TOWERS WATSON

Towers Watson response to the Basel Committee on Banking Supervision and the Board of the International Organisation of Securities Commissions on their Second Consultative Document on margin requirements for non-centrally-cleared derivatives

Towers Watson is a leading firm of investment consultants to a wide range of institutional asset owners globally. In the UK our predominant client base is the trustees of large occupational pension schemes. We would be happy to meet with the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) to discuss this topic further and expand on the points made below.

We would also be happy to provide the BCBS and IOSCO with further background and evidence with regard to the points made in our response.

Question 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?

- As we commented in previous consultation, we support the margining and clearing of derivatives to reduce systemic risk and counterparty risk. However, we believe that these margining requirements should be measured against the increase in capital requirements and hence costs for margining these derivatives. If the capital requirements/ costs associated with margining (both initial and variation) physically-settled FX swaps and forwards are such that it would result in market participants not transacting these derivatives to control risk, then we would support exempting these transactions from initial margin requirements.

- We are comfortable with applying different treatment to FX contracts with different maturities provided that this does not lead to market participants taking excessive risk or incurring significant costs as a consequence.

Question 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.

- Whilst the intention is to protect customer assets in a manner consistent with the key principle, it is not clear how re-hypothecation of collateral would work in the case of initial margin and so we maintain our reservations on this. We recommend that initial margin is not allowed to be re-hypothecated by the collecting party.
- We understand that re-hypothecation aides in managing the costs of transacting derivatives. However typically our clients do not re-hypothecate under their existing derivative arrangements.

Question 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 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 are broadly comfortable with the proposed phase-in arrangements. However we note that for pension funds that have a temporary exemption from central clearing it is counterintuitive to require pension funds to implement the margining requirements of non-centrally-cleared derivatives in advance of this.
- We are supportive of the phase-in requirements applying to both the exchange of variation margin and initial margin at the same time rather than applying variation margin requirements in advance of this (ie on 1 January 2015). We recommend that sufficient time should be given to allow market participants such as pension funds to understand and set up the operational infrastructure. In particular, most pension funds do not hold significant levels of cash required to meet the potential variation margin requirements under the proposed margining framework.

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

- No comment.

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