Position Paper

BCBS-IOSCO second consultative document on margin requirements for non-centrally cleared derivatives

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Insurance Europe welcomes the opportunity to respond to the second BCBS-IOSCO Consultative Document on margin requirements for non-centrally cleared derivatives. We support the efforts of the international regulatory community to promote central clearing of standardised OTC derivatives where appropriate, and to strengthen bilateral counterparty credit risk management practices for un-cleared OTC derivatives in relation to the mitigation of credit and operational risks. The current BCBS-IOSCO proposals address many of the concerns that we highlighted in our response to the first consultation. However, there are still a range of concerns that in our opinion need to be addressed by the BCBS-IOSCO group.

Key concerns of the insurance industry:

Insurance Europe considers it important that the strengthening of the derivatives framework in an OTC environment strikes a balance between the need to mitigate counterparty risk and the potential liquidity and economic risks that could derive from the proposed measures:

- Liquidity risk, with a pro-cyclical effect, when massive amounts of eligible collateral have to be made available during times of crisis at the same time as collateral requirements increase.
- Economic risk, because excessive requirements for derivatives may result in an excessive cost of hedging financial risks, and therefore discourage hedging operations. Furthermore, we highlight the fact that any additional costs arising out of the margin requirement will, directly or indirectly, be passed on to customers, i.e. policyholders. Therefore, every effort should be made to ensure that costs associated with non-centrally cleared derivatives do not become prohibitively high and eventually harm policyholders.

EMIR (European Market Infrastructure Regulation) recognizes that pension funds "typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders". The same principle is also fully applicable to insurance companies, given that the business model and profile of the liabilities held by insurers enable them to take a long-term view of their strategic asset allocation, and therefore to have limited (economically justified) cash exposure.

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Insurance Europe welcomes the definition of a broad range of eligible assets for collateral needs. We are pleased to see that the Consultative Document places no restriction on the use of assets in the portfolio as collateral for margin requirements. We are, however, aware that potential restrictions on insurance companies exist in some (European) jurisdictions, so we consider it important that the BCBS-IOSCO group encourage the elimination of any such restrictions. Insurance Europe would like to highlight the importance of allowing insurance companies to use assets backing policyholder liabilities to cover collateral needs. **Restrictions in this respect would unnecessarily limit the ability of insurance companies to invest in the long-term assets that support long-term economic growth.**

Moreover, there is some concern that certain jurisdictions might act to restrict the range of eligible collateral, and we therefore strongly encourage the BCBS-IOSCO group to make it clear that national supervisors should not impose unnecessary restrictions on eligible collateral. For example, although acceptable collateral under EMIR is represented by a reasonable range of "highly liquid assets" which we generally think insurers would be able to cope with, in practice, CCPs appear to only accept cash and, unfortunately, there is currently no reassurance that CCPs will expand the acceptable collateral in line with the EMIR regulation**. Insurers therefore risk having to uneconomically increase their allocation to cash, to the detriment of both policyholders and economic growth i.e. since investments in real assets that support real economic activity and growth will instead become pure cash holdings.**

The requirements for initial margin reflect the banking model and do not cater for the specificities of the insurance business model, or for the scope of the derivatives to determine the level of the initial margin. The consultative document uses the NGR method to determine appropriate initial margin levels and it justifies this approach by referring to best practices in the banking sector. The BCBS-IOSCO approach therefore fully relates to certain banking supervision principles and the general banking business model, which significantly differs from the insurance business model.

We strongly encourage the Working Group to consider the possibility that insurers need not post upfront initial margin, at least where derivatives are bought for asset liability management objectives. When assessing the purpose of the initial margin, a distinction could be made depending on whether the derivative under consideration actually mitigates a risk run by the party or not. For example, the objective of a hedge is to have zero exposure of the balance sheet to market risk via the use of a derivative able to match variation in assets with variation in liabilities. At any point in time, the balance sheet exposure (assets + derivative – liabilities) is zero and any negative valuation of the derivative (that would trigger a variation margin call) can be covered by the excess between assets and liabilities. Therefore, in the case of hedging, insurers' assets (backing policyholders' liabilities) will always be sufficient to meet the variation in margin requirements with a very high confidence level, so that there is no economic need to require insurers undertaking asset liability management via derivatives to post initial margin.

Physically-settled foreign exchange (FX) forwards and swaps should be exempt from initial margin requirements, regardless of the maturity. While we agree with the key principle in the consultative document that "appropriate margining practices should be in place with respect to all derivative transactions", the proposal that "margin requirements apply to all non-centrally cleared derivatives" is not appropriate for deliverable foreign exchange swaps and forward transactions. We strongly believe that the risks associated with foreign exchange markets are appropriately mitigated by the current global regime of prudent supervision, practice guidelines and capital implications. This includes principal (or settlement) risk reduction through use of CLS, replacement cost risk reduction by appropriate usage of CSAs, and strengthened supervisory guidance that focuses on ensuring sufficient capital is held against potential exposure to all foreign exchange settlement related risks.

The insurance industry supports the ability to engage in limited re-hypothecation of collected initial margin, subject to full transparency and bilateral approval of re-hypothecation terms. An alternative to re-hypothecation could be represented by an increase in the (EUR 50 Million) initial margin threshold. It is important that the requirements of initial margin re-hypothecation strike a balance between costs and benefits for end users. Full transparency and full counterparty agreement on collateral re-hypothecation would act to dis-incentivise and ultimately to limit the extent to which client assets are re-hypothecated. At the same time, regulators should acknowledge the important liquidity risks if re-hypothecation were not to be allowed; should this be the case, the obvious solution to mitigate the liquidity impact would be to define higher levels of IM threshold. Moreover, we are of the opinion that re-hypothecation rights should be accompanied by harmonization of securities laws in Europe, as this has the potential to ensure a more stable environment and therefore to overcome some of the re-hypothecation concerns highlighted by the BCBS-IOSCO group.

The proposed phase-in framework should reflect the significant implementation effort that would be required, given the processes that have to be defined or updated in the bilateral space. Insurance Europe supports a phase-in approach for the implementation of margin requirements for non-centrally cleared derivatives. However, we consider that the current phase-in proposals with a starting date of 2015 do not properly respond to the operational challenges that insurers will face in this respect. The new requirements will involve a lot of effort on the part of the insurance industry to define appropriate internal frameworks, processes and build/update IT tools. The challenges will be even greater for emerging markets or small market participants, for which margin practice is less widespread and where investors need additional time to design and implement appropriate frameworks. Moreover, we consider that the EUR 8 billion threshold should be increased to reflect balance sheet growth until 2019, e.g. to EUR 15 billion. In such case, the EUR 50 million threshold for IM should be adjusted to EUR 150 million i.e. 1% (standard charge of least consuming instrument) applied to EUR 15 billion. **We therefore consider that higher thresholds and longer phase-in periods would be appropriate for all market participants.**

Valuation rules should be consistent. Care should be taken to avoid artificial balance sheet volatility due to different valuation basis (e.g. valuation for accounting/prudential/collateral requirement purposes).

The proposals should be flexible enough to integrate into other regulatory initiatives. The current proposals for collateral haircuts appear to be based on banking practices and fail to incorporate specific features of prudential requirements (existing or under-development) for insurance. Specifically, the proposed collateral and haircut proposals completely disregard the approaches envisaged in the Solvency II framework (under the Counterparty Risk Module/CDR - Collateral requirements), which will thus lead to inconsistencies. For example, applying both collateral haircuts (BCBS-IOSCO) and a correction factor for market risk in collateral (CDR module of SII) would lead to double counting of the future collateral value risk.

We are concerned that some of the requirements remain unclear and would need to be addressed further. The Consultative Document leaves a significant amount of discretion in place, which in turn risks revealing an incomplete framework that would be difficult to implement in practice. **We are particularly concerned by the lack of specific guidelines on how the models (i.e. for initial margin or haircuts) will be approved.** Are supervisors able to use the models? Will there be a general, globally-used practice? How is a level playing field ensured? We strongly urge the BCBS-IOSCO group to provide clearer guidance on internal models for margining in order to ensure consistency for bilateral trades where internal models are used. **We also strongly encourage the BCBS-IOSCO group to provide guidance on how disputes will be resolved in practice.** An additional concern is the discrimination between using the model and the standard grid (for IM and/or haircut levels). The standard grid is extremely punitive and is a very crude measure on risk. Moreover, the standard grids do not allow for distinctions across countries or industries. Global (re)insurers transact across multiple jurisdictions, and will find it impossible to obtain model approval from each regulator in every jurisdiction. **We strongly encourage the BCBS-IOSCO group to consider**

that as long as a model has been approved by one IOSCO member regulator, other regulators should accept and allow the use of the same model.

Response to the specific questions:

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?

As highlighted in our response to the first consultation, we consider that FX forwards and swaps should be exempt from initial margin requirements, as we believe that the risks do not warrant the additional costs. FX derivatives are used massively for hedging purposes. Imposing initial margin requirements upon these transactions would create significant liquidity risk and costs and would seriously damage the ability to hedge FX risk, and therefore to invest in foreign-denominated assets.

For FX forwards and swaps, the risk is primarily driven by settlement risk (loss of principal), rather than the volatility of the mark-to-market value (i.e. replacement cost risk). This settlement risk can be better mitigated through either Continuous Linked Settlements (CLS) or the establishment of prudent settlement limits, rather than through mandatory IM requirements. The risks emerging from mark-to-market exposure can be managed through the use of variation margin. These processes are well established, generally available and have proved to work well.

For portfolios that do not have easy access to eligible securities, the need for initial margin would make the use of FX forwards uneconomic. This may result in a general increase in risk, given that the majority of forward FX transactions are executed to reduce currency risk in asset portfolios.

Moreover, international companies with a holding structure would be penalized even more. They hold participations in foreign currencies and put in place hedge strategies. Since they do not hold securities, they would be forced to post cash on an evergreen basis because of the structural nature of these hedges. This specific situation would lead to an extremely severe liquidity stress for holding companies and could dis-incentive them from managing their economic risk properly.

In addition, Insurance Europe strongly urges the BCBS-IOSCO to consider that, in order to avoid regulatory arbitrage and to ensure operational efficiency, margin tools and requirements need to be aligned in a global context (e.g. with the Dodd-Frank Act and other U.S. regulations, as well as those in Europe and other regions). Therefore, exempting FX derivatives from initial margin requirements would reflect, at least to some extent, international convergence in terms of the treatment of FX derivatives.

We believe that the same treatment should be applied to all FX forwards and swaps, irrespective of the maturity of the contracts. A different treatment, depending on contract maturity, would add unnecessary complexity to the framework, which may significantly outweigh the potential benefits.

We also consider that the BCBS-IOSCO requirements should allow companies to decide whether to calculate variation margin via supervisory guidance or via internal model.

In conclusion, we consider that subjecting FX derivatives to mandatory IM requirements may create suboptimal risk incentives and result in an increase in settlement risk. We recommend that all FX contracts be exempt from initial margin requirements.

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.

The treatment of provided margin is a key concern for insurance companies. We recognize that allowing re-hypothecation would (1) increase the availability of collateral, and therefore enhance market liquidity; (2) reduce the cost of funding transferred by banks to the buy side; and (3) increase the possibilities of investing the collected margin in risk-free yielding assets, thereby mitigating the funding cost charged by counterparties for IM posting, costs which are ultimately transferred to the end user. We are also aware of the fact that in specific cases not allowing for re-hypothecation generates an important liquidity problem.

At the same time, we are aware of the risk that re-hypothecation can undermine the benefits of collecting initial margin due to the risk for a margin provider of losing the pledged initial margin. Additionally, allowing for unlimited and un-conditional re-hypothecation has the potential to create counterparty risk, operational complexity and unfair advantage.

We believe that the proposed conditions (i), (ii) and (iii) can be considered appropriate tools for ensuring sufficient counterparty protection. However, implementation, monitoring and compliance with these conditions are likely to be too complex and costly, and far outweigh the corresponding benefits. Moreover, whereas the proposed approach may be applicable and relevant for some banking activities, this is not the case in an insurance context. Insurance Europe maintains that the international guidelines should ensure that all market participants have equivalent rights and tools in re-hypothecating collected margin.

It is important that the requirements of collateral re-hypothecation strike a balance between costs and benefits of re-hypothecation. Therefore, given the considerations listed above, we propose two alternatives:

1. If re-hypothecation is to be allowed, this should only be possible if both parties to a contract explicitly agree on the terms and potential limits of re-hypothecation. Financial stability risks arising from unlimited re-hypothecation of client assets can best be addressed through increased transparency rules, so that market participants know to what extent intermediaries have used client assets for the purpose of re-hypothecation. Full transparency of collateral re-hypothecation would act to dis-incentivise and ultimately limit the extent to which client assets are re-hypothecated.
2. If re-hypothecation is not to be allowed, than similar liquidity benefits should be given by defining a higher threshold for the IM (compared to the current proposal of EUR 50 million), thereby minimising the liquidity needs of the new margin 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?

In our response to the first consultation, we highlighted the need for the implementation timeline to reflect the significant implementation effort that would be required, given the processes that have to be defined or updated in the bilateral space. The clearing obligations already impose many operational developments for

market participants: adding bilateral obligations to be developed in parallel may represent an additional challenge to them and may also threaten the soundness and robustness of internal frameworks. We therefore consider that the proposed start date (i.e. 2015) is too demanding and creates the risk that investors will not have sound and robust frameworks for OTC trades in place.

In addition, we consider that:

- Where central clearing of standardised derivatives cannot yet be supported by CCPs, the margin requirements for non-centrally-cleared derivatives should be assessed on a basis consistent with the potential margin requirements for cleared derivatives.
- A detailed schedule should be provided on the validation by the regulator of the internal model for IM calculation.
- Consistent with Q1, the phase-in thresholds should not take into account FX forwards and swaps.
- For an investment vehicle such as a mutual fund or an investment trust, it should be made clear that the phase-in thresholds are applied at the level of the vehicle itself, regardless of its unit-holders. For example, the obligation to pledge initial or variation margin should not be imposed on other unit-holders solely because of the individual status of one particular unit-holder who is subject to the obligation.

More background rationale should be provided for the phase-in thresholds, in particular the EUR 8 billion. Our view is that the EUR 8 billion threshold should be increased to reflect balance sheet growth until 2019, e.g. to EUR 15 billion. In such a case, the EUR 50 million threshold for IM should be adjusted to EUR 150 million i.e. 1% (standard charge of least consuming instrument) applied to EUR 15 billion.

In addition to these, intragroup transactions should be explicitly exempted from margin 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?

We consider that initial and variation margining are tightly related, both from a legal and operational standpoint. Moreover, the application of two different timelines would increase both legal and operating costs and risks. Therefore, we believe that variation margin should also be required when initial margin is required, as specified in the phase-in schedule.

We would also like to highlight the fact that, in the case of the latest stage of the tiered levels (2019 and beyond with EUR 8 billion from EUR 0.75 trillion in 2018), margin requirements could mean that a broad range of firms will be affected, including many that cannot be regarded as a potential source of systemic risk. This could have a negative effect on the quality of collateral available for entities that have to comply with the new regulation at a later stage.

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?

Not only for emerging markets, but also for smaller market participants, margin practice is less widespread and investors need additional time to design and implement appropriate frameworks. The new margin requirements should not prevent these participants from trading derivatives, and the phase-in should ensure that they are still able to hedge against adverse market movements. At the same time, we are aware that flexibility will come with a significant implementation cost (e.g. doubling procedures, IT tools requirements, etc.). **These concerns could be overcome by a single phase-in implementation, which goes beyond**

the currently proposed 2015 and which is able to cope with all these challenges and limit any unnecessary costs and risks.

We therefore consider that higher thresholds and longer phase-in periods would be appropriate for all market participants.

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

Please see below our comments regarding the QIS exercise:

- The QIS results clearly show that the calibration of the standardised schedule is inadequate and too punitive in comparison to model-based margins or margin required for central clearing, which will create an unfair advantage and market imbalance. We would therefore highlight the non-level playing field that is being crated between centrally-cleared and non-centrally cleared derivatives.
- The QIS clearly highlights the potentially huge liquidity issue under the current proposal. This might lead to liquidity problems being replaced by higher counterparty risk. The QIS figures reveal that, based on currently used internal model for IM calculation, 0.7 trillion liquidity needs to be found globally for IM for non-cleared derivatives. This would be multiplied by 11 (!) based on the proposed standard formula. Therefore, the difference between an internal vs. a standard model approach seems quite disproportionate.
- The confidence level of 99% over 10 days appears too onerous. Considering that the collateral obeys strict eligibility criteria in terms of quality and liquidity, we believe that the time needed to liquidate the collateral should be significantly reduced. Current market practice is 3 days grace period and 2 days for settlement. Therefore we consider that a 99% confidence level over 5 days would be more appropriate.
- The estimated collateral needs will lead to a potential shortfall in liquid and eligible collateral even if there is a phase-in approach. We expect the figures to be higher than those summarized in the executive summary under 1. (g) in terms of unencumbered assets. Moreover, an estimate of only 0.5% of gross notional exposure seems to be very low for IM. Due to offsetting effects, the IM requirement for the portfolios of brokers and banks could be quite low compared to client portfolios. Therefore the EUR 1.7 trillion may significantly underestimate the total requirement.
- As revealed by the QIS, the best estimate on the initial margin amount impact on the system will be significantly lower under central-clearing mandate vs. internal model approach (and even less than the standardised schedule). Therefore, a strong reluctance for both the standardised approach and internal model towards a central-clearing mandate will be seen. However, this conclusion also reflects the fact that where CCPs do not allow for central clearing of specific derivatives, the margin proposals of BCBS-IOSCO will result in too onerous requirements, significantly above those that would be applicable if CCPs were able to clear centrally. This is again proof of non-level playing field between centrally and non-centrally cleared derivatives.
- The QIS should also consider the impact of simultaneous regulatory changes. As an example, the implementation of Solvency II should be considered in the QIS, given that the industry will need to comply with all requirements.