Position of DAI, BDI and VDT on the BCBS/IOSCO Consultation Document on "Margin requirements for non-centrally-cleared derivatives"

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Deutsches Aktieninstitut (DAI)[1], Bundesverband der Deutschen Industrie (BDI)[2] and Verband Deutscher Treasurer (VDT)[3] welcome the opportunity to comment on the BCBS/IOSCO Consultation Document on "Margin requirements for non-centrally-cleared derivatives". Our answers represent the view of non-financial companies using derivatives almost exclusively to mitigate risks related to their commercial or treasury finance activities.

Although we welcome the approach to implement a global level-playing field regarding margin requirements for non-centrally-cleared derivatives, the proposed principles should better take into account the specifics of non-financial companies.

- It should be unambiguously expressed that non-financial companies which are not required to post margins under their respective legislation [e.g. because they do not exceed the clearing threshold of the European Market Infrastructure Regulation (EMIR)], are exempted from the BCBS/IOSCO-principles as well;

- We strictly oppose the requirement to collateralise intra-group transactions as superfluous from an economic point of view and fundamentally contradicting already existing exemptions e.g. according to EMIR;

- Transactions with non-financial companies exceeding the clearing threshold which are used for risk-mitigating purposes should be exempted from the requirements at all, because they do not pose any systemic risk. Additionally, derivative transactions not qualifying as risk-mitigating should not have to be collateralised with initial margins as non-financial companies do not have access to central bank liquidity and/or are typically much more cash-constrained than financial institutions;

- The proposed standards should adequately reflect current collateralisation standards of non-financial companies. Hence, (1) the exchange of collateral should not be required more frequently than once a month, (2) margin thresholds and minimum transfer amounts should be applied and (3) segregation of collateral should not be mandatory. Furthermore, BCBS/IOSCO should refrain

1 Deutsches Aktieninstitut e.V. (DAI, www.dai.de) is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

2 Bundesverband der Deutschen Industrie e.V. (BDI, www.bdi.eu) is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and has 15 regional offices in the German Länder. BDI speaks for more than 100,000 private enterprises – 98 % small and medium sized – employing around 8 million people. Membership is voluntary.

3 Verband Deutscher Treasurer e.V. (VDT, www.vdtev.de) is the official German association of Corporate Treasurers representing more than 950 treasury professionals from 450 companies.

from developing a “one size fits all” approach and should leave details e.g. of the asset classes acceptable for collateralisation and the threshold approach to the discretion of the contract partners;

- We welcome efforts to conduct a quantitative impact study to assess the impact of the proposed margin requirements. Firstly, such QIS should explicitly cover non-financial companies and the impact of the margining requirements to invest in employment and growth. Secondly, the impact on the liquidity of current OTC markets needs to be analysed.

Please find below our answers to selected questions. We would appreciate if you could take our comments into consideration.

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 (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

As only OTC-derivatives not eligible for clearing have to be collateralised bilaterally both obligations are closely linked. Therefore, both timelines should be coordinated in a manner, that margin requirements will not be mandatory until competent authorities will have determined the clearing eligibility of at least certain classes of derivatives. It should be avoided that market participants will have to adjust their practices twice in a short period of time: to implement bilateral margining in the respective contracts and to novate the same position to the CCP, shortly afterwards.

Furthermore, an appropriate phase-in period for the transposition of the margin requirements should ensure that affected non-financial companies, most of which do not collateralise their derivatives so far as a standard, have sufficient time to implement the respective processes.

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?

We support the general view that the above mentioned instruments should be exempted from the margining obligation as the counterparty credit risk involved is very small (due to the very short average maturity of the contracts) and settlement risks are very well addressed especially through the widespread use of payment-versus-payment arrangements. This would also contribute to a global level-playing field and avoid regulatory arbitrage as for example the U.S.-legislator has also proposed such an exemption.

The exemption should not be restricted to a specified tenor as this will lead to an artificial accumulation of FX swaps and forwards with a maturity just below this tenor. For example, limiting the exemption to a 365 day maturity will lead to an accumulation of activity in instruments with a tenor of 364 days. Hence, the exemption should simply be defined per product type.

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?

The beneficial effects of derivates used by non-financial companies to reduce risks related to their commercial or treasury financing activity are commonly acknowledged among regulators and are reflected in certain legislations, e.g. EMIR and Dodd-Frank. As a negative market value of the derivative is offset by a positive performance of the underlying exposure from operative business (and vice versa) the total risk arising from that constellation is almost zero. From an economic point of view derivatives used for risk mitigating purposes by non-financial companies do not increase their counterparty risk and do not endanger the stability of the financial system. On the contrary, they increase the ability of non-financial companies to plan ahead and, by reducing income volatility, thus stabilising their credit standing. Therefore, these risk-reducing instruments should be exempted from the margin requirements (see our answer to Q4). As counterparties will be obliged e.g. by EMIR to report whether the individual transaction is “risk mitigating” (or not) supervisory authorities are enabled to identify such collateral-free transactions in practice.

In addition, as intra-group transactions do not increase the risk position of the whole group it is inappropriate to require margining for these transactions. This obligation would also contradict already existing legislations, e.g. EMIR, where intra-group transactions are exempted from the clearing and the margin obligation subject to certain conditions (see our answer to Q26).

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?

In order not to contradict already adopted derivative market legislation like EMIR and Dodd-Frank it is of utmost importance that non-financial companies which are not obliged to centrally clear their derivatives should not be required to post margins bilaterally as well. This should be a core principle of the proposed standards and unambiguously expressed.

Furthermore, the margin requirements should adequately reflect the specifics of non-financial companies. Becoming obliged to post margins, e.g. after exceeding the clearing threshold, does not imply that the respective derivative portfolio of non-financial companies would mainly consist of “speculative” contracts. On the contrary, non-financial companies will continue to apply derivatives to reduce risks related to their operational activities. As mentioned above, risk-mitigating derivatives do not constitute any risk for the stability of the financial system.

One has also to bear in mind that non-financial companies are much more cash-constrained than financial counterparties as they – inter alia – do not have access to central bank liquidity. As a result, capacities to collateralise derivative transactions are limited. Additionally, the cash which has to be delivered as collateral will no longer be available for operative purposes. Therefore, any obligation to collateralise derivative transaction will restrict the non-financial companies' ability to maintain or even expand their businesses and thus create new employment opportunities, so that the potential negative macroeconomic impact of an overly demanding collateralisation regime should also be taken into account.

In addition, while systemic risk might be reduced in financial markets as a consequence of the obligation to collateralise non-cleared transactions, for non-financial companies the costs for risk-mitigating derivatives will increase significantly. Regulators should also pay attention to the interplay with other regulatory initiatives. Especially the charges for CVA-risks in the Basel III accord will require banks to put aside a notably higher amount of risk capital for non-cleared OTC transactions. This will be passed on in pricing and lead to another significant increase of costs for non-financial companies, while reducing the availability of derivatives overall. All of this will lead to reduced hedging activities by non-financial companies, keeping more risk on their balance sheets. Thus, the benefits related to a perceived reduction of systemic risk might be fully offset by the increase of unhedged risks.

Because of the lower risk of a large part of the derivative transactions in question and also in order not to inappropriately overstretch liquidity reserves, risk-mitigating derivatives of non-financial companies obliged to centrally clear should be exempted from the margin requirements generally. At the very least, all derivative transactions of non-financial companies should be exempted from the obligation to exchange initial margins. This would reduce the negative effect on liquidity and would also reflect current (bilateral) market practice.

Although bilateral margining is not wide-spread, in some cases variation margining already takes place between non-financial companies and their counterparties. The standards for margin requirements to be defined by the BSBC/IOSCO should reflect these usances:

- On the basis of the mark-to-market exposure the exchange of collateral with a specific counterparty takes place on a regular basis (usually monthly). The exposure per counterparty is calculated on a net basis;

- Collateral is only transferred if the mark-to-market net exposure exceeds bilaterally agreed thresholds;

- Counterparties usually agree on minimum transfer amounts to avoid multiple transfers of an insignificant amount of collateral;

- Collateral received is not segregated from other assets as it is not necessary from a risk management perspective. Furthermore, the specific costs to open an omnibus account with their commercial banks to segregate collateral received and the administration of the accounts, in order to make sure that positions are allocated correctly, are very high.

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?*

To avoid a severe liquidity impact non-financial companies should not be obliged to post initial margins at all (see our answer to Q4). If BSBC / IOSCO adhere to initial margin requirements thresholds for non-financial companies should be calibrated on a very high level to avoid unacceptably high negative liquidity effects.

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?

Non-financial companies should not be required to post initial margins at all (see our answers to Q4 and Q5).

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?

As regards our view to initial margins and thresholds please refer to our answers to Q4 and Q5.

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

The thresholds should not be determined on a "one size fits all" basis but should leave sufficient discretion for the contract partners to appropriately consider the creditworthiness of the counterparties individually and existing limits. Calculation methods available under the standards should range from relatively simple standard approaches to more sophisticated internal models, as especially non-financial companies will presumably use more simple models.

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?*

As mentioned in our answer to Q4 overly ambitious margin requirements will negatively impact non-financial companies' ability to invest and to preserve employment. This is one reason why bilateral collateralisation is not a widespread practice among non-financial companies. Nevertheless, some firms collateralise parts of their derivative portfolios by exchanging variation margins (see also our answer to Q4). We strictly oppose mandatory initial margining.

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?

To oblige banks to additionally post initial margins to unregulated counterparties will increase prices and reduce availability of derivatives without enhancing the stability of the financial system, at least as far as corporates with their low-risk business models are concerned (see our answer to Q3). Both would exacerbate such negative tendencies that are already observable in the derivative markets and which are closely linked to current regulatory initiatives. For example the Basel III accord requires inter alia regulated entities to back CVA-risks related to OTC-derivatives with bank capital which causes the above-mentioned effects on costs and availability.

As a consequence, non-financial companies will tend to hedge less their business risk which in turn will increase risks for the economy as a whole. Therefore, requiring regulated entities to post initial margins to unregulated counterparties is without benefits and very cost-intensive.

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

Yes, non-financials' exemptions from clearing and margin requirements can be found in several derivative market regulations (e.g. EMIR and Dodd-Frank). These exemptions reflect the view of regulators that derivatives of these market participants are not of systemic relevance.

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?

Please refer to our answer to Q3.

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 use of internal models for the calculation of *variation* margins makes sense as models and their parameterisation for the majority of products traded are sufficiently standardised and accepted among market participants. We strongly doubt that this holds true for the calculation of *initial* margins. The exposure to be considered for the calculation of initial margins is a VaR-type quantity and thus modelling this requires the definition of volatility and correlation measures and choosing a suitable price dynamics. Therefore, it seems reasonable that different counterparties model the exposure differently and thus the outcome would most likely cause disputes over the initial margin amounts.

Bearing these arguments in mind a standardised schedule for initial margin calculation should be the rule for both counterparties of a CSA – if not agreed otherwise.

Furthermore, as footnote 13 indicates netting must at least be allowed for (a) long and short positions on the same product and (b) positions in highly correlated products (e.g. in basis swaps or time spreads). This is something which BIS must specify further.

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?

Compared with models already used by market participants' initial margin levels of the proposed standardised schedule are much too high. Therefore, the standardised schedule should be adjusted to adequately reflect current market practice.

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?

All netting and diversification effects should be acknowledged in the calculation of the variation margins without limitation. This would reflect current market practice and the realistic amount of risk involved.

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?

A daily exchange of collateral should not be mandatory for non-financial companies. A monthly exchange would better reflect current market practice and would be sufficient for the future as well.

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

In order to limit operational costs we welcome the approach to provide a minimum transfer amount below which the exchange of collateral is not mandatory. Nevertheless, the determination of the concrete amount should be left to the discretion of contract partners taking into account common market practice and the creditworthiness of the counterparty.

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

The determination of asset classes acceptable for collateralisation should take into account that non-financial companies do not have access to central bank liquidity. Therefore, the counterparties should be provided the flexibility to agree on different types of collateral they regard as appropriate to effectively mitigate the risk related to the transaction. In particular, it is important to acknowledge bank guarantees as collateral, as provided in EMIR to secure derivative transactions settled by CCPs. Furthermore, acceptable collateral should include tangible assets (e.g. inventory, real estate etc.), which are already used in bank lending. In order to acknowledge the uniqueness of every transaction, supervisory authorities should refrain from developing an exclusive list of eligible collateral.

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?

A segregation of collateral would not be feasible for non-financial companies due to a loss of liquidity, massive administrative burden and therefore additional costs. Therefore, segregation should not be mandatory for non-financial companies.

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 described in our answer to Q4 non-financial companies collateralise, if at all, their derivatives on a net-basis. This practice should be preserved in future.

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 mentioned in our answer to Q22 we oppose mandatory segregation which would prevent re-hypothecation and would result in a massive liquidity drain. Therefore, assets should be allowed to be re-hypothecated.

Q25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in *determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

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

Our answer refers to Q25 and Q26. For two reasons we strictly oppose margining of intra-group transactions.

Firstly, intra-group transactions of non-financial companies are mainly used to centralize treasury and risk management services on the group level. As a result, external transactions providing the required market risk coverage are concluded on the central treasury level, and are then redistributed internally to those operative entities that requested to be hedged. Therefore, internal deals act as mirrors of the external transactions and do not affect the net risk position of the entire non-financial group; at group level the risks are compensating each other: Potential losses of one group member are potential gains of another. In addition, in multi-level organizations with profit and loss sharing or even cash pooling agreements in place any collateral posted by the entities would finally end up at the ultimate holding level again anyway. Furthermore, a centralised treasury management is a very efficient tool to decrease the credit counterparty risk as only the net risk position of the whole group is hedged by derivatives with external counterparties, i.e. banks. It also increases the effectiveness of internal control, as the number of counterparties acting in markets is reduced. These favourable structures are at risk if internal collateral would need to be applied. Therefore, from an economic point of view collateralisation of intra-group derivatives is unnecessary and counterproductive as it will discourage companies to centralise their risk management and increase their credit counterparty risk.

Secondly, this proposal is also not reasonable from a legal perspective as it would contradict Art. 11 EMIR which exempts intra-group transactions from margin requirements under certain conditions.

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?

To ensure the global compatibility of the margin rules is an important yet only one aspect which should be considered in the cross-border environment. Other barriers, which thwart a coherent global implementation of the margin regime, are significant differences in national bankruptcy legislation which are very likely to hinder the timely recovery of collateral by non-defaulting parties.

In any case, the effectiveness of a cross-border margin regime severely depends on a harmonised legal regime which guarantees the immediate reflux of collateral in insolvency cases. However, we doubt that this is already the case or can be achieved in a short period of time.