Annex

Saudi Banks Comments on Margin Requirements for Non-Centrally Cleared Derivatives

Bank # 1:

The background to the consultative paper is clear, as the policy proposals in the paper seek to ensure that appropriate margining practices will be established for all non-centrally- cleared over the counter (OTC) derivative transactions.

With regard to the four issues highlighted in the letter seeking feedback, we have the following comments:

1. **The treatment of physically-settled foreign exchange (FX) forwards and swaps under the framework.**

Comment:

FX forwards and swaps are the most plain vanilla FX structures executed in the market. These FX forwards and Swaps if proposed to be excluded from a centralized clearing system; it would be prudent to exempt the standard vanilla forms of these FX forwards and swaps from initial margin requirements for shorter tenor trades extending up to 6 month tenors and for trades with tenors exceeding 6 months it would be better to have a uniform rate of initial margining. Variation margin requirement in this Basel paper has been equated to the current outstanding Mark to Market position of trades. It would therefore be prudent to require variation margin for all FX forwards and swaps as proposed for margining in the Basel document since it collateralises the adverse market position with the variation margin.

2. **The ability to engage in limited re-hypothecation of collected initial margin.**

Comment:

Re-hypothecation of collateral may be required/permitted given the liquidity requirements of institutions, provided the legal framework of the jurisdiction permits and institutions have efficient collateral monitoring systems. Without the proper systems and procedures, there is the risk of: i) committing the same collateral more than once, and/or ii) not being able to obtain the collateral back when needed.

3. **The proposed phase-in framework.**

Comment:

The proposed phase-in arrangements appear to:

appropriately trade off: i) the systemic risk reduction & incentive benefits, with ii) the liquidity, operational & transition costs associated with implementing the requirements. Appear appropriate with a gradual introduction of higher-to-comparatively lesser- systemically vulnerable institutions being required to follow the margining requirements for non-centrally cleared derivatives over a few years. This despite the benchmark of EUR8Bln in aggregate notional that will exclude a substantially large number of institutions.

In addition to phasing out of introduction of initial margin, the phasing out of introduction of variation margin requirements would also be appropriate, as this would gradually introduce the institutions in stages to both forms of margin. However this phased introduction of variation margin requirements, should not result in dilution of current practices at institutions that have already introduced variation margin through the Credit Support Annexes attached to an ISDA. A phase-in approach should require all banks to have the PFE systems, which are essential for PFE calculations.

4. **The adequacy of the conducted quantitative impact study (QIS).**

Comment:

The QIS appears to have made an attempt to derive in as short a time as possible, the initial numbers, in the absence of readily available information. It appears from data made available that subject to constraints in collecting information as brought out in the document, <u>the QIS results have served the purpose of the study quite well.</u>

Bank # 2:

The Group has reviewed the document available at BIS website: www.bis.org and below are it's comments:

- In line with the Secretary of the Treasury's determination in the USA, physically settled FX forwards and swaps should be exempted from any margin requirements, as long as they are:

  - The actual exchange of principal amounts of specified currencies that are fixed at inception of the related contract;
  - The shorter maturities that are typical for FX Swaps and FX Forwards;
  - That FX Swaps and FX Forwards are not structured to evade regulatory requirements that apply to other swaps and are predominantly used to hedge risks associated with short-term fluctuations in foreign currency values or to manage global cash flow needs; and
  - That FX Swaps and FX Forwards are traded in highly transparent and liquid markets.

  If the above is implemented, the applicability of these rules to banks in KSA will be significantly diminished, especially given that the paper proposes a minimum initial margin threshold of Euro 50mln.

- Banks will need to re-evaluate their existing margining models, and obtain SAMA approval for them. In many instances, new models may need to be developed, as existing models used for market risk or counterparty credit risk may not be adequate. Banks will also have to ensure that their collateral models are adequate, and that they capture risks such as wrong way risk, which is the risk when exposure to a counterparty is adversely correlated with the credit quality of that counterparty.
- Development of systems to track initial margin thresholds across the different legal entities of a single group will be required. In addition, banks will have to enhance their systems for tracking the sources, uses and location of eligible collateral. This would require significant costs, and time.

Notwithstanding the somewhat limited applicability of these measures in developing countries if FX forwards / swaps are exempted, and the Euro 50mln threshold, the proposed timeline for implementation (in 2015) is aggressive, given all the operational / system changes that may be required. In our view banks should be given at least a three year period to come up the curve in terms of system, and models, and the timeline given in the paper should be deferred by two years.

<u>Bank # 3:</u>

The Basel Committee and IOSCO seek comment on this near-final proposal and specifically seek feedback on the following four issues:

1. the treatment of physically-settled foreign exchange (FX), forwards and swaps under the framework;
2. the ability to engage in limited re-hypothecation of collected initial margin;
3. the proposed phase-in framework, and
4. the adequacy of the conducted quantitative impact study (QIS).

We have analyzed the consultative document and these are our comments:

Bank comments:

a. Covered entities: The precise definition of financial firms, non-financial firms and systemically important non-financial firms needs to be elaborated further. Paper states that these will be determined by appropriate national regulation.
b. We believe that the financial institutions should be exempted from IM (Initial Margin) requirements as financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. It is important to recognize ongoing and parallel regulatory initiatives that will also have significant liquidity impacts; examples of these initiatives include the BCBS's Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).
c. We agree with the document that physically settled swaps and FX forwards should be exempted from the margin.
d. We need definition of high quality government, corporate and covered bonds
e. It would have a significant impact on liquidity management and posting bond collateral would increase the cost of doing business.
f. The haircut on Gold and Equity at 15% may be on a lower side.
g. Additional hair-cut of 8% for USD denominated bonds posted as a collateral seems to be quite high.
h. Posting Cash collateral in a currency other than the currency of exposure seems to have been deleted from the haircut schedule.
i. Setting a same limit threshold (beyond which collateral needs to be posted) across all counter-parties of equally different credit quality/rating seems to be unfair.

No comments on Point 2, 3 and 4.

Bank # 4:

Bankresponsestothefourspecificissuesare asfollows:

1. **Treatment ofphysicallysettledFX forwards andSwaps**

Weareinagreementwiththeprinciplethatexceptphysically-settledFXforwardsand swaps, themarginrequirementsapplytoallnon-centrallyclearedderivatives.

2. **Abilitytoengageinlimitedre-hypothecation ofcollectedinitialmargins**

Inordertoavoidanyoperationalissuesthatmayensue,weareinagreementthatinitial marginshouldbeexchangedonagrossbasisandheldinamannerconsistentwiththe keyprincipleabovei.e.cashandnon-cashcollateralcollectedasinitialmarginshould notbere-hypothecated,re-pledgedorre-used.Aslocalmarketmaturesthisissuemay bereviewed.

3. **Proposedphase-inframework**

Wearecomfortablewiththeframeworkbeingphasedinstartingfrom2015goingupto 2019asitgivesenoughtimeforbankstogetreadyforimplementation.

4. A**dequacyofconductedQuantitativeImpactstudies(QIS)**

WhileQIShasbeenconductedattheinternational levelbyBCBSandISOCO,we suggestthatsimilarQISmaybeconductedbynational regulatorytounderstandthe non-standardOTC derivativesvolumeandflowsandmarket tradingpractices.This couldfacilitateregulator toissueguidelinesformarginingandhaircutsbettersuitedtothe localbankingsystems.

Overall,fromBankperspective,wefeelcomfortablewiththeproposedamendmentsan d shouldbeinapositiontoimplementthe guidelines.

Bank # 5:

While we are providing our detailed comments to the questions in the attached document, we would like to draw attention to the following:

- Requirement to exchange the full amount of variation margin on a regular basis (i.e. daily) has been proposed without allowing for a minimum threshold. This is likely to increase operational challenges substantially. We recommend that, like initial margin requirement, a minimum threshold be allowed for variation margin settlement as well.

- Variation margin requirements are proposed to be effective earlier than the Initial Margin requirements. We recommend that the phase-in period for both initial and variation margins be synchronized.

1. ***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?***

Bank Response:

FX swaps and forwards market is highly liquid with settlement risk eliminated through CLS. Net open positions are well monitored by central banks and warrants higher capital allocation under BIS rules. Hence, there is a strong case to exempt them from margin requirements especially when the remaining tenor is less than one year.

2. ***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.***

Bank Response

No. given the several instances of customer assets comingled with firm's assets, it is preferable that collaterals are not re-used or re-hypothecated. In particular, re-hypothecation potentially creates a daisy-chain of credit secured by one set of collateral.

3. ***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 providefor 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?***

Bank response

- We consider the proposed phase-in arrangement appropriate.

- While we agree that the phase-in arrangements should apply to the exchange of variation margin, in addition to the exchange of initial margin, we propose that the requirement to exchange variation margin should come into effect in synch with the requirement to exchange initial margin.

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

Bank Response:

We support the conclusion of the QIS results.

<u>Bank # 6:</u>

We present below first some general observations on the paper and then responses to several of the questions contained in the BCBS document.

General observations

The aims of introducing initial margin requirements for non-centrally-cleared derivatives are stated to be two-fold: (1) to encourage a greater proportion of transactions to be centrally cleared and (2) to reduce systemic risk.

<u>As regards the first point, we believe the introduction of margin requirements to non-centrally-cleared derivatives may be somewhat successful in meeting this aim</u>. However, this raises the issue of creating massive concentrations of systemic risk in central clearers (which history shows are not immune to failure) and, in the local context, is problematic since there is, as yet, no central clearing arrangement in many developing countries.

With regard to the second motivation, the paper starts from the premise that OTC derivatives in general have been problematic in terms of causing unhealthy levels of systemic risk and that this was evidenced during the recent crisis. We would argue that it is less than clear that that was the case, rather the problems occurred overwhelmingly in credit derivatives and like instruments, rather than in, say, vanilla interest rate swap.

<u>Accordingly, the proposals raise the prospect of "throwing the baby out with the bath water" – making it more expensive for all derivative contracts to be executed and potentially reducing liquidity in all derivative markets</u>, when the crux of the problem relates to a subset of the overall derivative market. These costs would be passed on to the end consumer, for example making fixed rate mortgages in the nascent local mortgage market more expensive for the aspirant home buyer, as well as acting as a disincentive for corporations and banks to properly manage their risks.

In addition to having a material negative effect on derivative contracts that might widely be considered to be beneficial to individuals, corporations and the economy as a whole, <u>there is also doubt</u> whether initial margining is a particularly effective tool to mitigate the risk of those derivatives that did give rise to systemic risk issues, most obviously with the collapse of AIG.

Credit derivatives are, in essence, deep out of the money options, initial margins on this kind of contract, calculated along the lines suggested in the paper (99%, 10 day move) would have resulted in negligible initial margin on the majority of credit derivatives written in, say 2006, when credit spreads where very low. Even the proposed standardized initial margin requirements contained in appendix A to the document suggest only a 5% initial margin on a 5 year CDS. Given the gap risk of these contracts, this seems inadequate to provide material comfort in the event of a new financial crisis of systemic proportions.

Furthermore, as the paper suggests, systemic risk from these contracts is concentrated in a few large institutions. Accordingly, it seems to us inequitable to impose general requirements, raising costs for all participants and end users. Greater targeting of regulation – be it margin requirements or otherwise – on the institutions that pose the systemic risk seems to us fairer. Indeed, perhaps by requiring that systemically important institutions need to post substantially more margin than other entities one would reach a scenario where - to the extent they have posted adequate margin - their failure will become less unthinkable: in short they could continue to be big, but would tend to cease to be too big to fail.

Issues raised in the paper

RE: appropriate phase-in period

We feel an answer to this question is dependent on the completion of our own and wider market Quantitative Impact Studies.

RE: exempting FX swaps and FX forwards, Q3…additional product exemptions

Exempting short dated FX transactions would certainly ease implementation and reduce unintended consequences. But it is not clear that these transactions pose less systemic risk than say (vanilla) IRS, so why should not also be excluded? Exclusion criteria could be based around a (regulatory or internal) PFE calculation, over the life of the transaction or a shorter term based on the (variation) margining documentation it is subject to. An intent (hedging, speculation) criterion might also be imposed.

This does rather come back to our opening observations that (1) lower risk transactions do not need initial margining and (2) there is limited meaningful risk reduction in applying initial margin to the much higher risk instruments.

RE: are the proposed key principles and proposed scope of applicability appropriate.

Exchanging initial margin creates delivery risks. It also increases the counterparty risk run by the party that is out of the money, who would otherwise have no counterparty risk. Imposing initial margin requirements could even make it harder for an institution seeking to de-risk its positions to do so, given the liquidity burden it would impose if positions were closed other than with the original counterparty.

Questions would also need to be answered about the implications of non-receipt of initial margin. Would this result in trade cancellation? Default of the entire portfolio? How long would be given to receive?

RE: the suitability of margin thresholds in respect to managing liquidity / differing levels across entities (SIFIs) / prudentially regulated entities / evaluation basis.

In our view the "appropriate" magnitude of thresholds is likely to fall out of the proposed QIS.

Again we would argue that banks and other entities engaged in modest levels of derivative activity for commercial purposes, driven by customer requirements, and which activities pose no systemic risk, domestically or internationally, should be exempted from posting initial margin. Setting thresholds at a sufficient level may be a way of achieving this.

RE: the exemption of non-financial entities that are not systematically important.

A blanket exemption of sovereigns and central banks, in the context of e.g. the EU crisis, seems unduly generous to some of these entities.

Exempting end-users, does not really exempt them - they will still have to pay for the cost of the liquidity.

RE: any specific exemptions that would not compromise systematic risk.

We believe thought should be given to "exempting" smaller banks whose derivative activities do not pose systemic risks.

RE: should model based initial margins restrict diversification benefits.

Given that the intent is to reduce systemic risk, we should be examining possible outcomes *given that a potential systemic risk event is occurring* diversification benefits should therefore be viewed very sceptically.

RE: are the proposed requirements in respect to the treatment of provided margin appropriate?

The principle is sound. The difficulty of achieving this with legal certainty in all relevant jurisdictions should not be under-estimated.

In closing, we would like to emphasize regulatory's and supervisory's representatives critical role in discussions with the BCBS on this subject and like topics. These proposals will no doubt receive a great deal of attention and lobbying from the major international banks, predominantly from the G7 countries. We believe it is vital that the implications for the banks and wider economies of other countries, be considered and that countries with smaller banks are not penalized under the guise of "level playing field" concerns.

Bank additional comments on the revised paper are as follows:

- We note the phase in is now planned for 2019. We would encourage a long phase in period given the potentially significant additional costs and implementation complexities;
- In line with our previous comments and noting the above costs, it remains unclear to us that requiring small and mid-sized banks with modest trading activity in vanilla products to post initial margin provides any material reduction in systemic risk whilst it clearly will have negative impact on those banks and ultimate end users,
- The document references notionals in EUR, it would make more sense to have all values referenced in USD in line with the predominant base currency of most derivative contracts.

Bank # 7:

We have reviewed the documents and principally agreed on the contents therein. However, there would be practical issued with regard to implementation which need to be addressed by regulator providing clear guidance, in particular, to maintain the consistency across banks. One of the challenges is to maintain the harmonization when engages in derivatives activity through a variety of legal entities in different national jurisdictions i.e. most of the transactions with counterparties on a cross-border basis.

Under Requirement 8 of the document states “The requirement to exchange variation margin will become effective on 1 January 2015. The requirement to exchange variation margin between covered entities only applies to new contracts entered into after 1 January 2015”.

We would like to know the regulator’s opinion on the above target date given that significant change in the current processes and procedures are to be in placed before implementation.

With regard to “Standardized initial margin schedule and Haircut schedule”, we understand that the rates mentioned therein would be applicable across the globe and would be same for the developing countries as well. However, we need regulator guidance on the rate applicable to structured derivatives which embedded with unique features.

From Bank perspectives, the bank is in the process of developing OTC collateral management policy which focuses on defining specific rules and guidelines for the setup and running of collateralized relationship and margin calls in bank and through CSA contracts".