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CANADIAN BANKERS ASSOCIATION

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March 15, 2013

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

International Organization of Securities Commissions
C/ Oquendo 12 28006 Madrid, Spain

Dear Sir/Madam,

Re: CBA[1] Comments on consultative document:
"*Margin requirements for non-centrally cleared derivatives*"

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) consultative document, *Margin requirements for non-centrally cleared derivatives* dated February 2013 (Consultative Document). We recognize that the Consultative Document builds on the initial July 2012 proposal and subsequent quantitative impact study (QIS), and seeks industry feedback on four key questions with respect to the BCBS-IOSCO's policy on margin requirements for non-centrally cleared derivatives.

We have provided our comments on some key issues below, and offer a more detailed response on the Consultative Document and its four questions in the attached appendix.

Question 1: Exemption of physically-settled FX forwards and swaps

We recommend that the BCBS-IOSCO consider excluding all deliverable foreign exchange transactions (spot, forwards, currency swaps and cross currency basis swaps) regardless of maturity dates, from the proposed margin requirements. As further discussed in the attached appendix, this market is highly liquid and usually short dated. Requiring both initial and variation margin on these products will severely stress the liquidity profile of counterparties and is of particular concern for the Canadian market with higher than usual concentration in the FX market.

[1] The Canadian Bankers Association works on behalf of 55 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 274,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

Question 2: Re-hypothecation of initial margin

While we acknowledge the challenges associated with the re-hypothecation of initial margin, we believe that some degree of initial margin re-hypothecation is desirable. The primary objective must be, however, to preserve the pledgor's ability to recover any collateral. Unfortunately, the current comment period does not provide us with sufficient time to determine if that objective can be reconciled with any amount of re-hypothecation.

We further emphasize the need to avoid introducing highly prescriptive regulatory constraints to respond to these concerns. We believe that a more principle-based approach (one that provides room for commercial solutions to these issues) should be considered.

We stress that further work in this area is required, perhaps involving third party custodians and/or central banks to determine if a construct can be established and if it can be implemented internationally.

Question 3: Phase-in of requirements

It is premature for us to determine whether the proposed rules appropriately trade off the systemic risk reduction and incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements. In the absence of a more rigorous analysis, the attached appendix reflects some of our concerns with respect to the current phase-in proposal.

We would however recommend a phase-in approach related to initial margin requirements which is more aligned with Dodd Frank, pursuant to which dealers would phase-in at once commencing 2018, and where funds would phased-in commencing 2019. Delaying implementation until 2018 will allow financial institutions to address challenges concerning the development of consistent initial margin models and a standardized initial margin formula (please refer to the appendix for further details).

We further note that the Consultative Document's proposed requirements and timelines are predicated on the assumption that the rules will not be excessive with respect to draining liquidity from the system. We believe that this needs to be validated through careful analysis. We find such analysis difficult given the range of products that might clear in the future and that do not yet clear at present. We encourage regulators to avoid unintended consequences by carefully modeling the impact of the rules under realistic assumptions about products that may or may not clear. In this regard, it appears risky to release a 'near final draft' with a one-month comment period, in the absence of more rigorous analysis. At present, there are numerous 'unknowns' regarding clearing, and we question the feasibility of completing this type of analysis within this timeframe.

As you are aware, the proposed margin requirements for non-centrally cleared derivatives represent a fundamental change to the current workings of the market. There are potential impacts on systemic liquidity that concern all market participants. Given the scope of the change and the potential harm to the system should the proposals be inappropriate, we believe that the feedback period should not be rushed. At the very least, we hope that the BCBS-IOSCO recognize the importance of, and need for, a more detailed QIS.

Question 4: Accuracy and applicability of QIS results

As discussed in the attached appendix, models tend to be most different for complex derivatives, which are also most unlikely to be cleared. The accuracy of the QIS results is predicated on the consistency of the internal models. Given the variability in a Value-at-Risk (VaR) based approach, as demonstrated in the recent regulatory consistency assessment programme (RCAP), initial margin can be dramatically different. In the absence of benchmarking models prior to the commencement of the QIS, a further benchmark study or additional QIS may be required to determine the impact of model differences on QIS results, and also guide operational constraints for initial margin reconciliation. Furthermore, additional concerns on the extrapolation of QIS results exist because of significant changes introduced in the updated proposal (e.g. increased netting benefits in the standardized approach and the application of threshold at a consolidated counterparty level).

Additional comments

In addition to our comments pertaining to the four key questions posed by the BCBS-IOSCO in the Consultative Document, the attached appendix provides additional feedback with respect to other elements of the proposal. The CBA believes that several aspects of the proposal may need more careful analysis and additional guidance. Examples include the impact of regulatory differences across jurisdictions, reconciliation and operational difficulties under the modeled approach, consideration of the multi-currency Credit Support Annex (CSA) proposed by the International Swaps and Derivatives Association (ISDA), implications of foreign exchange fluctuations on the EUR 50 million threshold in a currency different from the legal agreements, and the EUR 100,000 minimum transfer amount that will result in an increased operational burden.

We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Sincerely,

Attachment: Detailed comments

cc: Nikil Chande, Assistant Director, Bank of Canada

CBA Members' Comments and Requests for Clarification
Element 1: Scope of Coverage – instruments subject to the requirements *Question 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?
The CBA strongly believes that physically settled or deliverable foreign exchange transactions should be exempt from the proposed margin requirements due to the distinct characteristics of these instruments. The argument for exempting physically settled foreign exchange transactions is based on the unique nature of the foreign exchange market. Of the five asset classes, foreign exchange is unique in that the vast majority of FX transactions are short-term and involve physical settlement. These transactions are often closely tied to the participants' funding and liquidity management activities. Physically settled foreign exchange products, while having some derivatives characteristics, should more appropriately be viewed as money market or funding products. By definition a physically settled foreign exchange transaction is an agreement to deliver the full principal of a bank payment in one currency in exchange for a bank payment in another currency. For Canada in particular foreign exchange swaps and forwards are an important component in cross border borrowing and investment activities (e.g. foreign exchange derivatives represent approximately 22.7% of total derivatives notional for Canada compared to approximately 8% for the global average). The CBA recognizes that replacement cost for foreign exchange derivatives, while less material than settlement risk, is still a significant risk when compared to other OTC derivative product classes. However, introducing mandated initial margin on physically settled foreign exchange derivatives could, by adding to the foreign exchange swap or forward cost and availability, increase funding costs and/or reduce investment yields. As a result, the reduction in replacement cost risk achieved could be offset by an increase in systemic and pro cyclical liquidity risk consequences. An additional and important argument supporting the exemption relates to the significant regulatory and infrastructure challenges facing the central clearing of deliverable foreign exchange derivatives. A central clearing solution for deliverable foreign exchange will need to avoid reintroducing settlement risk into the foreign exchange market and no such solution is on the horizon. The US Treasury's proposed determination to exempt deliverable foreign exchange swaps and forwards from clearing requirements under the Dodd-Frank Act (DFA) recognizes the unique characteristics of the foreign exchange market and challenges associated with reaching an acceptable clearing solution. The imposition of initial margin on non-centrally cleared foreign exchange products is intended by design to accelerate the move to clearing. In the event of prolonged absence of a clearing venue the initial margin requirements will impose a structural cost on both exempt and non-exempt users of foreign exchange products. Multi-lateral clearing via a central counterparty is inherently more margin efficient than

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a bilateral initial margin approach. In the event no central clearing venue is available it is not unreasonable to expect the foreign exchange forward and swap market to bifurcate into a two tiered market with cleared non deliverable forwards and bilateral physically settled trades. The market and policy implications of such a development need to be better understood. We would also note that most of our interbank relationships, accounting for the vast majority of FX swap volume by notional, are already subject to low to zero threshold CSAs and are marked-to-market on a daily basis. Considering this fact, the introduction of an initial/variation margining program will not provide any additional loss protection for the firm should a tail-risk event occur. Moreover, introduction of initial margin requirements for physically-settled FX transactions could ultimately have an adverse effect on the collective FX market including FX settlement. Corporations that have historically hedged FX risk will be deterred from doing so, owing to the introduction of complex and costly initial margining infrastructure. The exchange and segregation of gross initial margin between market participants will negatively impact market depth and market liquidity leading to a potential procyclical liquidity scarcity. In addition, the cost of calculating initial margin, particularly when using internal-based models, and the cost of segregating initial margin will impose operational and legal risks respectively, such that costs will outweigh benefits for this type of asset class. The bulk of transaction volume in the FX swap market occurs within a three-month term and, while longer-dated swaps are subject to more volatility in MTM gains/losses, the notional volume further out the curve is markedly less. Since initial margin is primarily a risk mitigant towards a potential future exposure of a CP's risk of default and since the bulk of the transaction volume in the FX swap market (excluding interest rate cross currency swaps) occurs within a three-month term and while longer-dated swaps are subject to more volatility, the risk of CP default should be very low, even in times of stress. In either case, the damage that would be sustained by the FX market as a result of a gross-settled EUR 50 million threshold initial margining requirement would more than outweigh the scarce benefit already realized by interbank CSAs. Given the above, we recommend that the BCBS-IOSCO consider excluding all deliverable foreign exchange transactions (spot, forwards, currency swaps and cross currency basis swaps) regardless of maturity dates from the proposed margin requirements. We are concerned that the absence of such an exemption will adversely impact those products and the market participants that rely on them to achieve financing, investing and risk transfer objectives.
Element 5: Treatment of provided initial margin *Question 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-

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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.
Re-hypothecation of margin is necessary, particularly in a variation margin context. For initial margin, while more complex considerations come into play, we believe that the primary objective must be to preserve the pledgor's ability to recover any collateral. Unfortunately, the current comment period does not provide us with sufficient time to determine if that objective can be reconciled with any amount of re-hypothecation. We acknowledge the challenges associated with the re-hypothecation of initial margin, as outlined in element five, but would caution that care should be taken to avoid introducing highly prescriptive regulatory constraints to respond to these concerns. We believe that a more principle-based approach (one that provides room for commercial solutions to these issues) should be considered. Further work in this area is required, perhaps involving third party custodians and/or central banks to determine if a construct can be established and if it can be implemented internationally. Unfortunately, the current comment period does not provide us with sufficient time to put forward viable solutions.
Element 8: Phase-in of requirements *Question 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?

General Comments on Phase-in Period

It is premature to answer whether the proposed rules appropriately trade off the systemic risk reduction and incentive benefits with the liquidity, operational and transition costs associated with the requirements without a more thorough analysis. In the absence of a more rigorous analysis, below are comments that reflect some of our concerns with respect to the current proposal.

- **The proposed phase-in arrangements are unnecessarily complex and may not be operationally feasible:**
  - Element 8 requires a calculation of the average non-centrally cleared derivative notional as of month-end, over the last three months of the year, with the expectation of having the first collateral posting commence in the beginning of the following year. Given that the averaging computation will require data up to December 31st, with payments theoretically beginning on January 1st, there will be no time to identify new covered entities that now meet the criteria, ensure the proper initial margin infrastructure is in place for both entities, and ensure all documentation is in place addressing these new margin requirements.
  - Collateral groups will have an enhanced operational burden to manage margin requirements on multiple CSA's for the same counterparty (one for the legacy portfolio, one for the new portfolio). Some collateral groups may not have the infrastructure in place to separate the portfolio or, at a minimum, will require time to separate the portfolio once a new covered entity has been identified. This will have a particular burden on smaller fund managers that would require significant operational enhancements to their current infrastructure.
  - The phase-in notional requirement has the potential of creating short term competitive disruptions between two similar counterparties (one that is slightly below the threshold versus one that is slightly above). Although it stabilizes by 2019, the short term disruptions could be material over the phase-in period.
  - <u>We would recommend a simpler, and more aligned approach to Dodd Frank, where all swap dealers are phased-in at once commencing 2018, and where funds are phased-in commencing 2019.</u>

- **Tie in of phase in to availability of clearing venue:**
  - Phase in of all asset classes should be dependent on the availability and capacity of suitable clearing venues for each asset class. In the absence of an appropriate clearing venue, introduction of initial margin for that asset class should be delayed.

- **The notional calculation doesn't address the true systemic risk of the portfolio:**
  - A book of legacy non-centrally cleared plain vanilla basis swaps has a much different risk profile than a portfolio of long dated inflation derivatives. Further, given the importance of FX to a country like Canada with a small open economy, Canadian banks will tend to have higher proportions of non-centrally cleared swaps than other countries.

- **Consistency of Initial Margin Model:**
  - Based on the QIS, the Consultative Document appears to acknowledge that the standardized initial margin formula is too conservative as compared to the internal models, which puts more emphasis on creating an internal model. The viability of the proposal is predicated on the wide spread approval and adoption of internal models. We question whether the following

challenges have been addressed by the BCBS-IOSCO:

- Are all implementations of internal models consistent across entities? Operationally, does this create an additional burden on collateral and market risk (valuation product control) groups managing margin disputes based on inconsistent implementation of internal models?
- Models tend to be the most different for more complex products which are less likely to be centrally cleared. Has any analysis been performed looking at the impact of initial margin based on internal models for similar portfolios?
- Do regulators have the resources to approve internal models in a timely basis?
- What happens to relatively small players that meet the threshold, but lack the infrastructure to implement internal models? Do both parties revert to the standardized model? A third-party internal model? Have one party act as the calculation agent?
- Are there enough global custodians to properly segregate margins? Would segregating margin to Central Banks be more appropriate considering they also monitor systemic liquidity?

  - In order to ensure consistent pricing across entities, internal models for initial margin need to evolve to something that is fairly standardized so that a broad range of market participants can apply them. This will require additional time beyond that contemplated in the Consultative Document.

- **Standardized Initial Margin formula:**
  - The QIS analysis suggests that the standardized initial margin formula is too conservative as compared to the internal model method. The data implies the standardized model is 11.1x the margin of internal models.
  - Some more thought is required with respect to the weights and the netting benefit calculation (which simply sets a floor to 40% of gross initial margin) in order to calibrate the standardized method closer to the models-based method.
  - Aligning the standardized model to the outputs of an internal model would reduce the significant operational enhancements required on smaller entities in order to develop their own internal models. This alignment will also reduce the costs of having these entities source third parties to perform internal model calculations.
  - A full cost analysis is required to understand the costs associated with implementing an internal model, using a third-party service or using a standardized initial margin formula.

- **Euro 50 million threshold:**
  - The initial intent on establishing minimum standards for margin requirements for non-centrally cleared derivatives was to reduce systemic risk by ensuring that collateral was available to offset losses caused by the default of a derivatives counterparty. However, it appears that the minimum initial margin threshold was calibrated such that the total expected market size of initial margin would not create an additional significant liquidity burden when considering other liquidity constraint (such as the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR)). We would argue that higher minimum thresholds (multiples higher than the current proposal) can achieve the same outcome while still ensuring that systemic risk and contagion effects are dramatically reduced, and while also providing ample liquidity in the market to support other regulatory concerns. The "one size fits all" model in determining thresholds may not work across varying sized institutions. A

simultaneous systemic event on the top five largest institutions in Canada could easily tolerate moves multiples higher than the proposed Euro 50 million threshold. Using a similar approach to LCH.Clearnet's (world's largest interest-rate swap clearinghouse) default fund methodology, the ability for a Canadian financial institution to absorb a worst case loss scenario of two or three simultaneous largest counterparty defaults, when compared to their quarterly revenues, reflects initial margin thresholds of at least 5 times higher. More specifically, we would recommend that a threshold of Euro 250 million should apply for Canadian banks.

- **Haircut on Collateral in Currency different from Derivatives:**
    - Appendix B of the Consultative Document requires an 8% additional haircut on assets in which the currency of the derivative obligation differs from that of the collateral asset when counterparties choose to use standardized haircuts instead of internal models. Do these haircuts apply to only initial margin or also variation margin?
        - Initial margin: How would this work on a portfolio containing derivatives in multiple currencies? Although a further segregation of the portfolio by asset class and currency is possible, has there been an assessment on the impact of this loss of diversification? Also, how would a cross currency swap be handled? Is initial margin on each leg separately calculated taking the 99th percentile loss for each leg?
        - Variation margin: How would posting of variation margin work on a cross currency swap? We believe that posting variation margin based on the currency leg of the swap would defeat the purpose of the swap in the first place.
    - <u>We would also note that the 8% haircut is extremely conservative in the case of Canada where our currency is closely correlated to the USD. Given the volume of CAD business undertaken by Canadian banks, and the fact that the CAD is not a reserve currency, the 8% haircut is unreasonably punitive for Canadian banks.</u>
    - <u>We would recommend the elimination of the 8% currency haircut on collateral on the basis of the very conservative calibration of the initial margin and variation margin frameworks.</u>

<u>Variation Margin</u>

- Generally, the assumption that zero threshold re-hypothecation of variation margin can be implemented sooner rather than later in most markets seems reasonable. However, there are settlement period issues in some jurisdictions that need to be worked through.
- Furthermore, some time needs to be allocated to allow implementation of the required changes to ISDA and CSA legal agreements.
- We would agree that variation margin represents less of an operational hurdle for institutions to overcome and it should be enforced effective January 2015.

Appendix C: QIS

Question 4:
The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

As discussed in our response to question 3, models tend to be most different for complex derivatives which are also most unlikely to be centrally cleared. The accuracy of the QIS results is predicated on the consistency of the internal models. For an identical portfolio, initial margin can be dramatically different based on the VaR model chosen (historical window, relative or absolute shocks) and the model chosen to value that particular derivative. Due to the absence of benchmarking models prior to the commencement of the QIS, further analysis is required in order to determine the impact of different internal models on the QIS results as well as the operational aspect of managing collateral.

Furthermore, the proposed margin requirements for non-centrally cleared derivatives represent a fundamental change to the way markets currently work. The QIS results assessed the impact of margining based on existing portfolios but did not address how these portfolios could change based on these new margin requirements. A further detailed analysis on the composition of portfolios can lead to identifying which businesses or products will be most impacted by these margin requirements, and an assessment can be made on their relative importance in terms of the systemic risk they create.

In particular, has analysis been undertaken to determine unintended consequences such as liquidity and impacts on short term markets? It is also unclear as to the level of analysis undertaken with respect to the quantum of unencumbered assets that institutions currently have and what percentage of these would represent eligible collateral for initial margin purposes. For example, if debt issued by financial institutions is not eligible collateral due to correlation risk, then how much residual eligible collateral is available in the system? The data disclosed in the QIS is of a very high level and it would be expected that a rigorous analysis be conducted to determine whether in fact sufficient collateral exists in the financial system (fully factoring in that not all institutions will be able to model their initial margin, taking into account what the general profile of unencumbered assets are for the large participants etc.). In addition, it is not clear whether the QIS assessed the significant additional collateral requirements for initial margin under CCP's, as well as the additional capital requirements dictated under Basel III.

Moreover and with respect to the extrapolation of the QIS results, we have the following concerns:

1. The QIS assumed applicability of the threshold at the legal entity level. Results obtained by applying a 50MM threshold at the legal entity level do not directly correspond to the application of rules at the newly proposed consolidated level. Impacts may thus be more appropriately estimated from results obtained using lower threshold results from the QIS.
2. The QIS did not apply the NGR style netting following the new standardized treatment. This would result in potential reduction of initial margin of 60%, or even more after consideration of thresholds.

Additional Comments

EUR50MM Threshold:

- The application of the EUR 50 million threshold for posting initial margin at the consolidated group level may give rise to operational difficulties in practice. As pointed out in the Consultative Document, for example, there is the question of how to allocate posted initial margin between the various legal entity relationships that may exist between two consolidated groups. Not contemplated in the Consultative Document is the less frequent but very real scenario of a corporate action that involves the consolidation of two previously unconnected groups. In this scenario, the EUR 50 MM thresholds with two previously separate organizations will effectively become a single EUR 50 MM threshold after consolidation, potentially giving rise to an immediate requirement to post an additional EUR 50MM. Given the complexity of updating netting and collateral documentation and the likely requirement to renegotiate certain commercial terms related to existing trades with the two previously separate but now merged entities, we suggest an explicit grace period of some reasonable time (such as 12 months) prior to the consolidated threshold coming into effect.

- A standardized threshold expressed in EUR is subject to FX fluctuations. Variations of the threshold with respect to the CSA agreement currency would by itself result in frequent margin calls, in particular considering the low MTA introduced in this proposal. A regulatory proposed grid of thresholds for each currency may be a possible solution, although periodic (annual) updates could trigger sudden initial margin calls. More thought needs to be given to the exact implementation of thresholds.

- Does the proposed threshold apply to new derivatives only, so that initial margin will only be posted once initial margin for new derivatives exceeds the threshold?

Margin Transfers:

- We certainly agree that a rigorous dispute resolution process is critically important and should be encouraged. We believe, however, that practically speaking, a EUR 100,000 minimum transfer amount is very low and will result in increased noise and operational burden in terms of agreeing to margin valuations. In particular, any variation in the EUR threshold due to FX fluctuations with respect to the settlement currency introduces significant noise which would be higher than this MTA. For example, a 1% day-to-day FX fluctuation of the EUR 50 MM threshold would trigger a margin call of EUR 500,000. We therefore believe a larger threshold of 1,000,000 to 2,000,000 is appropriate and still protects the integrity of the collateral process. We would argue that increasing the operational burden can actually increase the risks as it could defer resources required for otherwise more material valuation issues.

Methodology:

- Is it really necessary to calibrate initial margin requirements at the 99^{th} confidence interval? While calculating at the 99^{th} makes sense for a CCP to protect the resiliency of the margin mechanism, we would argue that, for bilateral trades, using the 95^{th} is sufficient as it is used broadly in CCR exposure calculations. Firms should still have an incentive to conduct their counterparty credit risk and the goal should not be to remove counterparty credit risk from the system which would open up capital markets to the concept of moral hazard. Certainly calibrating to a stressed market environment makes sense which should capture some of the potential tail risk.

Given initial margin at 99th C.I. covers PFE during the close out period, how would credit default capital requirements be established for these transactions? The actual implementation of the model approach was not discussed in the Consultative Document in detail. Without a uniform model introduced for all participants, how will counterparties be expected to reconcile their initial margin amounts to such small thresholds given the amount of variability introduced in a PFE model? Significant additional operational burden would be added to the collateral and market risk (valuation product control) management process (multiple times what is experienced in current variation margin world). Our view would be that this has to gravitate to one standardized model implemented globally.

- Little consideration has been given in the current proposal to the reconciliation difficulties and loss of transparency that initial margin calculations under a non-standardized modeled approach would introduce. Given the variability in modeled VaR type results (due to use of different stress periods, differences in VaR models, etc.) a comparative benchmark analysis may be required before the methodology for the modeled approach should be finalized. Internationally standardized stress scenarios provided by regulators could be considered for calibration of the model.

- How do the regulators intend to treat collateral deposited as part of the variation margin requirements? The internal model methodology could integrate collateral into the modeled approach to capture correlations with exposures. For example, collateral in a certain currency deposited could offset the FX risk of an exposure partially. Exposure reducing incentives such as this should be recognized in the initial margin methodology in place of risk insensitive and conservative haircuts.

Improvement to Models:

- The significant differences in the output of quantitative versus standardized models that firms may use to calculate initial margin could give rise to undesirable consequences in the market. The fact that, per the QIS results, standardized initial margin values could be as much as 11 times greater than initial margin calculated by quantitative methods could lead to an un-level playing field where firms that are employing quantitative models have a competitive advantage due to the ability to offer non-centrally cleared derivative products to clients with initial margin requirements that are an order of magnitude less than those offered by firms employing the standardized approach. Furthermore, without a coordinated global move in which the majority of firms implement largely equivalent quantitative models at roughly the same time, there could be a material decrease in liquidity in the markets in which firms that remain on the standardized approach historically trade. Without the ability to offer competitive initial margin rates to clients, the market will be pushed to trade with the smaller number of firms that have implemented quantitative models. This could have especially negative effects on those transaction types that will not, for the foreseeable future, move to CCPs (of particular concern for Canada is the cross-currency swap market, given the current challenges faced by CCPs in offering such trades). We therefore urge the BCBS-IOSCO to revisit the differences between quantitative and standardized models and look to narrow them, as well as ensure that the implementation of quantitative models occurs globally and consistently across all jurisdictions.

Regulatory Differences:

- The consultative document proposes an approach for resolving home and host regulatory differences by allowing national regulators to recognize the equivalence and comparability of their respective rules. We agree with this approach and believe that where a transaction is subject to the rules of multiple national regulators that recognize the comparability of each other's rules, the types of eligible collateral that may be pledged by each party in the transaction should include eligible collateral recognized by either national regulator.

  Example: Banks A and B are from jurisdictions X and Y respectively, and have entered into a covered transaction with each other. National Regulators X and Y recognize each other's rules as comparable. Bank A should be allowed to pledge to Bank B eligible collateral recognized by National Regulator X, as well as eligible collateral recognized by National Regulator Y, and Bank B should be allowed to pledge to Bank A eligible collateral recognized by National Regulator Y, as well as eligible collateral recognized by National Regulator X, regardless of whether Bank X and Y agree to a single choice of rule (Circumstance 1 in 7(i)).

  Absent such mutual recognition, we are concerned that forms of eligible collateral on multi-jurisdiction transactions will be restricted to assets that are explicitly recognized by both regulators (or one regulator), without regard for jurisdictional variation.

Netting:

- Although we recognize and support the efforts made to capture the benefits of netting in the standardized margin calculation, we have concerns with the proposed approach to incorporate the net-to-gross ratio (NGR). The NGR is intended to provide a capped amount (at 60%) of netting benefit to the potential future exposure (the 'add-on factor' component) in the Current Exposure Method (CEM) for calculating derivatives EAD. It may not provide a good estimation of the benefit of natural offsets, or portfolio effects, between transactions in a closeout period and will result in a risk insensitive asymmetric initial margin between two parties to the same portfolio of transactions. One suggested approach is to calculate NGR as the ratio of net MTM of the trades to the gross MTM, rather than replacement cost which is floored at zero, so that both sides arrive at the same NGR and simultaneously increase the 0.6 factor in the standardized initial margin calculation to 0.85, consistent with Method 1 for calculating CCP Default Fund capital in recognition that the 0.6 factor in the CEM calculation provides limited netting benefit.

Consideration of multicurrency CSA:

- No consideration has been given to how the new multi-currency CSA as proposed by ISDA would be integrated into the variation and initial margin approach. For example, the threshold may have to be broken down appropriately into multiple currencies. Further regulatory clarification would be needed to address these recent changes to standardized collateral treatment.

Procyclicality:

- While we certainly agree that initial margin models should be calibrated for stressed events, we believe there remains significant systemic risk under the proposed approach and suggest that pursuing this model represents even larger risk in the future. By implementing thresholds, institutions will presumably take advantage of these thresholds in normal market environments yet, given the ability to call on the full available margin in times of market stress, it would be expected that institutions would take advantage of this resulting in massive swings in collateral/funding requirements. This in turn could have liquidity/funding implications which should be assessed along with large return of collateral risk.

Scope of coverage:

- If one of the main objectives is to reduce potential systemic risk, we question the recommendation to exempt sovereigns, central banks and supranationals from margin requirements. We acknowledge that these institutions do not necessarily have the same level of infrastructure to conduct this activity however, given the current state of sovereign finances, we are of the view that these entities above all represent systemically important institutions and should not be exempt from the requirements to at least 2-way margin.

  We also acknowledge that changing this assumption would have dramatic ramifications on the QIS results and likely change the assessment of the potential impacts of these recommendations.

Eligible Collateral:

- While we agree that a broader range of eligible collateral is required, we note that broadening the eligible collateral subjects additional asset classes to market disequilibriums due to the creation of non-market based demand for certain assets. These potential risks should be well understood by all involved and further assessed if necessary. This again could have broader ramifications on the functioning of markets.

Differential treatment for systemically important non-financials:

- Since the original proposal, the current proposal introduces a large differential treatment for high risk vs. low risk non-financials through thresholds: Systemically important non-financials have low thresholds with medium to high margin requirements whereas low risk non-financials are exempt completely. A large differential with a sharp cut-off definition for systemic importance could be problematic and introduce an unlevel playing field. High initial margin requirements with low thresholds for systemically important end users will provide disincentives for hedging of exposures and heighten systemic risks. A solution involving the removal of margin requirements for non-financial end users would be preferred.

Exacerbates existing cash collateral challenges in Canada:

- The mandated use of variation and initial margin that has been proposed will significantly amplify an existing problem in Canada relating to the use of cash collateral for non-centrally cleared trades. Under current provincial personal property securities laws, the ability to perfect security for cash collateral is ambiguous. This creates uncertainty/increased costs for the use of cash collateral, including for non-centrally cleared trades under the existing environment. These concerns will be significantly exacerbated as international rules on mandated collateral requirements and increased margins are implemented. These changes will contribute to an already existing pro-cyclical, systemic risk aspect to this problem for both Canadian sell-side and buy-side market participants. In a time of financial stress, there may be flight to quality collateral, especially cash. In such circumstances, foreign counterparties may become less willing to accept cash collateral from Canadian entities due to a combination of the current provincial laws and the increased margin requirements on cash. This could impair market liquidity at a time when it is needed most.