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Consultation Response
The Working Group on Margining Requirements

Margin Requirements for Non-Centrally Cleared Derivatives

28 September 2012

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

The Working Group on Margining Requirements
International Organization of Securities Commissions
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28006 Madrid
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28 September 2012

Dear Sir/Madam

Margin requirements for non-centrally-cleared derivatives

The Institute and Faculty of Actuaries welcomes the opportunity to respond to this consultation. In preparing this response, this consultation was referred to our Finance and Investment Practice Executive Committee to discuss.

Below we present comments in response to the questions posed that we feel we can provide best insight into. The general position we have taken in response to specific elements of the questions posed is that any regime needs to be proportionate and not so onerous or costly as to discourage entities from engaging in hedging trades which reduce their financial risk. We urge you to consider our comments in that context.

Q.1 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 (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

Where certain market participants that trade OTC derivatives (in particular pension funds) have been granted exemption from central clearing, there are good reasons for this exemption being granted because it is too costly or not practical to implement. Implementing essentially the same margining requirements on these market participants is potentially very onerous. We would suggest a longer phase-in period be allowed for margining requirements for non-centrally cleared contracts.

In particular the following requirements, if introduced, may take some time for these entities to put in place:

- Re-organising assets to ensure sufficient cash will be available to meet daily variable margin requirements (unless central clearing houses are able to accept a wider range of collateral)
- Re-organising assets to make sure sufficient highly liquid assets are available to deliver as initial margin under the contract
- Setting up the infrastructure to facilitate daily movement of collateral where this is not currently in place.

We would suggest a minimum phase-in period of 12 months.

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Q.2 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 agree that such foreign exchange swaps and forwards should be exempted as many market participants who trade these instruments but do not trade any other OTC derivatives will not have the infrastructure set up for managing daily margin movements. In these cases, provided the maturity of the FX swaps and forwards is limited, e.g. to three months, it would seem overly burdensome in terms of costs to require these participants to meet the same standards as for more risky/longer term OTC derivatives.

Q.4 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?

A Two way margin increases overall costs and may discourage some participants from engaging in hedging trades, thus leaving financial risks unhedged. This is a major disadvantage of the proposed approach.

We do acknowledge, however, the need for regulation to reduce counterparty risk in the system that is behind the proposal. There is a trade-off between allowing cost effective, efficient hedging strategies, and minimising systemic risk.

Any margining requirements placed on pension funds and insurance funds should reflect their credit worthiness and be proportionate to their OTC exposure. Margining arrangements should allow for margin to be posted by banks to counterparties such as pension funds and insurance funds (which in some cases may be higher quality credit risks than the banks they trade with) and vice versa.

Insurance funds in particular may suffer, to the extent that in the UK, the insurance industry has been positioning itself as a "buy and hold" investor of illiquid corporate bonds and infrastructure debt. Such assets would not be eligible for margining requirements.

Q.*5* 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?

Initial margin thresholds may help mitigate the liquidity impact of the proposed requirements. These thresholds should reflect the credit-worthiness of the counterparties.

Q.6 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?

We are of the opinion that thresholds should take account of the credit-worthiness of each counterparty at the time of entering into the trade. We would prefer thresholds to be a proportion of position risk.

Regulated insurance firms in the EU should be allowed credit for compliance with Solvency II.

Q.7 Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. 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?

If thresholds are permitted, they should be extended to institutional investors e.g. pension funds, that have high credit-worthiness and use OTC derivatives for liability hedge management, even if they are not prudentially regulated. In some cases pension funds may have higher credit-worthiness than the banks they face.

Q.9 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 concern is that higher costs and lower liquidity will apply across the industry. This could result, at the margins, in some economically useful hedging activity not taking place because it is no longer cost effective.

Q.10 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?

We believe that banks will likely pass on the cost of funding this initial margin requirement to clients. The proposal will, however, give greater protection to these unregulated counterparties in the event of a counterparty bank default. Clients such as pension funds and insurance funds should employ fund managers, or in-house asset management units, to manage the margining requirements.

Q.14 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?

Interest rate and inflation swaps are structurally linked so they should be treated as the same asset class.

Margining requirements should be netted across interest rate and inflation hedging instruments, so as not to unduly penalise pension funds and insurance funds that are using OTC derivatives to hedge liabilities that are exposed to both interest rate and inflation risk.

Q.17 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?

In our view, best practice would be daily collateralisation, although a phase-in period would be desirable to allow investors to put in place the infrastructure for this.

Q.24 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?

Re-hypothecation for initial margin should not be allowed unless very strong safeguards are put in place to ensure the pledger can quickly and easily claim back the assets in the event of counterparty default. In order for the margining framework to operate effectively in the event of a counterparty default, this initial margin needs to be available quickly in order to provide initial margin for the pledger's replacement trades.

Re-hypothecation of variation margin is permitted within the current OTC framework and is beneficial as it provides cost and liquidity benefits to the market. Where variation margin is re-hypothecated, there is an offset against the P&L on the OTC positions. This would mitigate the impact of any failure to return collateral (as the pledger could withhold payment of the P&L on the swap position to the pledgee).

Yours faithfully,

Chris watts

Chris Watts,
Chair, Finance and Investment Practice Executive Committee
The Institute and Faculty of Actuaries