Alternative Investment Management Association

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Basel Committee on Banking Supervision
Bank for International Settlements
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By email to: baselcommittee@bis.org and wgmr@iosco.org

15 March 2013

Dear Sirs,

AIMA's response to the joint BCBS-IOSCO Second Consultative Document, 'Margin requirements for non-centrally cleared derivatives'

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions' (IOSCO) Second Consultative Document, 'Margin requirements for non-centrally cleared derivatives' (the Second Consultative Document).[2]

AIMA commends the efforts of the both organizations to work towards a consistent set of international principles for the regulatory regime for non-centrally cleared derivatives. Many of the proposed key principles demonstrate a considered approach by BCBS-IOSCO to ensure that a robust international regime for margin for non-centrally cleared derivatives is implemented. However, AIMA raises certain concerns with the proposals put forward in the Second Consultative Document which largely follow on from those raised in its response submitted on 28 September 2012 to the first consultative document, 'Margin requirements for non-centrally cleared derivatives'[3] (the First Consultative Document).[4] These include recommendations that:

i. margin requirements for financial instruments, specifically with respect to physically-settled FX forwards and swaps, be tailored to the nature of the risk that such instruments present to the financial system and should be developed separately from those for the other non-cleared derivatives;

ii. initial margin (IM) which is segregated under relevant segregation arrangements should not be rehypothecated, as this would compromise the level of client protection afforded by such segregation. Rehypothecation of IM in omnibus accounts could be allowed, but should be governed by strict conditions, including a requirement for robust levels of customer transparency; and

iii. any phase-in arrangements correspond with the implementation of clearing obligations in key jurisdictions and take account of specific counterparty and product risks.

We urge BCBS-IOSCO to ensure these are adequately dealt with in the final principles it formulates.

AIMA provides its response to questions 1-4 of the Second Consultative Document, as well as certain additional comments, in the Annex below.

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[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge fund managers, prime brokers, fund administrators, accountants and lawyers, membership comprises over 1,300 corporate bodies in over 50 countries.

[2] Available at: http://www.bis.org/publ/bcbs242.pdf.

[3] Available at: http://www.bis.org/publ/bcbs226.pdf.

[4] Available at: http://www.aima.org/objects_store/aima_response_-_margin_requirements_for_nccd_-_28_sept_12.pdf.

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Overall, AIMA believes that the proposals put forward in the Second Consultative Document address a number of concerns not adequately dealt with in the First Consultative Document. AIMA commends BCBS-IOSCO for its responsiveness in this regard. However, we feel that the comments made above highlight key outstanding issues on which BCBS-IOSCO should focus in order to be best placed to realise the goals of the margin for non-centrally cleared derivatives framework – the reduction of systemic risk and the promotion of central clearing.

AIMA would like to thank BCBS-IOSCO for the opportunity to respond to the Second Consultative Document and would welcome the opportunity to discuss the contents of this submission in greater detail.

Yours faithfully,

Jiří Król
Director of Government & Regulatory Affairs

ANNEX

1. Questions 1 to 4 of the Second Consultative Document

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?

AIMA supports the requirement to post variation margin for physically settled FX forwards and swaps. Current market practice is such that the large majority of AIMA's members who enter into bilateral trades in the FX space are already required to post margin (both IM and VM). However, any IM requirement imposed on such instruments should be tailored to the nature of risk they present to the financial system and developed apart from those for the other non-cleared derivatives. Specifically, a 99%, 10-day liquidation horizon would be inappropriate and excessive for highly liquid, short-dated FX swaps and forwards. Such instruments by virtue of their liquidity have a shorter close out time than many other non-cleared derivative products and, therefore, do not need as extensive IM provision, the purpose of the latter being described at Paragraph 3(d) of the Second Consultative Document as to protect the transacting parties '…from the potential future exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out the position.' AIMA, therefore, recommends that BCBS-IOSCO permit a significantly lower time horizon for short-dated FX swaps and forwards.

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.

AIMA strongly believes that clients should have the ability to contract for optional segregation of IM, on a reasonable cost basis. In cases where IM is segregated, however, it is unlikely that rehypothecation would be possible without undermining the protection otherwise provided by such segregation. In such situations, therefore, we would not support rehypothecation of IM. AIMA, nonetheless, does not consider that the conditions outlined above are necessary in respect of variation margin (VM).

As a more general point, to the extent that assets are rehypothecated, including VM and unsegregated IM, there should be strict governance conditions in place, including robust levels of transparency over such re-hypothecation e.g., ongoing disclosure as to the level of re-hypothecation caps and daily reporting as to where assets are held. We also consider that prime brokerage clients should be able to freely negotiate the re-hypothecation cap on a fund-by-fund basis.

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?

AIMA commends the efforts of BCBS-IOSCO with respect to the suggested phase-in arrangements. However, AIMA would refer BCBS-IOSCO to the First Consultative Document wherein it expressed the need for any phase-in arrangements to correspond with the implementation of clearing obligations in key jurisdictions. We are concerned that the phase-in schedule envisaged by BCBS-IOSCO in its Second Consultative Document is potentially too rigid, both in terms of the envisaged pace of phase-in and the ultimate thresholds.

Furthermore, AIMA also disagrees with the methodology used to assess the applicability of the phase-in periods. We believe that measuring non-cleared derivatives by notional value alone is misleading, as different asset classes have different levels of risk; counterparty risk and the nature of the product should also be taken into account in developing the methodology. For this reason, AIMA would argue that the net mark-to-market value of non-cleared derivatives should be used for relevant phase-in provisions.

Q4: The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

AIMA has no comments on the QIS results appended to the Second Consultative Document.

2. Additional Comments

i. <u>Two-way exchange of margin and IM threshold</u>

Key principle 2 in the Second Consultative Document states that:

> "*All financial firms and systemically-important non-financial entities ("covered entities") that engage in non-centrally cleared derivatives must exchange initial and variation margin <u>as appropriate to the counterparty risks posed by such transactions</u>*" (emphasis added).

As stated in AIMA's response to the First Consultative Document, AIMA agrees with the principle of two-way margining, provided it is proportionate to the particular counterparty credit risk. The underlined wording above does provide comfort to AIMA that the BCBS-IOSCO recommendation for two-way exchange of margin takes a proportionate approach to the implementation of such requirement. We would, however, highlight the need for the BCBS-IOSCO proposals to be mindful of (a) a requirement for too much IM being posted and (b) an increase in operational complexities, which would in turn result in increased costs, potentially to the extent that non-centrally cleared derivatives might become commercially impossible to trade.

AIMA recommends BCBS0-IOSCO take a similarly proportionate approach to the requirement for an IM threshold amount. AIMA does not agree with a flat IM threshold i.e., the proposed flat IM threshold of €50 million proposed in the Second Consultative Document. Any thresholds set should be based on each party's assessment of the credit worthiness of its counterparty.

ii. <u>IM Calculation</u>

Paragraph 3.1 of the Second Consultative Documents states:

> "*The required amount of initial margin may be calculated by reference to either (i) a quantitative portfolio margin model or (ii) a standardized margin schedule.*"

AIMA supports the possibility, as contained within the Second Consultative Document, for dealers to develop their own proprietary quantitative IM models tailored according to the particular risk profiles of their clients. We feel that market participants benefit when dealers compete to develop more sophisticated ways through which to model risk, including the ability to account for risk offsets between correlated instruments on a portfolio basis, which generates margining efficiencies with no increase in risk.

We identify, however, that the standardised initial margin schedule contained within the Second Consultative Document, requires additional clarity. In particular, the schedule does not take into account the fact that different instruments within an asset class have different levels of risk. For example, it is not clear how the different levels of risk associated with Western European Sovereign CDS would be accounted for as compared to US corporate debt instruments. AIMA, therefore, recommends that classes under the Standardised Initial Margin Schedule such as 'Foreign Exchange\Currency' and 'Equity' are made more risk specific, in a similar manner to the 'Credit' and 'Interest Rate' classes also provided within the schedule.

iii. Cherry picking between margin model and collateral

Paragraph 3.8 of the Second Consultative Document states:

> "*Derivative market participants should not be allowed to switch between model- and schedule- based margin calculations in an effort to "cherry pick" the most favourable initial margin terms.*"

AIMA respects the policy reasoning behind this statement, however, identifies that the above goes into no further detail as to how this will be affected. We encourage BCBS-IOSCO to provide further information on this.

AIMA would also like to highlight that the mere fact that a participant switches between model- and schedule- based margin calculations for a particular asset does not *prima facie* involve 'cherry picking' in the negative sense of the term used within the Second Consultative Document. We express our strong support for the ability of market participants to legitimately switch between collateral models, provided that adequate notice periods are introduced.

iv. Key Principle 5 - Definition of "*immediately available to the collecting counterparty*"

Key principle 5 of the Second Consultative Document states that the margin collected should be "*immediately available to the collecting party in the event of the counterparty's default*". AIMA requests that BCBS-IOSCO clarify this further so as to make clear that this requirement is without prejudice to legitimate market practices regarding limitation periods negotiated by counterparties in situations involving tripartite arrangements which might entail a legitimate delay in access to margin. Such limitation periods in practice are actioned either through delayed instruction to the custodian or a notice to the custodian with an in-built delay, and allow cooling-off of the counterparties or dispute resolution processes to be initiated.

v. Appendix B – Standardised Haircut Schedule

AIMA believes that the haircut schedule contained in Appendix B of the Second Consultative Document fails to adequately define the financial instruments subject to such haircut levels (e.g., how is a high-quality corporate bond defined?) and account for the different levels of risks between financial instruments. For instance, Appendix B applies an 8 per cent haircut on an asset in which the currency of the derivative obligation differs from that of the collateral asset. This fails to account for the different levels of FX risk between different currencies.