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RE: EFET response to the consultation by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) on Margin requirements for non-centrally-cleared derivatives

The European Federation of Energy Traders (EFET)[1] welcomes the opportunity to respond to the consultation by the BCBS and IOSCO on their proposed Margin requirements for non-centrally-cleared derivatives.

EFET key concerns are summarised below, followed by detailed answers to the specific questions of the consultation in the Annex.

General considerations

- We support the objective of reducing systemic risks in financial markets and welcome the opportunity to comment the proposals of the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commission (IOSCO).

- IOSCO and BCBS do not give evidence in the consultative paper that the framework proposed for non-centrally cleared derivatives could work in practice. In most cases, if

[1] The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information, please refer to: www.efet.org.

there is no CCP available to clear a certain type of derivative instrument, this is because such an instrument is not sufficiently standardized, liquid and with price information available and reliable on on-going basis to allow central clearing. Therefore it cannot be possible to replicate the margining approach where the basic conditions are not appropriate: the calculation of margins could require unprecedented efforts, potentially leading to never ending disputes.

- IOSCO and BCBS should consider a **set of tools for credit risk management** that are adequate, in particular for the energy business. The exchange of IM and VM is one of these tools, but it is not always possible to use in practice. Besides, it is also not the only tool available to manage credit risk: lines of credit, external ratings (where the rating agencies take into particular consideration the existing debts and liabilities of a company, before issuing their rating), detailed credit risk assessments and risk monitoring activities are among these tools. Where the law permits netting across all contract forms and the underlying products are sufficiently standardised, liquid, with reliable on frequent price information available, Credit Support Annexes (CSAs) are put in place to mitigate the credit risk arising from in the money positions. Therefore, the number of contracts that are not eligible for central clearing is potentially high, but a negligible number should be subject to two-way margining.

- Furthermore IOSCO and BCBS should acknowledge the limited possibilities to **access to liquid collateral** (such as cash) by entities within non-banking groups. Indeed banking firms have access to central bank liquidity as part of their core business, whilst non-banks would have to increase lines of credit or enter into collateral transformation arrangements with banking groups in order to obtain more liquid collateral to satisfy such obligations, if this is possible at all given the increased level of demand for liquid collateral across the entire market. Increasing demand in both the cleared and uncleared space will lead to a collateral squeeze and place an undue and unnecessarily heavy burden on non-banking entities compared to banks. This would tie up liquidity that could be otherwise used to invest in the wider economy. This is arguably also unnecessary in the case of many non-banks which, whilst they may have less ready access to liquid collateral than banks, may have stronger balance sheets/ better credit ratings. To require banks to collect IM from such entities, especially in circumstances where the bank is less objectively creditworthy than the relevant non-bank, and where this would essentially require a collateral transformation/ liquidity facility/ credit line from another bank in order to do so, would not seem to serve any market stability function.

- EFET opposes the requirement to provide collateral in the form of either Initial Margin or Variation Margin in respect of **intra-group transactions**. This serves no market stability function, at the very least in the case of non-banking groups, would unpick existing group treasury activities and fundamentally contradicts the economic reasoning behind intra-group exemptions, for example under EMIR.

- The consultative document does not take into consideration the criteria proposed in different jurisdictions to identify non-banking entities deemed to be **systemically important**. Although this is not a topic for discussion in the consultative document, IOSCO and BCBS should clearly affirm that these criteria should be carefully targeted in order to avoid that non-banking entities which are not of systemic importance will be 'covered entities'.

- Finally, although EFET welcomes efforts to conduct a quantitative impact study to assess the impact of the proposed margin requirements, it should be recognised that any QIS that does not include data concerning the effect of such proposals on non-banking groups and non-financial companies will necessarily be incomplete and not reflective of their effect upon the entirety of the market. For this reason, the QIS should explicitly cover non-banking companies and the effect of such requirements on the ability of such parties to invest in the creation of employment and upon economic growth. Data collected under the EMIR transaction reporting schemes could be perfectly used for this. The impact of the liquidity squeeze should also be carefully analysed. This will require additional time and we would caution against introducing mandatory requirements without giving sufficient time for a comprehensive QIS covering all relevant considerations to take place.

If you have any questions regarding this response, please do not hesitate to contact: Karl- Peter Horstmann (Chair of EFET Task Force Market Supervision), Cemil Altin (Vice-Chair of EFET Task Force Market Supervision), Reinier Waters (Chair of EFET Working Group on EMIR) and Peter Styles (Member of the EFET Board, Chairman of the EFET Electricity Committee).

Yours sincerely,

On behalf of the European Federation of Energy Traders (EFET)

Jan van Aken

EFET Secretary General

Annex: Detailed answers to the consultation questions

Consultation document 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?

Any requirement for margining of non-centrally cleared derivatives cannot be introduced before a tangible and proved feedback on the methodology proposed, i.e. exchange of initial and variation margin, and after coordinating with the measures for mandatory central clearing of eligible derivatives.

Once the methodology has been approved, EFET generally believes that a phase-in approach is often a good way to enable smooth implementation. The discussed margin obligation requires bilateral agreements between the respective parties, which needs time to negotiate. In addition to the time lag to put the contractual frameworks in place, we would like to remind IOSCO and BCBS that non-banking entities do not have a direct access to needed liquidity. Therefore, market parties need to be given sufficient time to develop models used for margin calculations and to build new structures and to implement the proposed changes The required collaterals have to be financed by (a) additional credit lines or (b) readjustment of cash flows and investment decisions. Both financial sources need a sufficient time period to implement.

Only OTC derivatives that are uncleared must be collateralised bilaterally. As a result, the obligation to clear (and so provide Initial Margin and Variation Margin to a clearing house) and the obligation to collateralise uncleared trades are linked. As such, both timelines should be coordinated so that margin requirements for non-cleared trades are not mandatory at least until competent authorities have begun to designate which OTC derivative trades should be subject to mandatory clearing. From a European standpoint, non-financial firms are currently unable to assess whether the margin requirements will be applicable to them or not, bearing in mind that the European Securities and Markets Authority (ESMA) has not finalised its decision with regard to the clearing thresholds for OTC derivatives, that discussion about the handling of physically settled forwards under MiFID is still on-going. Therefore, it is rather uneasy for non-banking entities to prepare for the margining requirements as proposed by IOSCO and BCBS, and a phased-in implementation phase would be quite justified and very welcomed by non-banking entities.

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

We support the view that foreign exchange instruments should be exempted from the margining obligation as the counterparty credit risk is small (due to the short average maturity of such contracts) and settlement risks are suitably addressed through use of coordinated payment versus payment arrangements. This would also assist in the drive towards a level global playing field and avoid regulatory arbitrage, as US authorities intend to adopt such an exemption.

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, practice shows that additional product specific exemptions must be inserted. The principle of margining relies on the **availability of public prices for standard products**, subject to margin calls.

Assuming that margining must be regulated tightly in order to "reduce systemic risk, promote central clearing, and limit liquidity impact" does not correctly reflect market realities in energy markets. In most cases, if an OTC derivative is not eligible for clearing, it's not the intention of non-financial counterparties, or commodity trading firms within the energy (non-banking) sector, to circumvent the clearing obligation, but rather the characteristics of the products being such that no clearing is available: the derivatives are not sufficiently standardised or liquid to make them suitable for clearing and/or price information is not available or reliable enough to allow daily mark-to-market.

Non-standard products cannot be margined, in particular on a short time basis, and as such should not be subject to any mandatory margining requirements. An important prerequisite for margining is a liquid market that gives proper price signals. Market practice shows that for less liquid products (the ones that are generally not cleared), it is very difficult to agree on market to model because of lack of information on future prices. For instance, non standardised power contracts in a country divided in different pricing zones (e.g. in the Nordics) where a counterparty purchases a financially settled power contract in a certain price zone, and sells the same financially settled power contract in another pricing zone, prices are not readily available and margining will be very unpractical and sometimes even impossible to implement. The valuation and calculation of VM can be highly contentious, and can lead to lengthy discussions with a counterparty, which are time consuming and potentially costly (and may not lead to an ideal solution with regard to risk mitigation).

Likewise, margining will in practice not be possible without distorting competition in the event where the calculation of prices/margin calls by a counterparty will cause the counterparty to reveal its internal pricing models and other commercially sensitive information, which is protected.

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?

As explicitly stated on page 9 of the consultation document, it is the specific goal of the current proposal to reduce systemic risk in derivative markets. EFET appreciates that the BCBS and IOSCO foresee that the exchange of collateral for non-cleared derivative transactions should be "appropriate to the risks posed by such transactions", as mentioned in the Key Principle on page 14. Indeed, given the significant consequences associated with capturing firms that do not pose a systemic risk to the financial system, BCBS and IOSCO must carefully consider the extent to which the proposed measures would also be applicable to non-financial firms. We strongly believe that capital should not be unnecessarily tied up in margining or segregation requirements without actually improving the stability of the market, limiting liquidity impact, and providing significant benefits in terms of lower or more efficient risk management.

EFET believes that the approach proposed by the BCBS and IOSCO according to which the margining requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempt from central clearing mandates under most national regimes, is appropriate. However, the assessment of the systemic relevance of non-financial entities, which is key to this principle, remains unclear. Although this is not a topic for discussion in the consultative document, IOSCO and BCBS should clearly affirm that these criteria should be carefully targeted in order to avoid that NFCs which are not of systemic importance will be 'covered entities'.

More specifically, non-financial and commodity trading firms within the energy (non-banking) sector use OTC derivatives to mitigate commercial risks arising from the underlying activity of these firms. We would welcome clarity from the BCBS and IOSCO that the requirement for non-financial counterparties to exchange collateral does not apply to transactions that are objectively measurable as reducing risks directly related to the commercial risk or treasury financing risks of the group. We believe this is the policy in the US, as embodied in the "end-user exemption" for requirements to clear or collateralise swaps which are used to 'hedge or mitigate commercial risks'.

As acknowledged by the CFTC, 'requiring end-users to divert scarce capital to margin would increase risk, rather than reduce it, by making hedging more expensive and thus less likely to occur." Imposing initial margin collateralisation on "risk-reducing" transactions will inevitably drive up the capital cost of, and dis-incentivise non-financial companies (and commodity trading firms within the energy (non-banking) sector who enter into such transactions on behalf of their group companies) from undertaking such transactions. So while "systemic" risk may reduce, "commercial" risk may rise instead. We should urge the BCBS and IOSCO to clarify their position and exercise caution in imposing such radical measures which may have unintended consequences.

From a European standpoint, it should be clarified that in accordance with and under the conditions of Art. 11.5 (and following) of EMIR, intra group transactions are clearly exempted from the margining requirements. EFET opposes the requirement to provide collateral in the form of either Initial Margin or Variation Margin in respect of intra-group transactions. This serves no market stability function, at the very least in the case of non-banking groups, would unpick existing group treasury activities and fundamentally contradicts the economic reasoning behind intra-group exemptions, for example under EMIR.

Finally, EMIR obliges only non-financials above specific thresholds to perform bilateral margining. More information is therefore needed with regard to what will happen in case a company falls back below the threshold and can therefore be regarded as systemically irrelevant. Would the other party obliged to accept that the provided collaterals for the already covered transactions is repaid or is this subject to bilateral negotiations?
See also our suggestion in the answers to Q25 and Q26

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?

1. *Use of initial margin*

The use of initial margin (IM) and variation margin (VM) as systemic risk mitigation tools is at the heart of the consultation. It is EFET's view that a number of issues should however be addressed with regard to the situation in energy markets.

Smaller players in Europe's energy market do not have any experience with margining

Many smaller non-financial counterparties do not currently use margining in the energy trading business in the EU. The BCBS and IOSCO should not assume that energy trading companies would be able to move to margining without any important additional costs, which not all companies will be able to afford. The imposition of such requirements may, therefore, increase systemic risk by making hedging prohibitively expensive for some and economically unattractive as opposed to going unhedged.

Other collateral options

Posting initial margin should be considered as only one approach to risk mitigation among others, including the BASEL III capital requirements, collateral reconciliation, use of credit lines and credit ratings and detailed credit risk assessments over the life of counterparties' business relationship, and ODSG reporting and resolution procedures. Imposing an IM requirement would lead to a significant cash liquidity constraint, increased costs, and would lower market liquidity. IM would also deny the existence and functioning of current methods of risk mitigation used by non-banking groups in the course of their normal business activity.

The BCBS and IOSCO do not consider alternative credit risk management methods concerning non-banking counterparties. It is a reality that utilities, energy traders and commodity trading firms within the energy (non-banking) sector use, for example, credit lines, external ratings (where in particular the rating agencies take into consideration the existing debts and liabilities of a company, before issuing their rating) and risk monitoring of counterparties to mitigate risks. These should at least be considered as sufficiently robust credit risk management to ensure that non-banking counterparties are not subjected to mandatory initial margin requirements or for the application of any appropriate level of thresholds.

Credit risk for non-financials and commodity trading firms within the energy (non-banking) sector is also mitigated through the utilisation by energy trading companies of contractual tools for credit risk management, for instance the EFET standard Master Trading and Netting Agreements. The EFET form Master Trading and Netting Agreements have become the predominant market standard for physically settled wholesale energy transactions in continental Europe. They cater for performance assurance and permanent fluctuation of exposure in credit lines, payment netting, and enforceable early termination and close-out netting, across all contracts between two counterparties, leading to a net exposure.

EFET believes that collecting IM should be considered as only an alternative approach to risk mitigation among others. OTC market participants should be entitled to decide on their own risk-mitigation methods within a clearly defined set of sound business practices including the measurement and mitigation of counterparty credit risk using capital and other risk transfer instruments as well as initial margin, if appropriate.

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?

No answer.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

We see no rationale to limit the use of IM thresholds to entities that are prudentially regulated. It can't be ignored that whereas prudentially regulated entities hold regulatory capital, non-financial entities in the energy sector are backed by production assets, which when properly evaluated (such as by rating agencies) provide a solid financial backing.

If non-financial counterparties are not exempted altogether from IM, they should benefit from the thresholds set for prudentially regulated counterparties provided they have "risk management procedures in place that are adequately sound, robust and consistent with the level of complexity of their derivative transactions" (EMIR, Art. 11.5 and following). Only objective and non-discriminatory conditions would avoid any uneven playing field.

We firmly believe that the notional value of OTC derivatives is not an effective measure to determine risks underlying the participation in derivative markets. Calculating positions on a net basis and only with external counterparties reflects non-financial companies' (and more generally non-banking groups') exposure to counterparties in a more realistic way, and would better represent the actual systemic relevance of a specific counterparty.

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

The applicability of IM should distinguish between financial and non-financial entities (below the EMIR clearing threshold). The driving principle should be the open access to collateral for different type of entities i.e. financials vs. non-financial entities. Thresholds should not be approached on a "one-size-fits-all" basis. Their calibration should leave sufficient flexibility to take into account the creditworthiness of the relevant counterparty and the risk profile of the relevant transaction(s), among others.

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?

The requirement to post initial margin will in effect require non-banking groups to divert capital away from productive economic activity, where they can afford IM payments, or to move away from energy trading, thus affecting the liquidity of the market as a whole. We believe that the intention of the BCBS and IOSCO proposal is to circumscribe any undesirable impact on the real economy by limiting the requirement for risk mitigation through collateralisation to circumstances where there is a genuine and warranted need for it; i.e. when the relevant non-banking groups poses systemic risks to the financial system.

As mentioned previously (see Q.3 and Q.5), non-standard products can in most instances not be margined, and non-banking entities using appropriate credit risk management tools should be exempted from the scope of margining requirements. In the worst case, initial margining should apply with a threshold in order to ensure that only systemically relevant entities are captured. With regard to variation margin, two-way payments are acceptable only between non-financial counterparties posing systemic risk, such as is in place through the EFET / ISDA CSAs. In any case, intra-group transactions should be exempted from the scope of margining (see Q.4).

Especially for smaller companies the use of initial and variation margin is marginal, and obviously a mandatory posting and collection of margins for all non-cleared products will have a significant impact on a firm's cash liquidity as a whole and will ultimately reduce market liquidity as firms find the costs of hedging their risks becomes too high. This would also have the perverse result of increasing the overall level of risk in the sector by incentivising parties to go unhedged.

In the energy sector some smaller players, large industrials, (companies similar to) Stadtwerke generally do not possess the infrastructure and the means to put in place bilateral margin agreements (be it initial or variation margin). Currently in the energy sector initial margin is only used for counterparties with very low credit-worthiness. Any forced initial margin requirements would therefore place an additional and unnecessary liquidity strain on energy companies that would increase the cost of business disproportionately to any risk they are purportedly seeking to address, especially given the underlying value of their assets, the strength of their balance sheets and, in many cases, their high credit ratings. Variation margin on the other hand is generally already calculated between more sophisticated (bigger) players in the energy market. Among the parties where margining is applied, well established market practices are already in place that are based on the ISDA and EFET Credit Support Annexes (which include the ability to take variation margin by way of full title transfer of collateral and/or the provision of standby letters of credit. We ask the BCBS and IOSCO to carefully take these existing market practices into account when drafting requirements for non-financial firms and commodity trading firms within the energy (non-banking) sector.

Finally the consultative document does not provide a definition of 'key market participants' and how these are identified. Our understanding is that this is a subset of all 'covered entities', although we would appreciate IOSCO/BCBS to provide a clarification in this sense.

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?

In the event where two-way IM would be required (contrary to our proposals) there should be a level playing field between regulated entities and non financial entities. There is no reason why regulated counterparties should be exempted from posting IM.
See also our suggestion in the answers to Q23 and Q24.

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

See Q3, Q5 and Q9.

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?

See Q3, Q5 and Q9.

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?

As expressed in the introduction to this document, we are doubtful that the methodology to exchange IM and VM would be practicable for derivatives which will not deemed to be eligible for central clearing. We believe that this methodology would not be applicable for instruments which are not sufficiently standardized, liquid and with price information available and reliable on on-going basis.

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?

No answer.

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?

We refer to our response to Q.13. Furthermore, we believe that the initial margin level prescribed in the standardised schedule for commodity derivatives is extremely penalising, in particular if applied to the gross notional size of each derivative contract.

We are particularly concerned about the impact that these requirements could have on the entire functioning of energy commodity derivative markets.

As for the regulatory standards under development in Europe by ESMA, we emphasise the need to have more specific clarification about certain definitions e.g. notional exposure and prices applicable as well as clear indications on netting possibilities in case ‘a limited degree of netting may be performed’ as mentioned in the notes of the consultative document.

Q16. Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?

We believe that the methodology of two-way margining is applicable only if certain market conditions are satisfied, therefore we appreciate and support the view expressed in the consultative paper that ‘*the valuation of a derivative’s current exposure can be complex and, at* *times, become subject to question or dispute by one or both parties. Moreover, in the case of non-centrally-cleared derivatives, these instruments are likely to be relatively illiquid, often with little or no price transparency making the process of agreeing on current exposure amounts for variation margin purposes even more challenging.'*

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?

It is acceptable to allow for less frequent postings of variation margin. Generally, the frequency of the VM exchange should depend on the availability of reliable price data that could justify the underlying exchange of payments. Therefore, flexibility would be required when implementing this requirement.

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?

No answer.

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

A Minimum Transfer Amount should be calibrated appropriately to limit operational costs. Whilst we welcome the concept of a Minimum Transfer Amount for this reason, the determination of this amount should be left to the discretion of the parties, taking into account the creditworthiness of the parties, the administrative and operational capability of the parties to exchange margin on a timely basis when required and common market practice.

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

The eligibility of collateral should take into account that non-financial and commodity trading firms within the energy (non-banking) sector do not have access to central bank money and liquidity facilities such as the ECB's LTRO (that is itself already under strain providing banks with liquidity to satisfy current market requirements, which will increase exponentially if the classes of eligible collateral for cleared and uncleared trades is too restrictively drawn). Alternatives to cash collateral are vital and the parties should have the flexibility in an uncleared context to agree on collateral that they regard as appropriate to effectively mitigate risk in respect of the relevant transactions and the nature of the parties themselves. We strongly support the possibility of using commercial bank guarantees as eligible collateral for bilateral collateralisation[2]. This should not have a negative impact on setting incentives for central clearing but would rather produce the opposite effect, making central clearing less prohibitively expensive and burdensome to non-banking groups where and when central clearing is possible.
From a risk point of view, we do not see any reasons not to accept the mentioned securities in case the bank is obliged to pay on first demand within a short time period. The payment obligation under the guarantee is in principle equal to a payment obligation of a bank account, to which an IM has to be transferred, or the payment obligation of a bond.

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

[2] We would also like IOSCO and the BCBS to consider letters of credit, PCGs, and similar credit management instruments often and successfully used by non-banking companies as eligible collateral, although we understand that they may not have the same liquidity properties as commercial bank guarantees.

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?

No answer.

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?

Segregation in principle is a good thing, at least with regard to initial margin (if this is posted). The BCBS and IOSCO should however be aware that mandating segregation will also substantially increase the cost of doing business for non-financial and commodity trading firms within the energy (non-banking) sector. If also made applicable to (smaller) non-financial firms, the additional cost of trading and resulting liquidity constraint might easily push smaller parties out of the market altogether meaning that they would be unable to hedge their commercial or treasury financing risks.

Requiring companies to apply segregation would increase the following costs:

- cost of tying up liquidity for segregation;
- cost of additional borrowing/collateral transformation facilities to fulfil segregation requirements; and
- cost attached to the segregation itself (systems have to be installed and banking counterparties will certainly charge more for this).

A regime mandating the posting of initial margin will lead to significantly higher credit risk for those required to post collateral unless all Member States have regulatory rules and bodies that can:

- effectively supervise and enforce segregation requirements; and
- ensure unhindered and timely recovery of collateral by non-defaulting parties.

This aspect poses even greater concern should it be required for initial margin to be posted across national borders when transacting with foreign counterparties. The recent liquidation of MF Global has demonstrated how challenging it can be even for relatively sophisticated jurisdictions to ensure adequate protection of segregated assets. Hence, while we agree that the two-way exchange of initial margin is effective only when held segregated, posting of initial margin should not be mandated unless parties that are required to post can be confident that segregation regimes are in place and effective across nation states. However, there is currently little evidence that is the case.

See also our suggestions in the answer to Q23 and Q24.

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

As previously mentioned, the scarcity of collateral in general, and cash collateral in particular, makes this requirement extremely penalising and leading to the impacts mentioned in the introductory remarks of this paper. We do not exclude the possibility that it could create concentration risks, but we believe that such a requirement would most likely lead non-financial entities to use less derivatives and potentially leaving price risk uncovered in order to be able to manage the cash flow risk.

Please see the answer to Q24 for a suggestion as to how this requirement to exchange Initial Margin on a gross basis could be made more flexible whilst still achieving the same extent of market stability function. As for concentration at custodian banks, it may be possible to explore further protections for custody assets by amendments to applicable insolvency regimes and covering the relevant accounts with sufficiently flexible charges. Any such arrangements would need to be the subject of rigorous legal review taking into account the jurisdiction of incorporation of the relevant counterparties, the custodian and the location where the relevant custodian account was held. No mandatory bilateral Initial Margin requirements with regard to uncleared trades should be enacted until the relevant protections can be put in place and the appropriate legal due diligence has been concluded to protect market stability.

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?

If an obligation to collect Initial Margin is imposed on both parties to a transaction, then it would appear that segregation and no right of rehypothecation or reuse should be permitted. If the obligation to collect is only on one party, then it should be open to the other to also require provision of Initial Margin and it should also be a matter for negotiation as to whether such Initial Margin should be segregated. However, segregation should not be required with regard to Variation Margin and rehypothecation or reuse should be permitted. Full title transfer of cash collateral should also be permitted in the case of Variation Margin. One possible way of allowing two way Initial Margin to be segregated without rehypothecation or reuse, whilst at the same time minimising the impact of such collateral requirements on liquidity in the market and the effect of collateral squeeze, would be for such Initial Margin to be held at a third party custodian. Alternatively, if parties are permitted to use standby letters of credit as Initial Margin then these are, by their very nature, naturally segregated from the other assets of the insolvent's estate and would not tie up other liquid collateral, which will be in demand to an unprecedented level, from the outset.

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?

Intragroup transactions are usually not collateralised, since the parties to an intragroup transaction will generally have no credit risk differential between them and will in many cases have credit support and financing provided at a group level. Hence, collateralising the risk would be inappropriate and unnecessary from an economic point of view and would be an inefficient use of liquid resources. Intragroup transactions do not affect the net risk position of the entire non-banking group; at group level the risks compensate each other: potential losses of one group member are potential gains of another. Any residual credit risk is usually hedged on a portfolio basis by one or two external market-facing entities. Forcing affiliates to bilaterally collateralise their intra-group transactions would not serve any market stability function and would not reflect the reality of the economics of trades in derivatives within non-banking groups.

Intragroup transactions in non-financial firms and between commodity trading firms within the energy (non-banking) sector and the companies within their group on behalf of whom they trade are necessary and common practice because treasury and risk management services are typically performed centrally in order to optimise the needs of different entities within a group Therefore we believe that in general there should not be requirements to exchange margins between affiliates, unless there are evident and specific impediments that could justify a similar treatment to transactions with unaffiliated counterparties. Please see the answer to Q27 for further details.

Imposing margining between intra group entities would be in clear breach of EMIR, which exempts intra group transactions from the risk management requirements (Art. 11.5 and following). This exemption is applicable subject to the condition that there is no practical or legal impediment to the prompt transfer of own funds or repayment of liabilities and that there is a centralised evaluation, measurement and control with regard to risk. If these requirements are fulfilled, then there is no appreciable additional benefit to be gained from bilateral margining.

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?

The costs of requiring exchange of margins between affiliates are linked to the unjustified additional complexity and the unnecessary exchange of margins to cover a counterparty risk that does not exist.

The possibility that one affiliate builds up a large and uncollateralised exposure to another affiliate or parent, which could in turn jeopardise the entire group should be handled within the group through appropriate risk allocation methods. We believe that the intrusion in these internal arrangements has limited or no connection with measures to limit systemic risk. This is certainly at least the case with regard to non-banking groups where there are usually limited external contact points out to the wider market, with the majority of the inter-affiliate trading being undertaken for hedging or treasury financing purposes. In non-banking groups (which may be comprised of one or two authorised financial entities to conduct trading activities and a majority of non-financing entities who do not have any external derivatives trading contact with the market themselves) an obligation to post variation margin on a bilateral basis between affiliates does not serve any market stability function and does not contribute anything in terms of additional protection for the counterparties of the external market facing companies within the group. In addition, as the external market facing companies are not banks they do not have investors or depositors that may wish to withdraw funds and so may require additional protection in the same way as customers of a bank. In practice most non-banking groups have a central treasury function that sets the treasury policies for the group and acts as an internal bank, providing treasury services for the rest of the group, including (if applicable) the group's commodity trading business. Many such groups already employ cash pooling/ margining arrangements under which cash is periodically (e.g. daily) swept from several bank accounts of different group entities into one or more header accounts in the name of group treasury entities. This is an economically efficient and well-established risk-reducing cash optimisation arrangement that is already widely used by non-banking groups. Imposing bilateral margin requirements in respect of inter-affiliate trades would require the unwinding of such efficient structures for no appreciable market stability reason. We oppose such a change, especially where other, more efficient group structures already exist.

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?

Ensuring global harmonisation of margin requirements for uncleared trades is important, however, it is also necessary to consider the cross border effect of the differences in national bankruptcy and netting legislation. These differences may make it more difficult in some instances for non-defaulting parties to recover collateral posted with a party that becomes insolvent.