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Margin Requirement on non-Centrally Cleared Derivatives

Dear Sir/Madam,

It is amazing that the Working Group could, in such a short time, come to such functional but relatively simplistic draft guidance on such a vexatious subject with interests from such wide cross section of financial market participants. The Group has done a commendable job to also run a QIS to assess the impact of the proposed approach and to take the same into consideration.

2. Based on the concern that margin requirements could push costs or can result in adversely impacting liquidity in the collateral market, initial proposals have apparently been drastically changed. One gets a distinct feeling that these perceived impediments have been allowed to largely overshadow the original concerns as listed in page 12 under Objective in the Executive Summary which were (a) Reduction of Systemic Risk and (b) Promotion of Central Clearing.

3. Potential liquidity shortage in collateral market is surely a big issue; but deferring collection of Initial Margin or sharply reducing liability to exchange initial margin by setting an inordinately high threshold of Euro 50 million to achieve this is far worse than the implications that the perceived collateral shortage could have had on the stability of financial market. If promotion of Central Clearing is an objective and the approach to make transaction in non-cleared derivatives costlier (vis-à-vis clearing through Central Clearing) has not been given up, any action that will make Central Clearing costlier vs non-Central Clearing will surely militate against the objective.

4. Variation Margin will be applicable for both Centrally Cleared and non-Centrally Cleared derivatives. Thus, if full netting across products is allowed at bilateral level, net variation margin exchange in case of partly Centrally Cleared and partly non-cleared trades may lead to higher cost vs. all non-Centrally cleared trades with netting arrangement. It will perhaps not be out of context to add here that many of those entities who firmly believe in effectiveness of the netting arrangements would refuse to do transactions relying on such agreements under a stress scenario. This was clearly seen in immediately post-Lehman era.

5. As a result of the proposed dilution in the requirements to maintain Initial Margins, it will now be effectively applicable only on Centrally Cleared contracts. For Central Clearing, this was already applicable and is now being substantially enhanced under the new Principles for Financial Market Infrastructure issued by CPSS-IOSCO in April ‘12.

CCPs also collect contributions to their Default Funds from its clearing participants. Basel Committee on Banking Supervision, in its latest guidance for deciding on bank's capital requirements for exposures on CCPs have stipulated sharply high level of charges on initial margins kept with CCPs by banks and at even higher level on Default Fund contributions.

6. It is therefore apparent that the proposed steps to dilute the proposal to make initial margin payable mandatory for all identified counter-parties or even deferring the proposal by some period will probably boomerang and will, sooner than later, start marching the market towards new potential crisis. I, therefore, would request the Working Group to reconsider this aspect.

7. If centralisation of collateral through bilateral exchange and keeping these margins segregated is perceived to be impacting liquidity in the collateral market significantly, a solution could be found by creating Centralised Collateral Agencies like CCPs which could accept collaterals towards initial margin on a multilaterally netted basis (multilateral netting would probably reduce collateral requirement by about 70 to 80% without impacting efficiency) and in case of a less recovery in a default, it can have a process of allocation of shortfall to the counter-parties of the defaulter. It will be a secure and transparent arrangement and is likely to be workable under almost all legal jurisdictions.

8. In the light of my observations as above, may I now respond to the questions asked:

Q1. *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?*

Response: Fx Forwards are possibly most volatile non-leveraged financial derivative products. If the Potential Future Exposures on those are not collected as Initial Margin, the underlying risk will remain un-covered. Such an action will surely facilitate that these transactions remain outside Central Clearing on cost consideration (as cost towards Initial Margin for Central Clearing is likely to be substantial in this case). Given the data from QIS showing the huge level of outstanding forward contracts of duration above 1 month and taking into consideration that real market is most susceptible to exchange rate volatility, a step in the direction to waive initial margin on FX Forward contract will appear to be most inappropriate. Decisions on collection of Variation Margin should also be uniform across the jurisdictions so as to avoid divergence; else such divergence will have the potential to move the market from one location to the other.

Fx_Swaps excepting a small portion which are of forward starting variety become forward contracts as the near leg is settled. As long as both legs are in not-settled status,

the margining approach will take the potential volatility at lower value. Hence, in my view, no separate treatment is required.

Q2. *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.*

Response: Re-hypothecation right is a reasonable right. However, the cost of tracking re-hypothecated assets and its restoration in time is so high and the process so cumbersome, even if it is allowed, it is likely to be inadequately utilised. However, if the approach suggested in para 7 above is used, need for re-hypothecation would almost disappear. Even if it is so required at that stage, the management will be easy & transparent.

Q3. *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 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?*

Response: The response to this issue is included in paragraphs 2 to 5 above.

To summarize,

(i) Phase in proposal for initial margin is grossly inappropriate and will cause trades to move out of Central Clearing thus causing potential systemic inability. If at all required, entities which are less systemically risky, may be given some extra time.

(ii) Phasing in collection of Variation Margin will only add to the problem. In any case, CSA is already an established market practice for the last few years and any phase in of collection of variation margin will effectively mean moving backwards. If possible, scheduled date for starting collection of Variation Margin may be pre-poned.

(iii) For Emerging Markets, national regulators should have some discretion in the model to be used for computation of Initial Margin etc; but variation margin should be collected in all eligible cases.

9. This submission is being made by me in my personal capacity. Please feel free to get in touch with me if any clarification is needed.

10. I again take this opportunity to thank the Working Group for excellent piece of work done. In case any clarity is required on my submission, I would be very happy to provide such clarification.

With regards,

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