DIA Comments to BCBS-IOSCO consultative document on margin requirements for non-centrally-cleared derivatives

The Danish Insurance Association (DIA) welcomes the opportunity to provide comments to the BCBS-IOSCO consultative document on margin requirements for non-centrally-cleared derivatives.

General remarks

In part A of the consultation document on the background it is explained that the proposals is set forward in order to mitigate the systemic financial risk posed by OTC-derivatives transactions, markets and practices.

We believe that when this is the goal, consideration should be given to which entities constitute a systemic risk. We therefore find that an important first step should be to identify which entities constitute systemic risk. We do not believe that Danish insurance companies qualify for that label.

Another goal is to promote transparency within the global financial system. In a European context this is expected to be provided by reporting of transactions to trade repositories. This will provide an overview of where the systemic risks are located and is a sensible first step, which can be obtained by reporting requirements primarily.

Since a general requirement to pose initial margin for non-cleared derivatives will be quite burdensome to entities, measures to reduce the systemic risks posed by OTC-derivatives should be targeted to the most systemic entities and transactions. A reduction in systemic risks posed by OTC derivatives may also be achieved by other means than a requirement to pose initial margin.

Answers to questions

Part A:

Below please find our answers to the questions. We have not provided answers to all questions. Only those that have the most relevance for Danish insurance companies.
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?

A period of 1 – 2 years is necessary in order to ensure the technical setup.

Coordination is preferable to ensure for example consistency between Dodd-Frank and EMIR. Furthermore, an exception for insurance companies should be considered due to the low threat that properly supervised insurers pose to systemic risk.

Consideration should also be given to the question of when the supervisory authorities are actually capable of establishing an approval process for internal models for calculation of initial margin.

Further, we recommend that the requirements are for future OTC derivatives transactions only and not existing, which would also be in line with the European regulation, EMIR.

Finally, the interaction between capital and margin requirements is important and we appreciate the statement that this needs further careful consideration. A charge on capital requirements twice (i.e., through the solvency requirement and the initial margin) for insurance companies is inappropriate.

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?

Considering level playing field arguments there should be equal treatment of foreign exchange swaps and forwards in Europe and USA.

A requirement for initial margin might affect liquidity substantially – but the variance margin is warranted regardless of the maturity. Exempting shorter maturities from initial margin could also increase the rolling activity of hedging currency risk to avoid initial margin requirement. This would be introducing regulation based behaviour but at another cost.

Settlement risk is significantly reduced by for example clearing through CLS.

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?
In the European regulation, EMIR, on OTC-derivatives there is a 3 years exemption from central clearing for insurance companies hedging insurance obligations. An exemption should therefore apply to non-centrally-cleared interest rate swaps as well. Furthermore repo’s should be exempted too due to the same arguments as FX forex.

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?

We support the proposal to reduce the initial margin requirements for entities that are subject to public supervision – especially due to the increased future supervision. For the European insurance companies a new supervisory regime – Solvency II - is expected. Furthermore we recommend the requirements to apply to key market participants only, which would be consistent with the goal of G20 of reducing systemic risk when key market participants are those who pose a threat to systemic risk.

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?

If an entity has to exchange initial margin, thresholds are an adequate tool. Setting the threshold should be done in accordance with the assets under management (AUM). For instance if the threshold was 2% of AUM then that would encourage the entities to spread the trades over several counterparties as such it would not result in regulatory arbitrage. Furthermore as mentioned initially, a higher threshold should apply to entities that do not constitute systemic risk.

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?
See answer to Q4. Systemic risk should be considered the primary factor after all that's why central clearing is being promoted in the first place. The amount outstanding says nothing about whether an entity has systemic risk. For instance pension funds can have a large amount of outstanding derivatives, typical they are long-only as they are used for hedging purposes.

**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?

Yes.

**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?

Transparent and simple measures are recommended; more sophisticated measures tend to be opaque and can encourage regulatory speculation.

**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?

It would clearly increase administration costs and furthermore liquid bonds can be scarce putting bond markets under pressure. The alternative is to post cash which is not a "natural asset for insurance companies" and in Denmark it's not allowed to have more than 10% of the liabilities in cash. Furthermore cash normally requires that you pay EONIA when you receive cash as collateral, a possibility insurance companies doesn't have as you typically obtain EONIA minus a spread on your account. Hence receiving cash automatically incurs a loss for pension funds.

**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?

It’s rather difficult to see if the proposal is appropriate as the examples only contain the initial margin, not the size (in risk terms) of the trade.

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?

- 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?

We believe that a 99% confidence interval might be too tight and that 95% should be used. Otherwise the suggestions are practicable.

The risk measure from which the initial margin requirement is calculated is not aligned with the risk measure in the requirements on central clearing (EMIR) (99.5% over 5 days or 99.5% over 2 days). We recommend one risk measure as the basis for initial margin calculation on all derivatives – regardless whether it is cleared or not. This will increase transparency and simplicity.

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?

The more granular models used the better but allowance for diversification should be allowed based on supervisory approval of the model.

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?

An initial margin of 6% is too high for a FX contact with a maturity of less than one year. Otherwise, the suggestion seems reasonable.

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.

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?

Daily.

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?

Daily variation margin is best practice. However it is not impossible to avoid difficulties in pricing illiquid derivatives. Therefore the suggestion of robust dispute rules is necessary.

With regard to discrete call for additional initial margin, it’s a tool that should be used carefully and not in periods with severe market stress as it could start “a vicious circle” further stressing the market. In general many possibilities for discrete calls is not preferable as it increases uncertainty of the costs involved.

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

Around 0,01% of AUM

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

Yes.

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?

To restrict concentration in a single asset should definitely be a requirement. There is quite a difference in receiving German Bunds and equities and that
should be reflected.

A haircut of 8% to cash in different currency is too high if the currency is managed with a band. For instance DKK is officially managed towards EUR and accordingly a lower haircut for cash in EUR is appropriate for Danish insurance companies.

Further, it’s important to ensure that the rules are in accordance with local prudential regulation for instance Solvency II.

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 mitigant in all cases?

If you want to be sure that the initial margin is available immediately after a default then rehypothecation is not an option. However, using gross margin can put severe pressure on the financial markets. See Q23 as well.

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?

If financial entities are properly supervised then the need for gross initial margin is reduced and this should be reflected. Concentration with gross margin is indeed a risk and lack of high quality collateral is another. Concentration on a few custodian banks will mean a higher risk charge under current prudential rules in Denmark today and under the future Solvency II rules.

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 key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

Rehypothecation will make things go more smoothly and as stipulated in Q23 if financial entities are properly supervised then rehypothecation should not constitute a problem.

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 dis-
cretion 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?

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?

Yours sincerely,

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