Mr David Wright
International Organisation of Securities Commissions
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cc: Basel Committee on Banking Supervision

15 March 2013

Dear David,

Re: Consultative document: Margin requirements for non-centrally cleared derivatives

Thank you for the opportunity to respond to this consultation paper. We recognise that the scope of the consultation is deliberately narrow and that the Working Group on Margining Requirements ("WGMR") of the BCBS and IOSCO has already made several key policy decisions. Nevertheless, we raise several points which we believe are of importance for how the rules will be implemented in practice.

Firstly, we would urge WGMR to exempt physically settled foreign exchange ("FX") swaps and forwards from the scope of the final rules. This is crucial for several reasons:

- There is a real need for FX risk management. Trillions of global trade, commerce and investment are executed in US dollars by counterparties in countries where the currency is not a US dollar. If the cost of using these instruments increases significantly, these counterparties may be inclined to reduce their activities or stop hedging altogether. There would be an adverse impact on the real economy. In particular, the rules would discriminate against emerging markets, where FX is a matter of commercial reality. In many of the countries in our footprint, there are no big blocks of trade where the use of FX is not prevalent (as might be the case in the EU), nor do those countries have a global reserve currency which allows them to worry less about FX risk.

- The introduction of margin in FX markets would be entirely disproportionate to the amount of risk posed. Our experience of banking with thousands of financial institutions in Asia, Africa and the Middle East – before, during and after the crisis – has been of virtually no credit or market risk losses. Ultimately, by introducing margining for these instruments, regulators will unintentionally replace a small, second order risk (the credit risk associated with the FX risk) with a much larger, first order risk as banks and their clients stop hedging FX exposures. This will unquestionably increase the overall risk in the system, which is precisely the opposite of the desired outcome and the G20 commitment.

- There needs to be consistency of treatment globally. Some jurisdictions have already exempted FX swaps and forwards from clearing and trading requirements, recognising their difference. The imposition of mandatory margin requirements would largely undermine the existing exemptions accorded to these products.

Second, Standard Chartered Bank is a leading international banking group, providing a wide range of products and services for personal and business customers across seventy markets. Our key concern with regard to the WGMR proposal is how the new rules are intended to work on a cross-border basis – an issue that was raised by many of the respondents to last year's consultation paper. Although the second paper touches upon it, we are disappointed that this has not been addressed in the near-final rules in a sufficiently meaningful way.

There are three broad strands to the cross-border issue.

- The paper urges regulators to ensure that each jurisdiction's rule are 'territorially complementary' in order to avoid duplicative or conflicting requirements. Although this is a laudable aim which we support, it is not easy to achieve - at least not in the short term. It will require equivalence and cooperation agreements to be drawn up between many jurisdictions, which can be a slow and politically-charged process. Enforcement of these proposals across all jurisdictions in their current form will add increased uncertainty for clients.

- There needs to be clarity about how the rules apply to transactions where one counterparty is in a jurisdiction where there is no netting or where collateral exchange may not be enforceable. This creates legal uncertainty, and the risk that the collateral posted to or received from such a counterparty may not become available in default.

- It is not clear how the rules would apply to transactions with entities in countries that do not immediately implement the rules, either because they plan to do so on a slower timetable, or because they do not want to do so at all.

WGMR should address all of these issues explicitly in its final rules, and agree in principle how cross-border trades should be treated. Our view is that trades with counterparties from jurisdictions without enforceable netting or collateral arrangements should be subject to a deferred implementation schedule until their legal regimes are sufficiently robust to support margin exchange. Trades where one counterparty is in a jurisdiction without equivalent legal certainty should also be subject to a deferred implementation schedule if the regulator's intention is to implement in due course. We explain this in more detail in our response to question 3.

Finally, we draw your attention to the difficulties inherent in the use of models to govern margin exchange as envisaged in the paper. If firms use a standardised schedule, the paper itself acknowledges that the amount of margin posted would increase significantly. If, on the other hand, each firm has to develop its own models and get them approved by regulators, this will not only be time-consuming and expensive but will also likely to lead to a great number of disputes. WGMR should take more time to consider feasible alternatives, and whether a model could be developed that all firms should use. Again, we would add that the requirement to approve models may have a disproportionate impact on smaller regulators in emerging markets jurisdictions, who may not have sufficient capacity to deal with the process.

If you have any questions or wish to discuss further, please do not hesitate to contact me.

Yours sincerely,

Lenny Feder
Group Head, Financial Markets

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?

Please see our comments in the covering letter. We are concerned that any requirement to margin FX transactions will discriminate against emerging markets jurisdictions, where the use of these instruments is a matter of commercial necessity.

Foreign exchange swaps and forwards are not the same as other derivative transactions, and should be treated differently - the distinctiveness of FX as an asset class is sufficiently pronounced to warrant specific regulatory treatment. In the EU, this is acknowledged in the European Markets Infrastructure Regulation ("EMIR") recital (19) which states that: "The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes." Similarly, the US Department of the Treasury has already exempted them from both central clearing and trading requirements under the Dodd Frank Act.

As a provider of foreign exchange swaps and forwards for clients across many legal jurisdictions and differing regulatory requirements, we strongly believe that these instruments should be exempt from the margining proposals.

In terms of the possible different treatment of instruments with different maturities, we do not agree with the introduction of tenor limits. This is chiefly because limits may create cliff-edge effects and lead to an artificial accumulation of risk just below the stated threshold. This is likely to create a bifurcated market.

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.

We do not believe that rehypothecation should be prohibited in principle. If there is a policy decision to do so, balance should be struck between investor choice and investor protection in order to avoid penalising clients unnecessarily. The conditional approach to rehypothecation outlined in the question would allow some capacity for rehypothecation but would intensify complexity for clients as well as the banks covered by these proposals.

Our view is that a party posting initial margin should be able to elect whether to (i) permit the collecting party to hold the margin without restriction on re-hypothecation; (ii) permit the collecting party to hold the margin, but only with limited rights to its re-hypothecation; or (iii) require initial margin to be held, at the posting party's expense, by a third-party custodian.

However, with respect to option (ii), in order to effectively implement a limited rehypothecation regime, each jurisdiction in which the collateral is located would have to accord creditors a first priority lien on the pledged collateral in the event of the pledgee's

insolvency. For this to happen, domestic insolvency regimes would need to be able to support such arrangements, and it is not clear whether this is the case in many jurisdictions globally. Any phase-in requirements should take this disparity in legal regimes into account: if some covered entities are permitted to rehypothecate margin in this way and others are not, this could create unnecessary competitive advantages between markets and opportunities for arbitrage. In fact, prudentially regulated firms such as Standard Chartered are required to hold capital against unsecured exposures they have for return of initial margin. As a result, these firms should be able to absorb losses on that margin already.

We return to this issue in our response to Question 3.

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?

We do not believe that the proposed phase-in is appropriate, either in terms of its start date, or how it is structured. This is for several reasons.

- First, although the WGMR proposals may be approved in 2013, national regulators will still need to implement them locally. In the EU, this would require a further consultation, which would most likely push the final rules adoption to Q1 2014. Considering the paper proposes that variation margin should be exchanged from 1 January 2015, this does not give sufficient time for firms to implement the necessary changes.

  We would suggest that the phase-in begins only after a number of jurisdictions adopt the final rules in their domestic legislation. BCBS/IOSCO should monitor implementation and determine a point at which there is a critical mass of covered entities globally to whom the rules would apply. This agreed trigger would ensure that there is sufficient clarity around which jurisdictions and which counterparties are in scope, which would be especially important where there are questions around the adequacy of legal regimes. It would also have the benefit of not disadvantaging counterparties from jurisdictions which implement the rules first, and of allowing sufficient time for the central clearing regimes to bed down.

- Second, the paper acknowledges that the universal two-way initial margin exchange represents a 'significant change in market practice' which will pose 'logistical and operational challenges'. We would highlight several issues in this context which we believe mean that a longer transition period is needed. These can be divided into issues of a legal, operational and regulatory nature, though they overlap to a great extent.

  Legal issues: It will be necessary to 'repaper' existing client documentation, whether by amending CSAs or *via* an agreed protocol. This will be a lengthy and resource-intensive task. However, a much more pressing legal problem is going to be how to treat trades with counterparties in jurisdictions where there is no netting and whose legal system does not support collateral exchange. The paper acknowledges the need for robust legal regimes to underpin the exchange of margin: it talks about netting agreements being effective under the laws of relevant jurisdictions, and about the margin having to be subject to arrangements that protect the posting party against bankruptcy. However, it merely concludes that jurisdictions should be *encouraged* (our italics) to review the relevant local laws to ensure that collateral can be sufficiently protected. We think the final rules should instead be seeking explicit commitment from WGMR members to tackle these legal differences.
  For a firm like Standard Chartered, the number of jurisdictions where netting and collateral arrangement could be a problem is potentially higher than for many firms whose business is primarily in the developed markets. It seems unlikely that all of those jurisdictions would be willing or able to make these substantial legal changes in the short term, i.e., in the period before we are required to comply.

  We would urge WGMR to clarify in their final rules how such trades are to be treated. Our view is that they should be granted further transitional relief until such time as the legal regime of a jurisdiction is deemed sufficiently robust to support the exchange of margin. In the absence of such legal certainty, complying with the new rules would lead to an increase in risk to the Bank itself but also possibly of systemic risk in certain circumstances. This is because the counterparty in a jurisdiction that has implemented the rules would be required to post margin without any certainty that it could recover it in the case of the other side defaulting. Alternatively, in lieu of mandatory posting of margin in these jurisdictions, WGMR mights consider requiring prudentially regulated firms to reserve an equivalent amount of capital against these exposures.

  Operational issues: Much of the infrastructure that would need to be put in place before margin can be exchanged in the way envisaged in the paper will take time to build. Collecting and segregating initial margin would require the development of operational and accounting systems that many firms have not previously had to implement. This will add additional costs that may be difficult to absorb. To the extent that third party custodians are required to fulfil these obligations, such arrangements may in many of the jurisdictions in which we operate be very onerous or simply not possible to establish: there may be no suitable custodians and/or local laws may not support the safe custody of client assets as contemplated by the proposals. In the developed markets, initial margin is likely to be concentrated within the major custodian banks who have the capability to support the complexities involved. This will have the effect of concentrating pools of collateral in a limited number of large institutions, which could increase systemic risk. Within the emerging markets, there is potential for this risk to be even more concentrated given the dependence upon the major western banks for custodial services.

Many firms will also not have the infrastructure needed to undertake appropriate collateral management. They will need time either to build systems or to make other arrangements. This may be true for non-bank and smaller financial institutions, and some emerging markets counterparties. But it is also likely that the existing collateral management infrastructure within many financial institutions will need material development to support the changes. Finally, although the rules apply to new trades only, which we fully support, there will be operational impact on how these interact with outstanding legacy trades.

Another operational issue that will need to be addressed is that of counterparty scope. Although the Committee has now decided that systemically important non-financial entities should be subject to the margin rules, there are difficulties inherent in this approach that should be tackled at the WGMR level.

There is no globally-accepted standard or methodology for determining which non-financial firms are systemic. What the UK deems systemic may not reflect what a local Asian regulator may think – this is the same issue that will have to be addressed in the context of developing the D-SIB (domestic systemically important banks) regime. If each jurisdiction were to develop its own parameters – which could be done by mirroring the exemptions from the clearing obligation – there will not only be no consistency between jurisdictions, but it will also not be clear who these counterparties are, as there will be no central and global repository that firms could refer to. In the EU, because the non-financial firms that breach the threshold must notify the regulator, the industry is urging the European Securities and Markets Authority ("ESMA") to maintain such a repository for everyone's benefit. It is not clear how this can be replicated globally, or who would be a custodian of such data. But without a central source of information, firms will need to invest a disproportionate amount of time and effort checking if a non-financial counterparty is systemically important. It seems likely that firms would need to rely on non-financials for representation of their status, which would take a while to validate. We would urge the regulators to interpret the paper's requirement about working together to "ensure that there is sufficient transparency regarding which entities are and are not subject to the initial margin requirements during the phase-in period" as a requirement to maintain a central list of such entities, as well as a commitment to align their rules.

<u>Regulatory implementation</u>: Developing initial margin models and getting them approved takes time. In addition to the work that would have to be done by firms internally - which would be significant - the possibility of every financial firm in a particular jurisdiction seeking approval from the same regulator is likely to cause logjams which will take time to process. Firms' current experience of getting models approved is that the process is a lengthy one.

More specifically, the problems of how counterparties from different markets, with different levels of sophistication, different models and different types of collateral mandated by their local regulators, can agree on the amount of initial margin to be delivered is much greater than we think the paper acknowledges. Coming to an agreement may be difficult even between large banks operating in the US and the EU, let alone outside the main market hubs and between smaller counterparties. Disputes are likely to be frequent and difficult to resolve, especially as models are proprietary and firms will be reluctant to disclose them. It is of course true that firms could use the standardised schedules but the quantum of margin required would increase significantly, as the paper itself acknowledges. We do not think this is a viable option because of the impact on the real economy.

Instead, we believe that regulators should take time to consider alternatives. One option would be to develop risk-sensitive standardized models across major products and markets to be used by all covered entities. It is imperative that this should be done on a global level to ensure consistency.

- Finally, we would add that a longer phase-in would allow market participants to tackle some of the commercial issues that will arise as a result of the new rules. We said in our response to the original consultation paper that the business impact of exchanging two-way initial margin is more pronounced for firms such as Standard Chartered that operate so extensively on a cross-border basis. The new policy proposals have not changed this. When we execute an uncleared OTC derivative with a counterparty, in order to hedge risk we are likely to enter into a related hedge trade either with our London head office and/or a cleared trade with a CCP or non-cleared trade with another financial institution. Given that repo markets in many jurisdictions remain less developed, local government bonds taken as collateral cannot easily be converted into a currency such as US Dollars eligible as collateral for the hedging trades. Furthermore, local regulations are likely to limit the extent to which local collateral, including the local currency, can be converted to an eligible currency and moved offshore. This additional cost of hedging will have to be factored into the price of transactions and passed back to the end user client, and may outweigh the benefit of doing the trade in the first place. There is a risk that end user clients would, as a result, choose not to transact and leave their risks unhedged, resulting in an impact on the real economy. It is not clear how this can ever be resolved but a longer transition period would at least allow the clearing infrastructure to develop in emerging markets jurisdictions, and for the effects of the various regulatory initiatives to become more transparent.

- We would also suggest that a phase-in period should be permitted for variation margin as well as initial margin. The exchange of VM is by no means universal, and would for some counterparties require a significant shift in practice. As the paper suggests, this could be particularly acute in emerging markets jurisdictions.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

Standard Chartered Bank did not take part in the QIS at the time of the initial consultation. We are therefore not in a position to comment on whether the results are representative of the views and data submitted.

However, we note with interest the industry concerns about the methodology used in the QIS and the assumptions used in the process – for example, the absence of uniform stress testing of estimated initial margin levels, the use of internal models versus the standardised schedule, or the availability of unencumbered assets.

We would add to that the lack of any analysis of cross-border complexities of how the rules would work in practice. The QIS does not take into account the asymmetry of model or collateral use between different jurisdictions – we cover this in our penultimate bullet point in response to Question 3. We would be happy to discuss this in more detail.