UBS AG
P.O. Box
8098 Zürich

Group Governmental Affairs

Mr Thomas Pohl
Bahnhofstrasse 45
P.O. Box
8098 Zürich
Tel. +41-44-234 76 70
Fax +41-44-234 32 45
thomas.pohl@ubs.com

www.ubs.com

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, 4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

baselcommittee@bis.org
wgmr@iosco.org

15 March 2013

Re: Second consultative document on "Margin requirements for non-centrally cleared derivatives"

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions for the opportunity to comment on the second consultative document on 'Margin requirements for non-centrally cleared derivatives'. Please find attached our response to the paper.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Andrew Bell on +44 20 7568 1385

Yours sincerely,
UBS AG

Thomas Pohl	Andrew Bell
Managing Director	Executive Director
Head Executive and International Affairs	Public Policy EMEA
Group Governmental Affairs	Group Governmental Affairs

UBS Response to the Joint
Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions' Second Consultative Document on margin requirements for non-centrally cleared derivatives

INTRODUCTION

UBS would like to thank the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) for the opportunity to comment on the second consultative document on 'Margin requirements for non-centrally cleared derivatives'. Please find below our comments on the key principles as well as the specific questions set out in the paper.

We are grateful to the BCBS and IOSCO for taking into account some of the comments in our response to the first consultative document. In particular, we appreciate the clarification that the rules will have no retrospective application and the proposal for a phased introduction of the requirements. However, many of the concerns we raised in our previous response remain outstanding. Whilst the proposed measures in the second consultation document will mitigate the liquidity impact of the requirements to some degree, in our view the requirements, if implemented as proposed, would still result in a global liquidity squeeze and impact negatively on the ability of the banking system to lend to the real economy.

Furthermore, the second consultation fails to address many of the significant legal and operational challenges associated with the original proposals. For example, many current OTC market participants would be required to make considerable investments in infrastructure covering margin calculation, account segregation, dispute management policy and procedures. Many counterparties are unlikely to have the resources (or want to bear the expense) of having to

calculate and collect variation margin (VM) and initial margin (IM). In terms of legal documentation, it is important to take into account that the length of time spent to negotiate each credit support annex (CSA) could extend to 3 months per contract. This is because current CSAs only cover VM and not IM, and for the latter, a different legal set up is required as it needs to be placed in custody and pledged.

We also note that in many jurisdictions it has not yet been determined which classes of derivatives will be subject to mandatory clearing obligations. We believe it would be a highly undesirable and inefficient outcome if counterparties were required to invest significant resources to facilitate IM exchange for classes of derivatives not yet subject to a mandatory clearing requirement, only for the given class of derivative to be subsequently subjected to mandatory clearing under national regimes making the previous investment redundant.

As it is not common market practice today to have two-way exchange of IM, we believe that the complexity of posting IM between counterparties which have never done so should not be underestimated. As a result, we do not believe that the proposed requirements appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact. The proposals are likely to reduce one important source of systemic risk (i.e. counterparty credit risk) but at the expense of introducing significant additional liquidity risks and reducing the extent to which risks are hedged.

The overall impact on systemic risk is in our view ambiguous and we therefore continue to oppose mandatory gross, two-way exchange of IM with only very limited potential to re-hypothecate or re-use.

If, despite our concerns the final proposals do require mandatory two-way exchange of IM, we believe the coming into force date of the proposals should be delayed to give a reasonable period to comply following the agreement of mandatory clearing and non-cleared margining requirements at a national level in all of the key derivative market jurisdictions. Our proposal would be for the requirements to

come into force no sooner than 2 years after implementation of requirements for margining of non-cleared derivatives in each key jurisdiction.

Key concerns we have with the specific proposals in the consultative document are as follows:

- We disagree that an objective of margin requirements for non-cleared derivatives should be to promote central clearing
- In addition to physically settled FX swaps and forwards, we consider it appropriate to exclude all short dated derivatives (maturity of less than 3 months) where the counterparty has the ability to close trades and reduce their exposure to a dealer
- We would be grateful for additional clarification on the calculation of the IM threshold and de-minimis threshold and for additional flexibility to determine the thresholds on a bilateral basis
- We believe the proposal to apply the IM thresholds at a consolidated level has the impact of materially lowering the effective threshold and should be reconsidered
- We believe demonstrable offsets across asset classes should be permitted when calculating IM
- We believe the proposals in this paper should be considered in conjunction with relevant capital rules in Basel III to avoid double counting of risk
- There should be grandfathering/flexibility to use existing margin models to prevent the need to use standardised approaches during the supervisory approval process
- We propose a wide range of eligible collateral provided risks are adequately mitigated. We would be concerned about an approach where national supervisors have discretion to develop their own list of eligible collateral assets as this risks creating an unlevel playing field at a global level and incentivising regulatory arbitrage

- We believe the proposed segregation requirements will likely result in increased concentration risk in the market due to material amounts of additional collateral being held on a tri-party basis
- We have concerns that the conditions imposed on the potential to re-hypothecate collateral in the specified circumstances will render the proposal unworkable
- We are concerned about VM or IM requirements for transactions with affiliates and believe local supervisory discretion to impose IM and VM on transactions with affiliates is likely to undermine global consistency
- We believe the overall implementation timetable should be delayed to give market participants additional time to prepare for the substantial legal, operational and liquidity challenges resulting from the proposals
- In our view, the QIS findings underestimate the liquidity impact of the proposals

Executive Summary

Consultation proposal

Promotion of central clearing: The paper states that margin requirements for non-centrally cleared derivatives have two main benefits: (i) reduction of systemic risk and (ii) promotion of central clearing.

UBS response

We disagree that an objective of margin requirements for non-cleared derivatives should be to promote central clearing.

The counterparties subject to margin requirements for non-centrally cleared derivatives are typically the same counterparties that are subject to mandatory clearing requirements. Therefore, in relation to classes of derivatives declared subject to a mandatory clearing obligation, they will need to clear.

In addition, for classes of derivatives not subject to mandatory clearing, capital requirements already address differences in risk presented by centrally cleared versus non-centrally cleared derivatives. In our view, the capital treatment

combined with the multilateral netting benefits of central clearing create significant incentives for the use of centrally cleared derivatives where viable.

If, despite these differences, a counterparty still chooses to use non-cleared rather than cleared derivatives, this will typically be based on the need to have a bespoke product to hedge a specific risk where the use of a more standardised cleared derivative would result in material basis risk. So to the extent that the use of non-cleared derivatives typically contributes to a reduction in basis risk, the use of such products should reduce overall systemic risk and should not be discouraged by overly conservative margin requirements.

Element 1: Scope of coverage – instruments subject to the requirements

Consultation proposal

The paper proposes that, except for physically-settled FX forwards and swaps, the margin requirements apply to all non-centrally cleared derivatives. Comment is sought on the treatment of physically-settled FX forwards and swaps.

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?

UBS response

We believe that physical FX swaps and forwards should be exempted from the margin requirements for the following key reasons:

- **Transparency:** Unlike many other derivatives, FX swaps and forwards already trade in highly transparent, liquid, and efficient markets. Also, FX swaps and forwards are heavily traded on electronic platforms and market pricing information is readily available from a number of sources.
- **Settlement risk versus counterparty risk**: Because FX transactions involve the actual exchange of currency, settlement risk (the risk that one

party to an FX transaction will pay the currency it sold but not receive the currency it bought), is the main source of risk. At a global level, there is a well-functioning settlement process that effectively addresses this risk. There is extensive use of payment systems that permit the transfer of one currency to take place only if the final transfer of the other currency also takes place.

- **Contract duration:** FX swaps and forwards are predominantly short-term transactions (68 percent of the market matures in one week or less and 98 percent in one year or less) whilst many other derivatives have much longer average maturities. The short duration of contracts means FX swaps and forwards pose significantly less counterparty credit risk than other derivatives. Consequently, margin that mitigates counterparty credit risk is not the appropriate mechanism for addressing the main risk posed by these products.
- **Fixed terms and physical exchange:** In contrast to other derivatives, FX swaps and forwards always require both parties to physically exchange the full amount of currency on fixed terms that are set at the outset of the contract. Market participants know the full extent of their own payment obligations and their exposure to the other party to a trade throughout the life of the contract.
- **No Cleared Alternative**: Importantly, it is now widely recognised that CCP clearing of physically delivered FX presents a special set of challenges, in particular a CCP would need to be able to source enough physical currency in many denominations to meet the defaulter's FX payment obligations, in what would almost certainly be a highly stressed market. So far this problem has not been solved, and CCP clearing for physically delivered FX is not on the horizon. (Recognising that FX swaps and forwards are different from other derivatives for many of the reasons above, US Treasury has determined not to submit FX swaps and forwards to a mandatory clearing requirement.) In this context, imposing a mandatory bilateral margin regime that would necessarily significantly increase costs for the market that underpins the global payments system and is fundamental to international commerce is something that should only be done with extreme care.

The overwhelmingly short dated nature of FX transactions, in contrast to many other asset classes, provides FX market participants with considerable greater flexibility in managing their counterparty exposures, as was demonstrated during the financial crisis. Therefore a "one size fits all" regime that mandates a high level of margin be collected even from financially strong counterparties whose creditworthiness is highly unlikely to deteriorate during the lifetime of an FX contract is a disproportionate response that will impair both the FX market and, given the ubiquity of currency conversion, the real economy. Similarly, mandating two-way margining may create an unnecessary barrier to entry for many FX market participants who need to do FX transactions occasionally but have little appetite to invest in the capability required to manage the collateral they will be forced to receive.

We do not consider it appropriate to subject FX transactions of differing maturities to a different treatment as the justifications for exempting such products from margining apply to all physically settled FX swaps and forwards.

In addition to physically settled FX swaps and forwards, we consider it appropriate to exclude all short dated derivatives (maturity of less than 3 months) where the counterparty has the ability to close trades and reduce their exposure to a dealer. For such short dated products we consider that concerns about the creditworthiness of a counterparty are better addressed by closing or transferring the trades than relying upon initial margin.

Element 2: Scope of coverage – scope of applicability

Consultation proposal

The paper proposes that all covered entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin (i.e. a zero threshold) on a regular basis (e.g. daily).

All covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million. The threshold is applied at the level of the

consolidated group to which the threshold is being extended and is based on all non-centrally cleared derivatives between the two consolidated groups. All margin transfers between parties may be subject to a de-minimis minimum transfer amount not to exceed €100,000.

Covered entities include all financial firms and systemically important non-financial firms. Central banks, sovereigns, multilateral development banks, the Bank for International Settlements, and non-systemic, non-financial firms are not covered entities.

Initial margin requirements will be phased-in, but at the end of the phase-in period there will be a minimum level of non-centrally cleared derivatives activity (€8 billion of gross notional outstanding amount) necessary for covered entities to be subject to initial margin requirements described in this paper.

The precise definition of financial firms, non-financial firms and systemically important non-financial firms will be determined by appropriate national regulation. Only non-centrally cleared derivative transactions between two covered entities are governed by the requirements in this paper.

<u>UBS response</u>

We do not support gross, two way exchange of margin

As stated in our response to the first consultative document, we do not support the requirement for IM to be exchanged on a gross basis. We believe IM should be exchanged on a net rather than gross basis. Reducing exposures in cases where positions offset each other is a fundamental concept and should not be prevented.

Operational concerns regarding the calculation of IM threshold

We consider it to be unclear how exactly the threshold should be calculated. The specific requirement is that "All covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million. The threshold is applied at the level of the consolidated group to which the threshold is being extended and is based on all non-centrally cleared derivatives between the two

consolidated groups". Based on the example in the CP, we understand that the threshold relates to the aggregate amount of the IM requirement between the counterparties (i.e. if aggregate gross IM requirement is 55, and the threshold 50, IM of 5 will need to be collected). IM must be exchanged on a gross basis so we infer that the IM threshold must be calculated on a gross basis (i.e. as the sum of IM owed by Bank X to Bank Y and owed by Bank Y to Bank X). However, we understand that in calculating the level of IM against the threshold, netting within asset classes is permitted. But we would be grateful for clarification of the precise steps to be followed when calculating the threshold, particularly in terms of the potential for netting.

Policy concerns regarding the calculation of IM threshold

Whilst we support a permanent IM threshold if IM exchange is mandated, we do not support the proposed methodology where the threshold is calculated on the basis of gross notional outstanding. Our concerns are that the approach (i) does not reflect the risk of the contracts and (ii) appears to include hedging contracts.

Re (i), by calculating the threshold on a notional basis, there is no differentiation between the risk of different types of contract. Therefore, contracts that are relatively less risky will contribute equally to threshold as more risky products. This will unfairly disadvantage counterparties that generally trade in liquid and relatively less complex that can nonetheless not be cleared who may be required to post IM despite not posing a systemic risk.

Re (ii), most counterparties hedge a significant proportion of their derivative positions, so the notional amount of their exposure does not accurately reflect the risk of those positions.

In terms of the transactions that count towards the threshold, we strongly believe non-cleared OTC inter-affiliate derivative transactions should not be included in the calculation (noting that the proposal allows national discretion to impose IM and VM on inter-affiliate trades). Otherwise, transactions used to manage risk at a group level will artificially result in the threshold being reached

very quickly for groups who manage derivative risk centrally, even though these transactions do not represent incremental systemic risk.

As an overarching point, whilst we support a threshold below which IM does not require collection, we are not supportive of a one size fits all approach as such a static approach is unlikely to appropriately reflect the individual risk posed by specific counterparties. Any thresholds should reflect the specific creditworthiness of the counterparty and we therefore continue to believe thresholds should be set on a bilateral basis as there should be sufficient flexibility for counterparties to assign thresholds in a manner which reflects their specific characteristics and also the credit appetite of the parties.

Application at consolidated level

We believe the proposal to apply the IM thresholds at a consolidated level has the impact of materially lowering the effective threshold and should be reconsidered

Furthermore, the proposal for IM thresholds applied at the consolidated level is not consistent with the current legal documentation framework in place across the industry. The ISDA/CSA which represent the master agreements for collateralizing non-cleared OTC derivatives are executed on a legal entity level. These agreements include reference to all applicable thresholds. Given the proposal suggests the threshold is applied at a consolidation level, this can not be documented within the existing master agreements. In some cases various entitles across a consolidated group may execute agreements under different legal jurisdictions, further complicating any construct beyond the single legal entity master agreement. We therefore suggest that we move ahead with an appropriate threshold at the specific legal entity level and do not implement thresholds at a consolidated level.

If, despite our concerns a threshold is implemented at a consolidated level, we believe it is important to clarify the application of the consolidated group concept to investment vehicles and funds managed by the same investment manager. In our view, funds that are separate legal entities should not be subject

to consolidation at the level of the manager and we believe this should be clarified in the final proposal.

Approach to VM

Whilst we support the daily exchange of VM in principle, we believe that in some cases this may be onerous for certain smaller firms. We would also re-emphasize that only sophisticated financial institutions have the infrastructure in place to manage daily trade and collateral valuations, and the operational means to manage cash payments.

We also note that whilst daily exchange of collateral is useful when underlying positions can be meaningfully re-valued on a daily basis, this may not be realistic in markets which are lacking robust observable price data. There should be some flexibility in the proposals to reflect this

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

Consultation proposal

Initial margin: The paper proposes that when calculating the initial margin baseline, the potential future exposure of a non-centrally cleared derivative should reflect an extreme but plausible estimate of an increase in the value of the instrument that is consistent with a one-tailed 99 percent confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress. The required amount of initial margin may be calculated by reference to either (i) a quantitative portfolio margin model or (ii) a standardised margin schedule. Any quantitative model that is used for initial margin purposes must be approved by the relevant supervisory authority. There will be no presumption that approval by one supervisor in the case of one or more institutions will imply approval for a wider set of jurisdictions and/or institutions.

Quantitative initial margin models may account for risk on a portfolio basis. More specifically, the initial margin model may consider all of the derivatives that are approved for model use that are subject to a single, legally enforceable

netting agreement. Initial margin models may account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit, or commodities, but not across such asset classes and provided these instruments are covered by the same legally enforceable netting agreement.

Margin levels should be sufficiently conservative to avoid procyclicality, even during periods of low market volatility. The specific requirement that initial margin be set consistent with a period of stress is meant to limit procyclical changes in the amount of initial margin required.

Parties to derivative contracts should have rigorous and robust dispute resolution procedures in place with their counterparty before the onset of a transaction.

Variation margin

The paper proposes that in respect of variation margin, the full amount necessary to fully collateralise the mark-to-market exposure of the non-centrally cleared derivative must be exchanged (e.g. daily). Parties to derivative contracts should have rigorous and robust dispute resolution procedures in place with their counterparty before the onset of a transaction.

<u>UBS response</u>

Role of the Basel capital framework

We note the comment on page 3 of the consultative document that capital requirements are not designed to cover the loss of the default of the counterparty but rather the probability weighted loss given default and that margin can therefore offer enhanced protection against counterparty credit risk. But we do not believe margin should be calibrated to cover all potential losses without any consideration of the probability of such losses occurring as the counterparty credit risk mitigation benefits of such an approach would in our view be far outweighed by the costs in terms of liquidity. IM is inefficient as it assumes that both parties to a contract must be fully protected against each other's simultaneous default which fails to give credit for the portfolio effects of counterparty credit risk.

We consider that initial margining is a risk mitigation technique used by CCPs which is less suited for replication for non-cleared trades. CCPs require IM because they typically lack the necessary level of capital to absorb potential losses without recourse to the default fund. By contrast, in the uncleared OTC derivative space, firms are not at risk that their capital will be depleted by absorbing the mutualised losses of others (in contrast to how the CCP default fund distributes losses). Furthermore, for cleared OTC derivatives, the CCP must guarantee a contract's performance should one of the two counterparties default. This guarantee requires the CCP to perform a close-out process with the defaulting party and replace the defaulting contract with a new one. The new contract's cost should theoretically equal the VM already collected. If the close-out occurs over a longer time period, any adverse movement in the replacement contract's cost can be covered by IM. In contrast, a non-defaulting counterparty in a bilateral situation has no obligation to replace the defaulted contract with a new one, thus reducing the rationale for IM.

The Basel III capital requirements will result in a significant increase in the amount of regulatory capital that prudentially regulated entities are required to hold. In particular, credit valuation adjustment ("CVA") capital charges are likely to be significant and are very sensitive to counterparty quality and risk mitigants and therefore materially address the risk of rating migration up to default. CCPs however are not subject to such charges which is why IM is more relevant for CCPs than counterparties subject to Basel capital requirements which already materially address derivative counterparty risk. If IM continues to be mandated for non-cleared derivatives in the final proposals, we at least believe a less onerous calibration than 99% over a 10 day horizon should be used to reflect the contribution of risk mitigants available to prudentially regulated entities that are not available to CCPs.

Potential for pro-cyclicality

We note the comment in the consultation that IM must be set at a conservative level to avoid pro-cyclicality. We agree that under stressed market conditions, IM requirements are likely to increase materially under VaR based internal modelling

approaches to reflect greater volatility. Combined with the increase in VM calls in times of market stress and the proposed restrictions on collateral eligibility, many firms are likely to be forced to liquidate assets during such periods in order to meet their increased IM and VM requirements with a resultant systemic impact. But we note that any risk sensitive approach to calculating IM will be pro-cyclical to some degree and we strongly believe the appropriate solution to mitigating pro-cyclicality is not to set margins at a very high level in all market conditions given the ongoing liquidity impact of this highly conservative approach. Rather, we consider the pro-cyclical impact to be a justification for not mandating two way exchange of IM when the risks of a transaction can be mitigated in other more appropriate ways such as via capital (a "survivor pays" approach as an alternative to the "defaulter pays" nature of IM), termination options and tight credit limits.

Cross-margining

We strongly believe that initial margin models should be allowed to i) account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit and commodities ii) across such asset classes and iii) between cleared and non-cleared instruments. Diversification benefits exist between different asset classes and these should be taken into account within the proposals. The onus should be on firms to demonstrate to their supervisors that their approach is robust.

The move to mandatory clearing will necessarily force the break-up of netting sets by requiring that some classes of derivatives be centrally cleared while others remain subject to bilateral netting agreements. Imposing separate initial margin requirements to both netting sets would significantly increase the liquidity impact associated with those requirements. To address these issues, arrangements exists to cross-margin centrally cleared and non-centrally cleared derivatives. Under these arrangements, the total initial margin would be calculated based on the risks of both centrally cleared and non-centrally cleared derivative portfolios. This will more accurately reflect the risk of default on a portfolio basis. We believe such arrangements should be permitted to the extent they are subject to a legally enforceable master netting agreement.

This would also be more consistent with EMIR where margining across multiple instruments is permitted subject to haircuts. Whilst we believe there should be full recognition of demonstrable offsets, we believe the haircut approach in EMIR could be used to give material recognition for cross-asset class offsets whilst adding a level of conservatism to address any perceived additional measurement weaknesses when margining across asset classes. As highlighted by the QIS, netting benefits for bilateral trades are already materially lower than for centrally cleared trades due to the lack of multilateral netting across counterparties so we don't consider it appropriate to impose further restrictions on bilateral netting that do not reflect economic realities.

Dispute resolution

We agree with the need for robust dispute resolution powers. We believe having ex-ante dispute resolution procedures in place should be feasible where both counterparties are using the standardised initial margin schedule. However, we believe it will be very difficult to settle disputes relating to IM calculations where both counterparties to a transaction are using a different margin model.

We highlight that current market practice is for firms to bilaterally agree the terms of any IM requirements. This ensures that both firms value the IM amount in the same manner and avoids any collateral disputes over IM. Moreover, existing dispute resolution procedures are designed to resolve collateral disputes associated with VM only. Furthermore, dealer polls are typically effective in addressing VM related disputes. Given that the proposal would allow two counterparties to an OTC derivative contract to use two different prudentially approved models for the calculation of IM (or allow one counterparty to use the standardised schedule and the other a modelled approach), we are concerned that the approach may significantly increase the number of collateral disputes. In the case of a dispute, it is unclear how resolution could be achieved as both firms are likely to argue that their calculation methodology is appropriate if it has been approved by their supervisor.

Use of a standardised model

We support the proposal that parties may use a single model for the purposes of margin calculation. Given the likely differential between the IM requirement using a model versus the standardised IM schedule, we believe a significant majority of users of bilateral derivatives will seek to use modelled approaches to calculating IM. To the extent some users may lack to sophistication to develop their own models, use of a single model is a sensible approach.

We would be supportive of third party model providers developing industry standard models but believe this will take time to implement. This is in our view further justification for delaying the implementation timetable so that less sophisticated users of derivatives who lack margin modelling capability will not be required to use the standardised margin schedule when the rules first come into force (which, as identified by the QIS, results in very conservative IM requirements as it fails to account for option deltas, off-setting positions etc).

Model Approval

Given the significant difference between the amount of IM likely to be required under the standardized schedule relative to a modeled approach, we consider it imperative that current IM models being used by firms are grandfathered until supervisors reach a decision on model approval under the proposed BCBS/IOSCO regime.

Given that many dealers already have regulatory approval for counterparty risk models, we believe there is significant merit in permitting such firms to continue to use their existing models and collateral processes with the requirement that they have to demonstrate to the relevant supervisors that the amount of IM they collect is sufficient to cover 10 day, 99% risk. In our view this would achieve the objectives being sought by the proposals but have the benefit of materially reducing resource implications for firms and regulators alike and mitigate against a potentially severe market dislocation if firms are temporarily unable to model their margin requirements or are forced to adopt new models which may result in additional operational risk.

In addition, we note the statement in the paper that in respect of model approval "there will be no presumption that approval by one supervisor in the case of one or more jurisdictions will apply approval for a wider set of jurisdictions and/or institutions". We do not support this statement and believe approval by one supervisor should be valid for use by that firm across multiple jurisdictions. We would be supportive of a process where supervisors jointly determine the ability of a firm to use a specific model globally, potentially co-ordinated under the auspices of BCBS and IOSCO.

Element 4: Eligible collateral for margin

Consultation proposal

The paper proposes that national supervisors should develop their own list of eligible collateral assets based on the key principle, taking into account the conditions of their own markets. As a guide, examples of the types of eligible collateral that satisfy the key principle would generally include:

- Cash;
- High-quality government and central bank securities;
- High-quality corporate bonds;
- High-quality covered bonds;
- Equities included in major stock indices; and
- Gold.

The illustrative list above should not be viewed as being exhaustive. Additional assets and instruments that satisfy the key principle may also serve as eligible collateral.

UBS response

National supervisory discretion to determine eligible collateral

We do not support an approach where national supervisors have discretion to develop their own list of eligible collateral assets. This risks creating an unlevel playing field at a global level and incentivising regulatory arbitrage. We believe

there should be a broad list of eligible collateral assets determined at a global level with the risks of different collateral mitigated via appropriate haircuts and other risk mitigation techniques. Firms should be able to demonstrate to supervisors that they have a robust process for mitigating the risk of collateral.

Potential consequences of an overly narrow scope of eligible instruments

The consequence of a narrow approach to eligible collateral is that it will make certain end users reliant on collateral transformation services offered by banks. We expect the costs of assets considered eligible for collateral to increase significantly due to an increase in demand. Accepting non-standard collateral for IM could alleviate funding pressure. A narrow approach may increase the likelihood of bubbles in the assets that are eligible as demand for such assets will be artificially increased by the requirements. This can create significant systemic impacts.

Existing incentives for prudentially regulated entities to take a prudent collateral approach

For firms subject to the Basel prudential regime, the requirements already differentiate between different types of collateral as more risky collateral receives less credit in reducing capital requirements. We consider this to already create incentives for such firms to take a prudent approach to collateral as firms can choose to either i) accept higher quality collateral in order to minimise their capital requirements or ii) accept lower quality collateral and hold additional capital instead.

We also note that consideration should be given to the correlation between the collateral and the derivative exposure. Collateral which is typically perceived as being very high quality/low volatility may be a less effective risk mitigant than lower quality collateral that is less correlated with the derivative exposure.

Potential for collateral disputes

Our overall view is that the list of eligible collateral should be as broad as possible with firms addressing the risks of the collateral by using haircuts. However, similar to the potential for disputes when calculating IM, we

are concerned that it may not be workable for two counterparties to a transaction to determine collateral haircuts based on separate methodologies as we believe there would be significant scope for disagreement as to the appropriateness of the respective haircuts. We believe this concern supports an approach where counterparties have flexibility to bilaterally agree eligible collateral schedules and appropriate haircuts.

Element 5: Treatment of provided initial margin

Consultation proposal

The paper proposes that initial margin should be exchanged on a gross basis and held in a manner consistent with the key principle above. Cash and non-cash collateral collected as initial margin should not be re-hypothecated, re-pledged or re-used.

UBS response

Potential increase in concentration risk

We believe that there are significant credit risks associated with the posting of IM from prudentially regulated entities (e.g. dealers) to non-prudentially regulated entities which would need to be mitigated via segregation. To the extent dealers cannot get comfortable with the level of protection and segregation provided by the non-prudentially regulated counterparty (likely in cases where such party has no previous experience of segregating collateral and where local bankruptcy laws are weak), margin posted by dealers to non-prudentially regulated clients would almost exclusively have to go into tri-party accounts. We also note that cash collateral can generally not be legally segregated, consequently, initial margin as cash needs to be held at a third party custodian. There are two significant consequences of this: (i) significant cost implications which are likely to disincentivise the use of derivatives for hedging and (ii) a likely increase in concentration risk and systemic risk given that there are only two main tri-party providers globally.

If the majority of IM was held with third party custodians, we also do not believe it would be possible for those custodians to accommodate all firms seeking to

use their services in a timely fashion. The existing legal teams within those custodians would be too small to accommodate the high volume of requests for triparty custody. We also note that the cost per agreement is likely to have a disproportionate impact on the less-sophisticated parties, as their low level of familiarity means that the cost of negotiation is typically far higher than for more experienced parties. The cost of setup may mean that parties that trade derivatives infrequently will never choose to incur the initial setup cost as it will outweigh the benefit for that trade, even though the benefit may be greater than the cost when taken over a longer-term relationship.

Need for harmonisation of bankruptcy laws

The effectiveness of measures to protect posted margin via segregation depends on the local law and insolvency regulation in each jurisdiction. For effective collateral segregation, it is necessary to enhance the harmonization of bankruptcy legislation at a global level. Mandatory posting of IM will increase credit risk for those required to post collateral unless all jurisdictions have laws and regulations to ensure the effective supervision and enforcement of segregation requirements and timely recovery of collateral by non-defaulting parties. Segregation without hypothecation will be very expensive but with no practical benefit if local bankruptcy laws do not provide effective protection.

Whilst we note the comment in the paper that jurisdictions are encouraged to review bankruptcy laws, we believe more concrete amendments are necessary before segregation is mandated. We note that this is likely to be a time consuming exercise which supports the need to delay the introduction of the IM proposals.

Protection of asset value versus protection of specific assets

In our view, the requirement to protect collateral in the event of the collateral recipient's bankruptcy should relate to protecting the value of the collateral rather than protecting the specific assets delivered as collateral. We consider this approach to be far more operationally manageable and will therefore reduce operational and legal risk whilst delivering the same economic outcome in terms of return of value to the collateral poster.

Treatment of IM under Basel III

Leverage ratio impact

Cash IM that is collected by banks and required to be segregated with no possibility of rehypothecation would have the impact of grossing up the balance sheet for the purpose of calculating the Basel III leverage ratio. Since the proposal seems to prohibit recycling of the cash into a bank's internal funding process, this is a dollar-for-dollar uplift. It is not permitted to net cash collateral vs negative replacement values (out-of-the money OTC positions) for leverage ratio purposes, so there's no permissible offset. Consequently, we consider that cash IM should be exempted from the leverage ratio calculation, otherwise the mandatory collection and segregation of IM (when the collateral provided is cash) would artificially restrict the maximum size of a bank’s balance sheet and consequently restrict its ability to fund the real economy.

Risk weighted asset impact

Furthermore, if collateral is held tri-party, it is not possible to recognise the pledged assets versus trade exposures. For banks subject to Basel III, this will result in a significant impact on RWAs which is not reflective of the true risk. The Basel III rules and the proposals in this paper should be co-ordinated to ensure appropriate recognition of collateral in RWA calculations.

We also note that it is not clear under Basel III how cash collateral posted to a non-CPP counterparty would be treated for capital purposes. It is very important that this is clarified.

We therefore consider it crucial that the interaction between the Basel III framework and the proposals in this paper are reviewed and amendments made to the capital framework where appropriate to ensure credit is given for the use of IM in the capital rules or at least that the requirements for IM do not result in arbitrarily punitive capital treatments.

Approach to VM segregation

We do not support the mandated segregation of VM. This is because if the recipient of the VM defaults, the value of the VM will net with the exposure that the VM is collateralising, meaning that there is no net exposure other than the market moves since the last time that the collateral call was made and met.

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 believe it should be possible to re-hypothecate IM collateral received more generally and not just in the case of financing/hedging customer positions when subject to the conditions proposed.

In relation to the approach proposed above, we are concerned that the requirement for the applicable insolvency regime to allow customers first priority claim over the pledged collateral could not be met in many jurisdictions which would effectively make redundant the limited scope for re-hypothecation that is proposed.

This is because if the collateral taker transfers ownership of the relevant securities to a third party and the collateral taker becomes insolvent, the value of the collateral will be subject to netting or set-off between the collateral taker and collateral provider. But the collateral provider will still have credit risk on any excess collateral provided over its liability to the collateral taker. It is therefore unclear if the re-hypothecated assets can be considered customer assets. In order for condition (iii) to be met, it is necessary to have an insolvency regime that protects re-hypothecated collateral from the creditors of the original collateral taker, who has re-hypothecated those collateral assets, should the collateral taker become insolvent.

Element 6: Treatment of transactions with affiliates

Consultation proposal

The paper proposes that local supervisors should review their own legal frameworks and market conditions and put in place initial and variation margin requirements as appropriate.

UBS response

National discretion creates potential for global inconsistency

We fully support the stated intention on page 3 of the consultation document for consistent global requirements for margining of non-cleared derivatives. But we consider the requirement 6.1 that local supervisors have the discretion to impose IM and VM on transactions with affiliates to potentially undermine the consistency of the global framework and to potentially result in exactly the negative impacts highlighted in the CP.

Potential for IM requirements for non-cleared derivatives between affiliates

We do not support VM or IM requirements for transactions with affiliates as derivative transactions between entities within the same consolidation group do not pose systemic risks as they do not create additional counterparty exposure outside of the group and do not increase interconnectedness between third parties. Rather, inter-affiliate trades allow institutions to manage and reduce risks and to increase the scope of netting with individual counterparties by allowing counterparties to transact with a single group entity across a broad range of underlying asset classes. This flexibility would be undermined when imposing IM requirements on affiliated entity transactions. The amount of collateral tied-up would reduce firms' ability to manage risk on a centralized basis and would increase, rather than decrease, the level of risk within the financial system. Losses incurred by one affiliated entity should be completely offset by gains to the other affiliated entity so the group exposure is flat.

We would also stress the fact that prudentially regulated entities frequently collateralise intra-group exposures to minimise regulatory capital. This regulatory capital benefit is sufficient to encourage such firms to collateralise intra-group trades, if deemed appropriate, without the need for further obligations.

Potential for VM requirements for non-cleared derivatives between affiliates

We do not support mandatory exchange of VM between affiliated entities. If groups believe it is appropriate to exchange VM between group entities for internal risk management purposes, they should be free to do so, but the requirement should not be mandatory as firms may legitimately and more effectively seek to mitigate intra-group risks in an alternative manner.

Clarification of scope of "affiliated entities"

We believe it is necessary to provide clarification of the definition of "affiliated entities" and "transactions with affilitates". We do not believe branches should be considered affiliated entities.

Element 7: Interaction of national regimes in cross-border transactions

<u>Consultation proposal</u>

The margin requirements in a jurisdiction should be applied to legal entities established in that local jurisdiction, which would include locally established subsidiaries of foreign entities, in relation to the initial and variation margins that they collect. Home-country supervisors should permit a covered entity to comply with the margin requirements of a host-country margin regime with respect to its derivative activities, so long as the home-country supervisor considers the host-country margin regime to be consistent with the margin requirements described in the paper. A branch should be treated as part of the same legal entity as the headquarter, thus subject to the margin requirements of the jurisdiction where the headquarter is established.

<u>UBS response</u>

Need for more concrete proposals to promote international consistency

We agree that regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative margin requirements for non-cleared derivatives. However, we observe that the global implementation of the G20 mandate for the mandatory clearing and reporting of derivatives has resulted in material differences in the regimes across jurisdictions with no agreed mechanisms for mutual recognition of regimes between jurisdictions. We therefore consider it appropriate for BCBS/IOSCO to play an active ongoing role in facilitating cross-border recognition of requirements for both cleared and non-cleared derivatives to ensure the goals of consistency and non-duplication are achieved. The determination of whether a jurisdiction should quality for recognition should be outcomes focused and not a line by line analysis of legal rules. We are concerned that without clear mechanisms for cross-border recognition, disparities across jurisdictions will emerge and persist.

Classification of entities

It is stated that the precise definition of financial firms, non-financial firms and systemically important non-financial firms will be determined by appropriate national regulation. We do not support this approach as it risks the same counterparty being classified differently across jurisdictions which will create an unlevel playing field and potentially significant uncertainty and confusion in the market. For example, if a counterparty is classified as a systemically important non-financial firm in country X (and thus a covered entity) but a non-systemically important non-financial firm in country Y (and thus not a covered entity), it is unclear if the rules in this CP apply to transactions between it and a financial entity that is a covered entity given the rules only apply to transactions between two covered entities. We believe a consistent global classification system is necessary to make the proposals workable.

Potential for macro-prudential buffers

We do not support the proposal that supervisors should have the power to impose a macroprudential "add-on" or buffer on top of the baseline IM level. IM calculated via a VaR methodology will result in IM requirements increasing as volatility increases and this automatically disincentivise firms from taking on additional leverage/expanding their balance sheets. Furthermore, banks subject

to Basel III requirements will be required to hold macroprudential capital buffers and to also require IM buffers would result in a potential double counting of risk.

Element 8: Phase-in of requirements

Consultation proposal

The paper proposes that 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. Exchange of variation margin on other contracts is subject to bilateral agreement. The requirement to exchange two-way initial margin with a threshold of up to €50 million will be staged.

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?

UBS position

We strongly agree with the BCBS/IOSCO statement that the requirements represent a significant change in market practice and will present certain operational and logistical challenges that will need to be managed. But we do not believe the phase-in approach sufficiently mitigates these challenges.

Significant legal and operational cost implications

As set out in our introduction, we believe the legal and operational cost implications of a mandated two-way margining are likely to be considerable for many firms. As it is not common market practice today to have two-way exchange of IM, we believe that the complexity of posting IM between counterparties which have never done so should not be underestimated.

In our view, these issues, combined with the fact the proposals in the paper will require national implementation that could be expected to take around 6-12 months depending on jurisdiction, strongly supports a delay to the proposed implementation and phasing-in timetable. As previously discussed, we would propose that the rules do not come into force until at least 2 years after the BCBS/IOSCO framework for margining of non-cleared derivatives has been implemented in all key national jurisdictions.

Concerns regarding the calculation of the phase-in threshold

As per our comments on pages 9 and 10 in respect of the 50m Euro IM threshold, we do not support the proposed methodology for calcauting the phase-in thresholds on the basis of gross notional outstanding. Our concerns are that the approach (i) does not reflect the risk of the contracts and (ii) appears to include hedging contracts. In addition we are concerned that the phase-in threshold methodology only relates to contracts in the last three months of the year.

We_do not support the proposal that the threshold should be calculated based only on the last 3 months of the preceding year as we do not consider it appropriate to ignore positions in the first 9 months of the year when

undertaking the calculation. Furthermore, under the proposed methodology, a counterparty is unlikely to be able to determine whether or not it will exceed the threshold until the final days of the preceding year. If it turns out it does exceed the threshold and is required to post IM, it would need to acquire sufficient IM, transfer it and comply with all of its other regulatory requirements within one day. This would be extremely difficult if not impossible to comply with and has the potential to severely dislocate markets as multiple counterparties would need to source collateral in a very short space of time. We therefore believe a material period after year end before compliance is required is necessary to mitigate these potential adverse impacts and ensure the smooth operation of the market.

Need for alignment between IM and VM timelines

We strongly support aligning the timing of the introduction of any VM and IM requirements. This is because the legal documentation in respect of both VM and IM will need to be changed and it will be significantly easier and less costly from a logistical and operational perspective to change documentation once per client rather than once for VM and then again subsequently for IM.

Need for centralised approach to counterparty classification

We also believe it is very important to have a consistent classification across the market regarding which firms are above or below the threshold at any given time and thus subject to the rules or not. This would ensure consistent treatment globally of different counterparties. This could take the form of a public list of entities, potentially maintained by BCBS/IOSCO setting out those entities that are subject to the rules at any given time. Should there not be a global list, it is important that the requirements clearly state that a counterparty cannot be deemed liable for failure to comply with the rules should their counterparty to a trade claim to not be above a phase-in threshold (and thus not subject to the rules) when in fact they are above a phase-in threshold (and should be subject to the rules).

Treatment of funds

As per out previous comment, we understand that a covered entity is defined at legal entity level. Thus, in the case of fund management, the thresholds for

determining the phase-in rules would apply at the level of each individual fund (to the extent each fund is a separate legal entity) rather than at the level of the fund manager with all managed funds requiring aggregation. We would appreciate clarification of this point.

Quantitative Impact Study (QIS)

Consultation commentary

The paper indicates that, based on the QIS conducted in 2012, initial margin that would result from applying the near-final proposal to the derivative portfolios that are expected to remain uncleared at the QIS respondent firms is roughly €558 billion. Extrapolating from the QIS respondents to the entire global derivatives market would raise the estimate to roughly €0.7 trillion. Margin requirements using a zero threshold rather than a threshold of €50 million, as proposed in the July 2012 consultative paper, would result in roughly €1.3 trillion of initial margin at QIS respondents or roughly €1.7 trillion for the entire global market.

The paper notes that these results are based on firms using models to calculate initial margin. Bilateral margining requirements would increase significantly if the standardised schedule is used by a significant number of firms. The initial margin amounts required under a standardised schedule are roughly between 6 to 11 times higher than that observed under a model-based initial margin regime. It is also noted that bilateral margin requirements are estimated to be significantly higher than initial margin requirements that would result under central clearing.

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

UBS response

Period of data used may understate IM requirements in stressed market conditions

Based on table 4b, we understand that the models used to submit QIS data were based on an average look-back period of 2.9 years with a median period of 2

years. We note that this would not cover the particularly volatile period of Q3/Q4 2008 during which we would expect IM requirements to have been far higher than those in the relatively less volatile periods that appear to have been covered by the majority, if not all, of the submitted data. Hence we believe the period of data chosen does not accurately reflect the aggregate amount of IM that may be required in highly stressed market conditions.

Impact of segregation

We note that the QIS does not consider the impact of the proposed prohibition on the re-use and re-hypothecation of pledged collateral. To the extent pledged collateral is currently held under transfer of title and available for re-use, it is not just the incremental additional amount of IM that will be required going forward that will have a liquidity impact, but also the amount of IM that is currently exchanged and can be put to productive use but which will need to be locked up going forward. We therefore consider that the QIS methodology underestimates the liquidity impact of the proposals.

Need for better alignment between modeled and standardized IM requirements

The vast difference in the IM requirements under a modeled approach versus under the standardized schedule emphasizes the need for (i) a more appropriately calibrated standardized approach (and we note the use of the net to gross ratio as a positive but in our view insufficient step in this direction) and (ii) the need for appropriate transitional periods/grandfathering of existing margin models/other forms of flexibility so that firms capable of modeling IM are not required to use the standardized approach for an interim period when awaiting supervisory approval for the model.

Whilst we consider the standardised margin schedule to be a sensible approach for parties lacking the resources to robustly use internal models, we believe the proposed approach lacks risk sensitivity. For example, the proposed CDS margin levels don't take into account buy / sell, spread levels, or type of product (e.g. super senior tranche vs. equity tranche, main index vs. HY single name). As a consequence, we consider the proposed levels to be too high for some products which will remain uncleared (e.g. super senior tranches).

Our general preference is to have a standardised schedule that sets margin at a relatively low level so firms would not be locked into paying disproportionate amounts but to allow flexibility for counterparties to require higher margin levels where justified by the specific characteristics of the derivative in question.

Need to recognise all demonstrable offsets

We note the comment in paragraph 7 on page 34 of the consultative document "that the significant reduction observed here suggests that multilateral netting benefits are large and that bilateral margins should be expected to be many times larger than those required on centrally cleared transactions". This in our view emphasises the need to allow recognition of all economically justifiable netting of non-cleared contracts, including across asset classes and across cleared and non-cleared derivatives.