Response on margin requirements for non-centrally-cleared derivatives

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

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Insight INVESTMENT

Background to Insight

Insight Investment is responsible for c.EUR225bn 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 for these clients. As such, we make extensive use of interest rate, inflation, credit and equity OTC derivatives to execute these risk management strategies.

Insight Investment welcomes the opportunity to provide our views and is pleased to submit our response to the BCBS/IOSCO consultative document on "Margin requirements for non-centrally-cleared derivatives".

We have provided our high level summary of thoughts on this topic followed by an estimate of the liquidity impact and detailed answers to the questions posed by the consultation.

Summary

In this section we provide our high level thoughts on this paper.

Section A: Broad initial margin principle and thresholds

We generally support the principle of two-way initial margins (IM) for non-cleared derivatives as long as it reflects the credit quality of the counterparty. However, this may not make sense in all instances, in particular for bank-to-bank transactions, as explained below. Further, any margining requirements need to take into account the potential liquidity impact on the market to ensure that there are no unintended consequences resulting from this. We feel that an inappropriate margin approach would not only discourage market participants from using derivatives for legitimate risk management purposes, but it could also constrain the effective functioning of non-cleared OTC derivatives markets.

Reflecting the credit quality of the counterparty (by recognising the probability of default of the counterparty) in any IM requirement should reduce the burden of the overall level of IM that would be required to be posted (at least by higher credit quality counterparties) and help dampen the liquidity impact of such proposals. Practically this can be achieved by setting adjustments to the IM based on the credit quality of the counterparty.

For transactions that are not purely between banks, we propose that an adjustment factor (i.e. a 'threshold factor') should be applied to the position risk/potential future exposure (i.e. on the suggested 10-day 99% confidence interval number if a model approach is used, or on the notional multiplied by the factor in the standardised table) to reflect the credit quality of the counterparty. The level of IM that would be required to be posted by a counterparty should equal the position risk/potential future exposure multiplied by this threshold factor. The threshold factor should vary by the counterparty credit quality and could therefore be asymmetrical between two counterparties to a transaction. The factor should be lower for high credit quality counterparties, implying a lower required margin to be posted by high credit quality counterparties than low credit quality counterparties.

[1] Source: Insight. Data as at 30 June 2012.Insight's assets under management are represented by the value of physical securities and present value of liabilities subject to hedging strategies

The difficulty would be in setting the actual level of the threshold factor and in ensuring there was an objective approach to calibrate this to the credit quality of the counterparty. Practically this may be easier to implement using a principles-based approach. However if a prescriptive approach is desired by regulators for setting the threshold factors, we suggest that the regulators may wish to consider setting threshold factors based on the type of counterparties, which broadly reflects the credit qualities of those types of counterparties.

We suggest some broad threshold factors below by type of counterparties starting from an assumption/benchmark where banks have a threshold factor of one. *Please note that these are indicative suggestions only. There would need to be some flexibility for different regions to take into account any structural differences in the different markets.*

Based on this approach, the minimum IM that would be required to be posted by a counterparty would be equal to the position risk/potential future exposure multiplied by the relevant threshold factor for such a counterparty. **Note again that we believe inter-bank transactions should be treated differently and it may not make sense for them to be subject to this two-way IM regime, as explained later**. **However, we are of the view that banks trading with non-bank counterparties should be subject to the two-way regime.**

Example threshold factors:

- Banks: [1 .0]
    - This is a starting assumption/ benchmark; if it is determined that this factor should be lower, then the others below should also be adjusted accordingly to maintain the ratio.
- Insurers: [0.3]
    - This is on the basis that insurers are typically more stable than banks in a stress scenario given they have less reliance on funding from deposit holders and the wholesale market. Insurance policies tend to be more long-term in nature.
- Pension funds
    - In our view this threshold factor should be set by the national regulator given that national pension structures can vary greatly between different countries. For countries such as the UK where there is a robust entity set up providing protection to a pension scheme in the event of a sponsor default (i.e. the Pension Protection Fund), the threshold factor should be low, e.g. [0.5].
- UCITS using derivatives: [0.5]
- Hedge funds: [minimum 1.0]
- Other funds
    - Leverage can vary between funds. The threshold factor should represent the leverage and other risk mitigants of a fund. Low leverage and/or funds retaining strong risk mitigants should attract low threshold factors. High leverage funds and/or funds with weak risk mitigants should reflect a high threshold factor - this may include commodity trading advisors related funds and managed futures fund depending on their specific leverage and risk mitigant characteristics.

Transactions between dealers/banks only should be treated differently to ensure that a trade initiated by an end-user does not attract more than one set of IMs as the counterparty bank enters into offsetting back-to-back transactions with other dealers/banks to hedge the original transaction entered into with the end-user. If two-way IM is required to be posted at each chain of these transactions, the cost to end-users of using derivatives even for the legitimate use of risk management could be prohibitively high. **It may therefore make sense for banks that are already captured by the Basel capital regime to not be required to post IM when they trade with each other**. We think this is critical to ensure that the IM requirements do not constrain the effective functioning of non-cleared OTC derivatives markets.

However, when banks face non-banking entities they should still be subject to the two-way IM regime.

Finally, **any IM exchange should be above some de minimus minimum transfer amount.**

Section B: Cross asset class netting

For reasons of practicality, it would appear to us to be sensible to margin instruments at an individual asset class level. It is however crucial to get the correct definition and categorisation of the asset classes. Instruments having a structural or economic relationship between them should be treated as being within the same asset class. As such we would **strongly argue that interest rate and inflation derivatives should be treated as being within the same asset class**.

Section C: Variation Margin approach

We support the exchange of variation margin ("VM") being transferred to cover mark to market exposures on a portfolio of positions with a counterparty. We already transfer variation margin on a daily basis, above a de minimus minimum transfer amount, on all client OTC derivatives transactions as part of our normal course of business.

Liquidity impact

For pension funds using derivatives to manage their solvency risk, the liquidity impact of the proposed margin requirements for non-cleared trades is likely to be significant. In this section we provide a range of estimates for this view, based on the proposed IM approach in the Basel/IOSCO paper and assuming that thresholds do not apply. Whilst the magnitude of these numbers seem high, we feel that these are realistic estimates of the impact, and we provide detail for our assumptions in the footnotes.

Many pension funds use derivatives as a risk management tool to better manage their financial solvency. These pension funds use long-dated derivatives which are one directional in nature to risk mange, typically, interest rate and inflation risk (although it is not limited to these), that is naturally inherent within pension fund liabilities.

We estimate the additional margin requirements for non-cleared trades required by the UK pension fund industry to be in the region of **£50bn[2] to £200bn[3]**. The range represents some varying outcomes of the final rules as well as a range of the size of the UK pension fund industry that may adopt these strategies to better manage their solvency risk. Assumptions can be found in the footnote at the bottom of the page.

Where there is two-way initial margin, and assuming that the dealer banks will have to post a similar level of initial margins for executing with the pension funds, they would have to post another £50bn to £200bn of additional collateral. **The total liquidity impact therefore to the market as a whole could be as high as £100bn to £400bn in extra collateral being required purely to back derivatives used for risk mitigation purposes by the UK pension fund industry.**

[2] The £50bn collateral estimate assumes:

- Initial margins of 10% of liabilities hedged. We believe this is a reasonable assumption for a typical pension fund liability profile and where regulators permit netting between interest rates and inflation for IM calculations. This assumes that an internal model approach is adopted for calculating IMs.
- The size of the UK defined benefit pension market that utilises derivatives to manage its financial solvency is assumed to be £500bn. This is likely to be a conservative assumption given that this is likely to represent the size of the UK pension fund industry that already uses derivatives for solvency risk management currently, and therefore this assumes that there is no further growth in these risk management strategies by pension funds. In reality, we would expect the adoption of these risk management strategies to grow over time so long as the regulatory changes do not curb the use of derivatives for legitimate risk management purposes.

[3] The £200bn collateral estimate assumes:

- Initial margins of 20% of liabilities hedged. We believe this is a reasonable assumption for a typical pension fund liability profile and where regulators do not permit netting between interest rates and inflation for IM calculations. This assumes that an internal model approach is adopted for calculating IMs.
- The size of the UK defined pension market that utilises derivatives to manage its financial solvency is assumed to be £1,000bn. We estimate that currently, the size of the UK pension market utilising derivatives to manage solvency is approximately £500bn. This therefore assumes that more pension funds adopt the use of derivatives to risk manage their solvency. We believe that is a reasonable assumption given that the awareness of managing solvency risk has increased over time, especially since the recent financial crisis.

Furthermore, dealer banks are likely to pass on the funding cost of having to post initial margin themselves when end-users such as pension funds originate transactions with dealer banks. The funding cost will be a multiple of the funding cost of the bank and the initial margin that it will post for the transaction. Assuming a funding cost of 2% per annum for a bank, we estimate that the **funding cost that banks are likely to pass on to end-users could cost the UK pension fund industry £1bn[4] to £4bn[5] per annum**. This does not factor in any costs that banks may pass onto end-users for having to post two-way IM on any back-to-back transactions they may execute to hedge the transaction originated with end-users (as explained earlier). This could multiply the liquidity and cost impact further.

Given the potential liquidity impact from pension funds using derivatives for the legitimate use of risk mitigation, it is therefore paramount that:

- any initial margin regime for non-cleared trades adopts appropriate threshold factors to lower the overall liquidity impact and cost impact of the new regime (taking into account counterparty credit risk as described earlier),
- the list of permissible assets for these purposes is sufficiently wide enough to ensure that the broad set of high quality asset classes held by pension funds would be permissible as eligible collateral; and
- a different initial margin regime is created between inter-bank/dealer transactions that are subject to a robust regulatory capital regime to ensure that end-users are not charged funding costs on more than one set of initial margins as dealer banks hedge their positions originated with end-users by entering into back-to-back offsetting swaps with other dealer banks.

[4] The £1bn annual cost estimate is based the assumption that banks would be required to post initial margins of £50bn to pension funds (this uses the lower end of the range of initial margin estimate provided earlier). Funding cost is assumed to be 2% p.a. for the banks. Therefore total cost per annum is estimated to be equal to 2% x £50bn = £1bn.

[5] The £4bn annual cost estimate is based the assumption that banks would be required to post initial margins of £200bn to pension funds (this uses the higher end of the range of initial margin estimate provided earlier). Funding cost is assumed to be 2% p.a. for the banks. Therefore total cost per annum is estimated to be equal to 2% x £200bn = £4bn.

Questions and Answers

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

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 would like policy makers to confirm that margining for non-cleared trades will not apply before the rules are finalised. We are concerned that EMIR could be interpreted such that margin rules are retrospectively applied to non-cleared trades executed between when Level 1 entered into force in August 2012 and when Level 2 margin rules for non-cleared trades are finalised in the future. We strongly believe that **margining of non-cleared trades should not be retrospectively applied to trades executed before the rules are finalised.** Margining requirements would impact the economic terms of the transaction and it would be impossible for the market to trade derivatives without knowing the economic terms of the transaction at the point of trade.

We agree that there needs to be an extended implementation and phase-in period between the margin rules being finalised and when they come into force to allow the market enough time to prepare for such requirements. Margin requirements for non-cleared trades would be a significant change to the current market practice and therefore it is important that market participants are provided enough time prepare for the change and ensure that they have sufficient collateral and infrastructure in place to meet the requirements.

It would not make sense for the margin requirements of non-cleared trades to come into effect earlier than a clearing obligation for derivatives where it is only a matter of time before the clearing obligation is likely to apply. It would be better in those instances for the market to prepare itself for the end goal of clearing rather than set itself up for margining requirements of non-cleared trades and then not be prepared for clearing. **Any phase-in of timing for the margin requirements of non-cleared trades should start only once the clearing mandate has been implemented.**

Furthermore, **regulators need to give enough time for market participants to go through the internal model approval process with their regulators before the margin requirements come into effect**. It would not be appropriate to force non-prudential firms who currently do not have such internal models approved with regulators to be forced to use the standardised table approach by not allowing time to build and approve an internal model before the rules come into force. The standardised table adopts a simple and crude approach and therefore has its limitations (lack of correct recognition of netting etc.).

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?

In our view, foreign exchange derivatives of maturities less or equal to three months should be exempt from the margining 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 therefore would increase the ultimate risk in the system which would go against the over-arching G20 objectives.

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?

No comment.

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?

Our thoughts on this are set out in the Summary section A in this paper, but we repeat the points from that section below.

We generally support the principle of two-way initial margins (IM) for non-cleared derivatives as long as it reflects the credit quality of the counterparty. However, this may not make sense in all instances, in particular for bank-to-bank transactions, as explained further below.

Further, **any margining requirements need to take into account the potential liquidity impact on the market to ensure that there are no unintended consequences resulting from this**. We feel that an inappropriate margin approach would not only discourage market participants from using derivatives for legitimate risk management purposes, but it could also constrain the effective functioning of non-cleared OTC derivatives markets.

Reflecting the credit quality of the counterparty (by recognising the probability of default of the counterparty) in any IM requirement should reduce the burden of the overall level of IM that would be required to be posted (at least by higher credit quality counterparties) and help dampen the liquidity impact of such proposals. Practically this can be achieved by setting adjustments to the IM based on the credit quality of the counterparty. Our proposal for such adjustments (or threshold factors) are explained in detail in the Summary section A of this paper and below in question 5.

Transactions between dealers/banks only should be treated differently to ensure that a trade initiated by an end-user does not attract more than one set of IMs as the counterparty bank enters into offsetting back-to-back transactions with other dealers/banks to hedge the original transaction entered into with the end-user. If two-way IM is required to be posted at each chain of these transactions, the cost to end-users of using derivatives even for the legitimate use of risk management could be prohibitively high. **It may therefore make sense for banks that are already captured by the Basel capital regime to not be required to post IM when they trade with each other**. We think this is critical to ensure that the IM requirements do not constrain the effective functioning of non-cleared OTC derivatives markets.

However, when banks face non-banking entities they should still be subject to the two-way IM regime.

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

We support the use of thresholds to adjust the initial margins to manage the liquidity impact. We believe however that any **IM threshold approach should be 1) be linked to the credit quality of the counterparty, and 2) be sensitive to the size of the position risk/potential future exposure rather than a fixed notional threshold approach that is insensitive to this**.

The use of appropriate thresholds, taking into account credit quality of counterparty, should reduce risk within the system and therefore will be consistent with the underlying goals of margin requirements. The use of thresholds would not result in a regulatory arbitrage if it is implemented robustly and there are is a common framework agreed internationally.

Our threshold approach is set out in the Summary section A at the beginning of the paper but we repeat the key views below.

For transactions that are not purely between banks, we propose that an adjustment factor (i.e. a 'threshold factor') should be applied to the position risk/potential future exposure (i.e. on the suggested 10-day 99% confidence interval number if a model approach is used, or on the notional multiplied by the factor in the standardised table) to reflect the credit quality of the counterparty. The level of IM that would be required to be posted by a counterparty should equal the position risk/potential future exposure multiplied by this threshold factor. The threshold factor should vary by the counterparty credit quality and could therefore be asymmetrical between two counterparties to a transaction. The factor should be lower for high credit quality counterparties implying a lower required margin to be posted by high credit quality counterparties than low credit quality counterparties.

The difficulty would be in setting the actual level of the threshold factor and in ensuring there was an objective approach to calibrate this to the credit quality of the counterparty. Practically this may be easier to implement using a principles based approach. However if a prescriptive approach is desired by regulators for setting the threshold factors, we suggest that the regulators may wish to consider setting threshold factors based on the type of counterparties, which broadly reflects the credit qualities of those types of counterparties.

We suggest some broad threshold factors below by type of counterparties starting from an assumption/benchmark where banks have a threshold factor of one. *Please note that these are indicative suggestions only. There would need to be some flexibility for different regions to take into account any structural differences in the different markets.*

Based on this approach, the minimum IM that would be required to be posted by a counterparty would equal to the position risk/potential future exposure multiplied by the relevant threshold factor for such counterparty. **Note that we believe inter-bank transactions should be treated differently and it may not make sense to for them to be subject to this two-way IM regime as explained further in the Summary section A of this paper**. **However banks trading with non-bank counterparties should be subject to the two-way regime still.**

Example threshold factors:

- Banks: [1 .0]
    - This is a starting assumption/ benchmark; if it is determined that this factor should be lower, then the others below should also be adjusted accordingly to maintain the ratio.
- Insurers: [0.3]
    - This is on the basis that insurers are typically more stable than banks in a stress scenario given they have less reliance on funding from deposit holders and wholesale market. Insurance policies tend to be more long-term in its nature.
- Pension funds
    - In our view this should be set by the national regulator given that national pension structures can vary greatly between different countries. For countries such as the UK where there is a robust entity set up providing protection to pension scheme in the event of a sponsor default (i.e. the Pension Protection Fund), the threshold factor should be low, e.g. [0.5].
- UCITS using derivatives: [0.5]
- Hedge funds: [minimum 1.0]
- Other funds

- Leverage can vary between funds. The threshold factor should represent the leverage and other risk mitigants of a fund. Low leverage and/or funds retaining strong risk mitigants should attract low threshold factors. High leverage funds and/or funds with weak risk mitigants should reflect a high threshold factor - this may include commodity trading advisors related funds and managed futures fund depending on their specific leverage and risk mitigant characteristics.

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?

We believe that it is appropriate for initial thresholds to differ across different entities, depending on their credit quality. We support a regime where initial margin thresholds can be different and asymmetrical between two counterparties, as long as it reflects their individual counterparty credit quality.

We understand the difficulty in objectively measuring the credit quality of counterparties. Practically this may be easier to implement using a principles-based approach. However if a prescriptive approach is desired by regulators for setting the threshold factors, we suggest that the regulators may wish to consider setting threshold factors based on the type of counterparties, which broadly reflects the credit qualities of those types of counterparties. We provide an example of how this could work in both the Summary section A of this paper and question 5 above.

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 do not agree that initial margin thresholds should only apply to prudentially regulated entities. There are many high credit quality entities that pose less risk than prudentially regulated entities. Pension funds for example, being asset rich, and employing generally conservative investment strategies are normally considered by the market to be of higher credit quality than dealer banks. As such in instances where IM is exchanged, the market practice is for banks to post to pension funds. It would not be appropriate to move to a regime where high credit quality counterparties, such as pension funds for instance, are required to post a greater amount of initial margin than lower credit quality counterparties purely because they are not prudentially regulated and therefore do not have the benefit of applying a threshold. Any IM threshold approach should be flexible enough to link the initial margin thresholds to the credit quality of the counterparty. See our Summary section A for further details on our thoughts here.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts?10 Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

See Summary section A or question 5 above for our thoughts on how initial margin thresholds should work and be set.

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?

Current market practice is generally for counterparties to post variation margin on a daily basis and post one-way IM from the lower credit quality counterparty to higher credit quality counterparty. Typically when pension funds transact with banks where there are provisions for IM, the banks post one-way IM to pension funds (reflecting the lower credit quality of bank counterparties versus pension funds).

The introduction of wide scale two-way IM will have a significant liquidity impact for the market. Please see the Liquidity Impact section at the beginning of this paper for estimations of this.

Key summaries form the Liquidity Impact section:

- The total liquidity impact to the market as a whole could be as high as £100bn to £400bn in extra collateral being required purely to back derivatives used for risk mitigation purposes by the UK pension fund industry.
- The funding cost that banks are likely to pass on to end-users would cost the UK pension fund industry £1bn to £4bn per annum.

This is likely to discourage and potentially prevent pension funds (and other end-users) from using derivatives even for the legitimate use of risk management of their exposures.

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?

As long as the initial margin is held in a secure manner (e.g. in a third party segregated account, or any other similarly robust set up) it would not create or exacerbate systemic risks. There are situations when it is normal course of business for regulated entities such as banks to post IM to non-regulated entities such as pension funds reflecting the fact that pension funds are typically of higher credit quality than banks.

The internal processes required to allow end-users and market participants to support frequent IM posting for non-cleared trades will be significant in terms of operational change and cost. The operational and transit risks (i.e. where the collateral is held during transit) associated with IM posting may increase significantly dependent upon the final solution.

Market participants should be allowed to explore/implement alternative IM structures to reduce operation risk and cost, so long as the key principle to protect IM in a segregated bankruptcy remote structure is maintained. Potential examples may include legal pledging of assets, use of client money rules, etc.

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

Regulators should be aware of an inconsistency between the treatment of non-financials and pension funds which may cause some unintended consequences.

Non-financials are likely to be exempt from the margin requirements of non-cleared trades that are deemed to be hedges, whilst pension funds would not be exempt from margin requirements of non-cleared trades under any circumstance. This could provide an economic incentive for non-financials to keep pensions liability on their balance sheets given that the use of OTC derivatives for the purpose of hedging could be permitted without the requirement to clear. This could disadvantage non-financials that prudently manage these liabilities by transferring the pension fund liabilities into a separate stand-alone entity (such as a pension fund), because these entities would not be able to take advantage of the non-financial exemption, even when used for hedging purposes.

We believe the difference in treatment of the use of OTC derivatives used to manage pension liabilities as described above unfairly favours those non-financials that adopt a less prudent approach to risk management of pension liabilities.

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?

Short-dated foreign exchange derivative contracts of up to three months duration should be exempt. We do not believe that an exemption of these contracts would exacerbate systemic risks because the vast majority of risks within these contracts relate to settlement risk which can be mitigated by other means.

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?

We believe that initial margin methodology should be calibrated to reflect the credit quality of the counterparty. The methodology currently proposed in the consultation does not capture this. Please see Summary section A of this paper for our proposal on this.

Regarding the standardised table versus the model approach we recognise that a simple table approach maybe desirable for smaller institutions that may be unable to implement a model-based approach. Insight would however want to implement an internal model approach to more accurately reflect the risk and take into account netting benefits between the transactions etc. It is important however to ensure that adequate time is allowed for counterparties to build models and get them approved through the regulators before the margin requirements come into effect.

Regarding the model approach, we generally support a one-tailed 99% confidence interval over 10-day approach. In practise we envisage this to work as a value-at-risk model that is based on a non-parametric approach and uses historical data. The advantage of such an approach is that a consistent methodology can be applied across all different market and risk factors. The observation window for the historical scenario needs to be an extended period of time including representative turbulent periods in the market.

Having said that, practically we are concerned that a model approach developed by each market participant (albeit being approved by regulators) would increase the level of IM disputes in the market and reduce price transparency to end-users.

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?

For reasons of practicality, it would appear to us to be sensible to margin instruments at an individual asset class level. It is however crucial to get the correct definition and categorisation of the asset classes. Instruments having a structural or economic relationship between them should be treated as being within the same asset class. As such we would **strongly argue that interest rate and inflation derivatives should be treated as being within the same asset class**.

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 approach as currently proposed would not make sense for options, credit derivatives and other products with asymmetrical payoffs. For these products it is important to distinguish from the buyers and sellers of those contracts. For buyers of credit default swap protection and for buyers of option contracts the IM requirement should be no greater than the present value of the premiums payable.

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 agree with the proposed variation margin approach and the suggestion to post variation margin above a minimum transfer amount to cover for net current exposure (being the net mark-to-market) of the transactions. This is already market practice for most market participants.

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 transfer variation margin once daily.

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?

IM should be collected on an appropriately frequent basis.

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

We use GBP/EUR/USD 250,000 as the minimum transfer amount for variation margin. The minimum transfer amount for IM should however be higher.

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

We agree that as a minimum, cash, government bonds, government guaranteed bonds and central bank collateral should be acceptable as eligible collateral with appropriate haircuts. If a wider list is permissible it would make sense to also include money market funds given their high liquidity and high credit quality.

It is critical that non-cash eligible collateral is permissible for variation margin posting to ensure that these rules to not create a liquidity crisis in the future.

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?

Adding concentration limits could add another layer of complexity which we would view as being undesirable. It may however make sense to have concentration limits for non-sovereign collateral holdings.

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?

Market participants should be allowed to explore/implement alternative IM structures to reduce operation risk and cost, so long as the key principle to protect IM in a segregated bankruptcy remote structure is maintained. Potential examples may include legal pledging of assets, use of client money rules, etc.

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?

It is difficult to envisage how the concept of two-way margin would work on a net basis. Margin on a net basis would be more akin to one-way margin.

Custodian banks covered by robust client protection rules should alleviate any concerns regarding concentration risk of custodian banks so long as the IM is posted in non-cash format. Any collateral posted as IM should be held in an account that is bankruptcy remote, ring-fenced from the counterparty's positions (including the counterparty's house and other clients' positions), and is immediately available upon the counterparty default. A segregated custodian account would be the most obvious choice for this. However there could be cost implications of having to open and maintain separate custody accounts for this purpose.

We would encourage the regulators and the market to consider and develop alternative regimes that allows a more cost efficient model to be developed without using third party custodians whilst not compromising on the risk attributes. The regulators may want to look into the types of segregation models being developed for clearing, which aim to minimise cost whilst not compromising on risk issues, as approaches to be used for non-cleared margin regime.

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?

No comment.

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?

No comment.

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?

No comment.

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?

No comment.

Notes

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