15 March 2013

Dear Sirs

ICAP Response to BCBS and IOSCO Consultation on Margin Requirements for Non-Centrally Cleared Derivatives

ICAP welcomes the opportunity to submit comments to this further BCBS and IOSCO consultation on margin requirements for non-centrally cleared derivatives. As an interdealer broker, regulated platform operator and provider of post-trade services, ICAP's experience gives us a perspective that may be helpful in the context of this consultation.

ICAP supports the efforts to strengthen the regulatory framework for OTC derivative markets and mitigate systemic risk. For firms within scope of this proposal (financial firms and systemically important non-financial entities), we believe that, whether cleared or uncleared, derivatives should be margined proportionate to the risk that they pose; and that in the case of uncleared derivatives it is essential that the collateral requirements (including what collateral is eligible as margin, and the treatment of that collateral when it has been posted) take account of the potential impact on liquidity.

We appreciate that BCBS and IOSCO have considered carefully the feedback that was provided over the course of the initial consultation and note the proposal aims to minimise the potential liquidity and market impact by allowing the use of margin thresholds and a phase-in of the requirement for two-way segregated initial margin. Nonetheless, we remain concerned that the initial margin requirement could result in market makers withdrawing from some derivative markets, for example inflation swaps and options or cross-currency/basis swaps, with significant consequences for the liquidity in those markets and the ability of end-users to hedge their currency or inflation rate risks.

We are also concerned at the potential liquidity impact of the proposed restrictions around the treatment of collateral that is posted as initial margin. For covered entities, the ability to transact in a derivative will effectively be dependent on the availability of sufficient eligible collateral. If it is mandated that collateral posted as initial margin cannot be re-used, re-pledged or re-hypothecated, then the collateral that is available will likely be reduced - an effect that will be amplified by the requirement to exchange initial margin on a gross basis. We would therefore encourage BCBS and IOSCO to consider this aspect further in light of any feedback it might receive in response to its Quantitative Impact Study.

In addition, we would urge BCBS and IOSCO to consider the impact of the margining requirements on those commodity derivatives that are physically settled. The Quantitative Impact Study includes some analysis on the potential implications of initial margin requirements for commodity derivatives; however, it does not appear to distinguish within this asset class those derivatives that are physically settled. Given that physically-settled commodity derivatives have a wide range of non-financial counterparties and the risk to the real economy that the introduction of initial margin requirements for these products might present, we believe it is essential that BCBS and IOSCO conduct a more granular analysis. We would also encourage BCBS and IOSCO to consider whether an exemption for these products, analogous to the exemption for physically-settled FX forwards and swaps, would be appropriate.

Our response to the consultation questions, where relevant, is attached.

ICAP appreciates having the opportunity to comment and would be happy to discuss further.

Yours faithfully,

Hannah Gurga

Head of European Affairs

Treatment of provided initial margin

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 pledge treats re-hypothecated collateral as customer assets; and***
- ***(iii)*** ***the applicable insolvency regime allows customer first priority claim over the pledged collateral.***

We are concerned at the potential liquidity impact of the proposed restrictions around the treatment of collateral that is posted as initial margin.

The demand for high-quality assets as collateral is growing as a result of a number of regulatory reforms including central clearing, margining of uncleared trades and Basel III. This increasing demand comes at a time when the range of assets considered to be "safe" is reducing, for example because of rating downgrades of sovereign debt.

The imposition of universal two-way initial margin, coupled with the additional requirement that this collateral remains segregated and must not be re-used, re-pledged or re-hypothecated, will have a significant impact on the total pool of eligible collateral that is currently available. This will have consequences for covered entities, whose ability to transact in a derivative (whether cleared or uncleared) will effectively be dependent on the availability of sufficient eligible collateral. It will also have consequences for banks who are required to meet the liquidity coverage ratio under Basel III with high-quality, highly liquid collateral. Ultimately, there will be an impact on the real economy as assets that could otherwise be used to facilitate lending to businesses will not be available.

To alleviate the pressure on demand for collateral, we believe that the parties to the transaction should be permitted to determine whether the collateral posted as initial margin can be re-used or re-hypothecated.

Phase-in of requirements

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 (1 Jan 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 welcome the phased-in approach that has been proposed by BCBS and IOSCO. A phase-in of the initial margin requirements will help to ensure that market participants have had adequate time to prepare operationally. It will also mean regulators have the opportunity to observe and reflect upon the market and liquidity impact of implementation of related reforms (e.g. central clearing, Basel III).

However, while we understand that the phase-in is intended to minimise the liquidity and market impact, we believe it could still result in a withdrawal of market-makers in some derivative markets such as inflation swaps and options or cross-currency/basis swaps. This is because for these instruments the calculation of initial margin on a gross basis – certainly under the Standardised Model – would be extremely high, thereby affecting the willingness of market makers to provide liquidity. This would have consequences for end-users wishing to hedge their currency or inflation rate risks and in the case of cross-currency/basis swaps would increase the cost of financing (via bond issuance) to Governments and Corporates.

To put the potential impact in context, inflation swaps are a common hedging tool for pension funds. A typical pension fund has liabilities (the benefits it will eventually pay out) whose values vary with inflation. By hedging against the impact of inflation, the pension fund can help ensure it will have the funding required to meet its obligations.

Currency swaps are used by companies seeking to access a wider investment pool than their domestic market with a view to achieving the lowest possible funding costs. This increases the diversification of corporate bond risk. A driver behind this can be a lack of domestic investment demand in maturities they wish to borrow at. The cross-currency swap in effect dovetails with the bond which can be issued in an alternative currency, thereby facilitating access to foreign investors. The structure enables the corporate to retain a domestic liability (both principal and interest) at a cheaper all-in-cost than can be secured in its domestic market.

Given the real economy risk that the introduction of initial margin requirements might present, we would encourage BCBS and IOSCO to consider also applying the phase-in by asset class – beginning with those derivatives for which the introduction of initial margin requirements is less likely to lead market makers to withdraw liquidity and allowing more time for swaps that are currently uncleared to become eligible for CCP clearing.

In relation to the exchange of variation margin, we note that it is proposed that this will not be phased in, but take effect on 1 January 2015 for any new contracts entered into after this date. We would welcome clarification that for these purposes "new" contracts do not include amendments or modifications to contracts that were entered into before 1 January 2015.