

MEMO# 27543

September 5, 2013

Basel Committee and IOSCO Issue Final Margin Policy Framework for Non-Centrally Cleared Derivatives

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 73-13

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 66-13

ICI GLOBAL MEMBERS

INTERNATIONAL MEMBERS No. 38-13

SEC RULES MEMBERS No. 82-13 RE: BASEL COMMITTEE AND IOSCO ISSUE FINAL MARGIN POLICY FRAMEWORK FOR NON-CENTRALLY CLEARED DERIVATIVES

Recently, the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) issued their final policy framework that establishes minimum standards for margin requirements for non-centrally cleared derivatives. [\[1\]](#) The Final Margin Policy Framework is the product of two rounds of consultations by the BCBS and IOSCO. [\[2\]](#) Now that the international regulators have reached agreement on a consistent global framework, the national regulators will adopt their own laws. Chairman Gensler of the Commodity Futures Trading Commission (“CFTC”) recently testified that he expects the CFTC to repropose its margin rules for uncleared derivatives after the BCBS and IOSCO published their final framework. [\[3\]](#) The BCBS and IOSCO state that they will continue to work to monitor and assess how consistently the requirements are implemented across products, jurisdictions and market participants.

The BCBS and IOSCO will set up a monitoring group to evaluate these margin standards in 2014. The monitoring group will consider any initiatives to conduct further analysis of the costs and benefits and of the impact on competition for rules setting margin requirements for non-centrally cleared derivatives. The monitoring group will review the efficacy and appropriateness of the margin methodologies and standards and consider whether to provide more guidance in certain areas. Based on the findings of the monitoring group, the BCBS and IOSCO will determine whether any additional work needs to be undertaken or whether any modifications to the margin requirements are necessary or appropriate.

The BCBS and IOSCO articulate key principles of the framework in eight main elements, the most relevant to regulated funds are summarized below. The Final Margin Policy Framework incorporates many of the comments made by ICI and ICI Global. [\[4\]](#)

Instruments Subject to Requirements

In the Final Margin Policy Framework, the BCBS and IOSCO determined that margin requirements should apply to all non-centrally cleared derivatives except for physically settled foreign exchange (“FX”) forwards and swaps. The exception for physically settled FX forwards and swaps is consistent with the requests of commenters, including ICI and ICI Global. The BCBS and IOSCO believe, however, that variation margining of such instruments are common practice and that variation margin should be exchanged on physically settled FX forwards and swaps. The Final Margin Policy Framework suggests that those variation margin standards be implemented by way of supervisory guidance or national regulation.

The BCBS and IOSCO also are of the view that initial margin requirements for cross-currency swaps do not apply to the fixed physically settled FX transactions associated with the exchange of principal of cross-currency swaps. Therefore, the only payments to be excluded from initial margin requirements for a cross-currency swap are the fixed physically settled FX transactions associated with the exchange of principal. All other payments or cash flows that occur during the life of the swap would be subject to initial margin requirements.

Covered Entities and Threshold

Financial firms and systemically important non-financial entities (“Covered Entities”) that engage in non-centrally cleared derivatives would be subject to the requirements set forth in the Final Margin Policy Framework. [\[5\]](#) The BCBS and IOSCO leave the precise definition of financial firms, non-financial firms, and systemically important non-financial firms to be determined by national regulators.

Under the Final Margin Policy Framework, Covered Entities that engage in transactions in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin on a regular basis (e.g., daily). As advocated by ICI, among others, the BCBS and IOSCO adopted universal two-way margining – a requirement that would involve the mandatory exchange of both initial and variation margin between parties to non-centrally cleared derivatives transactions – rather than requiring counterparties (such as regulated funds) to post collateral only to dealers or systemically important entities.

Moreover, as supported by ICI and ICI Global, the BCBS and IOSCO would permit the use of a threshold of €50 million for all types of counterparties under which initial margin would not have to be exchanged rather than limit the use of thresholds to prudentially-regulated entities. The threshold is applied at the level of the consolidated group to which the threshold is being extended and is based on all non-centrally cleared derivatives transacted between the two consolidated groups. As requested by ICI and ICI Global, the BCBS and IOSCO also clarified that the threshold would apply at the fund level as long as the funds are distinct legal entities that are not collateralized by or are otherwise guaranteed or supported by other investment funds or the investment adviser in the event of fund insolvency or bankruptcy. [\[6\]](#) In addition, at the end of the phased-in period (described in more detail below), there will be a minimum level of non-centrally cleared derivatives activity (€8 billion of gross notional outstanding amount) necessary for Covered Entities to be subject to initial margin requirements.

Initial Margin

According to the BCBS and IOSCO, the initial margin should reflect the potential future exposure (i.e., an extreme but plausible estimate of an increase in the value of the

instrument that is consistent with a one-tailed 99 percent confidence interval over a 10-day horizon based on historical data that incorporates a period of significant financial stress). The required amount of initial margin may be calculated by reference to either a quantitative portfolio margin model or a standardized margin schedule (included as Appendix A to the Final Margin Policy Framework). The choice between the model and schedule-based initial margin calculations must be made consistently over time for all transactions within the same well defined asset class to avoid “cherry picking” to obtain the most favorable initial margin terms.

Models may be either internally developed or sourced from counterparties or third-party vendors. To use a quantitative model, the Final Margin Policy Framework imposes certain conditions. First, any quantitative model must be approved by a relevant supervisory authority and approved for use within each jurisdiction. Second, quantitative initial margin models must be subject to an internal governance process that continuously assesses the value of the model’s risk assessments, tests the model’s assessments against realized data and experience, and validates the applicability of the model to the derivatives for which it is being used. Quantitative initial margin models may account for risk on a portfolio basis, i.e., the model may consider all the derivatives that are subject to a single legally enforceable netting agreement. Initial margin models may account for diversification, hedging and risk offsets (with supervisor approval) within well defined asset classes but not across asset classes.

With respect to the use of the standardized margin schedules, the BCBS and IOSCO will permit the adjustment of the gross initial margin amount by an amount that relates to the net-to-gross ratio (“NGR”) pertaining to all derivatives in the legally enforceable netting set. The use of the NGR permits the recognition of offsets that would not be recognized by strict application of a standardized margin schedule.

Variation Margin

The Final Margin Policy Framework would require the full amount necessary to fully collateralize the mark-to-market exposure of the non-centrally cleared derivatives to be exchanged for variation margin. According to the BCBS and IOSCO, variation margin should be calculated and exchanged subject to a single, legally enforceable netting agreement with sufficient frequency (e.g., daily).

Eligible Collateral for Margin

The BCBS and IOSCO state that national supervisors should develop their own list of eligible collateral assets that are highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress. The Final Margin Policy Framework provides a non-exhaustive list of eligible collateral including: (1) cash; (2) high-quality government and central bank securities; (3) high-quality corporate bonds; (4) high-quality covered bonds; (5) equities included in major stock indices; and (6) gold. Eligible collateral can be denominated in any currency in which payment obligations under the non-centrally cleared derivatives may be made or in highly liquid foreign currencies subject to appropriate haircuts to reflect the inherent FX risk involved.

Under the Final Margin Policy Framework, potential methods for determining appropriate haircuts could include either internal or third-party quantitative model-based haircuts or schedule-based haircuts. Both internal and third-party models must be approved by supervisors and subject to appropriate internal governance standards. The BCBS and IOSCO also established a standardized schedule of haircuts derived from the standard

supervisory haircuts adopted in the Basel Accord (included as Appendix B in the Final Margin Policy Framework).

Treatment of Provided Initial Margin

The Final Margin Policy Framework would require gross initial margin between Covered Entities to be exchanged. Initial margin collected should be held in such a way to ensure that the collected margin is immediately available to the collecting party in the event of the counterparty's default and the collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event the collecting party enters bankruptcy.

Generally, cash and non-cash collateral collected as initial margin should not be re-hypothecated, re-pledged, or re-used. [7] The Final Margin Policy Framework states that a jurisdiction may allow the initial margin collector to re-hypothecate, re-pledge or re-use one time certain initial margin collected from a customer only for purposes of hedging the initial margin collector's derivatives position arising out of transactions with customers for which initial margin was collected if strict conditions enumerated in the framework are satisfied. The BCBS and IOSCO would impose 12 conditions, including a requirement for the customer to give express consent in writing to the re-hypothecation of its collateral and require the initial margin collector to give the customer the option to individually segregate the collateral that it posts from the assets of all the initial margin collector's other customers and counterparties.

Cross-Border Transactions

The Final Margin Policy Framework recommends that home and host country supervisors closely cooperate to identify conflicts and inconsistencies among regimes with respect to cross-border application of margin requirements. The BCBS and IOSCO may consider modifications to the requirements set forth in the Final Margin Policy Framework with a view to ensuring consistency in the treatment of cross-border transactions across all aspects of OTC derivatives regulation as other aspect of regulation of OTC derivatives evolve.

Phase-in of Requirements

The BCBS and IOSCO recommend a phased-in approach to the margin requirements. The Final Margin Policy Framework sets forth the following schedule.

- Requirement to exchange variation margin will become effective on December 1, 2015 for new contracts entered into after that date.
- Requirement to exchange two-way initial margin with a threshold of up to €50 million will depend on the aggregate month-end average notional amount of non-centrally cleared derivatives for Covered Entities beginning on December 1, 2015 to December 1, 2019.

On a permanent basis (from December 1, 2019), any Covered Entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year exceeds €8 billion will be subject to the margin requirements during the one-year period from December 1 of that year to November 30 of the following year. For purposes of calculating the aggregate month-end average notional amount for determining whether a Covered Entity will be subject to the initial margin requirements, all of the non-centrally cleared derivatives, including physically settled FX forwards and swaps, should be included.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

endnotes

[1] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> (“Final Margin Policy Framework”).

[2] See Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, July 2012, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf> ; Second Consultative Document, Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, February 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD403.pdf>. For summaries of the consultation papers, see ICI Memoranda Nos. 26325 (July 23, 2012) and 27033 (February 20, 2013), available at http://www.ici.org/my_ici/memorandum/memo26325 and http://www.ici.org/my_ici/memorandum/memo27033.

[3] Testimony of Chairman Gary Gensler before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 30, 2013) (“After the international standards are published, the CFTC will further propose margin rules likely later this year and seek to finalize those rules in the first half of 2014”).

[4] For summaries of ICI and ICI Global comment letters, see ICI Memoranda Nos. 27111 (March 14, 2013) and 26529 (September 27, 2012), available at http://www.ici.org/my_ici/memorandum/memo27111 and http://www.ici.org/my_ici/memorandum/memo26529.

[5] Central banks, sovereigns, multilateral development banks, the Bank for International Settlements, and non-systemic, non-financial firms are not Covered Entities.

[6] See Final Margin Policy Framework, *supra* note 1 at n. 10 (“Investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy”).

[7] Cash and non-cash collateral collected as variation margin may be re-hypothecated, re-pledged, or re-used.