The Royal Bank of Scotland

Response to BCBS IOSCO Second Consultative Document

Margin requirements for non-centrally cleared derivatives

14 March 2013

The Royal Bank of Scotland Group ("RBS") welcomes the opportunity to respond to the Basel Committee on Banking Supervision ("BCBS")/International Organisation of Securities Commission ("IOSCO") second consultation ("Consultation") on margin requirements for non-centrally cleared derivatives, having also responded to the July 2012 consultation. We remain receptive to further dialogue with representatives of the Working Group on Margin Requirements (WGMR) on this topic.

In this response we set out our main issues and concerns having contributed to the responses produced by the International Banking Federation, the International Swaps and Derivative Association, ("ISDA"), the International Institute of Finance and the Global FX Division of the Global Financial Markets Association.

In principle, RBS remains unconvinced of the need for a universal Initial Margin ("IM") regime, while strongly supporting mandated use of Variation Margin ("VM") as a risk management tool. We continue to hold the view that mandating universal IM would ultimately require a very large quantum of margin to be sourced from the market. The impact of this may be disproportionate in comparison to policy makers' objectives and the liquidity implications of universal implementation may also have serious unintended consequences for the economy.

We do recognise and acknowledge the WGMR's modifications to its July consultation in the form of phase-ins and thresholds which we accept are important measures for tempering potential liquidity impacts, in the event that IM is indeed mandated. However, we believe that both measures require further refinement and strongly urge the WGMR to undertake a follow-on quantitative impact study ("QIS") to thoroughly test assumptions and implications in differing stress scenarios prior to finalising the principles that will flow through implementation via regulatory technical standards or equivalent measures.

As stated earlier, we support the concept of phase-ins for tempering liquidity impacts, but are concerned that the timelines proposed are too ambitious. Assuming that in the EU, the Regulatory Technical Standards for margin are completed by the end of 2013, this leaves Covered Entities only a year to build the necessary systems and modelling capability and to obtain regulatory approval for those. Firms' market risk resources will also be needed to satisfy their market risk obligations under CRD4, which is likely to enter into force in 1 January 2014. We therefore recommend that the WGMR push back the beginning of the phase in period by a minimum of one year to 1 January 2016. We also stress the need for any phased-in approach to be suitably flexible to allow for mid-course correction should, for example, the annual BIS margin survey reveal higher than forecasted liquidity impacts.

Thresholds

With regard to our recommendation that a further QIS be undertaken, one particular concern is that the original QIS did not provide enough granularity at the top end of the spectrum to conclude that EUR 50mm is an appropriate margin threshold for mitigating liquidity impacts. This level is particularly relevant given the requirement that it represent an aggregated amount across a group's total activity in all its entities. This is not how firms currently manage their counterparty credit risk which is typically done at the entity or netting set level nor was this the basis on which responses were provided to the initial QIS. We suggest that an aggregate threshold approach should mean setting that threshold significantly higher than EUR 50mm, thus reinforcing the need for further analysis through a subsequent QIS. Regardless of the level set, however, we believe that it will be critical that the regime allow for temporary suspension during periods of market stress to reduce collateral pressure and mitigate pro-cyclical impacts.

In terms of the EUR 8 billion level for determining the ultimate population of "covered entities", we consider that this should be exclusive of any hedges so as not to deter, or create significant disadvantages in relation to, prudent risk management and in order to be consistent with the approach taken in both EMIR and Dodd Frank in relation to certain obligations (for example, the mandatory clearing provisions under EMIR, which specifically exclude hedging activity when determining which entities exceed the relevant threshold). To the extent that hedging activity is specifically disregarded for certain purposes, there seems no obvious reason why hedging should be included when setting the threshold for the level of activity determinative of a 'covered entity'. Is it the intention of the WGMR to consider as "systemically-risky" any group or entity that exceeds the EUR 8 billion threshold? We would make the point that, whilst volume may be indicative of systemic significance, it may not be determinative in and of itself. In addition, we have significant concerns about the challenges of monitoring the level of activity on an international basis [and to what extent firms will be expected to take responsibility for verification of the level of activity of their counterparties].

Treatment of Provided Initial Margin

We endorse key principle 5 of the Consultation. However, we believe that this principle should be applied consistently and without exception and we would therefore oppose limited exemptions to it. We also believe that any exemption to the principle would be extremely difficult to achieve given differing legal frameworks in terms of client asset protection regimes as well as applicable insolvency laws – these differences could result in inconsistent availability of any exemption resulting in confusion for counterparties as well as the re-introduction of credit risk.

Use of Models

We note and agree with the WGMR's observation that the standardised margin schedule leads to substantially higher levels of margin. This makes the availability of approved quantitative models a prerequisite for the implementation of the near final proposal. We would like to emphasise the substantial amount of work involved and are concerned that the timelines envisaged are optimistic. We are some time from having technical standards which the market can build to. Models will subsequently need regulatory approval. As referenced earlier in this document, this makes January 2015 a challenging start date.

Once models are implemented, it is unlikely that parties will arrive at the same IM calculation because models will not be identical. It is not clear from the Consultation how it is proposed that such differences can be reconciled or bridged. Unlike valuations where disputes can be avoided by breaking down values to a transaction level, VaR is an aggregate portfolio measure, which does not allow a line by line reconciliation of the margin calculation.

A central utility which calculates all margin for the market may be helpful. However, it is our understanding that any such venture would need to be based on risk engines which rely as inputs on representations of transactions which will differ from participant to participant. Secondly, whilst we are supportive of the emergence of such utilities which will facilitate margin management, regulators may well wish to approve the suitability for use of a utility's model on a firm by firm basis. This would not reduce lead times.

Transactions with Affiliates

We note the BCBS' observation that extending initial margin requirements to inter affiliate transactions would create additional liquidity demands for firms engaging in such transactions, a statement that we strongly support. We underscore that we currently manage the counterparty credit risk arising from our affiliate transactions, in some cases, by applying variation margin and seek to retain this flexibility going forward.

Should you have any questions in the first instance, please contact Emily Ludwick at the following email address: Emily.Ludwick@RBS.com