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MARGIN REQUIREMENTS
FOR NON CENTRALLY-CLEARED DERIVATIVES

SECOND CONSULTATIVE DOCUMENT
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AFG comments to second 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.

AFG is very appreciative of the work conducted by the WGMR on margin requirements for non-centrally cleared derivatives and welcomes this opportunity to comment on the major decisions that have been taken and on the questions specifically asked.

First AFG wants to stress that it fully supports the idea of enhancing safety on financial derivative markets through appropriate margin requirements. AFG is particularly sensitive to its clients safety and sees, despite some implementation difficulties, the development of central clearing for standardized derivatives as a major step in the right direction. Non-centrally cleared transactions should also be regulated with the double objective to reduce risk for counterparties and prevent development of systemic crisis.

[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).

Below, AFG lists remarks about the main features of the proposed regulation which are largely supportive of WGMR's work but include some suggestions for further improvements.

- AFG understands that the exchange of **Variation Margin** is the key to a proper mitigation of risk and should apply on a frequent basis, daily in most cases, and with a low Minimum transfer amount; however it feels that the usual amounts of **MTA** is higher than the suggested 100 000€: a figure between **500 000€ and 1 000 000€** would be more realistic; it would offer a good balance between the administrative burden and operational risk created by too frequent transfers and better risk mitigation;

- Status of VM should be more precisely defined when either cash or other assets are exchanged. If cash is transferred is it a final payment that will be fully and definitely part of the assets of the beneficiary? Or is it viewed as a transitory account whose balance at the end of the transaction will be cleared and which is not totally and finally transferred till that date? If securities, are they transferred as collateral for the cash amount that is due? What happens if the receiving counterparty defaults? AFG suggests that local authorities take notice of all the possibilities offered by local legislation in that respect and decide what is acceptable. International standards should try and avoid that the status of VM change with the type of assets exchanged.

- AFG agrees that most important entities should be required to exchange initial margin (IM); the "*de minimis*" principle should apply to non-systemic actors ; both proposed rules to catch only **entities with more than 8 billion €** gross notional of non-centrally cleared derivatives and introduce a **threshold of 50 million €** on the margin requirement are adequate and efficient as illustrated by the drastic reduction of number of counterparties pairings in table 5 p 32 compared to the initial margin exchanged;

- AFG totally agrees with the analysis provided by WGMR in foot note 8, p 6, where it **differentiates Repos and securities lending from derivative activities**; all transfers of securities should not be considered as collateral in relationship to their contractual framework and economic ground;

- AFG supports the recommendation to accept an extended list of assets eligible as collateral, provided that haircuts are adequately designed; it is important to leave some flexibility to local authorities but advisable to issue guidelines in order to avoid regulatory competition among countries; AFG believes that regulated **investment funds should be eligible** on the basis of their investment universe : thus, for example, a short term money market fund (which is a cash equivalent under IAS 7) should be assimilated to cash and a US government bond fund to high quality government bonds. Furthermore, securitization should be eligible under certain conditions.

- AFG suggests that further details be drafted about the usage of **Models for IM or haircut calculations**; in practice asset managers contract with investment banks that are designated as calculation agent in the contract; for the purpose of valuation, the counterparty communicates to the asset manager the price which is challenged by the asset manager before being taken into account; the same process should be acceptable for the calculation of initial margin and/or haircut; the internal model developed and formally monitored by the bank, once validated by the relevant authority, should be conclusive for the asset manager, except for its right and duty to challenge the result; the asset manager would not have to develop complete internal model but be equipped to be able to assess and discuss the results of the bank's model; it is from a practical point of view far more efficient that both counterparties agree on a common level of initial margin and **rely on the validated model of the bank acting as calculation agent**.

- IM should be segregated, directly accessible and bankruptcy remote in order to be an efficient risk mitigation tool; in that respect all improvements of the legislative and regulatory framework are to be encouraged; more specifically the use of **"nantissement**", a French regime for pledging, must be confirmed by authorities as an effective way to post collateral without transfer of propriety (and the implied problems resulting from coupons payments) but with full and secure access in case of default;

- As funds and sub funds in case of umbrella funds are totally independent entities, AFG is not directly concerned by the approach of thresholds at the **consolidated level of a group**; however AFG feels that there will be practical difficulties; if the internal exchange of information is all what is needed to calculate the 8 billion threshold it will be far more difficult to have a thorough view of the positions held by all the members of a group vis à vis all counterparties belonging to another group when assessing the 50 million threshold; this will require centralization on both sides of all positions held in the whole group on a continuous basis; an alternative approach should be considered, possibly to limit the centralization to the financial institutions that are prudentially regulated on a consolidated basis.
  In addition, (Cf. Requirement 2, point 2.2. p.8), AFG would specify that, If we agree on the principle that covered entities must exchange initial margin on a bilateral basis with the threshold mentioned, we have nevertheless one remark related to the definition of "consolidated group" in connection with the **UCITS** with **compartments**.
  Indeed, we recommend that the definition of "consolidated group" does not extend to the UCITS with compartments and that the threshold above-mentioned is solely applied to each compartments separately.

  In this framework, it seems that the European legal framework supports our opinion. The provisions are explained in further detail below:

  1. Legal Status of the Compartments:

     a. UCITS Compartments under French law:
        Unless otherwise specified in the regulations or statutes, under the French Law, each compartment is segregated financially: the compartments are solely responsible of the matters related to their debts, liabilities and obligations (Article L. 214-5, I).When a UCIT is comprised of one or more investment compartments, each compartment is considered as a distinct UCIT (Article R.214 -2).

b. UCITS Compartments under Luxembourg law:
When a UCITS has several compartments, each of them is considered as a separate UCITS (Article 40, Law of 17 December, 2010).
A UCITS may include multiple compartments, each corresponding to a distinct part of the assets of the UCIT (article 181 (1) Law of 17 December 2010).
The assets of a compartment are exclusively dedicated to the rights or claims of the investors and the creditors that have arisen on or after the date of the incorporation and before the dissolution of the compartment, unless otherwise provided in the management agreements or the constitutional documents.
Each compartment of a UCITS may be liquidated without affecting the rights of other compartments. ((s. 181 (6) Law of 17 December 2010).

2. Legal status of the compartment in the OTC Master Agreements:
Due to the legal status of the Compartments, therefore, some specific statements are made in the OTC Master Agreements, in order to uphold the idea that each Compartment is independent and separated from the other compartments as conveyed by the European regulation (including French and Luxemburg regulation) and that this regulatory framework applies solely to each compartment.

For example, under ISDA Master Agreement, the following clause is included:
"This Agreement shall take effect as if a separate agreement had been entered into between Party B and the Investment Manager for the account of each Fund or Sub-Fund in respect of all transactions which the Investment Manager enters into for that Fund or Sub-Fund's account.
It is produced in the form of a single physical document for convenience only.
For the avoidance of doubt, each reference to the Agreement will be construed as a reference to a separate agreement between Party B and each Fund or Sub-Fund, and no specific event of default under one Agreement will constitute an event of default with respect to any other Agreement. **No Fund or Sub-Fund shall have any liability under this document for the obligations of any other Fund or Sub-Fund**. Furthermore, **the close-out netting provisions incorporated herein will apply solely to the transactions entered into pursuant to one Agreement and there shall be no close-out netting or set-off between transactions entered into pursuant to different Agreements** notwithstanding the fact that such Agreements are included in a single document and no specific Event of Default or Termination Event under one Agreement will constitute an Event of Default or Termination Event with respect to any other Agreement. Further, Party B acknowledges and agrees that its recourse against each of the Funds in respect of any Sub-Fund of the relevant Fund is limited to that Sub-Fund to which the relevant claim(s) relate(s) and Party B shall have no recourse to any other assets of the relevant Fund or the other Sub-Funds of the relevant Fund in respect of such relevant claim(s)".

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After these remarks on topics not directly open for consultation, AFG answers to the questions specifically asked in the document.

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

Physically settled FX forwards and swap should be treated consistently on both sides of the Atlantic Ocean. As Dodd Frank apparently exempts them from margining requirements they should be out of the scope in Europe as well. The liquidity of currency markets and the diversity of participants makes it possible to trade almost any type of amount instantly. Thus IM is not appropriate for these transactions. VM offers a real protection to counterparty risk and should be encouraged. However minimum transfer amounts on currency transactions should be in line with the capacity of involved counterparties: a 1 million € MTA is typical of current practices and should be accepted as a standard.

A differentiation according to the maturity of the transaction for practical reasons is relevant when considering short term maturities both on FX and IRS transactions. Short term transactions are those with maturity shorter than one year or at least 6 months, in our view. Those transactions could be exempted from mandatory VM.

In addition, please note that the rationale for this statement is twofold:
1) The FX market is one - if not the most - liquid in the world. With regards to Initial Margin whose aim is to cover the close-out gap of a position in case when the counterparty is defaulting hence, the liquidation of an FX position would be easily implementable in the market.
2) The FX market has developed a robust framework based on CLS that mitigates drastically the FX settlement risk.

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

If collateral is transferred in full property, re-hypothecation is not an issue, as the new owner is totally entailed to use, actually re-use, what he received as he likes. This is a matter of concern with respect to risk mitigation. In that case re-use should be authorized but on the principle of an explicit agreement by the poster of the collateral. There are circumstances when it will be justified to allow the receiver of the collateral to use it to post margin with a CCP for example, or in the framework of the hedging of the initial transaction or a back to back transaction. If the collateral is not provided through a transfer of ownership, re-hypothecation should be authorized only through a specific contract granting that the posted collateral will remain accessible to the initial poster. That type of three-party-contract has still to be framed, in our opinion.

In that respect AFG feels that it is important that regulation allow for a difference in Europe between UCITS rules and regulation applying to AIF and other funds. ESMA’s guidelines on UCITS prohibit any re-use (and should be modified in order to authorize investment of cash with a CCP). Re-use or re-hypothecation should be authorized under strict conditions of authorization and transparency for other funds that aim at different types of clients.

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

AFG supports the idea of a progressive move to first include into the scheme those entities that present the highest systemic risk, due to the size of their positions in non-compensated derivatives. Scaling down from 3000 billion to 8 billion as a threshold is adequate and the time frame over a period of 4 years is consistent with the objective to allow for time for the smaller entities. The 8 billion threshold, considered on a consolidated basis, looks as a strict application of the principle of proportionality and the *"de minimis"* rule. It could be put at a higher level, say 20 billion, and still exclude only non-systemic entities.

AFG reckons that some members will be impacted in four ways by the initial margin requirements : (i) some of the larger funds may exceed the thresholds of 8 billion in notional and 50 million in margin, (ii) a more substantial number of funds and mandates are run for institutions that, on a consolidated basis, will exceed the limits before 2019, (iii) in-house licensed financial company will be consolidated within a group and subject to margin requirements and (iv) indirectly funds may be asked to exchange margins with financial counterparties that want either to reduce their capital needs or gain access to collateral that they have to exchange with other large institutions. Thus AFG is attentive to the necessity to have delays to implement new procedures and tools to comply with the regulation.

AFG considers that a starting point in 2015 would be too early for two reasons: one is the time needed for investment in IT, legal documentation and procedures to develop an adequate system, the other relates to the timing of implementation of central clearing under EMIR. It would be counterproductive to require collateral on non-centrally compensated transactions that are in the process of being eligible to central compensation in the near future. Due to the delays of implementation of CCPs and authorizations to clear new products, it is unlikely that on 1/1/2015 the scope of central clearing will be totally covered. One more year delay should be considered as a better solution in that respect. Furthermore, application of the same phasing in for VM as for IM sounds fair as there is no reason to split the system in two independent requirements. Especially so if 1/1/2015 were to be maintained as start point, making it very difficult for entities (mainly smaller ones) to meet the requirement.

AFG wants to stress that its members already operate with risk mitigation measures and do intend to keep them in place. However they may differ from the requirements suggested in the document in terms of scope (with some products, funds or counterparties not included), type of collateral eligible and re-use. But VM is a regular practice, even if not applicable in 100% of the transactions, and most calls for margins are done on a daily basis, even if it is not always the case, with MTA usually lower than 1 million €. Phasing in is necessary to organize an adequate planning for convergence at a time when developments implied by clearing through CCPs require for the coming two years full attention and most of the time of the concerned teams.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

AFG has no specific input, except for the fact that it trades roughly 90% of its FX forwards and swaps on a maturity shorter than 6 months, to add to the quantitative survey that is presented in Appendix C. It finds it very interesting as it points out:

- The evidence of the incentive for all market participants to clear through CCPs, provided there is not too much fragmentation among them; this is a key objective under EMIR;

- The efficiency to refer to internal models to determine collateral and haircut levels: with a ratio from 1 to 6 compared to standard IM schedule, it is obvious that models should be made accessible to all participants through the reliance on the tested model of the counterparty; otherwise the impact on liquidity of eligible collateral will be too heavy.

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If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr).

Sincerely Yours,

(signed)

Eric PAGNIEZ