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UniCredit reply to the BCBS and IOSCO consultation on "Margin requirements for non-centrally cleared derivatives"

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches and more than 155.000 employees. UniCredit is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit operates the largest international banking network with around 4.000 branches and outlets, and is a market leader.

General comments:

- **UniCredit welcomes the revisions proposed by the BSBC/IOSCO** in this second Consultative Paper on the topic of "Margin requirements for non-centrally cleared derivatives" (2nd C.P.). Although there are still some areas where there is room for improvement, we welcome the changes proposed which in our view represent significant improvements compared to the previous draft proposal, in terms of prudent risk management.

<u>- Margin requirements should be consistent and coordinated across national jurisdictions</u>

UniCredit appreciates the BCBS/IOSCO's efforts to develop global standards on margin requirements for non-centrally cleared OTC derivatives (e.g. element 7). In its role of cross-border financial Group, UniCredit regards consistency and coordination among national regimes to be crucial for addressing the risks of regulatory arbitrage and market disruptions.

Inconsistencies between national margin requirements would foster the so-called "race to the bottom" as market participants would move their activities to countries where margin requirements are less restrictive. Considering the global size of the derivatives market, we urge BCBS and IOSCO to eliminate or reduce national discretion both on the content and timing of the new margining requirement; see for instance: i) point 2.6 the definition of entities in the scope; ii) point 3. the macroprudential 'add-ons' or buffers on top of baseline (or minimum) margin levels; iii) point 4.1 the definition of the eligible assets.

UniCredit deems that the proposal of leaving national authorities to provide a definition of such key concepts (content and timing) may jeopardize the goal of the relevant regulations, since divergences may finally prevent such rules from establishing a common level playing field for non-centrally cleared OTC transactions.

<u>- Exemptions should be provided for transactions among affiliates within the same cross border financial Group</u>

Although it is welcome that the universal threshold (€50mln) is included to reduce the overly burdensome operational implementation and is applied at the level of the consolidated group (e.g points: 2.2, 8.2. and 8.3), we don't deem satisfactory the treatment of intra-group transactions.

With a view to ensure a smooth functioning of integrated cross-border financial groups and also to preserve their business models, we believe in fact that **derivative transactions among group entities**, also if located in different jurisdictions, **should be exempted from the obligation to post mandatory collateral margins.** This exception would properly recognize both the economic value of cross border financial groups and the role played by the internal capital market, where group resources such as capital and liquidity should be efficiently allocated, without unnecessary regulatory obstacles. UniCredit appreciates that the proposed amendments to Principle 6 pave the way towards a framework of intra group exemptions, which in our view is however not still satisfactory given the degree of discretion left to national authorities,

Any requirement of specific margins on transactions among group entities will imply an unnecessary burden and is likely to impair the activity of the whole group, whose assets have been allocated within the different Group entities to reach the most efficient and effective portfolio allocation.

In addition, UniCredit sees a potential risk in not providing indications as to the definition of "Affiliate entities". This is likely to conduce to uncertainty in the implementation of the proposed requirements where banking groups operating in various jurisdictions will face different legal definitions and inconsistent operating rules in respect to infra-group transactions.

- On the revised proposal for grandfathering

We appreciate the intention of the BCBS/IOSCO not to unduly penalise trades which were executed in the past, at a time when substantial regulatory changes could not be envisaged. However, we would like to point out that there will inevitably be a decrease in netting efficiency due to the split between new trades, where initial margin (IM) is required, and grandfathered trades, where IM is not required.

Timetable for implementation: the suggested processing of IM is something completely new in the Market. This means that systems as well as internal and external processes will have to be adjusted to meet the new requirements. This is why it is welcome to have an implementation timeline by January 2015, which should allow market participants to adequately prepare. Also the application of the IM aggregated at Group level will generally result in some internal restructuring of specific processes between the margining activities and in the risk management area of the subsidiaries. A best practice published in the market on how to allocate initial margin to different affiliates of a counterparty could be of benefit to proactively avoid a large number of future disputes.
Finally, a strong alignment overall between the implementation timelines and requirements of the EU and US legislations (i.e. EMIR and Dodd-Frank act) should be encouraged

UniCredit view on specific questions

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?

Answer 1:
UniCredit deems appropriate that the exemption should be allowed.
To a large extent FX forwards and swaps are short-dated transactions, hence when compared to other derivatives, they are less conducive (in relative and absolute terms) to systemic risk.
As a consequence, UniCredit deems that it would be unduly burdensome and unnecessary to increase the operational requirements for this particular assets class. Benefits in terms of risk management and financial stability would not justify the additional costs at system wide level.
In addition, the implementation of a penalisation mechanism with regards to maturity mismatches will not be helpful, since it will not address the nature of these particular trades (i.e. most of the trades being short-dated).

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.

Answer 2:
During the recent years financial institutions, and especially banks, have undertaken significant efforts for

enhancing collateral management practices. It is UniCredit understanding that regulators are currently intensifying their scrutiny on the re-use of available collateral. Although we appreciate the objectives of the regulator, it could be argued that failing to grant re-hypothecation or excessive constraints will inevitably lead to a sort of "hoarding" of collateral. The risk of a collateral shortage will imply a decrease in market liquidity and an increase in the price of eligible assets.

With a view to avoid such consequences, we believe that re-hypothecation should be allowed. We acknowledge that the major regulators' concerns are related to potential delays in the substitution or return of collateral when required. To this end, the market should be capable to: i) reduce this risk by applying Securities T+2 Settlement rules (as currently discussed in the financial market industry) and ii) reduce complexity of the current process by ensuring global consistency of timing and procedures for the delivery of collateral. Competent authorities may encourage and facilitate this agreement within the industry at international level.

The proposal to allow re hypotecation under strict conditions (non-proprietary position, the pledgee to use collateral as customer assets and an insolvency regime with first priority claim recognized to customers) might imply, at least for some smaller banks, operational issues and difficulties that should be carefully taken into account by competent authorities.

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?

Answer 3:

We appreciate the approach described for the phase-in methodology, i.e. to use a size indicator for implementation, thus granting smaller market players more time to get prepared. However, we also would like to point out that this will penalise larger market players (in relative terms) which will be subject to initial margins requirements as of 2015. Whereas their smaller counterparties will be exempted from the same requirement until 2019.

We would also like to stress that the phase-in can only be meaningfully applied subject to the implementation of the transparency requirements as explained in point 8.10. This implies that competent authorities are expected to help the industry to create the required level of transparency and standardisation.

Question 4

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

Answer 4

No comments on question 4 as UniCredit did not participate in the QIS exercise.

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Please find below the list of the key contact-people involved in this work, whose contribution made possible to coordinate and provide UniCredit answers to this Consultation. Some other experts have been involved alongside the UniCredit Group, but are not listed below.

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