Dear Working Group members,

Re: Consultative Document: "Margin Requirements For Non-Centrally-Cleared Derivatives"

The Australia and New Zealand Banking Group Limited (ANZ) appreciates the opportunity to provide feedback on the consultative paper, 'Margining requirements for non-centrally cleared derivatives'.

ANZ understands the motivation behind the committee’s proposed margin requirements on non-centrally cleared derivatives but foresees issues with some of the proposals. In particular, the standardised initial margin proposals could adversely impact liquidity unnecessarily. Consequently, the Working Group is urged to review this topic.

Below is a summary of our view with recommendations to create a workable initial margin solution that minimises any unnecessary impact on liquidity. Detailed responses to the questions are on the following pages.

In summary:

- The standardised initial margin requirements are simple and we acknowledge a simple framework is useful for entities with less sophisticated infrastructure.

- Preliminary checks indicate the standardised initial margin requirements appears to be a reasonable reflection of the market-to-market movements of undiversified or weakly diversified portfolios over the margin period of risk.

- Our calculations suggest the standardised initial margin requirements are very expensive for entities with diversified portfolios. There would be a significant increase in our liquidity requirements if we had to fulfil this proposal whilst meeting central clearing obligations. The overhead is probably excessive.

- Consequently, ANZ recommends permitting prudentially-regulated entities to calculate initial margin allowing for diversification across asset classes on a counterparty-by-counterparty basis. This fairly reflects the risks borne and also minimises the potential adverse effect of liquidity in the financial sector.
• Initial margining requirements should consider ‘smoothly changing’ thresholds based on credit-worthiness of counterparties.

ANZ looks forward to viewing the outcome.

Yours sincerely,

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Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g., central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

Implementing margin requirements in a short time frame will significantly create operational challenges (documentation and system changes).

The Working Group’s (WG) proposed standard margin requirements appear to be very expensive and may not strike the right balance between risk mitigation versus liquidity requirements. If the regulators mandate margin requirements then ANZ recommend phasing in margin requirements on non-centrally cleared derivatives.

If the WG proceed with the standardised margin proposal, we recommend a phase-in period of 2 to 5 years with regular checkpoints to (i) reduce the risk of a collateral shock across the market and (ii) provide opportunities to tune the approach as it is rolled out. We urge the WG to study the potential impact on liquidity in depth and in advance if the proposed standard margins become recommended regulations.

With regards to implementation and given the qualifiers above, ANZ suggest that margin requirements are phased-in category-by-category where each category is a class of product or assets with prices/margins that are (i) strongly correlated within the category and (ii) weakly correlated across categories. It is believed this will minimise any extra margin overhead that would be introduced as diversified portfolios are artificially split during the migration.

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

No. If regulators mandate margin requirements on non-centrally cleared derivatives, they should apply consistently to all products to minimise the risk of regulatory arbitrage.

Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

No (see Q2 response above).

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are
there any logistical or operational considerations that would make the proposal problematic or unworkable?

The aim of margin requirements is to mitigate counterparty credit risk and the committee needs to assess whether all entities - whether systemically important or not - should be compelled to exchange initial and variation margin. In our view, providing a level regulatory ‘playing field’ minimises the risk of unintentionally introducing regulatory arbitrage opportunities, or perhaps opportunities for companies to skirt the regulations with particular corporate structures.

The WG should consider whether initial margin may adversely impact liquidity; central clearing may concentrate and increase systemic risks because the majority of derivative trades will be funnelled through a small number of critical clearers.

Furthermore, ANZ recommend regulations that integrate the good aspects of the battle-tested ISDA framework. It is obviously unnecessary to post margin under a regulatory framework and under an existing CSA.

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

Perhaps. ANZ foresee that the threshold level is an extremely important choice balancing (i) a reduced need for liquidity, (ii) the primary goal to mitigate close out risk on non-centrally cleared derivatives, and (iii) the risk of introducing regulatory arbitrage opportunities.

The effect of thresholds and their optimal level is hard to gauge because it’s dependent on so many variables, including how new regulations are rolled out. ANZ recommends proposals are tested in-situ to find what the market can bear – perhaps set an initial threshold amount and then review and adjust that level over time based on market observations.

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity’s non-centrally-cleared derivatives activities? Could data on an entity’s derivative activities (eg notional amounts outstanding) be used to effectively determine an entity’s systemic risk level?
Yes, subject to credit rating and capital base. We believe thresholds based on a ‘sliding scale’ should be less problematic than requirements with ‘cliff-edge’ triggers.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

Yes. Also, Prudentially-regulated firms are subject to specific capital requirements that provide a buffer for potential unexpected losses.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

See answers to Q5 and Q6 above.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

2-way margining will strain liquidity, especially when financial markets face extreme conditions. The committee needs to consider whether margin requirements may actually cause defaults rather than protect against them during these times. Universal two-way margining would significantly decrease our liquidity portfolio.

Q10. What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

To reduce the chance of losing margin posted to unregulated counterparties, ANZ recommends that the margin is held by a prudentially regulated, independent custodian.

Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

We believe this is not appropriate as it skews the playing field and could have further liquidity and funding implications that could flow through to pricing. All participants in the derivatives market should be subject to margining.
Q12. Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?

No, see answer to Q11.

Q13. Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

The proposed methodology for calculating initial margin using internal models is broadly appropriate. ANZ recommends aligning parameters and assumptions with the Basel III standards, including the appropriate margin period of risk. Furthermore, in the future, any sudden industry-wide changes to the margin period of risk should be phased in across a period of time to smooth the transition.

Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

ANZ urges the WG to apply diversification benefits within and across asset classes on a counterparty-by-counterparty basis. The diversification is appropriate and it is effective at reducing liquidity requirements.

Q15. With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

ANZ believes the standardised initial margin requirements are very expensive. The margin specified and the results in our QIS response demonstrate the standardised schedule produces initial margins multiple times larger than those calculated using an internal model. While the standardised schedule promotes central clearing, it is likely it will adversely impact liquidity.

The standardised schedule does not capture diversification within asset classes and, although ANZ acknowledges it is advantageous to have a simple approach, is the (apparently) large overhead really appropriate?

Q16. Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?

Yes. We’d simply like to re-iterate the last paragraph of our answer in Q4 and recommend integrating the good aspects of the battle-tested ISDA and CSA framework.

Q17. With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin,
subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?

ANZ recommends daily variation margin payments. We would support less frequent payments is some circumstances, as per typical CSA terms and conditions. In these cases, we would urge the WG to (i) introduce the use of a timing cap to ensure payments are not too infrequent with (ii) an initial margin penalty via the margin period of risk to compensate. A penalty on a sliding scale is preferred (no discrete jumps).

Q18. Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to “cliff-edge” triggers sufficiently discouraged?

No comment.

Q19. What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralized exposure?

Approximately US$250,000.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

The scope of eligible collateral is appropriate. As above in Q4 and Q16, ANZ suggests adopting ISDA’s battle-tested approach regarding eligible collateral and the associated haircuts.

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

ANZ agrees that concentration limits should be introduced as a condition of collateral eligibility to mitigate concentration risk. However, as with margining thresholds, the limit is important and should be based on analysis carried out on the QIS responses of all institutions. With regards to the standardised schedule, ANZ concludes that the standardised haircuts prescribed in the proposed schedule are sufficiently conservative. Compare and contrast with ISDA haircuts.

Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Putting the fundamental concern about initial margin proposals adversely affecting liquidity to one side, yes, we agree with the other proposals for the
treatment of provided initial margin. To be consistent with the aims of initial margining, transfer of Gross Margin and not allowing rehypothecation is appropriate. Past examples of counterparty defaults in the industry have provided a good case for not allowing rehypothecation of margins by receiving counterparties.

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

Yes. We agree with the proposed requirement of initial margin being exchanged on a gross, rather than net basis (provided margin requirements are based on regulator-approved internal models) as gross margining ensures that the funds are available to cover losses over the margin period of risk. As this approach will increase the concentration risk with custodian banks, these banks should be prudentially-regulated with appropriate capital requirements and risk weighting.

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee’s bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

ANZ recommends that collateral should not be re-hypothecated or re-used as that would undermine the primary aim of initial margin. In the event of a counterparty or third party default, it will be practically difficult to re-claim the re-hypothecated assets, even under the ‘re-hypothecation of collateral’ proposals, creating significant systemic risks.

Q25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?

Proposed requirements for variation margin between affiliates are appropriate. ANZ Banking Group Melbourne (ANZBGM) currently variation margins with ANZ New Zealand.

Generally, mandatory initial margin between affiliated firms is believed to be too risk averse. ANZ believes posting and collecting initial margin will create overheads and liquidity demands with little benefit for firms. As an exception, we do recommend local regulators have the ability to include initial margin requirements if the parents of key market participants are in less stringent regulatory markets.
Q26. Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

Full variation margin should be exchanged between affiliates within the same notional jurisdiction. The posting of variation margin from one affiliated entity to another simply involves the movement of collateral amongst the entities. As such, it should generally not create incremental liquidity demands on a net basis but it would have an operational overhead.

Q27. Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

Yes, the proposed approach here is consistent with the current overall group capital requirements.