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Secretariat

Basel Committee on Banking Supervision
Bank for International Settlements
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September 28th, 2012

**Consultation on "Margin Requirements for Non-Centrally-Cleared Derivatives"**

Dear Sir or Madam,

This letter contains our input for consideration in the standard setting process for requiring margin on non-centrally-cleared derivatives in response to the consultation document "Margin requirements for non-centrally-cleared derivatives" jointly issued by the BCBS and the IOSCO on July 2012.

Commerzbank AG supports its more than 100,000 corporate clients in Germany and around the globe to manage their risks related to changes in interest rates, FX rates or commodity prices and thus enabling them to concentrate on growing their business. The banks Corporates & Market segment is an active participant in inter-bank OTC derivative markets and has been at the forefront of adopting central clearing for its swap books.

We fully support measures to stabilize markets and make the system more resilient. The present proposal though, if implemented fully as presented, has the potential to undermine these very objectives by diminishing the supply of credit to the economy through undermining the role of unsecured credit, increasing the interconnection of financial products and markets, and not only reducing the possibilities to apply prudent risk management through the use of financial instruments but introducing the risk of an increased number of liquidity induced default and crisis events.

We would thus urge regulators before introducing initial margin requirements for bilateral contracts to wait for other measures to take hold and utilize the wealth of information made available through trade repositories before refining risk mitigation rules in order to reflect actual risk.

Yours sincerely,
Commerzbank AG
Corporates & Markets

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# I. Introduction and Key Concerns

While the consultation focuses on a number of technical aspects, to which we will respond further down, we would like to express some fundamental concerns. Foremost we have grave concerns about the impact of the proposed framework of bilateral initial margins which, if applied in the proposed form to existing positions, would have severe negative consequences for the funding situation of derivative users, market liquidity and indeed economic growth. Secondly we are seeing the move to mandatory collateralization, in combination with other recent measures enforcing collateralization, as further undermining the position of unsecured creditors and hence making it more difficult for credit to be obtained by borrowers – corporates, banks and public entities alike – on an unsecured basis. The posting of collateral to offset valuation changes is generally an effective and desirable tool to mitigate counterparty risk, provided it is supported by national insolvency law. It is not suitable for all counterparties though and may result in a significant negative impact for corporate users with limited access to eligible securities or cash.

*Non-rehypothecable initial margin requirements are equivalent to minimum reserves*

Minimum reserve requirements have been a standard tool of monetary policy for a long time. It should be recognised that the requirement for banks to lock away liquid assets, as implied by the proposal for non-rehypothecable exchange of initial margins, very closely resembles this monetary instrument. The only exception being that the assets are not posted in cash with the central bank, but in near-cash instruments on private accounts. From this it follows that the proposed measures have the potential to affect monetary policy, which hitherto had been the exclusive domain of central banks. The significance of this analogy depends of course on the amount of liquidity drained from the markets. For small amounts it could be well neglected. Our own estimates, and those of the ISDA, suggest otherwise though. Depending on the approach being used, we arrive at a range of 2,000 bn USD (risk based margining) up to 15,000 bn USD[1] (formulaic approach as proposed) for initial margins to be posted for existing positions across the industry if the proposed approach was followed globally.
Even at the lower bound the effect would be offsetting most of the extraordinary liquidity measures provided by central banks over the last years, suggesting that the effects of such a regime would be not just marginal but significant.

*Risk mitigation or Incentive for clearing*

The primary objective of the proposed bilateral regime is to mitigate counterparty risk and by extension to reduce systemic risk. As a general rule, the cost of mitigation measures should be proportionate to the risks. The direct costs of financing (at least) 2,000bn USD of “dead capital” across the industry are significant: assuming 1% financing costs, a ratio of liquidity to capital of 12.5 : 1 and capital costs of 8% suggests annual costs of about 30bn USD – without accounting for any secondary effects. These costs have to be seen in the context of risk mitigated, i.e. avoided losses due to counterparty defaults. Based on numbers from the US Office of the comptroller, the worst year for counterparty credit losses was 2009, following the default of Lehman Brothers. In this year losses amounted to about 2.5bn USD across all US banks. From this comparison it would follow that the proposed measures are not proportionate to the risks to be mitigated.
It has been proposed that measures should not just mitigate risks, but also provide incentives to clear. We agree that costs for transactions which can be cleared should not be lower when executed bilaterally than when cleared. Capital rules under Basel III (CVA capital charge) provide already a strong incentive in this direction. The experience of the last decade has also clearly been that market intermediaries – i.e. most institutions designated today as ‘systemically important’ have made use of the opportunity to clear OTC transactions, and indeed have

[1] Numbers derived from the ISDA OTC margining study and extrapolation of own data determined for the Basel Committee’s quantitative impact study

driven the development. Clearly this development has also been incentivised by capital requirements under Basel I and Basel II – but it largely followed from the self interest of market participants to mitigate credit and operational risks and to employ capital efficiently.
Given that recent regulations have introduced a clearing requirement for a large number of market participants, for whom the benefits of clearing so far either had not been significant enough due to their business model or size, or the costs and requirements of clearing membership, it is not immediately evident why the joint committees believe that punitive costs on OTC transactions are necessary as an additional incentive.

*Interdependencies and Evidence based risk mitigation models*

In the consultative document the interdependencies to other regulatory initiatives, in particular in the area of liquidity are recognised. We would point out that these interdependencies extend beyond liquidity. By preventing build up of capital, they counteract the primary objective of the Basel Committee to strengthen the capital base of banks. Further effects follow from the standard economic on the use of monetary policy tools due to the nature of neutralised deposits as quasi-minimum reserves described above.
Given the highly complex nature of these relationships and the still fragile state of the global economy and financial markets, it would seem a prudent course of action to aim for second level measures to be based on concrete evidence wherever possible. Measures to strengthen the capital base as well as the changes in market organisation and infrastructure which have been brought on their way should be allowed to take effect. By their very nature, there is a time lag between introduction and showing full effectiveness. EBA recently identified a capital gap for European banks of nearly 200bn EUR to reach the new targets implied by Basel III. This gap is unlikely to be closed over night. Introducing disproportionate additional requirements diverting capital, earnings and resources will necessarily further push out the point at which this gap will be closed.
Measures to date had to rely on assumptions and incomplete information. The introduction of trade data repositories has the potential to be a game changer in this respect. So far we have seen little evidence that a strategy for the use of this data pool has been developed. We believe particular efforts should be made to utilise the information available from trade repositories, which should allow reconstruction of positions and hence provide an objective data base from which to construct fit-for-purpose risk mitigation mechanisms. Given the lack of resources at national regulators and the need for international co-ordination we would propose the formation of an International Institute for Market Structure Analysis under the FSB in co-operation with academia and the industry to fully exploit the potential to advance risk management and regulatory strategy inherent in the trade data.

*The role of initial margin in a multi-lateral clearing framework vs. bilateral margining*

While it has already been mentioned before, we would like to reiterate that posting initial margin bilaterally is completely different from the use of initial margin in a centrally cleared framework, in particular in listed future markets. Firstly, initial margin requirements in an OTC CCP framework are usually not position based but portfolio based. In a CCP environment, initial margin protects the CCP, and hence the market, against potential losses in closing out a position and forms the first layer of defence in the capital waterfall. For the party posting initial margin it usually poses no extra credit risk. In the bilateral framework, only one counterparty, rather than the market, has some measure of protection. At the same time both parties posting collateral have additional counterparty risk: in the case of default, the non-defaulting party not only would have to replace an existing position, but also extract their collateral from the defaulting counterparty. While this would offset by the initial margin in their possession, the net effect is one of liquidity and assets still being potentially locked up in insolvency proceedings. Depending on insolvency laws, which are far from homogenous, independent amounts received may not be considered to reduce risks, and independent amounts posted may increase counterparty risks. Also, in the CCP framework the amount of margin is calibrated to the risk of the position, either on a portfolio or single contract basis. Using the same calibration in a bilateral framework will break this relationship, as now the amount needs to be posted twice.

Apart from the dubious benefits as a risk mitigant the economics of initial margin posted are very different in the two scenarios. Multilateral netting in one asset class is highly efficient: using the data for one OTC clearing venue[2] it can be seen that 152,000bn USD in cleared notional attract an initial margin of 40bn – i.e. just 0.025%. This is largely due to multilateral netting. In a bilateral framework, using a risk based approach and netting across exposures for counterparties, the ratio is more than 10 times higher, i.e. the same notional would attract at least 400bn in initial margins. The higher capital and liquidity requirements combined with the legal doubts around the usability of independent posted amounts suggest that the usefulness of this tool in a bilateral context is limited.

*An alternative model to achieve the objective of "defaulter pays"*

One of the objectives listed in the consultation documents is to ensure that the defaulter in an OTC transaction bears a higher share of the associated costs. Following this line of thought, initial margin in a bilateral context actually resembles the default fund in a multilateral framework. Most of the proposals of the text indeed would fit better in such a framework, and hence purely from a terminology point it is preferable to think about "bilateral default funds". Consequently a better way to achieve the desired outcome may be the use a "central counterparty for non-cleared trades". In such a model, counterparties would maintain independent funds in a mutual, bankruptcy framework – either at an established CCP or with central banks. Amounts posted there would be a function of their total OTC counterparty exposure, largely following the calculation mechanics employed for portfolio margining in established CCPs. By observing the relationship between funds such posted and the total available capital of an institution the build-up of undue systemic risk – where one counterparty functions de-facto as a CCP – can be avoided. Such a construction could efficiently address the perceived risk posed by SIFIs, can be extended easily to other market participants in analogy to client clearing models, and provides a natural transition path to a central clearing model.

*Differentiation among types of market participants – break of liquidity chains*

While at several points in the consultation document there are differentiations between the types of market participants we feel that not enough thought has been given to the fundamental differences between at least three distinct categories of market participants. Firstly, there are the interconnected liquidity providers. These market participants have frequent two-way flows in most product categories. Central clearing, due to the benefits of multilateral netting, is usually advantageous and desirable for this group. Liquidity transformation generally is relatively easy thanks to access to central bank repo facilities and the repo markets in general. Most institutions considered systemically important are in this category. Secondly, other financial institutions (in the sense of the definition of MiFID) with flows going predominantly in one direction. Specialty financers, like German mortgage banks, but also leasing firms, will usually be in this category. For these institutions, central clearing has limited benefits due to the unavailability of netting opportunities. While benefiting from the higher level of protection against counterparty risk, liquidity requirements can become a concern given a limited range of eligible securities. Lastly, corporate users of derivatives, form a distinct third category. These only have limited means to provide liquid collateral. For these users, who have entered long running positions with the objective to secure a long term secure planning basis for investment decisions, the impact on cash flows not only undermines the original objectives of such prudent hedging activities, but even raises the spectre of insolvency due to lack of liquid assets to post for these positions which hitherto had been largely accounting relevant.
Any regulation clearly should take these differences into account. Unfortunately, the differential treatment of counterparties with regard to requirements to post collateral either for valuation differences or initial margin opens a further issue which seems not having been given consideration in the proposals: the break of liquidity chains. Where one counterparty is posting cash variation margins and initial margins to offset risks, but on the other hand does not receive corresponding cash flows from their counterparties, such an intermediary faces the risk of a liquidity crisis

[2] Annual Report 2011 LCH

when valuations move strongly. Indeed, some of these mechanisms contributed to the default of Lehman Brother's. Paradoxically, protecting the occasional and prudent user of derivatives from some of potential negative effects of risk mitigation techniques put more pressure on intermediaries. The proposed interdiction of rehypothetaction of initial margin deposits, albeit sensible and indeed necessary to achieve a real measure of protection against counterparty risk, contributes further to the potential for liquidity pressures to build up. In this latter case though the joint effect of changes in the value of commonly used collateral for security deposit purposes actually means a real risk of an effect across the whole system, as not single (dealer) counterparties, but everybody would be pressed to find liquidity at a problematic time.

*Asymmetric exposures for some products*

Continuous exchange of collateral to offset changes in valuations is a proven tool to avoid the build up of large exposures and cliff effects. It is only of limited use though where jump risks are evolved. In many instances where a counterparty sells atonality and thus acts in an "insurance like" capacity, the counterparty – or market place – usually asks for some proof of the capacity of the counterparty to satisfy their obligations. This mechanism is also at the core of capital regulation governing the activity of insurers. Clearly, the risk profile in such transactions is highly asymmetric. Symmetric bilateral posting of initial margin thus seems hardly an appropriate solution in such a scenario. It also does not address the issue which surfaced in the recent crisis, where it was found that single market participant had become a systemically "insurer of last resort" in a single asset class. Beside more traditional capital based regulation, such concentrations can most efficiently be detected and mitigated at a multilateral level. The combination of the information available through trade registries and the "CCP for non-cleared positions" proposed above may provide an appropriate solution for this specific problem.

*The Impact of the drive to collateralisation on unsecured lending*

As an active participant in OTC markets we welcome the possibility to mitigate credit risks through the use of collateral and see a clear need to be able to do so where appropriate. Introducing an obligation for counterparties to enter into two-sided credit support agreements is thus a development we explicitly support, also for the positive effects it has on market stability, as it prevents liquidity break from building up and thus protects risk intermediaries and hence markets. As a bank though, we see it as our key and natural role to provide credit to support our clients in their financing requirements. While the first step in any credit decision is the analysis of ongoing cash flows available to the borrower, potentially resulting explicitly from the use of borrowed funds, the availability of further securities supports any credit decision, even when no explicit liens on specific securities are sought, or available for practical purposes.

Collateral posted though implies a preferential treatment in a default waterfall of OTC counterparties. It undermines the protection unsecured lenders typically believe they have obtained by negative pledges given in loan or bond documentation. Once collateral – either in the form of variation or independent margin – has been posted it leads to asset encumbrance: any new unsecured lender will consider this circumstance in their lending decision. This even impacts the role of creditors traditionally receiving preferred treatment in national bankruptcy laws, like tax collectors, employees or pension schemes: where significant amounts of assets have been effectively pledged as security, OTC creditors may use them ahead of these creditors.

This creates the potential for a perverse incentive: since OTC exposures receive preferred treatment, capital may be deployed to support these activities rather than to provide unsecured credit to corporate, private or public borrowers. Limited availability of capital and higher costs of refinancing will inevitably lead to a limited availability and higher cost of unsecured credit to everyone, from private households to corporates and public households.

Like with most medicines, it is also with collateral that the dosage makes the difference between cure and poison. A broad push towards collateralisation as the universal solution unfortunately is very likely to tip the scales in favour of the latter.

*Results of secondary legislation overriding constraints of primary legislation*

EMIR explicitly excludes non-financial counterparties from the clearing obligation. This exemption recognizes the limited access of these counterparties to liquidity which would make clearing – in particular the posting of continuous variation margins in cash – very difficult, and indeed risky as it creates the potential for an insolvency due to lack of liquidity despite a sufficient amount of capital and assets to offset the negative effect of mark-to-market. Subjecting these counterparties directly or indirectly to the very same requirements they were exempted from in the first place seems through the delegated authority given in Art 11 EMIR would seem highly problematic.

**Summary**

Introducing a framework which mandates the adequate management of bilateral risks is welcomed as it is likely to result in market intermediaries being in a better position to manage their liquidity risks. It also provides a natural path to clearing, which is the preferred solution for standardised contracts.

Too much reliance on collateral is very likely to lead to unintended consequence in other parts of the market though. In particular the proposed concept of bilateral initial margins, which in the proposed form acts analogous to minimum reserve requirements, can have far reaching effects and create problems which are more severe than the relatively minor risk of suffering losses due to the replacement of positions following the default of a counterparty. We would thus urge the regulators to concentrate initially at measures which are well understood, and allow for the effects of the primary legislation, in particular the further adoption of central clearing, to take hold. In a second phase, aided by data obtained from trade repositories, further measures can be considered.

Introducing changes on existing trade portfolios of OTC trades is likely to lead to cliff effects and severely change the economics of the underlying transactions. These cliff effects can destabilise not only financial, but also non-financial market participants. Any new requirements thus should apply foremost to new transactions. Where this is not practical, capital and liquidity requirements should be phased in over a sufficiently long period. The phasing of capital treatment under Basel III could provide an appropriate blueprint.

We fully recognise that the regulatory train is travelling at high speed, and some measures had to be taken at once in order to contribute to a stabilisation of the markets. We would hope though that finding an outcome which lives up to the objectives of the G20 agenda – increasing the resilience of the financial system and reducing systemic risks – is given precedence over meeting a specific deadline.

## II. Responses to Consultation Questions

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| Q 1 | 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 (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved? |

Margining requirements for non-centrally cleared transactions should be benchmarked and derived from procedures for centrally cleared products where possible. Also, it seems logical that a differentiation in the treatment for mandatory clearable, clearable but not mandatory clearable and non-clearable products should apply given the objective to direct volumes to clearing venues. While minimum standards for procedural requirements can thus be introduced along with the introduction of clearing requirements, more detailed and technically, operationally more expensive measures, should only be taken sequentially.

Requirements should, where technically achievable, only apply to new transactions since application on existing trade portfolios could severely impact and change the economic result which counterparties had aimed to achieve when entering in such transactions.

An immediate introduction of measures would make cliff effects likely, as some counterparties may face liquidity or capital difficulties lacking any prior provisions.

Where existing transactions have to be covered, due to portfolio effects, the possibility should exist to phase in the capital and liquidity requirements over at least 2 years, but preferably over half of the average time-to-maturity of the existing bilateral trade portfolio.

Such a portfolio-specific phase in regime allows for natural replacement of old transactions with transactions where appropriate provisions for liquidity and capital requirements have been made.

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| 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? |

Yes: The primary risk connected with FX transactions is the settlement risk. This specific risk is adequately mitigated by the use of the CLS system. In its recent consultative document, the Basel Committee is urging the industry to make use of similar systems, recognizing that Herstatt risk is the main issue with FX transactions. Margining requirements would not add any significant further level of protection and may actually impede the existing systems by adding additional levels of complexity and exposing the counterparties to additional risks.

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| Q3. | Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage? |

It should be considered to provide for an exemption for transactions for the cover pool of covered bonds since the existing privileged position afforded to claims against a cover pool already serves as adequate protection. Additional collateralisation requirements would thus not be merited. In addition existing regulatory requirements may actually

prevent the provision of collateral by/for a cover pool. The issue could alternatively be addressed by a counterparty based exemption instead of a product based exemption.
Transactions in support of the issuance of funding issues should be exempt. This will maintain the flexibility of issuers to convert fixed funding streams into floating stream or vice versa, as demanded by the business model of the issuer. This reflects the fact that capital market issuance may not be available for both forms of payment streams. By exemption such issuance related transactions, the supply of the economy with credit at suitable conditions is supported. This should also apply where the issuer is a ring fenced special purpose issuer, to prevent negative effects on investors resulting from assets being pledged to support the auxiliary financing interest rate of currency translation transactions.
Transactions between intra-group entities should be exempted, in analogy to exemptions granted for clearing obligations.

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| 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? |

The proposed key principle overreaches both in the extent of the tools it employs and the types of counterparties it affects.
The exchange of initial margin in a bilateral framework is not necessarily reducing counterparty risk, but may even increase it, depending upon the legal framework. Most importantly it acts like minimum reserves, and hence can introduce the paradox effect that efforts to mitigate counterparty risk end up influencing monetary policy.
An equal application to all counterparties and products also overreaches the objective.

The cumulative effect of reliance on collateral, which is also emphasized in other pieces of regulation, introduces the risk for further systemic crisis due to revaluation of collateral, pressure on unsecured funding, and liquidity squeezes. In particular the significant amounts of previously liquid assets locked up in a non-rehypothecable security arrangement play an important role in this mechanism.

We believe that market participants should be given more freedom to develop appropriate and proportionate risk mitigation mechanisms together with the regulatory community without being prejudiced and restricted to the two tools of initial margin and collateral.

Please see also the introductory section of our answer for more details.

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| 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? |

No. Thresholds play a limited role in the liquidity cascading effects. Risk is concentrated largely among the dealer community. A large percentage of trades in this category will be directly subject to clearing requirements going forward though, suggesting the need for specific requirements is lower than perceived.
Introducing an obligation to phased in late-clearing of products for dealers in clearable products would be a much more appropriate tool in order to mitigate risks.

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| 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? |

Since initial margins are a substitute for counterparty risk it would seem logical that, if independent amounts were considered necessary, they, and hence also thresholds, reflect the actual credit risk. We reemphasize our point that in particular banks should be able to decide to whom and for which price they extend credit to a counterparty. Like with "normal" loans, the details of such arrangements should be left to counterparties, as long as objective guidelines set by regulators are satisfied.

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| Q7. | Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities? |

We re-iterate our view that initial margins are not a universal appropriate tool to mitigate risk. Operationally, we would consider prudentially-regulated entities as those best equipped to utilize initial margin methodologies amongst them.

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

Thresholds need to be set individually – any requirements regarding the calculation of the threshold thus must provide for sufficient flexibility. Thus, rigid/uniform caps or minimum thresholds have to be avoided.

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| 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? |

Universal two-way margining acts analogous to minimum reserves. Introducing such requirements thus has the same effect as engaging in a restrictive monetary policy. For individual market participants it introduces the risk of liquidity squeezes. Collectively this will lead to a larger number of financial failures, in particular if cliff effects due to a sudden introduction, or exceeding thresholds, came to bear.
Entities with a limited access to liquidity would be hit particularly strongly. Paradoxially, actively and highly leveraged market participants might actually be less severely impacted than occasional users of derivatives, whose aim is largely to stabilize their funding planning and mitigate currency risks.
Reliance on specific asset classes as the preferred mean to collateralize exposures results in a synchronization across markets and entities, loss of diversification – and an increased systemic risk following a revaluation of such an asset class. No asst class – regardless of any fiction maintained to the contrary – is immune to such revaluation. Purely practically, requirements for ongoing and consistent valuation of derivatives, which are not trivial in particular in regard to customized transactions for which, by definition, no clearing venues would be available even in the future, will be exacerbated.

Please see also our introductory remarks for further background.

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| Q10. | What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable? |

Unregulated entities will already face very considerable difficulties with implementing margining requirements limited to variation margins. Any requirement to additionally collect and post initial margin will exacerbate these difficulties.

The additional risk introduced by the posting and collection of initial margin for both of the counterparties (operational and credit risk) will be considerable and will almost certainly outweigh any potential risk mitigating effects associated with initial margins.

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| Q11. | Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate? |
| Q12. | Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered? |

As has been set out in the introduction we clearly see a need to differentiate between types of market participants. Asymmetric treatments of counterparties though introduces the risk of liquidity squeezes for intermediaries acting as

a counterparty to exempt entities, but have to enter in risk offsetting positions on the other side. In particular large counterparties, like sovereigns, development banks and others, which usually are considered high quality counterparties, recognized in low risk weighting, should thus not be exempt from the requirement to participate in the exchange of variation margin.
With respect to initial margin our view applies that we do not see it as useful and appropriate tool in most bilateral transactions – much less so, where the counterparty is, by the regulators own definition, considered risk free.
Exemptions to existing trades, as set out above (Q3), should apply.

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| Q 13 | Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why? |

The proposed regulatory model seems to overstate risks significantly – in our estimate by a factor of 10. Due to the very nature of the risk to be mitigated – counterparty credit risk – a comprehensive approach to the complete set of bilateral transaction has to be applied.
Finding a simple and also appropriate calculation methodology, like it is used for single contract margining on futures exchanges, seems an impossible task.
Existing models, which have been verified by supervisors, should be used where available, as these will result in a very good approximation of actual risk. Where results from two counterparties diverge, a simple resolution mechanism (mid-point) may be possible, provided differences are not too big.
Developing an industry facility to get portfolio risk valuations in conjunction with trade repositiories and central counterparties may be a possible approach for a mid-term (3 to 5 years) solution.
It has to be recognized though that the same problem is faced by CCPs offering portfolio margining over different products. Solutions for some asset classes thus may emerge.

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| Q14. | Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised? |

Diversification is a well established reality. While exact parameters for correlations will vary over time, some relationships are almost mechanic and thus will result in risk reduction over a larger, more diversified portfolio. In particular where cash-flows from one product have to be discounted over a longer period, offsetting benefits with interest products should be recognized.
While we do not consider the implementation of the correlation model in the Solvency II framework as perfect, it may provide one possible solution.
Another option is to rely on existing models, but preventing too-large diversification benefits across asset classes.

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| Q15. | With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis? |

No. The standardized schedule is currently resulting in risks which are significantly overstating actual risks. We are confident though that the analysis of the QIS conducted by the Joint Committees will clearly show this.
Where available, initial stand alone margins for listed contracts or margin schedules used in stabled CCPs may provide some guidance for a standard model.
We would like to point in this context to Q1 about the logical sequence of regulation. The development of standard models for bilateral transactions should thus follow the development of central clearing models.
As a general remark we would like to point out that despite the limitations of models, it does not automatically follow that a simple model will produce better or more stable results for a complex problem than an advanced model.

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| Q17. | With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin? |

In principal daily margining should be norm for revaluation margins. This should apply in particular to trades which are part of a chain leading to a clearing venue where they will be subject to daily margining in cash. The rationale for this requirement is the need for unbroken liquidity chains as set out above.
In practice, the frequency in which the variation margin is to be adjusted (and thus in which payments are to be made) should depend on the actual risk as well as the ability of counterparties involved to handle the requirements for liquidity provisioning and sourcing collateral. Uniform and rigid requirements should be avoided.

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| Q18. | Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to “cliff-edge” triggers sufficiently discouraged? |

Margining requirements are inherently pro-cyclical, as set out above. Cliff edge effects, e.g. due to change in the value of collateral posted, are present also in CCPs. The practice has shown that variation margining requires cash or near cash to be used along the chain. Where this is the case, cyclical effects may be mitigated somehow. The need to find liquidity, or assets, for positions at times of high volatility though is inherent in the concept of margining. In particular if applied across all assets and market participants the cumulative effect could well contribute to systematic crisis events.
Initial margins should be as stable as possible. But since they also have to reflect the portfolio risk, and can not ignore valuation of collateral posted, it is currently difficult for us to conceive a framework which precludes the danger of pro-cyclical effects.

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| Q19. | What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure? |

Minimal transfer amounts - just as thresholds – are an important instrument to permit a practical and effective collateralization by reducing operational complexity. As in the case of thresholds, the amounts have to be adjusted to reflect the relevant risks and counterparties and thus need to be determined individually.
In the interest of a smooth operation of markets, we consider the suggestion of about $100,000 made by the CFTC as appropriate.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

While we fully agree that assets serving as collateral should be of sufficient quality, it is of utmost importance that the quality requirements for eligibility do not result in a strong preference for a specific asset class. Applying the same standards as clearing houses would seem helpful in order to allow for continuous liquidity and collateral flows through a trade chain, but this would likely result in an almost exclusive concentration in short term bonds issued by a select few government issuers. Such a concentration would result in illiquidity and price distortions even in assets which otherwise would be highly liquid. It also creates the potential for a systemic risk increase due to the synchronization of the exposures across virtually all market participants.
Allowances have to be made for assets available to some market participants. An equity fund using FX derivatives to hedge the currency exposure in the portfolio will not be able to post anything else than the stocks it has in its portfolio. This disregards the aspect if investors and market stability really are furthered by such funds having to pledge some of their assets as collateral – or alternatively not hedge, and expose their investors to currency risks. By necessity collateral eligibility rules thus have to be cast wider. Lack of liquidity in collateral should be possible to be compensated through adequate haircuts calibrated to allow for a stressed normal liquidation period.
It should also be pointed out that collateral will not be liquidated on a trade by trade level but on a master agreement level. FX risk exists not only between the currency of the collateral and the currency in which the payment obligations under a single derivative transaction is made, but also between the currency of the collateral and the agreed termination currency of the Master Agreement, in which the close-out amount will be calculated. Splitting collateral and the FX risk on a trade level complex would therefore be in conflict with the single agreement concept and add legal risk if parties are required to accept collateral in certain currencies.
This point highlights the need for a proposed situation to be compatible with the existing master agreement framework in order to avoid destabilizing the legal foundation of the OTC trading framework and thus introducing a new kind of risk into the system.

Against this background we would urge the Committee to follow a red line approach and, if considered useful, only define not-permitted collateral and broad minimum criteria for permitted collateral. Allowing for differences in the assets available to counterparties will be crucial in order not to force market participants to either accept higher market risks, or to change their business model or accept other risks in order to also avail themselves of preferred collateral.

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?

The management of counterparty and credit exposures should remain under the control of the counterparties. In particular for banks no uniform and universal rules of diversification are possible since the exposure will depend upon the overall credit portfolio consisting of loans, direct trade exposures, collateral received, bonds in a trading book, etc. Counterparties must thus have the right to reject some collateral or to allow other collateral depending on their normal risk control procedures.

The standardized haircuts seem to be excessive. 10% on equity or gold would seem more appropriate. In particular the latter has proven to offer a significant market depth even in volatile periods and thus is a good way to insulate collateral portfolios against liquidation risk in stress periods.

Overly conservative haircuts result in additional counterparty risk for the party posting collateral since the difference between the fair market value and the haircut value will be at risk in the case of default of the receiving counterparty. On a macro level, excessive haircut increase the negative effects expected from pressure on liquidity profiles. This would apply in particular for collateral posted as initial margin.

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| Q22. | Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigant in all cases? |

In order to serve as an actual mitigant of counterparty risk, a claim has to be enforceable. Legal enforceability of collateral transferred by way of a pledge is a complex matter. Due to different and insufficient implementation in various jurisdictions the market participants face a high legal risk of holding a legally unenforceable security interest or providing non-bankruptcy remote collateral, because the requirements for a valid and enforceable creation and/or perfection of the pledge are not complied with, for whatever reason. Standard documents across jurisdictions may not be adequate to obtain legal certainty on enforceability and bankruptcy remoteness. A pledge of cash and certain securities causes additional complexity if a third party holding the collateral needs to be involved and therefore a further credit risk needs to be taken into account. In view of the intent to reduce risk, including legal risk, will require a concluded international implementation of necessary amendments to local laws and development of legally reliable standard documentation.
Because of the dependency on a fully compatible legal framework, enforcing collateralization in the absence of a suitable framework would result in counterparties residing in juridistictions to be excluded from market access. This may result in some countries becoming severed from the international financial markets, and by extension may find it more difficult to raise funding or attract investment which relies on the existence of risk-offsetting transactions.

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| 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? |

No. On an aggregate basis this results in a huge over-collateralisation relative to absolute risks. Situations where no discernible net exposures result in significant margining requirements are easily imaginable. It is therefore not proportionate, nor necessary, to mitigate risks.
The proposed key principle would raise fundamental concerns to the extent this is indeed meant to prevent the posting of initial margin to cover the relevant potential future net exposure vis-à-vis the counterparty in question. Such an understanding would effectively negate the effects of netting agreements which have been recognized as highly effective and efficient instruments to mitigate risks from derivative transactions, including other initiatives of the Basel Committee on Banking Supervision and which constitute a core element of risk management for derivative transactions.

Established principles for risk management, in accordance with accounting and regulatory best practice, should form the basis for any bilateral risk management regime. Netting exposures where sensible and possible is a standard feature of all these and therefore should also apply to the posting of bilateral margin.
We refer to our proposal for a central counterparty for non-cleared traded made in the introduction which would have the potential to alleviate some of these problems and achieve a heightened level of protection relative to the status quo.

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| 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? |

Re-hypothecation or re-use of collateral is a common feature as it significantly reduces transactional costs (by generation of interest on assets used as collateral)and also helps to limit the overall strain on liquidity (general availability of collateral).
The requirements for a legally valid creation and the perfection of a pledge do vary between jurisdictions.
Pledges, as understood under German law, would not permit any re-use, since the pledged collateral would remain the property of the pledger, subject to a security interest.
In the interest of legal certainty, re-hypothecation should thus be avoided. Given the systemic risk created by not permitting re-hypothecation in all circumstances – in particular withdrawal of liquidity and concentration in particular assets – creating means, which have to be integrated in existing legal frameworks and bilateral agreements, to allow this technique appears to be the lesser of two evils.
In the context of initial margins this underscores our point as to its limited suitability to actually counter any of the perceived systemic risks without introducing more significant risks elsewhere.

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| 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? |
| Q26. | Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction? |

Intragroup transactions often serve the purpose of centralizing risk mitigation thus enabling a group-wide risk management. Margining requirements, in particular initial margining requirements affecting such transactions would severely limit the effectiveness of group-wide risk management. Exemptions for intra-group for risk mitigation on bilateral transactions should under no circumstance be narrower than those granted for the clearing obligation.

Within a group, concentration of risk management and also liquidity management helps to reduce operational risks. It also avoids transactions being undertaken in ill equipped parts of the group. In particular the heightened requirements introduced by the recent market reforms means that for most groups it would be uneconomic and even impossible to use reasonable risk management tools, if each part of the group has to establish its own access to clearing venues or risk management centers.
Elsewhere, centralization of liquidity management is explicitly encouraged through the introduction of SEPA in Europe. It would seem very strange, if this objective was torpedoed from another piece of regulation.
Demanding collateralization of intragroup transactions can also be seen as impeding the right of establishment of a corporation and seeking a suitable organizational form to follow its business interest. In instances, where subsidiaries have been founded for regulatory reasons, e.g. to ensure that customers have a local contact point, placing high costs on the interaction of such a subsidiary with its parent undertaking would hardly seem desirable.
Exchange of variation margin could be mandated by the regulator for prudentially regulated institutions in order to avoid the security of local depositors being undermined or other tangible concerns exist, like the possible diversion of funds in not equivalently regulated jurisdictions. Otherwise we would urge the regulator to look at a broad exemption for intra group transactions, in particular on a national level, and to seek consistency with other areas of legislation, in particular the Basel 3 framework.

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 fully concur that there is a clear need for coordination between national regimes. This equally applies to harmonization in insolvency laws and other aspects, on which much hinges if counterparty risks are to be mitigated effectively. In particular where the demand for a level playing field is raised, finding that investors would have to post different margins only because they face a different regulators, would clearly be at odds with such a sentiment.
We would clearly welcome a greater harmonization in these fields.