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MARGIN REQUIREMENTS
FOR NON CENTRALLY-CLEARED DERIVATIVES

A CONSULTATIVE DOCUMENT
JONTLY ISSUED BY BCBS/IOSCO

AFG comments to BCBS/IOSCO's consultation paper on margin requirements for non-centrally-cleared derivatives

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The Association Française de la Gestion financière (AFG)[1] welcomes BCBS/IOSCO's consultation paper on margin requirements for non-centrally-cleared derivatives.

1. General discussion on the principle of initial margin

AFG is concerned that the proposal for payment of initial margin will be extremely complex and difficult and costly to implement. However, if payments of initial margin are retained, we believe that regulated funds (for example, UCITS and AIF) should either be exempt from paying initial margin, or if they are not exempt, be treated as "prudentially-regulated entities" with a high threshold amount, as for banks.

Indeed, Initial margin is introduced to prevent a risk of delay in undoing a position held with a defaulting counterparty; the idea of introducing a threshold under which counterparties could decide not to call initial margin is very efficient to keep a focus on actors presenting a potential systemic risk.

In addition, even if not called prudentially regulated entities (PRE), funds are heavily regulated and closely supervised entities which present a level of risk far lower than any PRE as (i) their leverage, if any, is limited and (ii) all their assets guarantee counterparties (which are senior to share or units holders) and represent intrinsic collateral; they should benefit from the largest threshold of all institutions.

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups. AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

More precisely, our analysis is as follows:

- Payments of initial margin

By principle, we are not convinced that the system of payments of initial margin proposed in the Consultative Document is workable, for the following reasons:

  - Initial Margin is not currently market practice. In general, counterparties only require the payment of variation margin and it works so far;
  - An automatic requirement for both parties to pay initial margin makes no sense for certain transactions, such as options, given that there is no counterparty risk for the buyer;
  - In practice, it may be difficult to ensure that the non-defaulting party actually recovers the margin paid to the defaulting party. This could involve lengthy delays and legal action;
  - It will be difficult to calibrate the thresholds of initial margin posted by counterparties of very different creditworthiness;
  - If certain market participants are exempt, this would give rise to incongruous situations, such as a major international bank making a one-way payment to a small, risky corporate. It is likely that banks would simply stop trading in such situations, thus preventing the corporate from appropriately hedging its risk.

Obviously, initial margin is intended to cover counterparty risk and variation margin is intended to cover market risk. However, if the philosophy is to provide for reasonable, not perfect, coverage it would be far simpler and almost as effective to reinforce the variation margin requirements.

- Initial Margin with respect to regulated funds

Funds which limit their global exposure to derivative instruments to their total net asset value, as is the case for regulated funds, do not present any systemic risk.

Moreover, Net Asset Value (NAV) are calculated on a marked to market basis with a daily publication .Thus, Regulated funds are more transparent than most financial institutions.

Regulated funds are subject to very stringent rules that ensure that they will not default, thus providing a very high level of investor protection. For example, the following rules apply:

- Diversification rules for investments and limits on the underlying assets for derivatives;
- Counterparty risk limits (e.g. a regulated fund shall not have an exposure on derivative transactions of more than 10% of its assets to a single counterparty);
- assets of regulated funds are separated from the management company's balance sheet;
- an independent custodian/depositary oversees the activity of the manager and safeguards the assets;
- the manager is required to develop risk management processes with respect to conflicts of interest and processes for managing liquidity risk in order to ensure that the funds it manages are able to meet redemption requests from investors.

As a result, such funds are not subject to bankruptcy and pose very little systemic risk.

Please note that current market practice is not to require that regulated funds post an independent amount; they post variation margin only. This reflects the extremely low risk of default of regulated funds and AFG believes that this should be taken in the proposed regulation.

For these reasons, we believe that regulated funds should be exempt from posting initial margin.

If, however, initial margin is to be posted by regulated funds, we believe that such funds should be considered to be *Prudentially Regulated Financial Counterparties (PRFC)* and that consequently a higher threshold amount (similar to the threshold applied to banks) for initial margin should apply.

Regulated funds tend to use derivatives for hedging rather than for taking positions. Applying a high minimum threshold amount would allow these funds to continue to engage in this activity without incurring excessive cost and would limit the negative impact of initial margin requirements on their liquidity.

Last but not least, requiring that they post large amounts of initial margin would have a direct effect on their performance as assets used for collateral cannot be invested elsewhere. It is important to remember that many of these funds are pension funds, mutual funds or life insurance products which are ultimately held by retail investors. Is the best use of the assets of the fund to be posting collateral for defaults which rarely occur, and which have very little impact on the financial sector, or to improve performance for investors?

More specifically among regulated funds, the structured funds present different specificities that make them even more eligible to an exemption or, at least, to a higher threshold amount.
First, they are usually guaranteed by a bank or a banking organization that is itself considered as PRFC. In addition to all aforementioned arguments stressing the fact that regulated funds pose very little systemic risk, structured funds can rely on this guarantee in worst case scenarios.
Secondly, the majority of these funds display a 100% guarantee, implying for the OTC instruments in which they invest to present a near to zero risk for the counterparts and making thus Initial Margin, and even Two Way Variation Margin in some case, irrelevant

2. <u>Other general comments and issues</u>

- As provided for in EMIR regulation in Europe, existing derivative instruments should not be retroactively concerned by new regulation as their economic conditions may just be impossible to maintain with the constraint of a collateral; a **grand fathering clause** is absolutely necessary to exempt existing transactions from collateral requirement even in case of reset lowering risk (to clear excess counterparty risk or to diminish notional amount, for example).

- Risk on derivatives is firstly linked to the structure of the derivative instrument and its underlying : if the value of the derivative does not move there is no risk whatsoever; secondly counterparty risk is key when examining non centrally cleared instruments: if the counterparty is good enough not to default there is no risk whatever the evolution of the price/payoff of the instrument; this counterparty risk can be mitigated by collateralisation and it is not relevant to focus too much on the rules of **collateral which is only a peripheral level of risk.**

- Reference to **model approved** by supervisory authority should be authorised to be used by both sides of a transaction (bank and client) so as to converge on the margin requirements.

- Exchange of margins on a gross basis is both inadequate in reference to risk involved and difficult and costly to implement; **net margining seems more appropriate**.

- It is not the re-use of collateral itself that should be forbidden but its excess; thus regulators should limit leverage due to these techniques and allow a **reasonable use of re-use (**or re-hypothecation) in some instances (for example in case of back to back transactions).

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Many other remarks on level of collateral or haircut, criteria of eligibility or access to models… will be expressed when answering the questions.

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?

Operationally the introduction of systematic collateralisation means an important investment within asset management companies and that type of project implies delays. AFG suggests to authorize, for non-large market players as asset managers, a delay running till the end of the following calendar year after final publication of the requirement for collateral to implement a new system, (to be in accordance with budget procedures and allow for legal documentation and tests). Thus a publication in 2014 would lead to a mandatory implementation at the end of 2015. Indeed, we are of the opinion that the determination of extensive phase-in periods (minimum two years from first publication of the relevant BCBS and IOSCO recommendations) is key for a successful implementation of margin requirements on non-centrally cleared derivatives. BCBS, IOSCO and subsequently regulators globally should recognize that the new measures with respect to mandatory bilateral collateralization will significantly change existing practice in the OTC derivatives' world. New regulations to be applied will request from market participants beforehand to renegotiate and amend their existing OTC derivative documentation, to arrange for new contractual relationships (for example with third party custodians) and to (re)build the operational environment ensuring new margining processes.

AFG thinks that the appropriate timing is to start with centrally cleared operations and initiate mandatory collateralisation on non-centrally cleared operations afterwards: as these operations are defined by exclusion as not eligible to central clearing (which has to pre-exist). Otherwise, there would be a terrible rush on collateral due to the fact that all operations should be collateralized at once and to a higher degree than eventually required, simply by lack of recognised CCPs. How much later should the collateral requirement on non-centrally cleared operation start? Shortly, is the answer and in practice it means within a delay of 6 to 12 months after central clearing started with authorised CCPs which is operationally a minimum delay to get organised and supposes that legal standard documentation will be available beforehand. These procedures, when operational, could afterwards help with organising collateral on non-centrally clearable derivatives.

Attention should be drawn to the exemption for operations that are due to be centrally clearable within a short delay where the collateral obligation should be established with reference to CCPs practices.

AFG would also like to draw your attention to the need for a grandfathering clause:

- for existing contracts, as such contracts were entered into without taking into account additional capital costs or margin requirements; this exemption would last as long as the deal is not modified (except changes aiming at lowering the risk, be it through notional amount diminution or reset to lower counterparty risk…).
- for the transactions entered into by the structured funds (i.e. formula funds, funds with capital guarantees, …) in order to avoid any negative effect on the performance that was guaranteed to the unit holder when the fund was launched. Indeed, the economic balance of those funds is ensured at the inception of the fund, leaving no room for additional/ exceptional costs without lowering the expected return for the clients.

AFG would like to stress that as there is interaction between regulations, the regulatory initiatives must be coordinated. The impacts on liquidity and on OTC derivatives markets in general by the different risk mitigation rules and regulations currently under way are not fully assessed yet. Hence uncoordinated implementation could be detrimental to overall goals of risk mitigation. A step by step implementation commencing with central counterparty clearing and trade reporting requirements seems recommendable before starting to implement bilateral margin requirements. Also in order to avoid regulatory arbitrage it seems necessary to give regulatory bodies globally a realistic time horizon to coordinate their measures.

Element 1: Scope of coverage – instruments subject to the requirements

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

Yes, AFG support the view that below a certain maturity, foreign exchange swaps and forwards should be exempted from margining requirements. Foreign exchange is probably the most liquid of all markets. And derivatives as swaps and forwards on forex are also very liquid on most currencies. On smaller currencies also local banks are often very active. Thus, initial and variation margining should be left to the appreciation of the counterparties and not regulated.

More precisely, a distinction should be made between:

- Initial margin: foreign exchange swaps and forwards should be exempt from initial margin requirements regardless of maturity.

  For certain AFG members portfolios using foreign exchange swaps, systematic exchange of IM would undermine the performance roughly by 3 bps.

  It is also worth noting that such transactions are usually hedges.

  This exemption could represent for all our industry a substantial saving of liquidity, especially if re-use of collateral is limited as repo and security lending transactions.

- Variation margin: variation margin should apply to foreign exchange swaps and forwards having a maturity of more than a year. These transactions do not present significant counterparty risk to market participants and are not likely to be a source of systemic risk. Variation margin is already paid on these transactions, and we do not believe it is advisable to change this practice.

  On these transactions, settlement risk can be mitigated thanks to the use of appropriate platforms. For instance, CLS allows real-time settlement between counterparties for each pair of matched instructions by matching the corresponding debit and credit entries across the Settlement Members'. The development of such platforms offers an alternative to systematic exchange of Initial Margin by limiting systemic risk.

  The experience of certain AFG members shows that maturities below 3 months (meaning 97 days) represent close to 90% of positions existing in the funds and 1 year more than 99%. Current practice is to roll positions regularly but not to often to avoid constraints on delivery limits. We suggest that 1 year is a proper limit for exemption and stress that, in any case, it would not be efficient to introduce a limit shorter than 3 months.

Please note in addition that, as these products are expected to be exempted from margining requirements in the US the same approach should be adopted in other jurisdictions to avoid regulatory arbitrage.

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?

Yes, we consider that there are other exemptions from margining requirements that appear totally justified. First, and this applies to all products, there is a threshold of materiality under which there is no risk of systemic scale. Furthermore, existing deals should benefit from a grandfathering exemption of collateral as long as they exist and even if they are reset in a manner that does not increase the total exposure of counterparties.

The main criterion to be considered when exempting some products from margining requirements is liquidity, firstly, of the underlying instrument and, secondly, of the specific derivative. Vanilla IRS (which are supposed to be centrally cleared though) are so actively traded that initial margining does not increase substantially safety and may even introduce unnecessary operational and counterparty risks.

Another sensible approach links margin requirement to risk incurred. For example derivatives aiming at hedging existing risks in a portfolio should, following that approach, be exempted from initial margin requirement as well as investors buying call options; and a counterparty that guarantees the payoff of a derivative it writes to a fund should be authorized not to call margin on its own risk of signature.

As mentioned above, transactions entered into by structured funds that benefit from an external guarantee should also be exempt from posting initial margin. First, these funds are guaranteed by a bank or a banking organization that is itself considered as PRFC. In addition to all aforementioned arguments stressing the fact that regulated funds pose very little systemic risk, structured funds can rely on this guarantee in worst case scenarios.
Secondly, the majority of these funds display a 100% guarantee, implying for the OTC instruments in which they invest to present a near to zero risk for the counterparts and making thus Initial Margin, and even Two Way Variation Margin in some case, irrelevant

Element 2: Scope of coverage – scope of applicability

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?

We totally agree with the key principle as it is expressed. It refers to the notion of appropriateness to the risks and we understand that appropriate margin requirement might be zero in some specific instances. It clarifies the point that for an asset manager the principle applies at the level of each fund. The proposed requirement adds the ideas of regulatory minimum amounts and of bilateral exchange. As explained later, the requirement is more specific as it demands that gross amounts, which may be different for each counterparty of the same deal, have to be exchanged on a segregated basis.

However we feel that the principle should be posed that Funds under 1 billion € of assets or 1 billion of notional amount in derivative present no systemic risk and are exempted from the scope of the proposed regulation.

In addition, it is vital that the methods for calculating and valuing initial margin be harmonised (please refer to our answer to questions 13 to 15 below). It would be easier for counterparties to post and collect initial margin based on a standardised model of calculation and threshold.

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?

Margin threshold is a highly relevant tool to deal both with the efficiency of the regulation in terms of systemic risk and the liquidity impact of mandatory collateralisation. It is clear that smaller participants will not have any impact on the broader view of a systemic risk analysis. In any case, all transactions will be reported to the Trade Repository and enable regulators to react if needed.
The balance between efficiency, cost and liquidity impact leads to recommend the introduction of a margin threshold. This threshold allows counterparties to decide not to call margin, it does not forbid them to decide otherwise according to their risk policy. This practice will probably incentivise counterparties to develop best practices in order to benefit from this possibility not to exchange margin below the threshold. It should however clearly be specified that in terms of capital requirements, banks that do not call margins below the threshold should be deemed collateralised and then not penalised. Otherwise the threshold exemption will never be used. As a consequence the threshold exemption must be strictly defined and reserved to situations of minimal risk.

Limited in amount and restricted to certain entities, a threshold will be totally consistent with the goals of the regulation to promote stability and safety on derivative markets and thus reduce systemic risk. AFG recommends that a two level threshold be introduced with a level of 500 million € of initial margin for entities with the lowest level of risk. Then counterparty could decide not to call the first 500 millions of initial margin theoretically callable from a Fund when adding all the different non-centrally cleared derivatives in all different broad asset classes.

Please note that AFG consider that a threshold based on Initial Margin requirements rather than notional amount is more conservative and does create an incentive for more risky products such as Equity or Commodity derivatives

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?

AFG is in favour of a restricted approach when defining who could benefit from an initial margin threshold. The aim is clearly to avoid systemic risk to develop on derivative markets. Thus there should be different levels of threshold depending on the level of supervision and risk control requirements applying to each. First the threshold for non-regulated or supervised entities should be low so as to allow a minimal activity on derivative markets. This threshold should be consistent with the level of exemption of central clearing applying to non-financial entities under EMIR (1 billion notional value for each of credit or equity derivatives, 3 billion for each of IRS, FX or commodities) with a view not to favour not centrally cleared transactions. For regulated and strictly supervised entities the threshold should allow transactions with no material impact on systemic risk level and be 5 or 10 times higher due to the risk control skills of the entities. With respect to SIFIs it is our understanding that closer supervision and higher capital requirements sufficiently reduce systemic risk not to impose a lower threshold to them that would bias competition among market participants. Thus AFG supports the mechanism as it is developed in example 3 of the paper with two levels of threshold. For funds, AFG suggests that the threshold be positioned at 500 millions €.

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?

When mentioning prudentially regulated entities as banks the consultation paper (p10) aims at defining “participants (that are) better equipped to manage the risks of non-centrally cleared derivatives and/or absorb the losses associated with any realised counterparty default”. Banks are not the only entities that meet that requirement and in terms of risks, the asset management industry is far less exposed. Funds are managed by authorised fund managers that must develop a risk control function totally independent from the fund management activities; moreover they are not enabled to over-leverage their positions (not more than to a 200% exposure for UCITS) and they only invest the capital they have received from investors. We suggest that all funds which cannot exceed a leverage of 2 should be considered as prudentially regulated entities with respect to threshold. Funds are closely supervised by their national regulator and must comply with a full set of strict regulation (UCITS and AIFM directives in Europe) requiring for example diversification, limits on the level of risk exposure, an active risk management and risk control. Moreover valuation is the most common exercise for a fund manager as it must publish a controlled NAV on a regular basis, i.e. daily in most cases. Furthermore funds are controlled not only internally by the management firm but also by their depositary and external auditor and submitted to a close supervision by the regulator. It is arguable that funds are far less risky than banks and should benefit from a larger threshold. Lastly, all the assets of a fund represent intrinsic collateral for counterparties since counterparties are senior to unit- or share-holders of the fund.

Then AFG suggests that prudentially regulated entities include strictly supervised entities and that regulation specifically mention funds, at least funds that cannot exceed a leverage of 2, as beneficiaries of the largest level of threshold.

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?

From an intellectual point of view it is highly coherent to express the threshold applying to an initial margin requirement as an amount of this margin requirement. From an operational point of view any other suggestion seems very difficult to implement. As a matter of consistency, it is advisable that the counterparties which agree on the computation of the amount of initial margin use the same method when applying the threshold. Thus using internal model is a current practice that should be maintained as long as the models used satisfy both supervision bodies and counterparties. It would be inconsistent to ask banks to monitor their prudential requirements with another tool than the calculation of margin requirements on derivatives.

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?

First, AFG would like to express its real concern that the industry of asset management will face very important operating costs and accrued operational risk if forced to implement two way margining system on a gross basis. When compared to the level of risk really existing on Funds presenting a leverage of less than 2 the requirement seems very disproportionate and unbalanced. The current practice of most asset managers is to organise for variation margin calls on a frequent basis, usually daily, and with a low minimum transfer amount (MTA). As to initial margin, it is not their current practice to ask for it and reversely to post any. The only acceptable way would be to operate a balanced two-way margining system where net amount is exchanged.

Secondly, considering that universal two-way margin will also have a positive effect on systemic risk by ensuring that the risks associated with non-cleared OTC transactions are covered if a counterparty defaults, AFG suggests, in order to ensure a higher degree of protection, investigating whether collateral could be posted to a third party, in order to avoid the problem of recovering collateral from a counterparty in default. The clearing houses could be well positioned for offering such a service, independent of their clearing business. The costs of having a third party custodian could be offset by reducing the initial margin for both parties.

This third party could also be the fund's depositary. Indeed, as a fund's account is open with a depositary which is a bank usually not active as counterparty for derivative transactions, choosing the depositary of the fund as third party for initial margin deposits could also be acceptable and workable even if depositary and fund manager are affiliates of a same financial group. Initial margin requirements revisions should, as well as variation margin calls, be subject to a MTA. These new practices will require a new negotiation of contracts with counterparties and amendments to the agreement with the depositary (among others, to deal with potential conflicts of interest).

However, AFG wishes to stress that universal two-way margin would be far from neutral for markets participants in terms of liquidity, operational impacts and cost.

On liquidity, universal two-way margin will have a major impact on most market participants. More precisely:

- Sourcing margin will be a major issue for UCITS, as structurally they do not have access to large pools of cash and are required to invest most of their assets. Especially if the practice of collateral re-use received under others transactions is forbidden.

- From an operational perspective, implementing universal two-way margining will constitute a challenge for all concerned entities as internal systems, tools and processes will need to be altered or even replaced in order to take into account new workflows, calculation models etc. Depending on the existence of one or several calculation models and on how accurate definitions of haircuts, threshold etc. will be, the risk of dispute between parties may rise significantly.

- Also, we need to consider the costs entailed by the implementation of universal two-way margining. As this stage, it is difficult to evaluate these costs but they will be mainly due to lost investment opportunities and the operational changes.

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?

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

Q12. Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?

Q 10 /Q 11/Q12: Regulated entities – non regulated entities

Firstly, please note that AFG considers that the proposal by which regulated entities post initial margin to unregulated counterparties would give rise to incongruous situations, such as a major international bank paying initial margin to a small, risky corporate. It is likely that banks would simply stop trading in such situations, thus preventing the corporate from appropriately hedging its risk.

In addition, when non-prudentially regulated entities start to experience difficulties, this proposal would accelerate their default by increasing their margin.

Furthermore, AFG insists on Funds to be considered as regulated entities in respect of exchange of collateral.

AFG insists also on the fact that funds with a leverage limited to 2 are highly regulated and closely supervised, are far less risky than banks and other financial or non-financial entities and should benefit from the highest level of threshold.

Another point is that AFG thinks that Hedging transactions should exempt the entity pursuing its hedging objective to post initial margin.

As a summary, AFG considers that the following points justify an exemption for funds:

- Regulated funds present no or only low systemic risk;
- Funds (especially UCITS or UCITS like) are tightly regulated with hard constraints in terms of leverage, diversification and counterparty risks preventing it from bankruptcy, limitation on global exposure relating to derivative instruments and counterparty risk limits;
- Funds hold balance sheet assets (capital) available to absorb loss due to a default of counterparties and protecting its counterparties against default.

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

As a general comment on this issue, AFG would stress the following point of view:

It is stated that the methodologies must "ensure that all exposures are covered fully with a high degree of confidence".
However, the VaR proposed by IOSCO is significantly more onerous than the VaR proposed by ESMA for the CCPs. Thus, we are concerned that the margin system being proposed is intended to cover all risk that market participants have with their counterparties.
Indeed, IOSCO consultation proposes a model-based approach does not appear with a one-tailed 99 per cent confidence interval over a 10-day horizon. These parameters are not consistent with the ESMA consultation paper, published on June 25th and named "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", in which the ESMA suggests European CCPs to set up a a one-tailed 99,5 per cent confidence interval over a 5-day horizon for their models.

For more consistency, the Initial Margin computation should use the same parameters for a model-based approach whether the contract is cleared or not. So, we suggest an alignment on the parameters applicable to European CCPs.

In our view, the philosophy should be to aim for reasonable, not perfect, coverage, for the reasons set out below:

- Capital requirements have been or will be significantly reinforced, thus reducing default risk for a large number of market participants (particularly banks under Basel III and insurers under Solvency II);

- o It would be preferable for the economy, particularly in times of recession, for assets to be used in financing the economy instead of lying dormant in collateral accounts;
- o Collateral requirements are likely to have a significant impact on market liquidity;
- o If margin requirements are too onerous, we are concerned that market participants will be less likely to prudently hedge their risks.

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?

AFG believes that the best solution should be a single model for calculating initial margin which is approved generally by the market, for a number of reasons:

- If counterparties to the same trade have different models, there will be continuous disputes about the amount of initial margin to be posted;
- Regulators do not necessarily have the resources to approve different internal models: this has been a problem with Solvency II, for example;
- Regulators in different jurisdictions are likely to have different approaches to internal models, thus exacerbating the differences between cross-border counterparties to the same trade;
- There is no incentive for market participants to develop internal models if they must be at least as conservative as the standard model.

Perhaps ISDA could propose a model to the market and to regulators for approval.

However, AFG is fully aware that such a solution could need a certain period of time to be implemented.

Then, in the meantime, we could say that the two suggested possibilities for computation of initial margin offer a welcomed diversification. As mentioned in the consultation paper, internal models should be approved by supervisory authority and subject to strict internal governance. This requirement is not appropriate for asset managers as, concerning derivatives, on one hand they are organised with a view to challenge prices communicated by counterparties which is not the same as producing prices with a view to trade and on the other hand the competent authority may not have the experience nor the necessary staff to validate models. Moreover there is a risk of breach of fair competition if local authorities do not rely on the same approach to validate models.
AFG suggests the following for the transition period : a fund should be authorized to rely on the computation of initial margin done according to an authorised model developed by its banking counterparty, or a third party, provided that the fund manager challenges this calculation (as is the case for NAV publication). Securities market and banking authorities would simply have to agree to a reciprocal recognition of their validation.

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?

AFG is not opposed to the segregation of broad asset classes when implementing netting of margin requirements. But, here again, a consistent approach with prudential requirements of banks seems appropriate and stable long term correlations are usually considered as relevant.

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 simple enough to be transparent and easy to understand. It should not multiply asset classes. The level of initial margin expressed as a percentage of notional exposure is expected to be conservative and may seem overly so when considering the fact that the aim of the initial margin is to allow for the time to unfold an existing transaction which may be rather short for many liquid derivatives (IRS or FX for example).

In addition, AFG would remind that the proposed initial margin levels are higher than those used in common industry practice and do not differentiate whether the transactions are entered into for hedging or speculative purposes. We ask the BCBS and IOSCO to exempt hedge transactions from the initial margin requirements and we would also request that the proposed percentages be reduced in a manner consistent with current market practice without compromising the goal of promoting central clearing. As regards the initial margin level for credit derivative transactions, we request that a distinction be established based on the status of each party to the transaction (i.e. protection buyer or seller), so that the risk generated by each party to such transaction is properly taken into account.

We also ask that the BCBS and IOSCO exclude plain vanilla option transactions from the initial margin requirements, as the premium paid under such transactions are already designed to cover the same risk. We also ask that the BCBS and IOSCO clarify the difference between the initial margin percentage of 6% specified against “Foreign Exchange\Currency” under Appendix A and the haircut percentage of 8% specified against “Cash in different currency” under Appendix B

Please note at last that AFG is also concerned by the very restrictive view taken in respect to netting of notional positions. Foot note 13 at the bottom of page 18 simply considers the case of netting two opposite IRS with the same maturity and probably the same floating reference. Some flexibility in terms of maturity is needed. A standardised approach must be simple when computing initial margin but not over-simplistic when assessing the risk basis. The opening for netting models suggested in favour of entities submitted to required capital regime should be extended to other entities and especially funds which monitor their risk.

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?

Asset managers are very well equipped to value, most of the times daily, their portfolio as they must publish an official NAV for each fund. This practice shows that the challenge mentioned at the bottom of page 19 can be met. As a matter of fact the dispute resolution procedure is very important in that case as it is the only way not to be blocked when there is a difference of significance between counterparties valuations (and thus margin calls).

For asset managers AFG strongly recommends that internal models might be used without prior official validation and/or that models approved by the authority relevant for the counterparty (a bank in most cases) be accepted.

Another solution could also be found by reference to current ISDA-CSA process whereby counterparties agree on variation margins is efficient and already operating.

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?

The higher the frequency or the lower the MTA (please see in addition answer n°19 below), the better the safety and the higher the operational cost. Market participants define these criteria according to their risk policy and reach a balance between lower risk and higher cost. Regulators should not go further than expressing a recommendation since there are instances where some **flexibility** is required (long term swaps in insurance portfolios for example).

The time horizon taken into account when computing the initial margin relates to the liquidity of the product and its underlying not to the frequency of computation of variation margin. However establishing a link between the two is relevant as a matter of simplification that would only apply to the model method though.

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?

The advantage of the standardised method is that the initial deposit is fixed and will not be revised. When using a model method initial margin will be adjusted. As long as models are authorised by a supervisory entity it is expected that non-procyclicality will be examined and mitigated before authorisation.
As far as discrete calls for additional margin are concerned, the main risk stems from the use of the threshold. When deciding not to call for margin that is below the threshold, a counterparty uses a possibility but may decide to change its view and call for initial margin. This would be a major discrete call and should be addressed either with a provision of advance notice of more than a week or delayed progressive call over a given period of time…

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

For instance in asset management, MTA can be expressed either as an absolute amount or as a percentage of the net asset of the fund in order to keep materiality in view for larger funds. Regulation applying to funds limits the exposure to counterparty risk and thus makes it impossible to have too large uncollateralised positions. Regulators should not go further than expressing a recommendation as there are instances where some flexibility is required (dedicated portfolio within a group for example).

Element 4: Eligible collateral for margin

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

AFG shares the view that eligible collateral should be (i) defined broadly in order to limit liquidity impact and (ii) accompanied with appropriate haircuts to increase safety.
Thus AFG believes that the proposal made by IOSCO adequately addresses all risk types inherent to collateral management: market, liquidity, credit and FX risks. However to face the current market conditions and evolving regulations, we believe that the scope of eligible assets as collateral for bilateral non-CCDs should be less restrictive in order to leave some flexibility to both parties. Depending on their core-business, financial entities would have different and broader asset types to provide as collateral such as for instance corporate bonds. Such bonds issued by large, robust, well-rated corporates domiciled in the most developed countries (OECD countries) should be in our opinion eligible with appropriate haircuts. A corporate bond issued by a German large cap company being A-rated on its LT debt by S&P well mitigates the market, liquidity, credit and FX risks mentioned by IOSCO assuming diversification guidelines and appropriate haircut. The same rationale can be applied to other securities types for example liquid emerging markets sovereign/investment grade and high yield corporate bonds and equities, Funds shares and units, and any other liquid assets subject to condition that an appropriate risk-based haircut is applied.

We also recommend this more extensive approach with respect to eligible collateral to allow flexibility relative to specific regulations and funds strategies. Fund industry is particularly sensitive to local regulations that limit the type and the quantity of assets a fund may invest in. Any

intermediation to transform fund assets into different eligible collateral would be costly for the fund and introduce new risk.
When expressing the key principle the paper goes too far in defining the wrong way risk: it should be limited to the exclusion of papers issued by counterparty and affiliates and not refer to “significant correlation with credit worthiness of the counterparty”. At some given times mathematical correlation might be high between issuers without proper rationale except for fear.

Two more comments on the proposed list of acceptable collateral which is not meant to be exhaustive but illustrative:

- Gold is in AFG view a volatile commodity which is not appropriate for collateralisation,
- For the sake of clarification, beside cash the list should include MM instruments and Money Market Funds, beside bonds, MM instruments and bond funds and beside equities, funds investing mainly in these equities, as well as other types of funds.

Finally, we note that the BCBS and IOSCO insist on the term of “high quality” assets, but do not address how such quality is determined (credit ratings?).

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?

One should not lose the aim of collateralisation: it is a way to mitigate risk on derivative instruments. The level one risk lies in the derivative instrument and level two with the quality of the counterparty. These are the key elements and should be closely monitored. Collateral is an efficient tool to reduce risk but it should not be the focus of the risk management as it is a third level risk. Bankers use to say that “a good guarantee does not make a good credit” to stress how important it is to keep in mind the reality of the risk. In consequence we feel that regulators should not regulate too much in details what can be left to the initiative of professional market participants. Diversification is an adequate principle but has to be appreciated at the global level of an entity and not on the collateral only. The only rule that could be included in the regulation is the exclusion as collateral of any instrument issued by the counterparty or an affiliate.

When discussing haircuts in page 24, the paper expresses the view that firms should “have an incentive to develop internal models” for computation. This is probably not a good approach as models tend to incorporate statistical data and introduce cyclicality. Standard levels which are fixed are the best way to avoid procyclicality. Hence it is arguable that the approach in determining standardised haircuts is too conservative allowing for an extra layer of haircut uncorrelated with risks but conceived as an incentive to turn to models. This is not appropriate and haircut levels should, in AFG’s view, all be reduced to eliminate that impact. When applying to a fund, the list posted in annex B should take into consideration the weighted average maturity of the portfolio of the fund.

Element 5: Treatment of provided margin

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?

The global analysis of the necessity to segregate margin in accounts accessible to caller-receiver in case of default of the poster and reversely recoverable by poster in case of default of caller is very sensible. It is true that local jurisdictions may have different tools to achieve such a result and any suggestion to promote an internationally recognised framework could be helpful, though difficult. The main two points to discuss are those expressed in the following two questions.

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?

The absence of netting and the exchange of gross margins seem at first look consistent with the aim to mitigate risk. However, as far as funds are concerned all the assets are intrinsic collateral (since counterparties are in their claim senior than unit holders). Thus the exchange on a net basis could be quite acceptable at least for transactions with funds limiting their leverage to a maximum of 2. On the other hand, the operational difficulties to set up a two way gross margining are not to be overlooked and the principle of proportionality (to the risk incurred) should lead to the conclusion to exchange net margins.

The concentration of risk on the head of the few custodians/depositaries that would receive initial margins on a gross basis from both sides is severe. Regulators and market participants should consider developing other legal ways to leave collateral with the counterparty and maintain it at the hand of the beneficiary. . When applying to a fund in particular, we ask that each fund be allowed to maintain initial margins received from its counterparties into a single segregated account opened within the books of its custodian. A revision of the directive on collateral could give the opportunity to enhance such a new legal framework in a standardised form throughout Europe.

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?

The risk does not lie with re-use or re-hypothecation but with the level of leverage resulting from these practices. Regulation should then limit the level of leverage and regulate the abuse and not the use of re-use and re-hypothecation. Funds, especially UCITS, are strictly limited by law in that respect. Many funds are also limited in their articles of incorporation and prospectus. When the beneficiary of the collateral has total property right on the collateral it is improper to use the word re-use instead of "disposition" or "use" of the collateral.

An example of reasonable use of collateral received is back to back transactions: the collateral received by B from counterparty A should be re-usable by B in order to hedge with C its risk in a back to back transaction by which it suppresses its market risk. Thus, a limited number of instances where total risk is not increased should be considered for (re-)use or re-hypothecation (with the approval of the constituent of the pledge).

Element 6: Treatment of transactions with affiliates

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?

Given that UCITS and AIF structures are not concerned by consolidated supervision, we are not in a position to respond to the proposed requirement to adapt margin requirements for derivatives between affiliates. However, perhaps the proposal for affiliates could be extended to apply to transactions between a fund and its custodian. We believe that in such circumstances, either no initial margin should be posted or that it should be posted to a third party.

Element 7: Interaction of national regimes in cross-border transactions

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?

This issue is very important and should certainly be addressed with a maximum of clarification. The suggested rules are consistent with general legal framework and compliant with the territoriality rules set forth in the cleared derivatives rules..

Nevertheless, the regime of branches may disrupt the level playing field approach as the branch will follow its home regulation when banks organised through a subsidiary in the same country will follow the local regime of the host country. If these two regimes are mutually recognised as equivalent, the difficulty disappears. However, this rule might also, in certain circumstances, lead to situations where, when the host-country margin regime is not approved by the home-country supervisor, one party would be required to post margin under its home-country regime while the other party would be exempt from such obligation, under its own regime.
As a consequence, it may be more appropriate to refer to the *lex situs* i.e. the law of the jurisdiction where the collateral is registered, which would ensure that a single regime applies to both parties in order to avoid discrepancies. This treatment would be coherent with the treatment of both the validity and the enforceability of collateral, to which the *lex situs* (*lex rei sitae*) also applies; this principle is recognized under private international law.
It would be preferable to refer to a single applicable law with respect to margin requirements such the *lex situs* in order to avoid a conflict of laws.

In addition, these rules do not put shade on the existence of a jurisdiction clause in the contract defining the applicable law and the relevant court. They show how relevant it would be to achieve a common international type of contract.

As a conclusion, AFG would like to emphasize that regulators globally should work on consistent regulation to avoid to a maximum possible regulatory arbitration and duplicative or conflicting margin requirements. They should create legal certainty with respect to applicable laws and regulation to maintain a level playing field.

Finally, please note that AFG believes and reminds that the financial system will be best served if an effective harmonized international framework is developed and if an effective coordination among regulators exists. Consistency between margin rules of different jurisdictions is critical to enable cross-border transactions and avoid opportunities for arbitrage between regimes. The implementation of the margin rules should be aligned across jurisdictions so that differences in timing of implementation do not have the effect of causing distortions and placing some participants on an unequal footing.

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Sincerely Yours,

(signed)

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