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FEDERATION
BANCAIRE
FRANCAISE

BCBS / IOSCO

MARGIN REQUIREMENTS FOR NON-CENTRALLY-CLEARED DERIVATIVES CONSULTATIVE DOCUMENT

FBF'S RESPONSE

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 500 commercial, cooperative and mutual banks. They employ 500,000 people in France and around the world, and serve 48 million customers.

The FBF welcomes the BCBS / IOSCO initiative to address the issues regarding margin requirements for non-centrally cleared derivatives on a global basis, in order to foster harmonization and coordination across jurisdictions. We appreciate the opportunity to respond to this Consultative Document.

As a preliminary remark, we would like to remind that **OTC derivatives are vital to the real economy**. They allow economic actors to optimize their capital and to secure their investments. We share a common objective of making these markets more secure and efficient without unduly penalizing an efficient way to properly reallocate risk within the economy.

While we agree with the principle of appropriate margining for uncleared derivatives in order to reduce systemic risk and to foster financial stability, we have serious concerns on a number of issues set out in this Consultation.

1) We recognize the **need for systematic, bilateral exchange of Variation Margin ("VM")**, which is an important mitigant of systemic risk. It will, in particular, avoid the build-up of excessive risk such as in the AIG case. This should not apply to entities that are part of the same prudentially consolidated Group.

2) However, **we think that the proposal of posting two-way Initial Margins ("IM") for any institution, including the Prudentially Regulated Entities ("PRE") is totally disproportionate to the risk which is intended to be mitigated**. It will drain a most probably huge amount of liquidity outside of the real economy, subordinate other unsecured

liquidity provider, increase the apparent leverage ratio, create additional credit, market and operational risks for the posting party and would probably damage the OTC derivative market to a point where any transaction, even for end-users, will be uneconomical, leaving most end-users exposed to market and economic risk.

For PREs subject to Basel III, the posting of IM is redundant with the capital requirements for counterparty risk. In an extreme case, if the all the counterparty credit risk is moved away from the bilateral world (and transformed into a liquidity risk and a risk on the custodians), the whole counterparty framework developed by the Basel Committee will prove useless and PREs will have no incentives in selecting their counterparties on the quality of their credit situation. **As far as liquidity is concerned, the need for additional funding will be exacerbated by the LCR requirements**, according to which the variations of margins should also be covered by additional liquidity buffers.

Additionally, any proposal should seek to avoid the immobilization of significant amounts of collateral as well as the exposure of OTC counterparts to additional credit risk exposure, which will offset the very rational of IM. **Should the no re-hypothecation requirement prevail, it should be required to centralize them in the only non-risky, systemic resilient counterparts, capable of redirecting liquidity into the economy: the central banks**.

As an **alternative** to the initial proposals in the consultation, we are in the opinion that

(i) **banks may elect to collect IM notably in cases of significant "risk asymmetry"** between contracting parties, i.e. when the counterparties have very different level of risks vis-à-vis each other). The IM collection may or may not apply threshold.
(ii) In addition to this, we suggest another alternative that has not been considered in the consultation. The idea would be to protect, counterparties, global economy and eventually taxpayer against a default by a major systematic firm by **structuring a "default fund" per PRE netting all the exposures of an entity due to its derivative contracts**. This default fund would be secured into a risk-free entity that could be the Central Bank or the resolution authority of the institution. The money would be used if the PRE comes to defaulting. More details are given under question 4.

3) In any case, **the posting/collection of VM and IM should take into account a number of issues in order to avoid a liquidity trap and to keep transactions and funding costs at an economic level** for all economic actors:
(i) margins should be calculated on a net basis, across all asset classes;
(ii) collateral re-use / re-hypothecation should be allowed for VM;
(iii) as suggested by the BCBS / IOSCO proposal, a broader range of eligible collateral should be allowed;
(iv) the combination with other regulatory requirement should be considered (liquidity, leverage, encumbrance, prudential capital) notably to avoid double-counting;

4) Finally, we would like to emphasize the need for sufficient phase-in periods of the margining requirements given their vast impact on OTC derivatives users in a multitude of areas, as well as the need of coordination and harmonization cross border and cross regulation for reasons of consistency and avoidance of regulatory arbitrage.

Detailed Responses to the Consultative Document

Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

We are of the opinion that the phase-in period for margining requirements on bilaterally traded derivatives should be aligned to the phase-in periods of the clearing obligation under EMIR, and to the new capital and liquidity requirements under Basel III. Identical time frames across different jurisdictions are necessary to avoid regulatory arbitrage and unfair competition.

In order to allow for consistency between the treatment of the centrally cleared and non-centrally cleared regimes, it is of utmost importance that similar timetables are applied, given the far-reaching implications on risk management, collateral management, funding, legal and operational procedures.

Also, appropriate phase-in periods should be considered to avoid cliff-effects on market liquidity given the cumulative impact of different regulations on derivatives users. Therefore, all regulatory initiatives that relate to the treatment of derivatives in one way or another should be closely aligned in time and content.

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?

It should be first reminded that FX swaps and forwards are cash products which are physically settled through an exchange of two currencies, and therefore distinguishable, by nature, from derivatives which are financially, cash settled products (whose value and settlement amounts are determined by reference to an index, etc.). These products are an essential part of the FX market by providing a critical source of liquidity and funding. The FX market is a *global payment system* that underpins the global economy by facilitating and supporting international trade and all forms of cross-border activity,

The risk profile of these instruments is quite different from other derivatives classes, as the tenor is normally short, payment obligations are known in advance and fixed throughout the life of the contract, and most importantly, there is an exchange of principal. As a consequence, the predominant risk for FX Swaps and FX Forwards does not relate to counterparty credit risk, but to settlement risk. Settlement risk for these transactions is already addressed through specific infrastructure arrangements already via CLS Bank as well as other risk mitigation techniques developed by the financial industry since the 1970's.

As counterparty credit risk here is far less meaningful than for derivatives and, hence, the overall risk of FX Swaps and FX Forwards is significantly lower, we are of the opinion that the cost of imposing margin requirements would be totally disproportionate to the benefit of the credit risk reduction that it would bring. Moreover, a new source of risk would be generated instead, namely liquidity risk, as well as increasing operational risk.

Subjecting these products to a mandatory margin regime creates unsafe structural economic incentives that can harm the well-functioning market structure. A mandatory margin regime raises costs of trading these products bilaterally, even when end-user exemptions exist due to the interbank margining required, which will:

- Attempt to incentivize central clearing when there is no approved robust and safe solution for these products,

- Jeopardize use and role of CLS (which is not mandatory) in reducing systemic risk as costs may move the focus away from settlement risk reduction,

- Discourage legitimate trading in these products, which might affect global trade and cross-border activity.

As a consequence, we are of the opinion that deliverable FX swaps and forwards should not be subject to any mandatory margin regime under which dealers would be required to put in place mandatory CSAs with provisions that require the collection/posting of mandatory variation margin and mandatory initial margin.

However, if deliverable FX swaps and forwards are subject to a mandatory regime, only variation margins and <u>not initial margins</u> should be mandated; and appropriate user-exemptions from this regime are necessary along with thresholds.

At last, to ensure a level playing field and foster international trade and competition, exemptions for FX Swaps and Forwards should be aligned across jurisdictions and harmonized to a maximum extent.

As a matter of international harmonization, and given the fact that the largest part of FX forwards and swaps have a maturity of less than one year, we would favour an exemption at international level covering all FX forwards and swaps up to a maturity of one year.

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?

We are of the opinion that margining requirements should not be indiscriminately imposed on all products alike, but rather be considered as a tool among others to manage counterparty risk appropriately.

The FBF believes that some products should be exempted given their specific nature and the fact that the counterparty risk is already appropriately mitigated. At least, the following products should be mentioned:

1) Covered bonds : we refer to Recital 24 of the EMIR regulation in Europe, which states that :

> *" ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk."*

Covered bonds issuers should therefore be exempted from IM and VM.

2) Forex Swaps and Forwards: see our answer to Q2.

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 way that the requirements are drafted seems to suggest that counterparty risk on derivatives needs to be completely eliminated. According to us, this goes beyond the G20 recommendations that seek to minimize credit risk. Credit extension, be it via traditional lending credit lines or via derivatives credit lines, is a key function of a bank, which the Basel III framework captures through the capital and liquidity requirements applicable to regulated credit institutions.

Systematically exchanging margins will dramatically increase the cost of derivatives, with severe repercussions on the end-users as banks will find themselves forced to take into account the way that margin requirements affect the level of their funding needs and the access that they have to funding.

Moreover it has to be noted that margining requirements will:

1) lead to allocate the scarce and inextensible bank funding sources to margin requirements at the expense of extending credit to the real economy (eviction effects), which will be highly detrimental to the whole economy (hardly a desired objective in the current economic environment);

2) subordinate the banks' senior debt holders up to 100% of the posted margin amounts and lead to a deterioration of the credit quality of unsecured liabilities.

In order to efficiently balance the envisaged policy goals, the FBF believes that the following should be considered:

1) **Exchange of Variation Margin ("VM"):** this is a critical mitigant of systemic risk, and therefore, should be applied as broadly as possible. This has been demonstrated during the 2007-2008 crisis: exposures to monolines and insurers (e.g. AIG) which were not subject to VM lead to dramatic losses, whereas exposures to Lehman (and in 2011 to MF Global) that were indeed subject to VM did not incur any material losses on the back of counterparty risk. Technical details on computation / exchange of VM are developed under Q17.

2) **Exchange of Initial Margin ("IM"):** this is a risk mitigant of future potential exposure and thus of second order and may be elected to be applied notably when there is a significant difference in credit quality between two Non-Prudentially Regulated or a Prudentially Regulated and a Non-Prudentially regulated transacting counterparties. PRE could be obliged to collect IM from Non-PRE when there is an asymmetry with the risk profile of the Non-PRE, taking into account the default probability and recovery rates to distinguish between Non-PRE counterparties in terms of size, credit worthiness or concentration of risk. In this way, IM will contribute to counterparty risk reduction efficiently. This has been demonstrated for example in the case of the default of Amaranth, where investment banks had indeed collected IM from this hedge fund.

Therefore, we believe that the posting of IM should be considered as a tool among others to efficiently manage risk and PREs should have room to manoeuvre in order to choose the most appropriate form of counterparty risk protection.
Moreover, we would like to underline that the two-way exchange of IM may paradoxically have a disincentive effect on financial institutions to clear derivatives on CCPs, as bilateral trades would allow a counterparty to potentially receive IM, which is not possible for cleared derivatives where IM is posted but never received from the CCP.

Whereas the exchange of IM will contribute to the reduction of counterparty risk on OTC derivatives, we fear that making this requirement mandatory and bilateral will at the same time give rise to a number of unintended consequences and consequently shift risk to other areas in the financial system:

1) Economy risk: Requiring all counterparties to post IM would induce a liquidity trap as hundreds of billions of collateral would be immobilized and would dramatically increase the funding needs of the global banking system. A rough estimate derived from the US Office of the Comptroller of the Currency estimated a US$2 trillion impact for US banks, which translates into US$7 trillion for worldwide banks based on BIS figures for derivatives notionals. Whereas any extrapolation is highly hypothetical in the absence of a comprehensive quantitative impact study, the FBF estimates of the impact of collecting systematically IM (based on our funding surplus needed and our approximate market share on the derivatives market) are roughly estimated at US$2 trillion.

This adds to the LCR requirement estimated at ca. US$2.3 trillion by BCBS in October 2010;

Please note that other trade associations also estimate the consequences at several trillions.

Any no-rehypothecation requirement would basically sterilize huge amounts of liquidity out of the economy, and would trigger a massive loan deleveraging process as the available

sources of fundings for banks are not elastic: they will have to re-allocate their available liquidity from loans to margin requirements.

2) Increase in unhedged market risk in the economy: as the cost of OTC transactions will increase significantly, end-users could turn away from hedging their commercial risk with tailor-made products, thus being exposed to basis risk or not being hedged at all, which would enhance economic risk. Moreover, in addition to the end-users, we would like to underline the fact that financial institutions do have non-standardized risks with tailor-made products. In that context, we think that regulation should not discourage them from hedging these specific risks entering into contracts with counterparties which are willing to support these risks.

3) Credit risks: the institutions that are mandated with holding the collateral, particularly when paid in cash, will themselves become sources of credit risk.

4) Market and issuer risk: the institution that will have to buy securities to post them as collateral will be exposed to additional market and issuer risk on its holding.

5) Concentration risk: knowing that the G16 banks are the major participants in the OTC derivatives, the same kind of collateral will be found in their accounts, possibly increasing the risk of financial instability due to overconcentration and lack of diversification. Moreover, similar collateral will also be held on the back of the liquidity requirements under Basel III (LCR and NSFR).

6) Procyclicality: imposing the same risk-mitigation regime on the entire OTC derivatives space enhances procyclicality in times of severe market stress. Therefore, we believe that the posting of IM should be considered as a tool among others to efficiently manage risk.

7) Counterparty risk: Additional counterparty risk is generated by posting cash collateral and borrowing securities to post as collateral.

8) Operational risk: risk of mis-payments, legal risks of perfection of rights over the IM posted.

All these risks will translate for Prudential Regulated Entities into supplementary capital requirements, that could result in partially or totally negating the capital benefit due to added surety on our counterparty risk due to the IM posted.

Alternatives to the compulsory collection of IM by all financial institutions ("FI") and systemic non-financial counterparties ("S-NFC")

1) In case of risk asymmetry between the two counterparties

We think that IM are justified in case of **significant "risk asymmetry"** between contracting parties, when the counterparties have very different level of risks vis-à-vis each other). This would be the case between a FI and an unregulated, highly leveraged fund (as defined by Basel III), where the FI should collect IM from the fund. In that case, the level of the IM would depend on the risk profile of the fund. Such **unilateral Initial margins** have proved efficient and have successfully contributed to the stability of the financial system, with some noticeable examples of limited losses on hedge fund failures (e.g. Amaranth) when IM were collected.

2) In order to cover the potential default of a counterparty

We are in the opinion that the purpose of exchanging IM is not about over-protecting each and every firm individually against one of its counterparties' default. In the case of PREs this is already covered by credit lines and capital allocation.

In our views, IM should rather be used to increase the global resilience of the markets, protect counterparties, the global economy and eventually taxpayers against a default by a major firm. Therefore, **there should be a direct connection between the use of IM and the resolution mechanism of the entity**.

More precisely, **to cover the markets against the default of a FI or S-NFC, both could be required to post IM for the whole of its uncleared portfolio** (as it is the case already for its cleared business) **at a netted level, across all its counterparties**. This IM should be segregated into a risk-free institution which will be involved in resolution of the FI if it comes to defaulting. That risk-free institution would be holding the IM and allocate it to all counterparties to cover their losses as it liquidates the portfolio of the FI.

The **risk-free institution / resolution authority would in that case play the same role as a CCP in the context of the resolution** (i.e. trade liquidation and replacement) of one financial institution. The resolution authority would have a bucket of money available to all parties based on the level of correct level of exposure of the FI in case of default (the netted exposures across counterparties).

In practice, all entities, whether exempted or not from margining requirements, would be required to sign an agreement (standardised by ISDA) for transacting OTC derivatives with all their counterparties. This contract will provide the counterparties of an entity a resolution mechanism of netting across counterparties and the protection of a default fund. Hence, in the event of the default of an entity, the counterparties which have liabilities on their OTC derivative transactions toward the entity will settle with a resolution authority. The resolution authority in turn will use the proceeds to pay the counterparties which have credit toward the defaulting entity for their OTC derivative transactions. Any shortfall will be covered by the

default fund that was deposited toward a risk free institution. This will make counterparties for OTC derivatives transactions senior from other creditor in the default resolution up to the total of the amount due to the defaulting entity by its counterparties for OTC derivative transactions and the default fund.

The default fund could be calibrated on an internal model or a standardised method. If calibrated with an internal model, it should be based on a regulatory approved VaR[1] such as a one tail stress VaR at a 99% confidence level over a 10 days horizon allowing full diversification across asset classes. The default fund should be held by a risk free entity in a bankruptcy remote fashion. This implies a building up of the fund with titles (no cash) without allowance for re-use or re-hypothecation.

As this "default fund" would be comparable to the ones of the CCPs and it will be much easier for regulators to calibrate the amount of IM to be collected for uncleared derivatives and make sure there is an inducement to clear standard derivative contracts on CCPs.

This default fund may be imposed to the systemic institutions only (or to the largest derivative dealers such as the US swap dealers), to all the Prudentially Regulated Entities or to every financial institution. In order to be consistent with the existing or future resolution frameworks that will apply to banks, we think that **such default fund could be imposed to every FI**.

The default fund could be calibrated in order to cover the potential losses of all the counterparties of a FI, including the end-user (non-financial) counterparties which are exempted from posting VM and IM under EMIR and the Dodd-Frank Act. This would protect a broader range of counterparties against the default by a FI, including end-users, and could therefore be preferable from a regulator's point of view (although, as explained above, a prerequisite would be to develop specific contracts with end-users under the umbrella of ISDA to precise that they are exempted from posting IM or VM but their derivative exposures with a FI would be netted in case of default of the FI).

We urge the Basel Committee and IOSCO to start the dialogue with the financial industry in order to develop alternatives such as this one as soon as possible.

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?

Thresholds will alleviate the severe impact of IM on liquidity to a certain extent, and recognize the effectiveness of the capital requirements imposed by the Basel III framework.

[1] *Value at Risk*

Again, these thresholds should be at the discretion of the counterparties, in line with their risk perception and risk management policy.

We have serious doubts around the fixing of a lower threshold for "key market participants", which will disincentive their willingness to make markets in OTC derivatives, with serious consequences on end-users and the real economy as a result. Moreover, their higher level of systemic risk will be captured anyway by a SIFI-surcharge under the Basel III capital requirements (see also our response to Q6).

The thresholds may however differ according to the nature of the PRE. Financial institutions which conclude a limited number of derivative transactions or are not regulated as SIFIs may apply simpler and more standardized thresholds than the large financial institutions which have internal models validated by their regulators to set IM and threshold levels.

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, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

We think that it is appropriate to have different thresholds that apply to different entities: this is the only way to efficiently manage counterparty risk, without overburdening the market with a "one-size fits all" approach.

It should be up to each counterparty to determine what threshold it finds appropriate to fix, depending on its risk perception and on its use of other risk mitigating techniques, such as the use of capital.
The use of different thresholds for different kinds of counterparties would not contribute to an unlevel playing field: it would reflect adequate counterparty risk management, as this is already reflected in the pricing of uncleared OTC derivatives today.

The G-SIFI level seems a reasonable way to determine an entity's systemic risk level, as this level takes into account many more factors than merely the volume of uncleared derivatives transactions. However, uncleared derivatives business as such will not pose greater risk to the system if the inherent risks are adequately managed. Moreover, it should be made clear that financial institutions that are deemed systemic, will also be subject to a SIFI-surcharge under Basel III capital requirements, which will be based (amongst others) on the size of their total derivatives business.

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?

Prudentially Regulated Entities are already subject to the capital requirements set under Basel III and to supervision. Indiscriminate margining requirements would disregard the purpose of these capital requirements and multiply risk mitigants where safeguards are already in place. Both capital and collateral requirements can be used appropriately depending on the type of transaction and counterparty, one being able to complete the other without leaving loopholes. The right balance between liquidity for IM and capital should be left at the discretion of the PREs.

Next to capital requirements and direct supervision, we would like to point out that under the liquidity requirements set by Basel III, the application of the LCR will require PRE to hold additional liquidity to cover future market valuation changes. We refer to CRD IV Art. 411.2 and Art 411.3 of CRR :

2. Institutions shall notify to the competent authorities all contracts entered into the contractual conditions of which lead to a liquidity outflows or additional collateral needs following a material deterioration of the credit quality of the institution. If the competent authority considers such contracts material in relation to the potential liquidity outflows of the institution, it shall require the institution shall to add an additional outflow for those contracts, including corresponding to the additional collateral needs resulting, from a material deterioration in the credit quality of the institution such as a downgrade in its external credit assessment by three notches.

3. The institution shall add an additional outflow corresponding to collateral needs that would result from the impact of an adverse market scenario on the institution's derivatives transactions, financing transactions and other contracts if material.

In this way, under the current proposals, a PRE will have to meet a deterioration in its credit quality both by posting extra IM on its uncleared derivatives, and by holding extra High Quality Liquid Assets to cover the adverse impact on its derivatives business. This means that the PRE will have to cover the same risk twice. Again, this argues against the mandatory bilateral exchange of IM for PREs.

Consequently, requiring IM collection would basically double count with the liquidity requirement.

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 standardized 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?

We believe that risk management is the pillar of the system and any new rule should tend to incentivize any party to better analyse its counterparty risk. Therefore, thresholds should be determined according to the perceived risk of the transaction and the counterparty involved, using approved internal models.

Especially in cases where there is a significant difference in credit worthiness between the two counterparties, unilateral IM could be a useful risk management tool.

In order to make sure that the calculation of IM and the thresholds are consistent between two counterparties and to avoid further disputes, PREs may sign a bilateral agreement to use one of the counterparties' internal model.

Comments on the capital Implications of IM for PREs:

In any case, the Basel Committee could clarify that if IM (B) >= IM (B / A),

- Where IM (B) is the amount of Initial Margin calculated by counterparty B which it ought to post for counterparty A

- And IM (B / A) which is IM owed to counterparty A by counterparty B, as calculated by counterparty A

- then A can deduct fully IM (B / A) from its EPE for the purpose of calculating capital and CVA.

On the contrary, if IM (B) < IM (B / A), then Counterparty A can only deduct IM (B), i.e. what has been posted and not its theoretical calculations. Using that method, any dispute or disagreement on IM would be automatically taken into account in the EPE profile, which would be aligned with the principles of Basel 3. But any excess IM posted by B will not be recognised for the benefit of A, because B might align its calculations to A's quickly and withdraw all excesses before defaulting. This would appear to us as a conservative position.

Symmetrically, thresholds should be included in the EPE calculations, i.e. the relief brought by IM should be net of thresholds applied.

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 collateralizing credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

As already stated under Q4, we believe that a systematic two-way margining would have a detrimental effect on the economy, market risk and transaction costs in general and while reducing counterparty risk on the derivatives, at the same time give rise to other risks.
More specifically,

Key market participants may become more reluctant to make markets in OTC derivatives as the cost will be significant: not only will they be required to hold extra capital on the back of the G-SIFI surcharge that takes into account the size of their derivatives business, they will also need to meet higher requirements as to their liquidity ratios.

Next to that, their funding needs will be severely impacted as significant numbers of collateral will be locked away and no longer be used to provide financing;

1) Prudentially Regulated Entities that are not key market participants will be confronted with the same liquidity and funding constraints;

2) Non-PREs will be severely impacted in their funding needs and may not necessarily have the required collateral immediately available and could therefore refrain from using bespoke derivatives for hedging purposes.

Universal two-way margining will imply mandatory segregation of margins, which could lead again to a number of unintended consequences (see also our response to Q22).

Finally, we must underline that an obligation to post collateral for IM, in particular if applied only to PREs or systemic PREs, will give to the derivative counterparties of the PRE a super-seniority compared to other creditors (as they will be protected by the IM posted).

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?

In practice this will mean that the transaction costs for the unregulated counterparty will be increased as this will use assets otherwise used as a surety reducing liquidity cost or require the costly borrowing of assets and reduce the available liquidity. This will be expensive

especially in times of market stress or scarcity of assets which is likely to be the case and this will be factored into the pricing of the derivatives transaction.

As mentioned under Q4, systemic risk will shift towards risks of a different nature instead such as liquidity risk, commercial risk and economic (credit, market, operational) risk.
Moreover, we would like to reiterate our argument made under Q7, that non-PREs will be protected from counterparty risk when transacting with a PRE, as the latter will have to comply with higher requirements to meet its Basel III liquidity and capital ratios in times of credit deterioration.

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

With regard to non-financial entities that are not systemically important and central banks, we think that these are appropriate. However, in line with current market practice that reflects the criticality of VM, bilateral posting of VM by non-financial entities and central banks should be possible on a voluntary basis.

With regard to sovereigns, we think that the BCBS / IOSCO paper does not provide clearly the reason why sovereigns should be exempted in a context where the systemic risk should be mitigated and the liquidity be reinforced. At this stage and given that lack of explanation, we do not find any justification which would justify an exemption for sovereigns. Therefore, we think that sovereigns should be submitted to the mandatory margin requirements for the risks they create to be properly reduced.

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?

Exemptions are appropriate where uncleared derivatives transactions will not enhance systemic risk and where margining requirements would, however, severely hamper normal business. Therefore, exemptions should be considered either on the level of the product (see our response to Q3), or on the level of the transacting parties.

We consider that the following exemptions would be appropriate:

1) Intra-group transactions: transactions within the same Group are executed for reasons of sound risk management. Where appropriate, collateralization of transactions between entities belonging to the same Group is common practice, as limiting the intragroup exposure can make sense based on the present value of the instruments. Hence, the exchanged collateral corresponds to the exposure (i.e. VM). Mandatory posting of IM would definitely create a liquidity trap, an increase in operational risk and counterparty risk;

Special Purpose Vehicles: a repackaging or structured finance special purpose vehicle ("SPV") will be classified as a non-financial counterparty under European rules. It will enter into OTC derivatives transactions to reduce risks related to its normal business of issuing debt.

Hence, their derivatives business should be considered hedging and therefore, should be exempt from collateral requirements.

Q13. 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 methodology is based on a 99% confidence interval over a 10 days' horizon. This is much more stringent than current practices of CCPs, which, unlike Prudentially Regulated Entities, are not subject to capital requirements and CVA charges that are already dissuasive to the use of OTC derivatives.

The schedule-based approach that is proposed should not be regarded as a floor to the model based approach.

We believe that the use of the Internal Model Method is appropriate and consistent with the method used for the calculation of capital requirements under Basel III, should allow to limit loopholes leading to regulatory arbitrage and avoid duplication of costs for PRE.

We agree that IM should be calculated on a portfolio basis, however, the right approach to take is the calculation across asset classes, not segregated per type of asset class. An across asset class approach is consistent with current practices for OTC derivatives and with the way capital for counterparty risk is calculated. Again, CCP practices in which IM is often segregated per asset class, is not a relevant reference.

When calculating IM, the effect of risk diversification, hedging and netting across asset classes should be taken into account. Also, the risk profile of counterparty and the type of collateral posted should be reflected in the calculation.

At least, we are wondering which would be the competent supervisory authority which would approve the Internal Model Method of non-regulated entities (non-financial etc.). To ensure a level playing field and to implement a relevant regime aimed to properly mitigate risks, the Internal Model Method should be harmonized to a maximum extent between the various market players and across jurisdictions.

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?

As already mentioned in our answer to Q13, we believe that it is appropriate to take into account the benefits of diversification across asset classes. Correlation between different types of derivatives is widely recognized and accepted and as such an important element in current risk management practice.

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?

The standardised schedule is based on gross notional amounts. This generates amounts if IM which are highly over-estimated and absolutely non-risk sensitive. This approach would completely deny the benefits of portfolio netting and portfolio diversification, which are widely accepted practices for effective risk mitigation. Moreover, it is not consistent with the current resolution regimes that consider overall counterparty exposure on a net basis. It would finally increase the liquidity trap.

Therefore, any simplified method developed by the BCBS-IOSCO should at least be consistent with the effective exposure in case of a future default of a counterparty.

Q16. **Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?**

We refer to our answer to Q13 VM should also be calculated on a portfolio basis, across all asset classes.

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?

We think that VM should not be required to be paid on a daily basis but should be subject to minimum transfer amounts that have been agreed bilaterally, adequately reflecting risk protection for the transacting parties concerned.

Also, whenever securities are used for paying VM, the denominations of the instrument itself need to be taken into account.

Indiscriminate daily exchange would merely step up transactions costs, without necessarily contributing to effective risk reduction in all cases.

In cases where a Prudentially Regulated Entity would consider it appropriate to receive IM given the perceived credit risk of the counterparty, less frequent VM payments may be envisaged if met by an increase in close out horizon used in the calculation of the IM.

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?

It is critical to strike the right balance between conservative margining on the one hand and the resulting effect on liquidity on the other hand. Being overly conservative in normal market conditions and periods of low volatility would pose extra pressure on liquidity.

We agree that additional IM should be built up and managed over time in order to avoid procyclicality. Avoiding standard thresholds is one of the ways to avoid similarities in behaviours and limit the risk that all the counterparties of one entity call for initial margins at the same time, thus generating potential cliff effects for the entity.

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

The level of the minimum transfer amount should be set taking into account the perceived risk on the counterparty. Hence, this amount should be agreed bilaterally. We do not think that it is appropriate to fix an amount that fits all.

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

We certainly welcome the broadened scope of eligible collateral and think that even a wider range of instruments should be considered eligible as collateral, as long as they are effectively valuable, deliverable in a timely manner, do not create additional sources of risks and subject to appropriate haircuts reflecting liquidity and credit quality. A sound haircut regime will allow a more flexible approach towards collateral. As such, asset backed securities or lower rated instruments could be considered so that collateral transformation would be reduced as much as possible.

This enlargement of the collateral eligible should go together with its inclusion in the computation of the margin requirement as those assets could be positively or negatively correlated with the portfolio of derivatives.

It is important to note that the demand for the same type of collateral will dramatically increase on the back of different regulatory initiatives (central clearing, liquidity ratios) which could lead to the creation of bubbles and cliff effects, if not sufficiently diversified.

However, the eligible collateral is only one part of the equation as those assets will need to be funded first. The actual constraints will come from the huge increase in funding requirement, which has proven to be scarce and inelastic. That is the reason why, whatever the eligible collateral, margin requirement will have dramatic effect on the economy, through lower financing capacity.

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?

We think that concentration limits should be managed at the discretion of the counterparties, according to their risk management principles. Hence, whether or not a counterparty is willing to accept a certain type of eligible collateral will depend on these internal limits.

We agree that where entities do not have internal models to determine haircuts, standardized models could offer a solution. At the same time, we recognize that a standardized model may be overly conservative, not necessarily reflecting normal market conditions and therefore punitive in terms of liquidity impact.

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 mitigants in all cases?

We are of the opinion that the level of segregation of initial margin exchanged on a gross basis should not be mandatory. In these conditions, where a counterparty asks for the segregation of the collateral it has posted, this option could not be refused by the other counterparty. At the same time, mandatory segregation should seek to avoid the following unintended consequences:

1) Immobilisation of huge amounts of assets posted as IM; as mentioned before it would drain an excessive amount of liquidity outside the real economy and would create a liquidity trap very detrimental for all participants;

2) Increase the cost of transacting: it would dramatically inflate funding requirements and step up liquidity costs, operational costs and funding costs, driving non-financial counterparties away from effective hedging;

3) Uncertainty when counterparties from different jurisdictions are involved in a transaction, being subject to different insolvency laws and regulations. For instance, depending on the jurisdictions, the transfer of the collateral could be based on different legal regimes (transfer in full title, pledge, re-hypothecation or not etc.) and an insolvency could be managed differently. In that context and as long as insolvency laws are not harmonized, we think that any mandatory regime on segregation may lead to unintended consequences;

4) Risk of over-concentration at the level of the key market participants;

Please note that, where client money and assets are segregated, any requirement to ensure that those assets are legally segregated from the entity receiving the collateral by placing them with a third party (i.e. a separate legal entity) should not be read as a ban on segregating the assets through affiliated entities. Legal solutions exist to ensure that full segregation can be achieved when assets are placed with entities within the same group. One of the reasons to do act as such is that affiliated entities may have higher credit ratings and may be more financially robust than unaffiliated third parties. In that case, clients should not be forced to have their assets placed with a bank or custodian that poses a higher credit risk. Otherwise, forcing clients' assets to be placed with unaffiliated third parties may in fact increase the risk that counterparties are subjected to and therefore increase the overall level of systemic risk in the derivatives markets.

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?

As a matter of terminology, we think it is important to make a clear distinction between the calculation (on a net basis) and the posting (on a gross basis). Should bilateral IM be required (in specific cases developed in Q4, the calculation should be done on a net basis per counterparty and per portfolio, across asset classes. The actual exchange of these amounts calculated should be done on a gross basis (i.e. collateral amounts posted do not take into account collateral amounts received).

We agree that asking segregation with a third party custodian would increase the level of systemic risk. In order to mitigate the systemic risk arising from the use of a third party custodian, a list of criteria should be established to ensure that such a third party custodian provides a high level of financial strength and asset protection. For instance eligible third party custodians could be limited to credit institutions which are identified as G-Sifis and for which additional prudential constraints increase the level of safety they provide to their clients.

Despite strong asset protection provided by G-Sifis, the only way to avoid this additional credit risk on cash collateral posted at a third party and a liquidity trap is to have these

margins held by the central banks. This would be the only way to make sure that there is no counterparty risk added in the system, and at the same time that the collateral could be re-used without any damage to the liquidity. However, whether central banks would like to play this role remains to be seen.

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?

As VM covers the current exposure due to the mark to market valuation of the derivative contract, it is crucial to transfer VM in full ownership with re-use or re-hypothecation right directly to the counterparty. Otherwise, this would drain the available eligible asset pool, would dramatically increase funding costs and reduce financing to the economy.

As IM protect against potential future exposure and not current exposures, assets posted shall be considered as surety for the receiving party but with no re-use right (except specific cases where the counterparty receive directly the collateral) as this would create an equivalent credit risk exposure.

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?

We can agree with the posting of VM on intragroup transactions (see our response to Q12). However, we do not see the need to exchange IM on uncleared derivatives between group entities, as long as both entities are subject to the same robust risk management regime
Leaving the decision on IM to the discretion of the local regulator will indeed lead to international inconsistencies and consequently, to regulatory arbitrage.

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?

The purpose of exchanging VM is to mitigate risks associated with the current exposure of a portfolio of derivative transactions. We do not consider that this risk is any different for group entities located in the same jurisdiction rather than in different jurisdictions.

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 think that cooperation between national regulators in cross-border transactions is crucial to guarantee a level playing field and avoid overlap of rules and regulatory arbitrage. Therefore, regimes for margining, netting, collateral and resolution should be harmonized and consistent across jurisdictions.