The Association of Corporate Treasurers

Comments in response to
IOSCO/BIS Consultative document
Margin requirements for non-centrally cleared derivatives
Issued July 2012

24th September 2012

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, The Treasurer magazine, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

This document is on the record and may be freely quoted or reproduced with acknowledgement.

The ACT accepts the general objective of the G20 to reduce the systemic risk from OTC derivatives but in introducing measures to achieve this we argue that any response should be proportionate. Any requirements should be appropriate given the risks involved and should carefully reflect the extent to which those risks are systemic. For example let us assume the bulk of the derivatives market in fact moves to central clearing and that variation margin is imposed on any remaining uncleared transactions, then for prudentially regulated entities we question the need for initial margin. This sort of counterparty will hold regulatory capital against such residual risk and in any case the scale of any problem for the system as a whole is already much reduced through central clearing and arguably is no longer systemic.
The second over-riding consideration must be to look at whether the risk reduction through margining is really only a risk transfer into a different problem or is spreading the risk to other parties less well able to carry the risk. The example here is that through margining credit risk is turned into a liquidity and funding risk. Unlike central clearing where a significant netting out of exposures can take place, with bilateral margining the liquidity needs for any individual party could be significant and considered in total for the financial system as a whole could generate a new shortage of acceptable collateral. This much increased need for collateral would be occurring at a time when there are collateral demands to cover all manner of exposures in other markets. It would therefore be prudent to introduce any new rules gradually so as to monitor the impact. Excessive collateral demands generally could have a paralysing effect on markets and liquidity.

Thirdly we would like to stress that in one sense the entire derivatives system exists only because there is a demand for risk management from the final end customers of the financial services sector. In solving the problems of the financial system care should be taken to avoid leaving the customers unable to manage their risks.

Within element 1 of the consultation document nonfinancial entities that are not systemically important are proposed to be outside any bilateral margining requirements, a point we very much support. However in preparing any detailed rules over margins, thresholds affiliate transactions and so on, it would be helpful if for each rule if is clearly specified that such non financials are not within scope.

Specific responses

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 (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

We note that the original official target timescales now leave very little time for implementation of clearing and bilateral margining. With much of the detail and technical standards yet to be determined timings should be realistic as to the work required to implement what could be very widespread changes to systems and working practices. In any case the timetable for non centrally cleared derivatives can only start to run once the procedures for centrally cleared transactions are fully up and running.

Element 2: Scope of coverage – instruments subject to the requirements

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?
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?

Any requirement for collateral entails a funding cost for that collateral and extensive administrative procedures around its payment, repayment and record keeping. FX being a highly liquid market will generate a high operational workload whereas the risks being addressed will be modest, at least for short dated currency transactions. From a purely practical point of view we would recommend that currency deals with a maturity of less than one year be excluded from the bilateral collateral requirements and we don’t think that such a provision would add material systemic risk.

Element 2: Scope of coverage – scope of applicability

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?

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?

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?

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie 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?

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?
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?

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?

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

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?

The ACT welcomes the comment in the consultation: “There was broad consensus within the BCBS and IOSCO that the margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempt from central clearing mandates under most national regimes.”

As stated in our initial general comments any rules on collateral should have regard to the over-riding objective which was to address systemic risk and to the principle we proposed that we need to preserve the ability of the end customer to manage their risks through using derivatives. It is totally appropriate then that, in Europe, EMIR excludes non-financial counterparties (NFCs) that are within the clearing thresholds from bilateral collateral since they are not a systemic risk. We perceive that the authorities are seeking to reduce derivative activity across the markets as a general objective, but this should not be a guiding principle applicable to end users and certainly not to those using the derivatives for commercial hedging rather than speculation. The vast majority of end users use derivatives to manage their risks and this should be encouraged as contributing to the success, health and efficiency of the global economy, permitting activity levels that would otherwise require much greater capital than is available.

However in setting the working rules the regulatory authorities should, for the avoidance of doubt, make it absolutely clear that where an NFC does an uncleared OTC derivative with a financial counterparty the bilateral collateral rules will not apply to either side of the transaction. Quite properly, of course, if the financial party decides to “back-off” the contract to another financial party, that second transaction should be fully margined in accordance with the intra-financial services sector systemic risk reduction objective.

Although exemptions exist for NFCs, these sorts of entities which are normally the end customer do have an indirect interest in the rules applicable to financial counterparties. The cost and availability of derivatives to end users will depend in part on the costs and availability of derivatives that their banks use to lay off or manage their risks. We accept that variation margin between financial counterparties will be required but we do question the need for full exchange of initial margin (IM). IM will add additional costs for the banks which will inevitably be passed on to customers, of course. However, financial entities that are prudentially regulated will have to hold capital against residual credit risk not
covered by variation margin and we consider that the choice of risk-management by margin or by capital should be a legitimate choice of the firm.

Alternatively if IM is to be required then the use of thresholds, probably with different thresholds depending on whether the entity is prudentially regulated or not, would be a part solution.

The ACT expects that most non-financial counterparties will fall below the clearing thresholds and therefore be exempt from mandatory clearing and bilateral margining. However there will be a number of non-financials that exceed the clearing threshold. For these entities it is absolutely crucial that initial margin is not mandatory when they are dealing with a prudentially regulated financial counterparty. Such non-financials are not natural holders of suitable collateral to post. It would be illogical to require IM for derivative exposures when it is not required for loan exposures. We recognise the potential effects on prudential capital requirements, of course.

We note that the consultation paper is proposing symmetric margining rules albeit that thresholds might not be fully symmetric. We would also point out that for transactions between a financial counterparty and a non-financial counterparty above the thresholds it would be wholly wrong were there to be asymmetric rules to require one way margining in favour of the financial side. This would be an example of passing risk to the side least well able to bear it. Any margining rules should be symmetric.

Although non-financials below the threshold, sovereigns and central banks would be outside of any mandatory rules we accept that it will always be open to the parties concerned to reach a commercial agreement as to any specific margin requirements they feel appropriate.

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

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?

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?

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?

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?

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?
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?

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

No comment

Element 4: Eligible collateral for margin

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

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?

We accept the proposals for eligible collateral as reasonable. As stated it is important to keep the scope of eligible assets broad so as to relieve pressure on the supply of such assets, maintain flexibility and reduce concentration risk.

Element 5: Treatment of provided margin

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?

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?

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?
We have earlier recommended that initial margin should not be applied to prudentially regulated entities. Where initial margin is required then in order to be effective we accept that it should be exchanged gross, and held in segregated accounts and not reused.

Element 6: Treatment of transactions with affiliates

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?

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?

Margin requirements between non-systemically significant non-financial firms in the same group should be nil as per the above.

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

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?

No comment.
The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,300 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

Contacts:
John Grout, Policy & Technical Director
(020 7847 2575; jgrout@treasurers.org)
Martin O’Donovan, Deputy Policy & Technical Director
(020 7847 2577; modonovan@treasurers.org)
Colin Tyler, Chief Executive
(020 7847 2542; ctyler@treasurers.org)

The Association of Corporate Treasurers
51 Moorgate
London EC2R 6BH, UK

Telephone: 020 7847 2540
Fax: 020 7374 8744
Website: http://www.treasurers.org

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address