From: Milko Ostendorf [mailto:milko@theviolinfactory.com]
Sent: Monday, March 18, 2013 8:55 AM
To: Consultation Reports
Cc: KRAMER, Baroness; mark.garnier.mp@parliament.uk; SchoolingLatter, Edwin; Nahai-Williamson, Paul; Elliott, David; john.tanner@fsa.gov.uk; Tom Springbett; Heather Pilley
Subject: Comments on WGMR's second consultation document

Dear members of the working group,

First my apologies for sending this slightly beyond the deadline of last Friday 15 March 2013.

In general I was impressed and pleased with the progress made in the second consultation document and I broadly agree with the requirements in almost every aspect, however with the exception of requirement 8.9.

Requirement 8.9 states that Initial Margin is not required for existing trades, so each bank will end up with two portfolio's, the margined portfolio and the non-margined portfolio.
I assume that amending an existing trade (e.g. amending the notional) will not introduce margin requirements for that trade, since it is still an existing trade.

The amount of Initial Margin each bank has to post is a function of the market exposure of its outstanding portfolio. Roughly (in the case of interest rates) it will be a function of the change in market value of the portfolio due to a significant shift in rates. Or expressed differently, the higher the delta of a portfolio, the higher the required Initial Margin.
If two banks want to reduce the Initial Margin they need to post to each other, they somehow need to reduce the delta of their bilateral portfolio.

Now assume that Bank A, before 2015, will execute the following trades with each of its biggest counterparties - It will execute a number of very long dated in-the-money swaptions (non-centrally clearable) and it will buy and sell each swaption in an equal amount.

Going forward in order to reduce its Initial Margin Requirements, Bank A can execute a long dated swaption with a delta which is opposite to the margined portfolio and simultaneously will do the opposite trade by amending the notional of one of its existing trades in the non-margined portfolio. Since both trades are part of the same netting agreement, from a legal point of view, it has merely executed two equal and opposite trades which fully net, i.e. it has done nothing. If Bank A does these trades regularly, the bank can keep the delta of the margin portfolio close to zero and thus save on the amount of Initial Margin.

In general, according to requirement 8.9, since each bank has a margined portfolio and a non-margined portfolio, in order to save Initial Margin, banks have an incentive to keep market exposure as much as possible in the non-margined portfolio. The above swaption trade is merely one way of achieving this objective and even if regulation would be adjusted not to allow this, there are almost certainly other ways of moving exposure from the margined portfolio to the non margined portfolio. So closing the "swaption" route is unlikely to solve the problem, which, in my opinion, can only be solved by making Initial Margin mandatory for all trades at some point in time.

As always please don't hesitate if you would like further discussion or comments

Sincerely
Milko Ostendorf