P-Solve

Margin requirements for non-centrally-cleared derivatives

P-Solve response to BCBS and IOSCO Consultation

March 2013

Dear Sir / Madam,

P-Solve welcome the opportunity to provide comments and views on the joint discussion paper on margin requirements for non-centrally-cleared derivatives issued by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

About the Firm

P-Solve are part of the Punter Southall Group and were founded in March 2001 to provide advice to liability-driven organisations such as trustee groups, corporations, charities and insurance companies.

We currently advise over 175 clients, covering defined benefit and defined contribution pension schemes and charities of sizes ranging from £2 million to £6 billion. P-Solve advise clients on over £24 billion of assets and also have approximately £8 billion of assets under management. In addition, P-Solve manage over £15 billion notional of derivatives for pension schemes, with the primary purpose being to hedge market risk.

About the Firm

As stated in our response to the first consultation, our view is that pension schemes, particularly under UK regulations, should be exempt from initial margin requirements for a number of reasons. Please refer to our previous response dated September 2012 (attached with the accompanying email) for our full rational.

We have limited our scope of response to the three questions posed in the consultation document – namely;

- Proposed exemptions from margin requirements for physically settled FX forwards and Swaps
- The re-hypothecation of margin
- Timescales for implementation

Yours sincerely,

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1. Exemptions for FX Forwards and Swaps

In our view, physically settled FX contracts should not be exempt from margin requirements for a number of reasons.

There is no fundamental difference between an FX trade and any other derivative contract (e.g. an interest rate swap or an equity option) in terms of the risk that the counterparty is exposed to – principal, replacement cost, liquidity and operational risks still apply. It's preferable therefore to keep margin requirements consistent across contract type.

As demonstrated in the QIS, the FX market represents the second largest non-centrally cleared market by notional outstanding i.e. the market is systemically important so should fall under the requirements of the proposed framework.

The exemption of certain types of transaction could create confusion and introduce complexity and ancillary risks – for example cross currency interest rate swaps could be subject to different margining depending on how they are structured if the margin requirements for FX and interest rate trades differ across contracts and jurisdiction.

2. Re-Hypothecation

We do not think that re-hypothecation of initial margin should be allowed.

Re-hypothecated margin runs contrary to the aims of the proposed regime – for example, the condition that both counterparty pairings must post initial margin above the £50 million notional threshold meets the requirements of a defaulter pay regime whilst maintaining market liquidity. Furthermore, in principle, the method is transparent and traceable. It does not seem sensible to introduce other conditions (like re-hypothecation) that could reduce transparency.

The re-hypothecation and "churning" of collateral prior to the financial crisis and the subsequent collapse of non-bank funding helped to exacerbate the downturn. At a time of increasing capital requirements and a decrease in interbank lending, an increase of €0.7 trillion of assets that could be re-hypothecated could lead to collateral flowing through the system instead of being held to collateralise positions.

Generally market makers / banks would be the principle candidates for re-hypothecating margin – it's unlikely that corporate entities / pension schemes would have the ability or the need to manage the process. Allowing re-hypothecation could mean that systemically important institutions at the centre of the market do not have sufficient initial margin to meet all required claims if liquidity falls or an institution fails. This seems to run contrary to the aims of the new legislation that has been proposed by the Basel Committee and IOSCO.

Whilst the decision as to whether to allow re-hypothecation could be left to the discretion of market participants, in practice this would lead to pricing differences which may not necessarily reflect the change in risk (as long tail events are by definition difficult to predict).

3. Timescales

In our view the proposed phase in requirements for initial margin are manageable - particularly as smaller entities with under €8 billion of gross notional will be exempt.

Given that the majority of non-cleared derivatives are collateralised, we do not see any reason to implement the variation margin requirements at a different pace to the initial margin requirements – the primary cost to participants of the new requirements will be the costs of system implementation so implementing all aspects in parallel seems sensible.