ABI’s response to BCBS-IOSCO
2nd consultation on
Margin requirements for non-centrally cleared derivatives
15 March 2013
Foreword

The Italian Banking Association (ABI) is glad for this further opportunity to provide the views of Italian banks on this important subject, following the first consultation ended in September 2012.

As a preliminary consideration, the Association acknowledges and values as greatly positive the recognition by BCBS-IOSCO of the significant change in market practice and the operational and logistical challenges implied by the proposed initial margin requirements. It also welcomes the € 8 bn gross-notional-outstanding-amount minimum level of non-centrally cleared OTC derivative activity, as the threshold below which the initial margin requirement would not apply. Equally, it welcomes the provision of a threshold for the exchange of initial margins by the entities falling within the scope of application, applied at the level of consolidated group. However it believes that the threshold level should be higher, in order to both control the systemic risk and ensure that the impact on liquidity is low.

As regards the initial margining calculation model(s), current market practice shows that initial margin amounts can differ by up to 10 times, depending on the different settings and parameters used. Despite the BCBS-IOSCO provision for conditional model approval by the supervisory authority (page 11), the views gathered by the industry suggest the need to ensure the definition of one widely-agreed “standardised” margin schedule/model. This is because a standardised approach should ensure that the margin computations run by two counterparties do not diverge significantly. A standardised approach, along with the appropriate use of proprietary internal models (compliant with any forthcoming BCBS-IOSCO requirements), appears to be the solution that ensures consistency of calculations and results, while preserving an appropriate degree of flexibility for the industry.

Response to the specific questions

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?

ABI considers it appropriate to exempt these products from the initial margin (IM) exchange requirement, in consideration of the following:

However, ABI would consider it greatly beneficial if BCBS-IOSCO could clarify whether both counterparties would have to reach the € 8 bn threshold – rather than just one of the two – for them to be subject to the initial margin requirement.
usually, the duration of this product is relatively short;

there is a (de facto entrenched) habit of including forex products in CSA\textsuperscript{2} agreements, already involved in the exchange of variation margins (VMs);

CCPs are working to include these products on the list of products suitable for clearing, which seems to be the best solution;

their use as alternative instruments to money market deposits (a market already hit hard by the current crisis) would reduce their liquidity and the liquidity of the deposits as well.

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.

ABI regards as greatly positive the fact the BCBS-IOSCO takes into consideration the possibility of allowing re-hypothecation of IMs. However, the Association gathered a general consensus about the principle(s) stated on page 18 of the consultation document, where the BCBS-IOSCO states that «...Initial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty’s default, and (ii) the collected margin must be subject to arrangements that protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law...». Indeed, it seems necessary to ensure the prompt availability of the IM posted and, accordingly, to ensure its actual segregation from the counterparty posting the margin, as this would safeguard the prompt availability of the sums posted in case of default of that counterparty.

In any case, the possibility of re-hypothecating IMs, as well as VMs, in some specific cases, would undoubtedly provide some important liquidity relief for the industry. Hence, ABI suggests that BCBS-IOSCO should clarify and list, in the forthcoming final proposal, examples of actual cases in which re-hypothecation would be allowed. In this regard, it does not appear simple to draft cases of (for example) "customer’s non-proprietary positions"\textsuperscript{3} that

\textsuperscript{2}Credit Support Annex.

\textsuperscript{3}See point (i) in Q2.
would allow collateral re-hypothecation, or (e.g.) allowed overnight re-use of cash collected as guarantee, or (e.g.) securities collected as IM used in a proprietary Repo.

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.

The industry welcomes the newly proposed phase-in approach for the IM requirements over a 4-year period. However, its entry into force in 2015 might not be ideal, given that the industry, as we produce this paper, is not aware of the extent of the likely cumulative impact of the Basel3 rules and EMIR taken together with the provisions of this consultative paper. For this reason, BCBS-IOSCO should consider the option of postponing the entry into force of the IM and VM requirement (preserving the phase-in approach over a 4-year period), to safeguard the industry from any unwanted over-collateralization side-effect. Similar considerations (date of entry into force and appropriateness of phasing-in) also apply to the VM requirement, as in this case BCBS and IOSCO should allow for currency haircuts to account for netting between VMs computed in different currencies, which does not seem to be the case as presented in the consultation paper.
4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

The QIS results were considered to be appropriately accurate; there seems to be no need to amend the analysis presented.