Response to the second consultative document on margin requirements for non-centrally cleared derivatives

Second consultative document proposed by Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO)

March 2013

Insight INVESTMENT

► A BNY MELLON COMPANY℠

Background to Insight

Insight Investment is responsible for c.EUR280bn of assets under management,[1] predominantly on behalf of European pension funds and other long-term savings institutions. Our business is largely focused on providing asset and liability risk management solutions for these clients.

The overriding objective of most pension schemes is to secure their members' benefits by protecting and improving their financial solvency. After a catastrophic deterioration in funding levels over much of the last decade where increases in the value of pension liabilities have outstripped any growth in assets, it is now widely recognised that managing long-term financial solvency cannot be achieved without an effective strategy for managing liability risk. Insight's specialist focus is liability risk management through an approach to pension fund investment known as liability driven investment (LDI). In providing this we are extensive users of OTC derivatives and other financial instruments.

Insight Investment welcomes the opportunity to provide our views and we are pleased to submit our response to the second consultative document published by BCBS/IOSCO on margin requirements for non-centrally cleared derivatives.

We have provided our key issues in the section below followed by responses to the specific questions raised.

Key issues

In this section we outline three concerns that are not raised in the consultation.

Inflation should be treated as being within the same asset class as interest rates/currency.

The BCBS/IOSCO proposal is silent on the asset class into which inflation derivatives would fall. Given the strong relationship between interest rates/currency and inflation, there is a strong case for inflation derivatives to be treated within the same asset class as interest rates/currency. This can be justified on the basis of a strong fundamental, economic and structural relationship existing between inflation, interest rates, and currency. For example, many central banks set their interest rate and monetary policy targets based on expected rates of inflation, creating a strong link between them. There are also other fundamental, economic and structural relationships between these instruments.

Many end-users of derivatives, including pension funds, use interest rates and inflation derivatives together to create a real rate hedge to hedge their real rate liabilities. This is an important risk management strategy that pension schemes undertake to manage their financial solvency. However, if interest rates and inflation derivatives are not categorised within the same asset class, users will not be able to net any margin calculations across the two types of instruments. This could therefore incentivise the creation of less liquid derivatives such as real rate swaps, which we believe is not the intention of the policymakers. To achieve their goals, regulators should recognise the use of these instruments as two parts of the same hedge and allow margin offsets between them.

We therefore believe the BCBS/IOSCO recommendation should be amended to clarify the treatment of inflation derivatives, and specifically to include them within the same asset class as interest rates/currency.

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[1] Source: Insight. Data as at 31 December 2012. Assets under management are represented by the value of cash securities and other economic exposure managed for clients.

Rules for funds are unclear in the current proposal: any initial margin requirements should apply at a fund level rather than at the underlying beneficial investor level.

The proposal is silent on the treatment of funds. We assume the 'covered entity' for funds and pooled funds to be the fund itself rather than the underlying beneficial investors. This is consistent with the fact that the counterparty to derivative trades will be the fund itself.

Any initial margin (and variation margin) proposal should work at a fund level rather than looking through to the end investors, as it would be impossible to attribute the notional of derivatives to underlying investors of a fund. While we assume that the policy makers will be applying the rules at a fund level, the BCBS/IOSCO proposal is silent on the issue and therefore creates an uncertainty for market participants. We believe the BCBS/IOSCO working group should make this clear in its recommendations.

The use of 'group' to aggregate derivatives notional does not work for funds, many of which are set up as umbrella structures.

Many jurisdictions in Europe have investment funds set up as a single 'umbrella' entity, each containing a number of sub-funds. The sub-funds have assets and liabilities that are legally ring-fenced from each other even though the sub-funds are not separate legal entities themselves. This is an extremely common structure for funds in the UK and Ireland, particularly for corporate (rather than trust) based funds, and is used by both Undertakings for Collective Investment in Transferable Securities (UCITS) funds and funds aimed solely at institutional and more sophisticated investors such as Qualified Investor Schemes (QIS) and Qualifying Investor Funds (QIF). For accounting purposes, financial statements are produced for the entire umbrella at the same time, but portfolio breakdowns are shown separately for each sub-fund together with a short consolidated summary financial statement.

Practically, each sub-fund is a fund in its own right with different investment objectives and different investors. Legally, the assets and liabilities of each sub-fund are ring-fenced and therefore we believe these sub-funds should, to all intents and purposes, be considered as separate entities.

Any initial or variation margin requirements, and the definition of 'covered entity', should therefore be defined at each sub-fund level, and not at the umbrella level. We are concerned that the reference to consolidated group structures would not work for fund structures, even though it may make sense for ordinary company structures.

Questions and Answers

In this section we provide our answers to the questions posed by the consultation.

Q1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

In our view, foreign exchange derivatives with maturities less than or equal to three months should be exempt from the margin requirements. The vast majority of the risk within short-dated foreign exchange derivatives relates to settlement risk which can be mitigated by other means. Based on our analysis, we believe that requiring margins to be posted on short-dated FX derivatives would significantly discourage many end-users from using FX derivatives for risk management purposes and would therefore increase the ultimate risk in the system, acting against the overarching G20 objectives.

Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

We have no comment.

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

We support the proposed long phase-in times and the recognition that only large users of derivatives should be captured by the initial margin requirements.

We reiterate our key issues raised above:

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