The ABBL\(^1\) welcomes the opportunity to respond to this consultation paper. Although this is the second iteration of a consultation, the delay offered for comments on such a game changer for the industry is probably too short. Comments of concern to the Luxembourg banking community will therefore focus on key principles and questions that in the eyes of the Association remain open. This response will be articulated in 3 parts, the first consisting of general comments, the second dealing with the key principles and the last answering to the specific questions.

1 General remarks

The Association considers that, although the new set of rules regarding the trading and clearing in derivatives instruments has been fully reviewed after the G20 Pittsburgh

\(^1\) The Luxembourg Bankers’ Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members’ universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.
requirements, the core focus of regulators has so far been the central clearing and the creation of trade repositories. In the EU, at least, it is still not clear what the scope of products covered by the regulation will be, nor the cost of posting collateral for CCPs (central counterparties). It may be appropriate to work on all fronts at the same time, but in this rapidly changing environment, where new rules of the game are prepared, extreme caution shall be the primary attitude. The Association sees in this exercise major risks for large parts of the industry. Identified are ideas concerning the need for delivering two-sided initial margins for all contracts, the requirement to integrate fully the forex derivatives as well as operational matters, like the exemption at group level until the 50 million threshold. There are also the intra-group exposures or the relationships between different jurisdictions.

In addition, at a time of unknown quantities regarding instruments for collateral, margins and capital requirements (under the Basel III/CRD-CRR IV in the EU), it may not be wise to take a restrictive approach in terms of limiting the instruments available nor to limit the re-use of instruments. In the end, the schedule from 2014 to 2019 may be problematic in that regard. Setting a programme today where full margining will be required and where dealing on CCPs will have to be covered as well, seems to be a particularly brave stance on limiting systemic risk. The risk that the Association foresees is that, in light of the general requirement to have recourse only to prime collateral, the latter’s cost and availability will be to tight for all institutions to have access to it. The Association would propose a two-step approach, where in a first instance a review period is established until the market stabilises and then, according to the new realities, policy measures are designed. Otherwise there is a risk of pushing stakeholders into undesired practices just so to comply with untested policy, with the potential outcome that interactions among them will create systemic concerns elsewhere. It is not as if regulators are creating a new game with its new rules; rather what is done today is a full change of the rules of the game, but with a legacy business and market structure that needs some time to change.

This being said, the Association supports the ideas to reduce systemic risk and increase transparency in the know-how and impact of trading practices. Yet it is not convinced that the material implementation of these requirements will deliver expected outcome and not create incentives for risky behaviours.

As two final comments, the ABBL notes that the QIS undertaken only has a handful of participants and that relying on a single period of evaluation is probably not sound and then specific situations like covered bonds pools or SPVs which are used as a package for structured products shall benefit either from exemptions or at the very least their situation and risk level shall be specifically addressed with a preferential treatment.
2 Key principles

1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.

The ABBL is forcefully opposed to the requirements of including the transaction in FX derivatives in the scope of margining. It considers that the current set up, both at EU level and globally, as well as the liquidity, depth of the markets and diversity of actors do not make them prone to systemic risk and that any new measures will probably increasingly incentivise the search for alternative practices, like stopping hedging which would lead to increased systemic risk taken by all actors, from large financial groups to even medium-sized corporates. Asking for initial margins is contrary to current market practices and will add an unnecessary layer of capital immobilisation. Today market operators consider that the CLS and ISDA agreements are largely sufficient to protect against risks.

Regarding other instruments, although the approach to require margin may sound correct from a theoretical point of view, at this stage, without knowing the cost of either the CRD/CRR IV (Basel III in the EU) nor that of central clearing, this bold one-size-fits-all principle does not seem healthy. Appropriate definition and calibration shall be designed with regards to the risk per typology of instruments.

The Association understands that changes are underway and they shall lead to a safer environment, but by requiring additional costs that today are difficult to assess in their substantiality will create incentives to cease some risk mitigation practices. Clearly if the cost of hedging becomes to high it will stop.

2. All financial firms and systemically-important non-financial entities (“covered entities”) that engage in non-centrally cleared derivatives must exchange initial and variation margin as appropriate to the counterparty risks posed by such transactions.

Conceptually, the Association sees at least three issues with the requirements. It is not certain that the 50 millions are appropriate for the threshold, nor that the “group approach” makes operational sense. about it has also doubts about the need to always have two-sided posting of margins.

The threshold of 50 million is probably too granular at group level to have exemption. Furthermore, in order to know if it has been crossed there is, in any case, a need to de facto calculate each margin at a contract level. The Association would rather plead to increase that amount to 500 million.

The notion of group level is likely to be problematic. It would indirectly imply a full centralisation of treasury and collateral/margin computation (and not only reporting) but
as also require that one knows, within each entity of groups, which are the counterparties and to whom they belong in the end. One should not forget that the entities that risk to be the most active in these types of instruments are global companies, be they financial or not. The proposal from the ABBL would then be to keep the 50 million threshold but apply it at single entity level, whatever the links among a group. That amount will most likely not be enough to justify the creation and maintenance of a dedicated subsidiary (as a branch would by default be consolidated with its parent). This would allow groups to continue to manage the day-to-day treasury in a decentralised way but report to the central treasury department. This practice will mean that clients or counterparties in remote locations (from the headquarter) will not have to wait before being approved; and clients like to get close to their suppliers or counterparts. This will also work as an incentive not to concentrate all financial activity in one or two single places across big regions, if not the globe.

The Association has reservations as well as to the need to always proceed to a 2 way margining. There are several reasons, among which immobilisation of good collateral is probably at the top of the list. This is completely against the principles of close out netting clauses in most contracts. The Association views these clauses as one of the best ways to protect counterparties from a failing entity. Indeed, with this bilateral exchange will the non-defaulting entity not only lose out on its contract but it is more likely than not at risk of being forced to forgo the margin it deposited with its counterpart.

The Association is wondering whether the 100,000 de minimis requirement will not add another burden to the management of the counterparty. In any case, to determine that amount or the 50 million, the computation shall be performed with written evidence to know when each of these 2 values has been crossed. The Association is of the view that current market practices in terms of exchange of variation margins are appropriate and that systems already exist on daily or intraday margining.

Additionally, the current market practice with corporates seems to be more about not requiring collateral, which is something that may be improved, but it should be understood that requiring these entities to post collateral is a Copernican revolution and that these corporates will have to develop management tools and systems to deal with that. The Association thinks here about airline companies, global manufacturing companies (car producers or any other goods). These are heavy users of derivatives for hedging purposes and the new practice may be a disincentive to protect themselves.

3. The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally cleared derivatives at issue and (ii)
ensure that all counterparty risk exposures are covered fully with a high degree of confidence.

The Association foresees many problems in this key principle, although it shares the view that both the product and the counterparty shall be taken into account when it comes to the margin requirements.

As in the recommendation of the EU (ESMA) advice to the EU Commission, the ABBL is dubitative as to the requirement to define scenarios based on historically distorted data. The reference to extreme but plausible scenarios is nice in theory but will lead in practice to an overvaluation of the margin most of the time and it is debatable if part of the data shall always be by default the worst available. The next question is why 10 days? For contracts, this may be largely below this timing or way beyond (even in years). In addition, this approach does not differentiate among the typology of products even if the risk structure is different.

The Association understands that models have to be approved, but is doubtful about the process, since a model approved by a supervisor may not be recognised in a different jurisdiction and that these may even go as far as to be conflicting. This also leads to a question regarding corporates. It is likely that financial institutions will develop tools to define margin requirements, but to whom will corporates report to validate their own models (if they are large and lucky enough to develop them)? The ABBL would propose to reverse the presumption: if one model has been approved by a supervisor, it shall be valid and agreeable for others. If at a certain point in time it appears that a supervisor is too weak, this may be addressed at the relevant level, either at BCBS, or regional in the case of the EU where the supervisory architecture implies that all authorities work alongside the relevant EU authority (EBA, ESMA or ESRB). The process of approbation by authority for diversification effect is in that case too heavy. These shall be determined by the notified model but not pre-approved (mostly because of the delay for such a procedure and the operational dimension attached to it, like documenting it, having audit trails…). The Association supports the views that, where feasible, netting or diversification factors shall be considered.

The ABBL further considers, contrary to the proposal, that counterparties that are mutually active with one another diversification, both within and across the portfolio of various instruments, shall be taken into account if only for the level of counterparty risk.

Just as hell is paved with good intentions so is the requirement to limit pro-cyclicality: easy to define in theory much less so in practice. The question appears not so much in the expansion phase of the cycle, where buffers may be added to curtail excessively risky behaviours, but in the trough where it may be difficult to consider the need to reduce buffers when counterparties are not necessarily in the most optimal shape due to economic uncertainties.
Similar computation and definition problems should be raised regarding variation margins.

4. To ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the requirements from losses on non-centrally cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.

A problem with this requirement is that every counterparty is willing to sit on the most secure and prime quality collateral. The problem is that at this stage it is not certain that it is available in a classic and direct manner. The Association points to the increased trend to limit reuse or re-mortgaging of assets, which is clearly in contradiction with the increased demand to rely on prime collateral. The risk of all the stakeholders being pushed by these conflicting requirements is that of drastically limiting the number of transactions and forcing them to concentrate on a handful of G-SIFIs, which are the only ones to have the means to be present at all times across markets. The risk taken by this approach is that of the failure of such an entity. The issue central to the debate is the following: is it less of an impact to have a node in a network that fails or to have a vital counterpart that disappears.

The Association would not be too limitative in the scope of available collateral to authorise as many categories of instruments, but with appropriate haircuts for quality, quantity and liquidity.

5. Initial margin should be exchanged by both parties, without netting of amounts collected by each party (ie on a gross basis), and 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 fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.

The ABBL does not fully understand the need for such a requirement, as it completely goes against the close out netting principle, which is probably one of the easiest and safest ways to prevent a domino effect in the system. If both parties exchange on a gross basis for the good counterparty in case of materialisation of risk, it means losing both on the contract and a high likelihood of losing on the collateral. In addition, if collateral should be segregated anyway, why also penalise counterparties with an excessive immobilisation of a rare commodity that will be unproductive for them and for the entire economy.

6. Transactions between a firm and its affiliates should be subject to appropriate
regulation in a manner consistent with each jurisdiction’s legal and regulatory framework.

The ABBL is of the opinion that intragroup transactions shall be exempt from specific rules to the maximum extent. In the case of banks, the intragroup regime envisaged in Basel III or its EU version of CRD/CRR IV has introduced capital requirements for intragroup and large exposures. The trade-off is to be made between considering the group as one entity and accordingly facilitate internal dealings among different entities and protecting local clients in case of failure. The ABBL considers that for financial institutions the prudential regime, in the EU at least, is largely taking into account these risks. The view taken under the EMIR is to offer on a declarative basis the option of a preferential treatment for intragroup margins. The Association thinks that these shall be removed from the outset as long as the group of reference is subject to a prudential framework.

7. Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions.

There is something odd in the proposal. Although the principle of non-duplication and consistency is sound, the different examples point to a situation where the criteria will be in the end left to the negotiation powers of the counterparties’ authorities.

An additional point should be made: there is a difference between a subsidiary and a branch. A subsidiary, although part of a group, is a legally fully independent entity with appropriate level of funding and capital requirements. It is entirely under the jurisdiction of the country where it is located. The branch is a kind of extension of its parent entity without a separate legal entity, just as if its counterparties were dealing directly with the parent. Applicable laws and the jurisdiction of competence is the one of the parent (for most of the cases), not the one where the entity is located. The ABBL believes that this makes a huge difference. As a consequence, in the different examples where the issue is trading by a subsidiary with a counterparty (be it a headquarter or else) the jurisdiction of reference is that of the country where the subsidiary is located, whatever its parent company jurisdiction.

The Association disagrees with example (circumstances) 5 as the dealings are between subsidiaries; the US or German regulator have nothing to do in the relationship and accordingly with the legal framework.

The Association is therefore of the view that any jurisdiction that has implemented G20 requirements in relation to OTC derivatives and applies prudential rules similar to Basel III or a local regulation with similar effect shall be “by default” considered equivalent. In other cases, when the dealings are with one counterparty from an “in” country with another in an “out” country, it may be envisaged to require an additional layer of
security, for example through additional margins. But this type of “penalty” shall be defined not at each individual supervisor level but through a higher standard setter (BCBS and IOSCO).

8. **Margin requirements should be phased-in over an appropriate period of time to ensure that the transition costs associated with the new framework can be appropriately managed. Regulators should undertake a coordinated review of the margin standards once the requirements are in place and functioning to assess the overall efficacy of the standards and to ensure harmonisation across national jurisdictions as well as across related regulatory initiatives.**

The Association notes that the timing is aligned on the Basel III liquidity criteria. It is not convinced that this is a sound idea, at the least because the start date is too near for institutions to be prepared.

It should also be noted that the other side of the OTC transparency regulation, namely the CCP part, will require vast amounts of collateral and accordingly a prudent approach may probably be to first observe the situation in terms of access to collateral and test the industry structure before requiring new measures based on a structure that is for sure changing.

### 3 Specific Questions

**Q1. 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?**

As said previously, the current market organisation for FX and FX derivatives makes these markets not prone to a crisis. Existing systems are already developed to protect counterparties (contractually and materially via the recourse to CLS). It should be made clear that all FX are ideally out of this scope.

**Q2. 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.**
Definitely yes, reuse and re-mortgaging are to be allowed. The Association understands that the ability to access the assets that have been reused is key, but ideas raised in the IOSCO/FSB shadow banking consultation (Trade repositories) may alleviate some of the concerns. Furthermore, from a purely legal point of view, going in this direction may mean changing the legal regime of many countries.

In addition, as long as the picture is not clear and the amount and access to collateral is not well understood, the Association would call for extreme caution and postponement of hardwired measures in favour of more observation or an additional QIS.

Q3. 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 Association is not convinced that the proposal will materially imply a reduction in systemic risk. The risk level may be altered or transformed but beyond a reduction in certain hedging transactions due to the increased cost of margining and increased cost of collateral, the overall impact may simply be a shift away from some derivatives to simply expose counterparts to the direct underlying exposure.

Otherwise, the ABBL would opt for at least a two-year review from 2015, so that more data is gathered and a better understanding of the deployment of Dodd-Frank/EMIR/Basel III can be made.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above
The Association notes that the QIS has been undertaken by a relatively small number of institutions at a time where the regulations are not in force neither on the centralised clearing nor on the margin requirements an in a period where at a global level interest rates are at all times low.