UniCredit

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UniCredit reply
to the BCBS-IOSCO consultation on
"Margin requirements for non-centrally-cleared derivatives"

UniCredit Group is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches and 150.000 employees. UniCredit Group is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit Group operates the largest international banking network with around 4.000 branches and outlets. UniCredit Group is a market leader in the CEE region.

Executive Summary

1. Margin requirements should be consistent and coordinated across national jurisdictions

UniCredit appreciates the BCBS/IOSCO's efforts to develop global standards on margin requirements for non-centrally cleared OTC derivatives. In its role of cross-border financial Group, UniCredit regards consistency and coordination among national regimes to be crucial for addressing the risks of regulatory arbitrage and market disruptions.

Inconsistencies between national margin requirements would foster the so-called "race to the bottom" as market participants would move their activities to countries where margin requirements are less restrictive. Uncoordinated timing for implementation into national jurisdictions,would be able to create competitive distortions in cases where counterparties are subject to different regimes. This could be the case of the EU, where we first need to evaluate the impact of the recently adopted "European Regulation on OTC derivatives contracts, central counterparties and trade repositories" (hereinafter EMIR).

The effectiveness of margin requirements could be undermined if the requirements were not consistent internationally. Considering the global size of the derivatives market, we urge BCBS and IOSCO to reduce national discretion both on the content and timing of the new margining requirement.

2. Margin requirements should not overlap with parallel regulatory initiatives and should not exacerbate the need of collateral

Financial institutions will have to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the liquidity impact of margin requirements cannot be considered in isolation but needs to be assessed together with ongoing and parallel regulatory reforms which have or are expected to have significant liquidity impacts.

Although with different scope and objectives, some of the current regulatory initiatives are overlapping in covering the same risk. This would be likely to happen e.g. between the proposed margining requirements and the Basel rules as to the pricing of the Counterparty Credit Risk (CRR). More in particular, Basel rules already provide that Counterparty Credit Risk (CCR) is priced in margins, according to the Valuation Adjustment (CVA) desk. The current exposure arising from derivatives business is already covered by regulatory capital. Basel 3 will also require future exposure to be backed by regulatory capital. If initial margin requirements were to be introduced,

there is the concrete risk that the same CCR would be priced twice thereby producing an increased need of collateral. This will exacerbate the shortage of collateral, with negative implications on market liquidity.

With a view to avoid overburdened collateral requirements we would suggest that banks covered by Basel rules should be exempted from the mandate to post initial margin. As to the current exposure, it should be covered by variation margin subject to a pre-defined threshold amount, which in our view does not create systemic risk.

3. Exemptions should be provided for transactions among affiliates entities within the same cross border financial Group

With a view to ensure a smooth functioning of cross-border financial groups and also to preserve the business model of integrated cross-border financial groups, we believe that derivatives transactions among group entities, also where located in different jurisdictions, should be exempted from the obligation to post initial margins.

As they stand, the proposed requirements do not properly recognize both the economic value of cross border financial groups and the role played by the internal capital market, where group resources such as human resources, capital, liquidity and assets should be efficiently allocated, without unnecessary regulatory obstacles.

The requirement of specific margins on transactions among group entities will imply an unnecessary burden and is likely to impair the activity of the whole group, whose assets have been allocated within the different Group entities to reach the most efficient and effective portfolio allocation.

Specific answers

- **Implementation and timing of margin requirements**

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 strongly agree with the proposal to introduce an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives as a way to ensure a smooth transition and avoid market disruption. Being closely related to the clearing obligation, the implementation of margining requirements should be applied in a manner which is coordinated with the implementation of the EMIR. According to us, the adoption of more detailed rules on margining requirements should follow an assessment (by BCBS/IOSCO) of the way the European financial entities comply with the clearing obligation provided under EMIR. In this regard, we would strongly encourage to draw first some lessons from the impact of the clearing mandate under EMIR and then to review requirements for non-centrally cleared derivatives.

- **Element 1: 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?*

Foreign exchange swaps and forwards should be exempted from the scope of the global margining obligation so as to ensure consistency with the exemptions provided under the Dodd-Frank Act. We would also suggest BCBS/IOSCO to reduce differences amongst national rules with regard to the criteria used for determining whether or not a certain product is included or excluded from the scope of the margining obligation. This is particularly true with regard to the legal uncertainty arising from extraterritorial legislations which have the potential to actually foster systemic risk by making it more difficult for regulators to monitor financial markets. We therefore believe that a more harmonized international framework would help in avoiding regulatory arbitrage and enhancing the level playing field among market participants.

- **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?*

As a preliminary remark, we would like to express our disagreement with regard to the proposal to introduce the bilateral exchange of margin requirements. Major concerns are related to the need of additional liquidity resources which financial institutions will have to provide in order to comply with the new margin requirements. As underlined in the consultation, the liquidity impact of margin requirements has to be considered in conjunction with other regulatory initiatives that will also have significant liquidity impacts.

Where such margining obligation were to be introduced, we consider the outlined scope of coverage too broad. We would suggest to calibrate the two-way margining obligation by limiting its application to cases where it is strictly necessary to ensure an appropriate protection against systemic risk.

We support the idea of exempting non-financial entities which are not systemically relevant as well as sovereign and central banks.

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?*

We understand the rational of the provision of initial margin thresholds as a way to offset the increased liquidity costs against the need to reduce systemic risk. We also support the view that the largest key market participants who transact in a significant amount of non-centrally-cleared derivatives should face the use of lower thresholds to better manage concentration risk.

We warn against divergences among national legislations which could arise in case the definition of thresholds were to be left to national supervisors. In this regard, uniform rules laid down by BCBS and IOSCO would be a welcomed step to avoid regulatory arbitrage and an unlevel playing field among market participants.

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?

The establishment of initial margin thresholds which differ across entities is likely to produce a significant impact on the market. A detailed regime on initial margin thresholds should follow a comprehensive assessment by BCBS/IOSCO of the way such thresholds would impact the smooth functioning of derivatives market. With a view to limit the use of thresholds we would also suggest to take into account other parameters such as the status of "regulated entity".

As to the proposal to use notional amount of outstanding derivatives activities to determine the level of systemic risk posed by certain entities, we are questioning about its effectiveness to the purposes of initial margining requirement. We do not support the inclusion of such a general indicator of systemic importance which is being considering elsewhere in the ongoing discussions which are intended to identify which entities pose systemic risk at global or domestic level (G-SIB/D-SIB).

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?10 Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?*

Methods for calculating initial margin threshold should be simple and comprehensible. A certain degree of flexibility is also desirable with a view to reflect the market dynamics. Using rating triggers as a way to fix initial margin thresholds could be not reliable as they are proven to fail in reflecting the true economic standing of financial institutions during the past financial turmoil. We also believe that the "systemically importance" of a certain financial institution cannot represent by itself the most appropriate criterion for the definition of thresholds. We therefore call for such methods to be set up at international level and based on a combination of criteria suitable for catching market needs in a timely and reliable way.

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?*

In compliance with the internal risk policies, UniCredit already applies two-way exchange of margins and Collateral Valuation Adjustments (CVA) for uncollateralized trading. We face practical constraints in cases where counterparties do not have any collateral management in place. The introduction of collateral management systems will be likely to produce an increase of costs for market participants who do not have such systems in place. Pledge constructions represent the only way certain market participants are allowed to post collateral, due to restrictions provided under their respective national legislations. Thus, general collateral management systems may not be appropriate to take this into consideration. A one fits all solution seems to be not a feasible solution for all market participants. Operational impediments may have a significant impact on the feasibility of the daily margining process.

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

The consultation seeks comments on whether or not sovereign and central banks should be excluded from the scope of the two-way exchange margining obligation. In our view, federal, state and municipal governmental entities (regardless the provision of a State's guarantee) together with entities which are owned by several States (supranationals) should be exempted as well. We also support the proposal to

exclude non-financial entities which are not systemically relevant.

- **Element 3: baseline minimum amounts and methodologies for initial and variation margin**

General comments:

As highlighted in the consultation paper, "*financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceeds current practices*". Moreover, the liquidity impact of margin requirements cannot be considered in isolation but needs to be assessed together with ongoing and parallel regulatory reforms which have or are expected to have significant liquidity impacts.

Although with different scope and objectives, some of the current regulatory initiatives are overlapping in covering the same risk. This would be likely to happen e.g. between the proposed margining requirements and the Basel rules as to the pricing of the Counterparty Credit Risk (CRR).

More in particular, Basel rules already provide that Counterparty Credit Risk (CCR) is priced in margins, according to the Valuation Adjustment (CVA) desk. Both the current exposure and the future exposure must be calculated.

The current exposure (including an add-on to cover the close-out period) arising from derivatives business is already backed by regulatory capital. Basel 3 will also require future exposure to be backed by regulatory capital. We are aware that the CRR does not internalise the systemic risk posed by interconnections deriving from derivatives transactions. However, if IM requirements were to be introduced, there is the concrete risk that the same CCR would be priced twice thereby producing an increased need of collateral. This will negatively impact on market liquidity.

Concretely we therefore suggest that:

- current exposure should be covered by variation margin subject to a pre-defined threshold amount, which does not create systemic risk, and;

- future exposure should be covered by regulatory capital for banks subject to Basel rules with no initial margin required.

In a nutshell, banks covered by Basel rules should be exempted from the initial margin requirements, since the current exposure is already backed by regulatory capital, whereas the variation margin requirements should be required above a certain pre-determined threshold, which does not pose systemic risk. As to the payment of interest on cash variation margins, it would be desirable to have a monthly payment at the end of each month.

As to the model based initial margin, we disagree with the proposal to restrict the benefits which arise from diversification.

Margining is largely used among market participants in the derivatives markets. The evaluation of variation margin is based on the Net Exposure. The industry associations such as the International Swaps and Derivatives Association (ISDA) have updated and reviewed the respective rules with a view to provide market participants with the most calibrated solution. We therefore regard such a topic to be left to the industry representatives and therefore jointly developed with market participants.

- **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?*

We share the view to keep the scope of eligible assets as broad as possible. The extent to which the definition of the scope will impact liquidity would depend on the definition of highly liquid assets which,

according to us, should not differ from the definition of the assets eligible for Central Banks credit operations.

We raise concerns also on the flexibility granted to national supervisors in defining their own list of eligible assets without coordination with each other. Such an approach would undermine the harmonization purposes thus creating an unlevel playing field among market participants.

Accordingly, we would like to provide our suggestions :

- An alignment between the eligibility criteria for margining requirements and the eligibility criteria used by central banks (who already address concentration risk, haircuts and other risk mitigation measures from a policy maker perspective) would be strongly desirable: what is eligible for the ECB credit operations should be eligible also for the purposes of margining requirements;
- BCBS and IOSCO should avoid an overlap between margining requirements and other liquidity requirements;
- An enhanced cooperation between national supervisors should be pursued with a view to harmonize the treatment of margins across jurisdictions. We would also suggest to address cooperation between central banks and supervisors.

Lastly, according to the consultation paper the collecting party should timely undertake dispute resolution protocols in case disputes arise over the value of eligible collateral. We deem such a proposal not to be sufficient in itself for the purpose of collecting the required margin in a timely fashion during times of high volatility. We therefore suggest to extend the scope of the eligible collateral with a view to offer an appropriate options in cases of disputes.

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?*

Limiting the haircut (HC) estimation to asset class "silos" would create unrealistic scenarios. The recent financial turmoil have proven that different assent classes react to stress periods in a manner which differs from each other (the post Lehman crisis had a significant impact on financial institutions and corporate issuers whereas the so called "Sovereign" crisis had a big impact on sovereigns). If stress scenario per asset classes should be used for HC estimation, this will result in unrealistic HCs, since the correlation between those asset classes is left out completely. Concerns relate to the approach of BCBS/IOSCO which explicitly exclude the diversification of assets thereby holding back the related benefits.

- **Element 5: treatment of provided margin**

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?*

Although protecting a firm from losses in the event of the default of a derivatives counterparties, the exchange of initial margin on a gross basis would tie up capital and reduce the benefits of netting as a risk mitigating tool. Hence, if any, exchange on a net basis would be more appropriate. The gross basis requirement would be able to produce unintended consequences, such as the risk concentration on a limited group of custodian banks. Before introducing the gross basis requirement, BCBS and IOSCO should carry out a proper investigation over the potential effects which could arise from its implementation.

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?

Current market practices provide the exchange of collateral on a transfer basis so as to allow the receiving counterparty to re-use it. Prohibiting the re-use of collateral would lead – beside an increase of transaction costs – to a considerable drain of collateral and market liquidity which may limit market's capacity. The simultaneous requirement to use both highly liquid and highly quality assets as collateral together with the immobilization of such assets would produce negative effects. Where collateral management should not be allowed for supplying the eligible collateral, it would be challenging to enter into a transaction and this would affect the overall functioning of the derivatives markets. The increased collateral needs will affect directly the business activities of the involved entities, including those which support the real economy. Where prohibitions or limitations will be introduced, we would suggest to ensure an appropriate level playing field among market players across countries. There should not be differences or exemptions, as proposed by the US SEC, for different players (e.g. banks and broker-dealers).

- **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?*

The proposal which extends the scope of the margining requirements to non-centrally-cleared derivatives transacted between affiliated entities raises several concerns, especially when affiliates are part of the same financial group.

With a view to ensure a smooth functioning of cross-border financial groups, derivatives transactions among group entities, also where located in different jurisdictions, should be exempted from the obligation to post initial margins. As they stand, the proposed requirements do not properly recognize both the economic value of cross border financial groups and the role played by the internal capital market, where group resources such as human resources, capital, liquidity and assets should be efficiently allocated, without unnecessary regulatory obstacles. The internal capital markets would be negatively affected by unnecessary costs if exemptions were not provided. Imposing specific margins on transactions among group entities will impair the activity of the whole group, whose assets have been allocated within the different Group entities for risk mitigation purposes.

The business model of integrated cross-border financial groups is likely to be significantly undermined. In this regard, a comprehensive analysis (QIS) is strongly desirable so as to carefully assess how additional requirements impact the liquidity of the financial group entities.

If such exemption proposal were not endorsed, we would strongly suggest BCBS/IOSCO to adopt mitigating factors such as "haircuts" applied to reduce initial margins or the possibility of applying multilateral netting among Group entities.

In addition, we do not support the proposal which allows national discretion over the introduction of the initial margin requirements for transactions among affiliated entities, especially when they are part of the same financial group. If any, initial margin requirements should be set out by BCBS/IOSCO throughout uniform criteria for the identification of the existence of cross-border financial groups. In this context, exemptions should be provided for transactions among affiliates which are subject to the same consolidated supervision, and definitely in the Euro area.

We regard international standards as the best suitable tools for both ensuring consistency among jurisdictions and preventing regulatory arbitrage.

From a more widen perspective, we call for an higher coordination between all the current regulatory reforms which are aimed at building up a new legislative framework for centrally and non-centrally OTC derivatives contracts.

- **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?*

We share the BCBS/IOSCO view that rules must be established such that (i) regulatory arbitrage opportunities are limited, (ii) a level playing field is maintained, (iii) there is no application of duplicative or conflicting margin requirements to the same transaction or activity, and (iv) there is substantial certainty as to which national jurisdiction's rules apply.

However, we believe that the BCBS/IOSCO proposals are not pursuing all the above mentioned objectives as they are neither appropriate nor suitable for a market which is global and not location-dependent. We strongly disagree with the proposal to allocate on national supervisors the choice on whether or not to introduce initial margining requirements. The initial margining treatment, as well as other detailed rules of the margining framework, should be established at international level in a manner that ensure consistency across national jurisdictions.

- **Part C: Impact of margin requirements for non-centrally-cleared derivatives**

We are strongly supportive with the proposal to assess the weight of the proposed margin requirements against the liquidity impact and related costs. In particular, the QIS should be focused on the level of the initial margin required on non-centrally cleared derivatives as well as on the amount of available collateral that could be used to satisfy these requirements.

A comprehensive QIS should analyse also the impact that other regulatory reforms (such as Liquidity Coverage Ratio, the Net Stable Funding Ratio and global mandates for CCP of standardised derivatives) have (or are expected to produce) on market liquidity. In this respect, we call for further dialogues with industry to be undertaken by international regulators with a view to properly weight the overall impact deriving from the imposition of additional margins requirements.

Such a QIS should cover also the issue of margining requirements required for transactions between affiliates, especially within cross-border financial groups.

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