Moscow International Financial Centre Liaison Group Derivatives Work-Stream

Comments on the BIS consultative document:
'Margin requirements for non-centrally-cleared derivatives'

September 2012

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Introduction by the Chairman

Thank you for the opportunity for us to provide comments to the consultative document 'margin requirements for non-centrally cleared derivatives', issued for comment by the Bank for International Settlements (BIS) and the board of the International Organization of Securities Commissions (IOSCO).

This paper represents the combined views of practitioners participating in the derivatives work-stream of the Russian-British Moscow International Financial Centre (MIFC) liaison group[1]. Participating organisations include key international banks, law firms, academia and consultancies with specialist knowledge of the Russian and international derivatives markets.

We believe that the proposed guidelines can have a fundamental impact in the shaping the derivatives market in Russia. In this paper, we are therefore putting forward suggestions to the Russian Central Bank and our Russian MIFC counterparts such that it could add value to their response.

[1] The Russian government set up the Moscow International Financial Centre (MIFC) initiative to lead this project and to ensure that international cooperation was at the forefront. Following discussions with the Lord Mayor of the City of London, the MIFC Taskforce identified the TheCityUK as its partner of choice in 2011, when a Memorandum of Understanding was signed between Alexander Voloshin, TheCityUK and Vnesheconombank in the presence of former President Dmitri Medvedev and Prime Minister David Cameron. For reference, the current MIFC Liaison Group structure chart can be found in the appendix.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

Global Context

Before we outline our considerations on specific issues discussed in the consultative document and their implications to the Russian financial institutions, we would like to express our observation more globally about the G20 agenda tackling OTC.

The recent global financial crisis highlighted the need for regulators to address systemic risks which arises from the large volume of inter-dealer financial transactions, which often involved complex and opaque products. OTC derivatives especially drew the regulators' attention as a source of triggering and transmitting the risks among the banks.

However, evidence suggests that plain vanilla interest rate and currency derivatives did not contribute to create such systemic issues, but such problems were largely caused by more complex derivatives, especially credit derivatives and their variants. Plain vanilla interest rate and currency derivatives have been safely and prudently used over past three decades by a wide range of end-user banks and market-makers to manage their ALM risks as well as trading businesses.

In contrast, credit derivatives, in the Chairman's view, carry many of undesirable attributes which the regulators expressed their concerns. Most importantly, they effectively allow any participant to contribute to the credit creation process. Non-bank market participants, which could underwrite credit risks via credit derivatives at higher leverage levels than regulated bank, contribute to the growth the growth of the shadow banking system. It is no coincidence that with the advent of synthetic securitisation we saw an explosion of the total leverage in the western financial system. The instrument also has in-built pro-cyclicality because it allows any market participants to underwrite credit risks independent of if they own actual assets. The leverage, combined with the need for collaterals, may also trigger a market-wide sell-off during the down turn especially market participants can no longer provide additional collaterals to cover market-to-market losses. Another undesirable attribute of credit derivatives is that, whereas most derivative classes have relatively normalised return distributions (even allowing for fat-tails), CDS's return distribution is highly asymptotic. Whilst default probability is low, a small amount of capital can support a large amount of notional exposure; however as credit ratings deteriorate, the amount of capital needed to support the position increases exponentially in a non-linear manner (sometimes known as "jump risk"). This makes the risk management of credit derivatives difficult and highly pro-cyclical.

Considerations for Russia

In our view, the Russian financial institutions will benefit significantly from deeper and more liquid interest rate derivatives markets. Due to the shallowness of the markets and high transaction costs, many financial institutions instead simply assume these risks as a cost of doing business. By applying the measures described in the consultative document, it could inadvertently inhibit the development of "good" OTC derivatives, which are likely to contribute reducing risk at both institutional and systemic levels.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

As we described, we believe that systemic risk considerations for credit derivatives often outweigh their benefits, especially in the countries which are not home jurisdiction or do not host headquarters of major investment banks. Therefore, instead of relying on these more indirect measures as proposed in the consultative document, there may be more straightforward policy measures with less unintended consequences to curb the use of "undesirable" OTC derivatives.

We also have several more technical observations:

- Exchanging initial margin on a gross basis and keeping them in segregated accounts without the ability to re-hypothecate will significantly increase the need for collateral; indiscriminately for both good and undesirable derivatives.
- Would there be sufficient 'high quality' collateral available to meet the resulting increased demand? Can collateral be legally enforced under bankruptcy in all jurisdictions? Is margining enforceable in bankruptcy across all jurisdictions?
- Even if all regulators were to approve the principles, some of them may not be in a position to approve specific models. They would thus need to go for the standard table, which will inevitably be difficult to agree across all regulators.
- Even if the overall framework were to be approved and adopted worldwide, it will increase the need for high quality collateral even further, at a time when the markets are already experiencing shortages due to demand driven by central clearing, Credit Support Annexes (CSAs) and the Basel liquidity ratios. More fundamentally, is there a global definition of what represents 'high quality' collateral and is it available to Russian counterparties at the same cost as developed market counterparties?

We have chosen what we believe are the key questions as posed by the BIS/IOSCO working group and grouped them along the elements of the topics. The numbering of the questions is kept the same as in the consultative document.

If you have any queries about this paper, please contact Liza Samoriz:
liza.samoriz@thecityuk.com.

Kind regards,

Axel van Nederveen
Treasurer, European Bank for Reconstruction and Development [2]
Chairman of the Derivatives Work-Stream

[2] The European Bank for Reconstruction and Development (EBRD) has been an active market participant of the Russian financial markets as a major international lender in Russia, as well as a major end-user of financial derivatives in the global capital markets for its asset and liability management. As defined in the EBRD's Articles of Agreement, which Russia is a signatory, the EBRD is committed to supporting financial market development in its countries of operation, and we would like to express our views to the Central Bank of Russia on the consultative document, especially its possible implications to the Russia financial institutions.

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?"*

- It is of paramount importance from a Russian perspective that, as a minimum, the short-dated exemption for FX swaps is granted. In our view, the proposed guidelines will otherwise make the instrument difficult for Russian counterparties to use because of the high levels of initial margin. It is also questionable whether foreign market participants will accept margining with Russian counterparties given the unenforceability of margin in bankruptcy under Russian law.

- Recent Oliver Wyman research and market discussions suggest that for short dated FX transactions (months), the risk exposure is weighted towards settlement risk (>90% of total risk exposure) rather than the credit risk component. In other words, settlement risk dwarfs all other risks in the FX market. For instance, the analysis illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a transaction involving foreign exchange instruments with a maturity of 6 months and 89% for instruments with a maturity of 2 years.

- Following extensive study of systemic risk, central banks and FX dealers went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank as a global settlement bank. CLS Bank's settlement system today eliminates virtually all settlement risk to CLS Bank participants. CLS Bank settles almost 90% of all inter-dealer FX trades. Efforts to extend the reach of CLS Bank are under way, with broad support from FX dealers and central banks around the globe.

- The use of CLS mitigates the settlement risk, and the margin is used to offset the residual credit risk exposure. This reasoning suggests that even for non-cleared business, margining may only have a limited impact on the overall risk exposure involved in short-dated FX contracts. The incremental benefits of subjecting such contracts to margining requirements should be weighed up against the implementation costs involved.

- Clearly, for this exemption to be applicable in Russia, the rouble would first need to become a CLS eligible currency. CLS eligibility for the rouble would be desirable even for shorter-dated FX swap transactions. CLS eligibility is one of the arguments under the exemption argument for FX swaps from the proposal.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

- To address the remaining mark-to-market credit risk, credit support annexes (CSAs) are heavily used and relied on in the FX market and are a particularly effective risk mitigation tool.

- Initial analysis by the Global FX Division estimates that 85% of the mark-to-market credit risk for FX swaps and FX forwards is effectively covered by CSAs. Even for 2-year instruments, only 1.65% of the credit risk of loss in FX instruments is not covered by CSAs (with 0.9% not covered by CSAs for instruments with maturities of 6 months). Mandatory clearing for FX swaps and FX forwards would therefore deliver almost no incremental credit risk mitigation.

- It is worth noting that the FX market performed well throughout the last crisis, as well as previous crises, handling multiple defaults including Lehman without a drying-up of liquidity or material losses.

- Any tenor-based margin requirement would encourage avoidance by trading just below the threshold, leading to increased roll and settlement risk.

If short dated FX and FX swaps are exempted from the proposed framework, we would also argue for the exemption of longer-dated cross-currency swaps. As otherwise we expect that it would:

1. Encourage financial institutions to manage their cross-currency balance sheet exposure on a short-term basis and thereby increase refinancing risk.
2. Close down the long-term cross-currency swap market, which allows the efficient management of long term liabilities for both banks and corporate end-users. The instrument is an important tool that allows issuers and investors to disassociate the currency and market they borrow in from the currency of denomination. Whilst the exclusion of FX swaps of under one year from the scope of coverage of the margining proposal is a minimum requirement, we would like to emphasise that exemption of long dated cross-currency-swaps (XCS) is also highly desirable, provided relevant risk mitigation clauses are included. FX resets upon each coupon payment, which by reducing the mark-to-market exposure of XCS induced by FX movements, significantly reduce the counterparty Potential Future Exposure (especially for non-collateralised XCS).

- There is a strong view from the international banking practitioners that the significant operational risk and costs to the global payment system of implementing mandatory clearing far exceed the benefits of mitigation for the small residual unsecured credit risk of FX swaps and FX forwards.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

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?"*

- Whilst not directly a systemic risk, the practical implementation of the proposed rules remains contingent on the availability of sufficient collateral eligible assets. Recent estimates indicated that over €5 trillion of collateral will be needed under these rules for the non-centrally cleared part only. This is a sizeable figure when, for instance, compared to the total sovereign bond market assets of circa €9 trillion.

- Given that risk is lower in foreign exchange contracts when compared to other product areas, we do not recommend the promotion of central clearing.

- Covered entities are also a key consideration – most OTC derivatives get traded between a few 'key market participants' (e.g. top 20 international banks). Of those trades, most are actually already standardised and will have to be cleared though CCPs in the future. The relatively low volumes of OTC derivatives traded by other entities, with the exception of credit derivatives, are too small to be a threat to Russia's financial stability. Therefore, we do not think that it is necessary to extend the scope of covered entities beyond the 'key market participants' as broadly as suggested in the document; and we believe that all Russian counterparties should be exempted from the application (unless they become sufficiently big in derivatives to qualify as systemic important FIs at a global level). Otherwise, we foresee difficulties for Russian banks to stay 'connected' to the international markets because the margin requirements will increase the need for Russian banks to be able to access 'high quality' collateral. Unless the definition of 'high quality' collateral is such that Russian banks will have sufficient access to it, they will be cut off from the international markets.

- We would like to point out to the regulator that the proposal is effectively an exchange of counterparty risk and capital requirement for liquidity and operational risk. The full effect and cost of bilateral margining on liquidity has not yet been properly assessed. It is very likely to interact with resolution planning and will be another drain on the total borrowing capacity of the market.

- Depending on calibration, the resulting liquidity impact of mandatory bilateral margining of un-cleared transactions might pose systemic risk. Despite the fact that the liquidity impact is not understood by any market participants including regulators, rules are now established that propose to force the market to exchange initial margin (IM). Some

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

participants will therefore struggle to find the required collateral and either borrow the needed funds, or ask banks to transform lesser quality collateral into collateral that complies with the rules. Neither outcome would reduce risk in the system, but would only move risk around and make it less transparent, in extremis even move it to the shadow banking system.

- Publicly available data shows that the funding by global banks is about the same order of magnitude as the expected IM impact (estimates in the press range from $2 trillion to over $6 trillion). WGMR will by now have visibility over the QIS results and be able to compare the funding of global banks with the overall margin requirements as suggested by this consultation paper. Banks may be able to increase their funding slightly, but not up to levels required by these proposals.

- The key principle that margin should be "appropriate to the risks posed by such transactions" indicates a measure of risk sensitivity that is not captured in the following details of this consultation paper, e.g. the universal exchange of bilateral IM with standardised thresholds.

- Unlike CCPs, banks do have capital to absorb losses. Banks usually expect a small fraction of exposures (be it loans or derivatives exposures) to be lost due to default and adapt their pricing and capital levels appropriately. This is not in question for lending exposures, but for derivatives transactions regulators seem to want to eradicate losses due to default at nearly any cost. Banks have the capability to review the risk attached to their counterparties and will continue using internal models and their own judgment for banking book transactions. However recent regulatory developments, especially the CVA capital charge and margining of un-cleared transactions incentivise banks to use mechanistic & simplistic models in the trading book instead of careful consideration of the counterparties to whom they wish to extend credit and the amount thereof. In our opinion <u>this is not a good way forward to more stability and lending.</u>

- Not only does the "defaulter pays" regime erode the incentive for banks to practice good "underwriting" of counterparty risk in the trading book, it also ignores the fact that the risk of a portfolio is less than the sum of its components – capital should scale in a manner that reflects the risk contribution of each part to the whole in stressed conditions even if it is not specifically allocated to any one client's risk. Margin, on the other hand, is specific to each client for their protection and additive across clients. The amount of margin held in aggregate will therefore greatly outstrip the amount the bank could lose; <u>the cost of this inefficiency will ultimately be borne by clients.</u>

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

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- Addressing the issue of systematic risk through margin requirements will not necessarily solve the problem and is wasteful in an economic sense because it ignores risk diversification effects that are observable even in crises.

- Basel III has strengthened the capital framework for counterparty risk considerably, and we do not share the belief that capital levels in stressed conditions might not be appropriate. On the contrary, the combination of the strengthened Basel III framework together with universal exchange of zero threshold variation margin between covered entities would be a very strong safeguard against systemic risk. In such a framework, many cases of overtrading (for example by AIG) would not have occurred, or would have been caught in an earlier stage of the crisis when these entities could have reduced their risk at an affordable price.

- If, however, the regulators do not feel that capital captures adequately the systematic risk posed to each institution by others, an alternative would be to put in place more stringent capital adequacy tests focused on the ability of banks and other systematically important entities to withstand the default of one or more of its most significant trading counterparties.

- Addressing systematic risk through Pillar II of the current regime would obviate the need for an expensive and time-consuming overhaul of banks' systems, processes and legal agreements to support. Those banks with insufficient capital to withstand such events would as a consequence be incentivised to manage their exposure appropriately through a number of means including: raising capital buffers, reducing concentration, promoting diversification, tightening collateral arrangements, and increasing margin requirements.

From a practical point of view, the industry has to overcome sizeable challenges:

- Building the infrastructure for segregated posting of margin. Given the widespread exchange of IM envisaged by regulators, these need to be automated processes, and industry needs to develop standards for enabling straight-through-processing of collateral movements, pledges and releases of these pledges.

- It is also questionable whether foreign counterparties will feel sufficiently certain that margin will be enforceable in bankruptcy when dealing with a Russian entity under the proposed arrangements. There is the possibility that bankruptcy laws need to be updated to reduce legal risk in these arrangements.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

- Updating of documentation – large banks have thousands of counterparties, all of which would need updated netting and collateral agreements. There is little chance of timely implementation without updated industry standardised documents that are quicker and easier to negotiate than a current ISDA agreement.

- Sourcing of the needed margin at a time when industry also needs to increase capital ratios and comply with Basel III liquidity and funding requirements. We suggest that margin phased in gradually, not by counterparty type, but as a percentage of the IM amounts to be called according to the rules.

- Working with regulators to review and gain approval for margining models covering majority of non-cleared exposures so that a level playing field is maintained. Judging by current workload of regulators, this will be a lengthy process, and transitional rules are needed (e.g. allowing IM models until regulators have finished their approval process of a firm's model).

Documentation cross-border and for non-netting jurisdictions have to be clarified;

- These processes just are not yet in place to any material degree in respect of OTC bilaterally cleared derivatives.

- Segregated IM would almost certainly be held by a small number of large custodian banks, which would introduce a new element of systemic risk. Requiring all participants to exchange bilateral IM would increase this risk dramatically.

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?"*

Bilateral exchange of margin in mandatory minimum amounts – under the current proposal, all covered entities entering OTC derivative transactions would need to post bilateral initial and variation margin. This will inevitably imply high funding costs for each counterparty that will need to fund the required collateral. The costs will disincentivise counterparties from hedging those risks. As previously stated, they may simply choose not to hedge. Also foreign counterparties may be less incentivised to enter into transactions with Russian counterparties; especially given the uncertainty of the legal status of margin in bankruptcy scenarios.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

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We believe that the cost-benefit equation of implementing these rules will not be attractive given the limited reduction in risks (as discussed in Q2), the pressure it creates on collateral demand and the implementation costs of supporting rules such as re-hypothecation.

Likely consequences of implementation would be:

- Higher cost, reduced volumes and liquidity of instruments that cannot be cleared, making it more challenging for market participants to manage the risk of these positions.
- Bespoke derivatives that are ideal matches to complex risks the buy-side wishes to mitigate will become more expensive and might become unaffordable, forcing clients to use standardized instruments and accept increased basis risk.
- Scarcity of eligible collateral, including increased use of collateral transformation and margin lending.
- Increased leverage of both banks and non-banks.
- Operational challenges: the tri-partite clearing market at present is not geared up to high volumes and straight-through-processing.
- Significant systems expenditure will be required up-front to monitor and manage collateral held at third parties and the cost of managing this collateral on an on-going basis will rise.
- Increased concentration of collateral at a small number of tri-partite providers: an operational failure or fraud at one of these institutions would have broad systematic implications.
- Universal two-way margining will increase the level of operational risk with significant amount of cash and non-cash margin transferring ownership and/or pledge accounting each business day.
- Significant legal expenses: thousands of netting and collateral documents would have to be re-negotiated.
- Disputes will likely increase and will put pressure on infrastructure, potentially taking longer to resolve.

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

- We would expect additional adverse side-effects in the real economy if OTC market participants drive up the price of funding, and also drive up the price of assets that can be used as segregated collateral.

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

Proposed Standardised Initial Margin Schedule Asset Class	Initial Margin Requirement (% of notional exposure)
Credit: 0-2 year duration	2
Credit: 2-5 year duration	5
Credit 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange\Currency	6
Interest Rate: 0-2 year duration	1
Interest Rate: 2-5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

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?"*

- Internal models vs. standardised schedule – Many domestic markets are not adequately sophisticated to develop internal models to calculate initial margins. Domestic regulators in emerging markets, if they want to approve and enforce the proposal would thus most probably opt for a standardised schedule.

- The current proposal is effectively CEM with higher percentages, fewer maturity bands for some asset classes and without netting. Given that CEM weights – in line with the usual Basel II time horizon – estimate the potential future exposure over one year, but initial margin is meant to cover a margin period of risk of 10 days, the levels seem to be

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

overly conservative, even taking into account that margin is calibrated to a higher percentile.

- As mentioned, the standardised margin percentages are overly conservative. This is particularly evident when comparing them to the observed benchmarks for liquid asset classes like foreign exchange. As an illustrative reference point, we examined the Interest Rates Swap portfolio of a large clearing house. They would target a ratio of 0.6 bps x notional for this portfolio. While not apples-to-apples, the margin requirements outlined in the proposed rules (100-400 bps across maturity) look much higher than the observed benchmarks, even when adjusted for liquidity differences.

- In addition, we felt that the table proposed in Appendix A is too simplistic; and that it should differentiate cross-currency-swaps according to maturity and currencies (because some currency pairs are more volatile than others). The margin requirements for credit derivatives should also vary according to the credit quality of the credit traded.

- The Trading Book Group and RMG are both looking at improved standardised methods for market and counterparty risk. We recommend using the results of this work in the margin context.

Element 4: Eligible collateral for margin

Q 21. *"Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?"*

- Eligible collateral for cross border transactions – having each national supervisor develop their own list of eligible collateral has major implications for cross-border derivatives and transactions. Only if there is a unified global standard, will all counterparties be able to transact across borders. The conundrum faced by all G20 jurisdictions highlight the issue, as they have varying definitions of what they deem to be high quality collateral. Unless the G20 can agree to a global standard of what constitutes "high quality" collateral at their lowest common denominator, there will be winners and losers. This can, by extension, lead to a fragmentation of markets across geographic boundaries. This is clearly not a desirable outcome and will have a detrimental impact on real economic activity.

- Internal models vs. standardised haircut schedule – as in the case of initial margin models, some market players and regulators may lack institutional capacity to develop internally risk-sensitive quantitative models. They would thus need to adopt standardised haircuts. The proposed standardised haircut schedule would need to elaborate on proposed haircuts for specific credit/liquidity risk. For example, the haircut

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

on a BBB government bond should indeed be higher than on a AA government bond. However, national supervisors in lower rated countries may not agree with higher haircut on government bonds for their domestic transactions. This leads to the possibility that supervisors should develop two Standardised Haircut Schedules: i.e., one for transactions between two domestic counterparties and one for cross-border transactions. The former schedule could see lower haircuts on domestic government bonds than the latter schedule, which would need to be globally approved. Again, this approach may penalise counterparties in lower rated countries and it could lead to a fragmentation of markets across borders. It is worth noting that eligible collateral requirements differ between IM and variation margin (VM). Whilst for VM cash and liquid bonds floored at AA are ideal, for IM the pool of eligible collateral should be much wider, partially to mitigate the liquidity impact.

- In general, at least for prudentially-regulated banks, less liquid collateral does not pose the same problem it poses for a CCP: a bank has greater capacity to manage the risk of the collateral, greater market-access for liquidating it and enough loss absorbing capital to cover the time it might take to sell less liquid collateral.

- Moreover, a well-diversified portfolio of collateral might overall be less risky than a concentrated portfolio with perceived high quality liquid collateral, e.g. government bonds that were thought to be riskless just a few years ago. What counts is not the credit quality and liquidity of collateral (this can be dealt with using appropriate haircuts), but the correlation between collateral and the underlying exposure.

- We welcome the wider pool of eligible collateral, given the collateral supply issues discussed in Q4. This may be particularly important given the on-going re-ratings and the shrinkage of the high quality collateral pools. As mentioned in the consultation paper, the list is not exhaustive. Once we know the scope of coverage i.e. the scope of instruments and counterparties to which the rules are applicable, we can recommend some rules surrounding the choice of eligible collateral.

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 rules need to distinguish clearly between requirements for collateral treatment of IM and VM. A party posting IM has a claim on the assets if the receiver defaults, but no such claim exists for VM. Therefore:

Registered in England number 7088009. TheCityUK, 65a Basinghall Street, London, EC2V 5DZ. T: +44 (0)20 7776 8970
Email: liza.samoriz@thecityuk.com www.TheCityUK.com

1. Bilateral IM should be kept segregated and bankruptcy remote without re-hypothecation.

2. Unilateral IM should have the option for segregation available.

3. VM should not be restricted. VM received from one counterparty will usually be paid out to the provider(s) of the hedge(s). Not allowing VM to flow freely through the financial system would increase the liquidity drain even more, without clear benefit.

- We also note that the word "posting" needs to be clearly defined – in a tri-partite arrangement "posting" would not necessarily mean movement of collateral, but the pledging of collateral (already available at the custodian) to another counterparty.

- For IM, the key principle covers the requirements well, despite the fact that "immediately available" should include a few days delay – even if the margin is held in a tri-partite arrangement, the custodian will usually take time to establish that the margin of a defaulted counterparty can be released to the counterparty of the defaulter, depending on local bankruptcy regimes.

- The onus of providing safe arrangements cannot fall on industry only. We are worried about the wording "…in the event that the collecting party enters bankruptcy to the extent possible under applicable law." – These laws need to be adapted to provide legal certainty that collateral will actually be returned.

- Despite currently seeing only segregation at third party custodians fulfilling these conditions, we welcome that the principles describe the required outcome, not the detailed ways to achieve this outcome.

We would like to note that there are material operational difficulties in the segregation of margin:

- Banks cannot post cash as IM as doing so creates even more connectivity and far higher capital charges (as an unsecured loan is deemed to be being made to the agent bank).

- The pledging of securities (certainly not cash) seems the only way that this process could work, but it is key that these connections are fully automated (which is not the case at present) to permit timely release of collateral.

- Operational challenges: the tri-partite clearing market at present is not geared up to high volumes and straight-through-processing.

- Significant systems expenditure will be required up-front to monitor and manage collateral held at third parties and the cost of managing this collateral on an on-going basis will rise.

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Email: liza.samoriz@thecityuk.com www.TheCityUK.com

- Increased concentration of collateral at a small number of tri-partite providers: an operational failure or fraud at one of these institutions would have broad systematic implications.

- Universal two-way margining will increase the level of operational risk with a significant amount of cash and non-cash margin transferring ownership and/or pledge accounting each business day.

- Disputes will likely increase and will put pressure on infrastructure potentially taking longer to resolve.

Rules need to be introduced for the default of a custodian. In this situation, the counterparty of the entity that posted collateral to a defaulted custodian should not have to treat this collateral as lost, but rely on mechanisms to either recover or port this collateral in a timely fashion in the framework of the resolution plan of the custodian. Requiring the counterparty to post IM a second time would exacerbate liquidity requirements exactly in stressed market conditions.

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?"*

- Exchanging initial margin on a gross basis and segregating and banning the re-hypothecation of it would significantly increase the need for collateral, and the cost of funding it, especially in countries short of 'high quality' collateral. It is not clear whether there would simply be enough high grade collateral available[3] to meet the margin requirements for cross-border transactions resulting from the proposed regulations. In all cases, having to fund and post high-grade internationally acceptable collateral is likely to significantly increase costs to counterparties in the Russian domestic market.

- Despite the fact that segregated gross posting of collateral will require large amounts of collateral, we agree that netting of IM would not be effective and could even increase risk.

- There are only a few global custodians that would have the ability to provide tri-partite custody service to the industry on a global basis. For some countries, most of them will share sub-custodians. Therefore we are worried about the concentration risk with third-party custodian banks, especially as some of them are also derivatives market participants.

- However, this custodian risk could be mitigated by stringent Recovery and Resolution Plans. In addition, mechanisms similar to portability from defaulting clearing members

[3] Also needed to meet Basel liquidity requirements, shift to of standardised OTC derivatives to CCP clearing etc.

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Email: liza.samoriz@thecityuk.com www.TheCityUK.com

could be introduced to make sure that collateral is not tied up in custodian defaults for a long time.

- Whilst overall the use of tri-partite arrangements seems to be the best alternative, there is still some legal risk, e.g. custody liens and the risk attached to sub-custodians in the prime-brokerage context.

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?"*

- We assume the consultation paper talks about IM only when mandating that collateral should not be re-hypothecated. VM clearly should not be restricted in this way, and market participants should be free to pay received VM to other counterparties where they have to post VM, e.g. the providers of the hedges.

- As for the model suggested by US SEC, it would be desirable that there was a method to safely re-use IM, as this would mitigate the liquidity impact. However we cannot see any credible way achieving this. As we have seen with recent events (MF Global and Peregrine), segregation of client money in a firm's books does not provide the required protection.

- However in cases where only one counterparty posts IM (i.e. a systemic important institution dealing with a non-systemic important institution), segregation and re-use should not be mandated, but left to negotiation of both counterparties. The client should have the choice to make the trade-off between cost and protection level.

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Email: liza.samoriz@thecityuk.com www.TheCityUK.com

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CEO Chartered Institute for Securities and Investments
Chairman of Education, Training and Qualifications Work-Stream

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Senior Manager, TheCityUK

Russian Federation

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President, Moscow Exchange MICEX-RTS

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Alexander Bazhenov
Director of Public Private Partnership Directorate, Vnesheconombank

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Allen A. Vine
Co-Head of the Moscow Infrastructure Sub-Committee of the Working Group on the Creation of Moscow International Financial Centre

Dmitry Stepanov
Managing Partner, Egorov, Puginskiy, Afanasiev and Partners

Denis Ivanov
Head of London representative Office, Vnesheconombank

Mikhail Eskindarov
Rector of the Financial University under the Government of the Russian Federation

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