favourable conditions for a minority of jurisdictions, thereby creating an un-level playing field.
- Firms generally don't hedge client transactions one-by-one, but hedge their central risk pool. It would be very difficult to allocate what hedging transactions are linked to which client, i.e. whose margin could be rehypothecated for which hedge.

- Such a limited rehypothecation would be operationally very complicated, and might actually be complicating a quick workout of a default.
- A more pragmatic solution would be to allow clients of a regulated firm to allow their IM to be rehypothecated without limitations. This would have a similar effect than unilateral IM, but would mitigate the liquidity impact on the system without adding operational or legal difficulties.
- Another alternative is not to allow rehypothecation, but to reduce IM levels considerably, to a level where systemic risk mitigation and added systemic risk due to high liquidity needs are better aligned (see also above).

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?

- Given the efficient mitigation of systemic risk by VM, we support the general implementation of mandatory VM from 2015, ideally even for existing transactions.
- As mentioned above, for some jurisdiction the phase-in schedule needs to be longer to allow them to implement a legal framework that recognizes netting and make the exchange of collateral safe for all counterparties.

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

- Due to the non-availability of data, the initial QIS was performed with thresholds up to EUR 50mn, assuming that these would be higher than required. The size of the liquidity impact surprised both regulators and industry. With this large liquidity impact in mind we suggest not just using the highest thresholds for which data has been gathered. The QIS should be extended to analyse the use of higher IM thresholds – it is likely that EUR 50mn is not the optimum IM threshold, and there could be a threshold that will reduce the liquidity impact significantly whilst still mitigating systemic risk.
- The QIS stated that IM across the industry was only 8% of unencumbered assets. However this view ignores the fact that the assets held by a firm are usually earmarked for other purposes, for instance their internal liquidity risk management or future IM at CCPs. Also assets might not be available to all legal entities of a group, thereby overstating the availability of eligible assets.