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Secretary General
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Re: Second Consultative Document – Margin requirements for non-centrally cleared derivatives

The Institute of International Finance (IIF) appreciates the opportunity that the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) have given to the industry to comment on the second consultative document on margin requirements for non-centrally cleared derivatives. As we stated in our letter on the same topic dated October 22, 2012, the IIF strongly supports the objectives of effective management of counterparty risk and the reduction of systemic risk. Nevertheless, the Institute is concerned about some aspects of the proposals on initial margin (IM) requirements and in particular their liquidity impact. We therefore commend the BCBS and IOSCO for making changes to the proposals that aim to take account of potential impact on liquidity. These changes include the use of margin thresholds and the minimum level of non-centrally cleared OTC derivatives activity necessary before a covered entity gets subjected to the IM requirements.

However, we believe that the proposed changes fall short of the changes that would be necessary to mitigate the negative consequences of the proposals and make them practical to be effectively implemented. The proposed margin threshold of Euros 50 million is far too low relative to the IM requirements that would result from the proposals, especially since it is applied at a consolidated level. The threshold should be significantly increased to ensure that (1) many small market participants are not required to post IM and (2) the resulting aggregate IM requirement will not have significantly detrimental impact on market liquidity. With regard to the Euros 8 billion minimum level of non-centrally cleared OTC derivatives activity, we believe that this simple notional amount threshold does not provide a realistic perspective of actual risks posed by a covered entity.

At the very least, this measure should exclude hedging transactions. We also have some comments on the practical application of this threshold, which we discuss below.

We are also concerned that some elements of the proposals will lead to level playing field issues. First, while we agree that there is a need for some exemptions to the no-rehypothecation rule, as indicated in Question 2 of the consultative document, such exemptions should be applicable to different frameworks in various jurisdictions in order to maintain level playing field. Second, there should be an international standard to the treatment of transactions with affiliates, and not just leave this to national discretion. Third, an international solution should be sought in the case of deciding which jurisdictions are compliant with the proposed rules, for example, by having the FSB, BCBS or IOSCO issue a list of compliant jurisdictions. The current proposals call for a unilateral decision by a national jurisdiction on the consistency of another jurisdiction's margining rules with the BCBS-IOSCO rules. This leads to a lot of uncertainty for firms and could lead to friction between a subsidiary operating in a jurisdiction that is deemed by its home regulator as non-compliant, and that jurisdiction's regulator.

Finally, in response to Question 3 in the consultative document on whether the phase-in arrangements are appropriate, we believe that given the many implementation challenges associated with the proposals, some of which we discuss below, the BCBS and IOSCO should consider pushing back the start of the phase-in period for at least two more years.

In sum, we believe that there are a number of essential changes that could be made to the proposals to make them more effective and more importantly, feasible to be implemented.

Following are detailed discussions of some issues on the second consultative document that we want to highlight:

Assessment of liquidity impact should take into account the LCR requirements

The initial margin requirements will likely lead to a significant drain on liquidity on individual banks and the system as a whole, transforming counterparty risk to liquidity risk and exacerbating the shortage of liquid financial instruments as a result of implementation of the liquidity coverage ratio (LCR) under Basel III.

The QIS results in the second consultative document show that the margin requirements represent only 8% of QIS firms' available unencumbered assets if they are using own models for calculating margins. While this figure might appear low, it is fundamental to consider that this figure increases to 86% if the standardized margin schedule is used (this huge difference between internal model and standardized margin requirements also raises level playing field issues since not all banks would be allowed to use internal models). The use of models is still subject to regulatory approval, so the percentage of available unencumbered assets that will be consumed by the margin

requirement will likely be between 8% and 86% in aggregate. If you add the LCR requirements, the available unencumbered assets could easily be depleted[1].

Hence, in response to Question 4 in the consultative document on the accuracy and applicability of the QIS results, we believe accuracy and applicability can be enhanced if the QIS also assesses the combined impact of the collateral requirements for IM and the liquidity needs arising from the LCR. In addition, further impact study should be conducted to capture all the new changes in the proposals. This will help in coming up with appropriate calibration of the thresholds.

Appropriateness of the objective of promotion of central clearing

The promotion of central clearing does not seem to be an appropriate objective in this context. As stated in the ISDA, IIF, GFMA letter dated December 12, 2012, only products that can be properly risk managed, valued and monitored daily by the clearinghouses, and which can be safely and quickly unwound in the event of a clearing member default, can and should be considered for clearing (i.e. sufficiently liquid and standardized OTC derivatives). It does not make sense to push transactions that do not fit these characteristics into central clearing. If a transaction is not fit for central clearing, then no amount of IM can drive it to be centrally cleared. The G-20 has already mandated that standardized OTC derivatives be cleared through central counterparties (CCPs). Hence, the rules for the remaining non-centrally cleared derivatives should focus solely on capturing systemic risk, while taking into account other measures already in place to capture systemic risk such as capital requirement.

Duplicative costs of having both conservative margin and capital requirements

The consultation document differentiated the role of margin and collateral (margin as "defaulter-pay" while capital is "survivor-pay"), and pointed out the advantages of margin over capital in covering for counterparty default (i.e. margin is more targeted and dynamic). What is not clear to us, however, is why both initial margin and capital need to be very conservative especially for banks. Capital requirement for non-centrally cleared derivatives is already significantly higher than for centrally-cleared OTC derivatives. This is meant to capture the increased counterparty risk when trading with a bilateral partner compared to a clearing house. If there is already an existing conservative capital requirement, the additional mitigant for counterparty risk (i.e. initial margin requirement), if at all needed, should not be punitive. Alternatively, if initial margin requirement is deemed more effective and would be implemented as proposed, the capital requirement should be adjusted to make it less onerous (including the clarification that collected margins with appropriate haircuts will offset counterparty and CVA exposures). Otherwise, requiring both conservative capital and IM levels for the same OTC derivatives will result in duplicative and unnecessary costs.

[1] Note that the most recent BCBS results, which are based on end 2011 figures, show a 1.8 trillion deficit in high quality liquid assets (HQLA). This means that for most banks unencumbered assets are held for complying with the LCR and thus cannot be considered as "available" for IM posting.

Treatment of FX transactions

In response to Question 1 on the treatment of FX forwards and swaps, the BCBS and IOSCO should seriously consider the potential financial impact of margin requirements on the deep, liquid and transparent FX market. We support the view of GFMA's Global Foreign Exchange Division, expressed in its letters to the BCBS and IOSCO dated September 28, 2012 and March 15, 2013, that risks associated with the FX market are already appropriately mitigated by the current regime and, hence, should be exempted from the IM requirement. We are concerned that the proposed rules will disrupt the currently working framework for mitigating the key risk of the FX market, which is settlement risk.

Treatment of transactions with affiliates

As mentioned above, the BCBS and IOSCO should come up with a uniform treatment of transactions with affiliates and not just leave it to national discretion in order to avoid level playing field issues. The consultative document noted that these transactions are not necessarily suited to harmonization due to differences in local laws and rules. However, this argument can also be said with regard to the re-use of collateral, as well as other regulatory issues for which international standards have already been developed (e.g. liquidity). We propose that these transactions should be exempt from, at least, the IM requirements. Subjecting these transactions to IM requirements would just create additional liquidity demands that are not commensurate to the materiality of risk that is being addressed.

Implementation issues

There are several implementation issues that need to be clarified before the proposals are finalized and implemented. Below are some that we have identified:

Definition of systemically important non-financial firms

The precise definition of systemically important non-financial firms that will be considered as covered entities will be determined by the appropriate national regulation. Are BCBS and IOSCO going to offer any general guidance on how these firms are determined? As we stated in our previous letter, the fact that these firms may come from different industries and do business in a number of jurisdictions will make it very difficult to identify criteria to designate systemic non-financial firms. Left on their own, it is inevitable therefore that different regulators would come up with different designation criteria. This will certainly result in inconsistent implementation and confusion. In the case of multi-national corporations, they could be considered systemic in one jurisdiction but not in others.

Application of the threshold on a consolidated basis

The consultative document noted that the implementation of the consolidated application of the Euros 50 million threshold "requires appropriate cooperation between home and host supervisors. As the threshold is applied on a consolidated basis, only the home supervisor of the

consolidated group will necessarily be able to verify that the group does not exceed this threshold with all of its counterparties." At the practical implementation level, does this mean that supervisors would issue an exhaustive list of consolidated groups and the entities that are included in each group, including monitoring the use of counterparty group margin threshold capacity on an on-going basis? Or does it mean each covered entity will need to confer with its relevant regulator each time it transacts with a counterparty to know the appropriate IM requirements? Either alternative does not seem to be feasible or practical. So it would seem that the effective monitoring of both the allocation and use of the IM threshold capacity on a consolidated group-wide basis rests on the covered entities. This will pose huge problems in data management and internal processes. The complexities that would be introduced by this proposal are disproportionate to the objective of preventing avoidance.

The application of the threshold at a consolidated level would also have legal implication in terms of the required level of due diligence that firms should do when dealing with a counterparty that belongs to a large group.

We recommend that 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.

<u>Model approval</u>

In the case of models used for IM purposes, the consultative document stated that (1) they must be approved by the relevant supervisory authority, and (2) approval in one jurisdiction will not imply approval in other jurisdictions. While we agree with the former, we believe that the latter will just lead to a wasteful, duplicative and expensive process of seeking approval from regulators in each jurisdiction that a covered entity operates. As such, model approval by the home regulator should be sufficient and should be recognized in other jurisdictions.

Related to this, we also believe that value-at-risk (VaR) models currently being used for risk management purposes, and which have been approved by relevant regulators, should not be subject to another approval process for purposes of calculating IM.

<u>Determination of minimum non-centrally cleared OTC derivatives activity</u>

We think it would be important for the BCBS and IOSCO to clarify the rationale for basing the measurement of OTC derivatives activity exclusively on the last three months of the preceding year. In this regard, we fail to understand the rationale for excluding the other months of the year. In addition, the proposals require margins to be posted as of January 1 of the following year. We believe this would present significant operational, liquidity and capital issues for most covered entities. A market participant cannot be certain whether or not it will exceed the minimum amount until the final days of the preceding year. The challenges associated with this requirement are detailed in ISDA's response dated March 15, 2013. To address this, compliance with the IM

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requirements should not be required until six months after a phase-in threshold has been passed by both counterparties.

In summary, while we believe the BCBS and IOSCO have taken important steps in revising the proposals, additional revisions are needed in order to clarify the practical implementation issues of the proposed rules and to ensure that the rules will result in a level playing field.

Once again, we appreciate the opportunity to comment on the second consultative document on *Margin requirements for non-centrally cleared derivatives*. Should you have any questions on the issues raised in this letter, please contact the undersigned (aportilla@iif.com) or Jermy Prenio (jprenio@iif.com).

Sincerely,

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