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**Subject: Response to the BCBS-IOSCO Second Consultative Document "Margin requirements for non-centrally-cleared derivatives"**

Dear Secretariats,

Shell once again appreciates this opportunity to respond to the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") with respect to the Second Consultative Document "Margin requirements for non-centrally-cleared derivatives" (the "**Second Consultation**").

## A. Introduction

Shell remains supportive of the objectives expressed by BCBS and IOSCO in their Second Consultation, namely:

- reduction of systemic risk
- promotion of central clearing; and

- a consistent international regulatory framework.

In this letter we have provided responses to the four questions asked in the paper, as well as additional comments on the near-final proposals put forward. Our responses reflect three main areas where we use derivatives within Shell:

- Within our Trading business, which acts to balance Shell's physical positions in hydrocarbons, power, freight and emissions, as well as trading in the external markets to unlock the option value of group positions;

- Within our Centralised Treasury function which provides intra-group funding to the group's operating companies and uses derivatives to hedge the exposures of the group to movements in foreign exchange and interest rates; and,

- Within our Asset Management function mainly for group pensions funds that use derivatives to help manage the matching of pension fund assets and their retirement commitments, and for hedging of various exposures.

## B. Responses to Questions asked

**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?"**

We agree that FX forwards and swaps should be exempted from initial margin requirements as the major risk in these instruments becomes settlement risk rather than counterparty risk which can be mitigated by using other methods.

We do not agree that physically-settled FX forwards and swaps with different maturities should be subject to different treatments because this may influence market trading practices, thereby causing distortions that may increase systemic risk rather than reduce it.

In our previous response (28 September 2012) we had proposed that physically settled FX swaps and forwards be excluded from all margin requirements, as the risk is primarily a settlement risk rather than credit risk. We note that at present there is an apparent inconsistency in treatment of these transactions whereby under Dodd-Frank, along with most other jurisdictions with published or draft regulations, these derivatives have been excluded from mandatory clearing and related measures, but presently they remain in scope under EMIR. We would like to see a consistent treatment across jurisdictions to avoid unnecessary complexity.

**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"**

In order to perform its function adequately, it is critical that any initial margin ("IM") collateral exchanged is properly segregated and fully protected in the event of bankruptcy of the collecting party. However, in practice, we believe such protection would be very difficult - or even impossible - to perfect, particularly when dealing with counterparties across multiple jurisdictions. We believe that the risks to collateral providers of allowing re-hypothecation as described in paragraph 5(a) of the consultation paper are significant. In the case of non-cash collateral we would want to be certain that, in the event of bankruptcy of either our direct counterparty or the party holding the collateral, we could recover the assets transferred rather than the liquidation proceeds of those same assets – if we receive cash, we could find ourselves facing unexpected foreign exchange risk or other asset-price risk, as in many cases these assets would have been hedged.

In order to reduce the legal and operational complexity around managing the above risks, we strongly believe that market participants should have the option to agree either to prohibit or allow limited re-hypothecation on a contract-by-contract basis, under the conditions set out in the question and where parties have the option of providing collateral in the form of a pledge, rather then via an outright transfer of title.

Shell believes Variation Margin ("VM"), which represents "gains and losses", should continue to be re-hypothecated without restriction, as is current market practice.

**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 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 IM 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?"**

In our response to the previous consultation, Shell requested a long phase-in period for any margin requirements, in order to provide affected market participants with adequate time to prepare. Therefore we support the phase-in arrangements suggested in the Second Consultation . For the same reason, we propose that variation margin requirements should be phased in over the same period, without retrospective application.

We also propose that for non-banking groups in which treasury & risk management are clearly centralised, thresholds should be applied with respect to "external" derivatives only (i.e excluding intra-affiliate derivatives).

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

Whilst we do not comment on the detail of the QIS, we note that the study focuses on banks, insurers and pension funds. Such focus is appropriate given that these organisations make up the majority of global, non-centrally cleared derivative activity. However, we also recognise that organisations outside of traditional financial services are impacted by these rules, which may have potential knock-on impacts for their activities in the 'real economy'. As such, Shell remains happy to participate in the ongoing dialogue on margin requirements for non-cleared derivatives.

## C. Key comments on the wider set of proposals

### Use of models to calculate initial margin (IM)

- As noted in our response to the previous consultation, allowing some parties to use their own internally developed IM models whilst requiring others who do not have their own models to use the Standardised initial margin schedule will create an uneven playing field between Covered Entities – the QIS estimates IM requirements calculated using the Standardised initial margin schedule to be 11.1x the IM for the same portfolio of derivatives calculated using an internally developed model.

### Potential inconsistencies in application of global principles by local regulators

- We note that both the **definitions of 'financial firms' and 'systemically important non-financial firms'** and the **treatment of non-cleared OTC derivatives between firms and their affiliates** have been left up to local regulators. The resulting inconsistencies are likely to create opportunities for regulatory arbitrage.
- In particular, Shell believes global rules on intra-affiliate margin are necessary to promote a level playing field and that neither IM nor VM should not be required between firms and their affiliates. In the case of non-bank Covered Entities which are part of non-banking groups with limited external OTC derivative market facing group entities and centralised treasury and cash management arrangements, the exchange of bilateral IM and VM between companies within the same group is not appropriate and serves no market stability function.

### Collateral

- Non-banks should be able to use letters of credit (LC) or bank guarantees as collateral in respect of uncleared derivative trades. This would assist Covered Entities in non-banking groups who may have significant less liquid assets and less ready access to highly liquid collateral by the nature of their business than banking groups.

The above response is based on our understanding and assessment of the effect of the regulatory landscape as it is, and as is currently proposed. Given that this landscape is changing as the regulatory reform agenda develops across different jurisdictions, we reserve the right to revisit, and if necessary amend, any of the comments we have made based on the position as it currently stands. On that basis, we hope that our response is of assistance. We would be happy to discuss any aspect of this response further with you. Please do not hesitate to contact us in this regard.

Yours faithfully,

Andrew Hammond
Senior Finance Advisor

On behalf of **Shell International Trading and Shipping Company Limited, Shell Treasury Centre Limited and Shell Asset Management Company BV**