Investment Management Association

Basel Committee on Banking Supervision
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15 March 2013

**Consultation response:**

**Margin requirements for non-centrally cleared derivatives**

Dear Sirs,

The Investment Management Association ("IMA") is pleased to submit its response to the BCBS-IOSCO second consultative document on *"Margin requirements for non-centrally cleared derivatives".*

IMA is the UK based trade association for investment managers. Our members manage investments worth more than £4 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Our members' interest in this consultation is therefore in their role as the "buy side" of the market, accessing capital markets on behalf of their clients.

## Key IMA points:

We thank BCBS-IOSCO for listening to comments made in response to the first consultative paper published last year. We believe that the proposed way forward is coherent and brings clarity to the outstanding issues.

Specifically, we support:

- the phase in of the margin requirements;
- the application of minimum thresholds before the requirements apply: this is a proportionate response to the risks presented;

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- the use of 2-way margin.

We believe that FX contracts do not require initial margin collateralisation; and that contracts with a short tenor, below 3 months, should not require collateralisation for variation margin (other than NDFs). We give reasons for our view below.

We believe further clarification is needed on several topics.

- The impact of some of the proposals on clients' businesses needs further thought, in particular for authorised funds (UCITS and AIFM). It is important that the application of initial margin to funds should apply at the fund or sub fund level (as appropriate), rather than look through to underlying investors; to do otherwise would be impracticable and not in line with existing practice or rules.
- The use of a "group" approach to aggregating notional derivatives exposure also needs further clarification. Many funds are set up as umbrella structures in line with UCITS (and AIFM) regulation, and beneficially each sub-fund is maintained separately from its fellow sub-funds. In many jurisdictions, including the UK, Ireland and Luxembourg, additional legislation has been introduced in the form of "protected cell" regimes to keep the sub-funds legally segregated from each other in the event of an insolvency of one of them. Furthermore, each sub-fund is a fund in its own right with different investment objectives and different investors. Therefore in the case of these types of structures it is important that the margin requirements should be handled at the level of the sub-fund, in line with existing practice and rules relating to these structures.
- In another respect however we suggest it would be inappropriate to attempt to aggregate "group" exposures, if by this is meant including the client business of an asset management company (where that business is not on-balance sheet for the asset manager) and requiring it to be aggregated with the holdings of its parent or affiliates, which could be a bank or an insurance company.
- Inflation derivatives should be treated as being within the same asset class as interest rate/currency derivatives. Interest rate and inflation derivatives are often used together to manage real rate risk. However, if they are not categorised within the same asset class, users will not be able to net any margin calculations across the two types of instruments. This could therefore incentivise the creation of less liquid derivatives such as real rate swaps, which we believe is not the intention of policymakers. We comment further on this in the Other Issues section below.

The transition should be made flexible to allow for changes in circumstances. We suggest that the roll-out of these recommendations should be with regard to the nature, scale and complexity of the participants concerned.

Annex 1 contains our more detailed response to the consultation questions, and further specific observations arising from the proposals.

Annex 2 summarises the differences between banks and investment fund managers.

We hope that you will find our comments useful. Please contact us by way of e-mail (jlowe@investmentuk.org and ihenry@investmentuk.org) or telephone on 020 7831 0898 should you require further information.

Yours faithfully,

Jane Lowe

Director – Markets

## Annex 1

**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 believe that physically-settled FX forwards and swaps should not be subject to initial margin requirements at all.

The biggest risk in FX relates to settlement. Where counterparties have dealt with this by using formal settlement systems such as CLS, we suggest that for short tenor contracts of 3 months or less, variation margin exchange should not be necessary. For longer dated contracts (over 3 months) we suggest that variation margin could be appropriate, reflecting potentially greater credit risk. However, we caveat this by suggesting that thresholds should be set (perhaps against notional amounts) below which the exchange of collateral for variation margin would not be required.

Rather than increasing regulatory requirements, banks should be encouraged or incentivised to join settlement platforms and these platforms should in turn be encouraged to extend the range of currencies covered.

Unlike many other derivative instruments whose payment obligations fluctuate daily in response to changes in underlying variables, such as interest rates, the payment obligations of FX swaps and forwards are fixed at the outset of the agreements and involve the actual exchange of full principal for settlement. Further, the vast majority of FX swaps and forwards have short average maturities, posing significantly less counterparty risk than other derivatives. Trades are largely cash backed, and market risk of transactions will be reflected in the P&L of the respective counterparties. For these reasons, we do not believe that FX should be treated identically to other derivatives.

It is welcome that BCBS is updating the supervisory guidance for managing settlement risk in FX transactions.

**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 starting point should we suggest be that re-hypothecation is not permitted at all in relation to exchanges of collateral for margin. For our members, the collateral belongs to their clients (the pension funds, UCITS funds, insurance funds and other clients) and

there is strong resistance to the suggestion that it should be allowed to come in to play for the reasons suggested.

Instead we suggest that regulators should consider other approaches to collateral management, to promote a safer market and mitigate any impact on liquidity, such as:

a. Promoting account structures such as those operating under pledge or security interest arrangements. Whilst not releasing collateral into the economic ownership of the bank counterparty, it provides an efficient and stable economic basis for investor clients, such as pension funds and UCITS funds, to manage their portfolio and their margin requirements.
b. Permitting a wide range of eligible collateral with appropriate haircuts if necessary, thus supporting a more counter-cyclical approach to collateral management and reducing asset concentration risk;
c. Encouraging much greater use of techniques such as portfolio compression, including in the cleared space, again with the aim of releasing collateral;

As mentioned, our starting position is that we do not believe that re-hypothecation of client assets should be allowed at all under the conditions set out, as it leaves too much in the hands of the bank counterparty. (The question has been phrased such that it appears that re-hypothecation can/will only be one-way, although that is debatable.) If policymakers are determined to allow this, we suggest that re-hypothecation should only be allowed if: (1) the customer has entered into a binding contractual agreement to permit such a course of conduct; (2) express permission is granted on a transaction-by-transaction basis ahead of trading; and (3) the conditions set out in the question apply, but most particularly (iii). IM in particular is intended for set aside, to cover unforeseen risks in the event of default. It should not be used on a routine or regular basis to finance a client's position; and if it is then it cannot fulfil its intended function.

The new credit valuation adjustment (CVA) capital charge introduced in Basel III should incentivise banks to push an increasing number of their derivative transactions through central clearing. CVA acts to deal with credit/client risk specifically. The exchange of variation margin will also be an effective tool to address product specific risk and prevent the build-up of large uncollateralised current exposures. The combination of the two should be enough to deal with the risks presented, leaving a question mark over the need for separate initial margin.

**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?**

We believe that the proposed phase-in arrangements are appropriate and helpful. Firms that present no apparent systemic risk to the market, many of which will be clients, should be allowed sufficient time to ready themselves for the changes. Failing to allow that extra time will not bring obvious benefit to the market. However it could actively hurt clients if their lack of readiness means that they cease to manage risks through derivatives whilst they ready themselves.

We believe that it is simpler and appropriate to require a formal VM framework from an effective date, in this case 1 January 2015.

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

We have no comments on this section.

**Other issues**

**a. Treatment of inflation swaps**

The BCBS/IOSCO proposal is silent on the asset class into which inflation derivatives would fall. Given the strong economic relationship between interest rates/currency and inflation, there is a compelling case for inflation derivatives to be treated within the same asset class as interest rates/currency.

Interest rate and inflation derivatives are often used together to manage real rate risk. However, if they are not categorised within the same asset class, users will not be able to net any margin calculations across the two types of instruments. This could therefore incentivise the creation of less liquid derivatives such as real rate swaps, which we believe is not the intention of the policymakers.

We therefore believe the BCBS/IOSCO recommendation should be amended to clarify the treatment of inflation derivatives, and specifically to include them within the same asset class as interest rates/currency.

### b. **Systemic risk**

The segregation requirements for initial margin may require the use of third-party custodians. However, there is a limited number of global custodians that would be able to provide such services on a global basis. This may lead to increased concentration risk on custodians.

Regulators intend margin requirements to apply to all financial firms and systemically-important non-financial entities ("covered entities"), when they deal with each other, but not when they deal with other parties.

Implementing this principle will be a matter for local regulators. In Europe, this raises the issue of the interpretation of article 11(3) of EMIR. When will "financial counterparties" and "non-financial counterparties over the clearing threshold" be required to exchange margin? This will need to be clarified in the expected technical standards.

Under the BCBS/IOSCO principles, covered entities would not need to take margin when dealing in non-cleared OTC derivatives with "non-financial counterparties under the clearing threshold". The position with regard to third country firms when those firms are systemically important is not clear and requires clarification.

### c. **Intra-group transactions**

The consultation leaves it to local regulators whether non-cleared intra-group transactions should be subject to margining requirements.

This allows local regulators to take different approaches, increasing uncertainty and the potential for regulatory arbitrage, with some requiring margin and others providing for straightforward exemptions. It would seem to expose large groups unduly to the risk of conflicting treatments in multiple jurisdictions. At the same time the approach appears to skirt round the treatment of potentially quite large exposures being held in institutions which present systemic risk, which could be problematic and not on the face of it in alignment with G20 intentions.

## Annex 2

### Fundamental differences between investment managers and banks

(a) All assets managed by an investment manager ("portfolio manager in MiFID terminology) are segregated and held by an independent depositary/trustee (e.g. as required by EU law) or custodian. In the event of the failure of an investment manager, these assets would remain segregated and held by the custodian. Consequently, the impact upon markets would be negligible as the volume of money circulating in the system would not change and the impact upon institutional investors and consumers alike would simply equate to the administrative task of transferring the investment management mandate;

(b) Investment manager costs are largely fixed (relating to staff and running costs) and as no deposits are accepted, there is immaterial maturity mismatch between balance sheet assets and liabilities. Liquidity management is thus a simple exercise with known requirements. There is consequently limited potential for a run on the firm, and even if one were to occur, the impact on markets and consumers would be insignificant as the assets managed do not belong to the investment manager and would remain segregated;

(c) Many investment managers are privately owned and not therefore publicly traded; those which are publicly owned are primarily funded by equity and retained earnings and have no reliance upon any kind of depositor (ie they do not take deposits). In the event of any concerns arising in relation to the firm, an investor could sell his/her equity stake, but this would not generate a run on the firm in the same way as a withdrawal of deposits would for a bank. Similarly, if concerns promulgated into the funds managed by the firm, any redemptions of shares or units in a fund would equate only to a sale of transferable securities and would not therefore have an adverse impact upon markets or consumers; and

(d) Operational risk is the principal risk to which an investment manager is exposed. With no dealing on own account permitted, market risk relating to trading book activities is minimal, and as credit cannot be provided, credit risk relates primarily to the counterparty risk associated with cash positions. The crystallisation of operational risk in an investment manager is unlikely to migrate to the broader financial system and should not therefore have an adverse impact upon financial stability or markets.