

**MEMO# 26325**

July 23, 2012

# **BCBS and IOSCO Propose Margin Requirements for Uncleared Derivatives and CFTC Reopens Comment Period on Proposed Margin Requirements for Uncleared Swaps; Conference Call to Discuss Comments Scheduled for August 21**

[26325]

July 23, 2012

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 24-12  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 36-12  
INTERNATIONAL COMMITTEE No. 25-12  
SEC RULES COMMITTEE No. 47-12 RE: BCBS AND IOSCO PROPOSE MARGIN REQUIREMENTS FOR UNCLEARED DERIVATIVES AND CFTC REOPENS COMMENT PERIOD ON PROPOSED MARGIN REQUIREMENTS FOR UNCLEARED SWAPS; CONFERENCE CALL TO DISCUSS COMMENTS SCHEDULED FOR AUGUST 21

The Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") issued a consultation document describing their initial proposal to establish minimum standards for margin requirements for uncleared derivatives. [1] Comments on the Consultation Paper are due by September 28, 2012. The BCBS and IOSCO expect to issue a final proposal after reviewing the comments received. In response to the Consultation Paper, the Commodity Futures Trading Commission ("CFTC") re-opened for comment its proposed margin rules for uncleared swaps for swap dealers and major swap participants. [2] Comments on the CFTC's proposed rules are due on September 14, 2012.

We will hold a conference call on Tuesday, August 21 at 12:00 pm ET to discuss the Consultation Paper and the CFTC's proposed rules and possible ICI comments. If you plan to participate, please rsvp to Gwen Kelly at [gwen.kelly@ici.org](mailto:gwen.kelly@ici.org) or (202) 326-5818.

The Consultation Paper addresses seven main areas related to margin requirements for

uncleared derivatives. A summary is provided below.

## **Instruments Subject to Requirements**

The Consultation Paper proposes to apply the margin requirements to all non-centrally-cleared derivatives. There currently would be no exemption for foreign exchange swaps and forwards, but the BCBS and IOSCO specifically seek comment on whether foreign exchange swaps and forwards with a maturity of less than a specific tenor (such as one month or one year) should be exempted from the global margin requirements. The BCBS and IOSCO also request comment on whether additional specific exemptions or criteria for determining such exemptions should be considered.

## **Scope of Applicability**

The Consultation Paper also discusses the scope of firms to which the requirements would apply. The BCBS and IOSCO propose to require financial firms and systemically-important non-financial entities that engage in non-centrally cleared derivatives to exchange, on a bilateral basis, initial and variation margin in mandatory minimum amounts. Recognizing that a two-way margin exchange requirement could impose the most substantial liquidity costs, the BCBS and IOSCO discuss possible use of thresholds (i.e., an amount under which a firm would have the option of not collecting initial margin) for different counterparties.

## **Minimum Amounts and Methodologies for Initial and Variation Margin**

According to the Consultation Paper, for initial margin, the potential future exposure of a non-centrally cleared derivative should reflect 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 BCBS and IOSCO would permit the required amount of initial margin to be calculated by reference either to a quantitative portfolio margin model (subject to certain conditions) or a standardized margin schedule (included in the Consultation Paper as Appendix A).

For variation margin, the BCBS and IOSCO state that the full net current exposure of the non-centrally-cleared derivative must be used. According to the Consultation Paper, the BCBS and IOSCO would require calculation and collection subject to a single, legally enforceable netting agreement with sufficient frequency (e.g., daily). They also would require minimum transfer amounts to be set sufficiently low to ensure that current exposure does not build up before variation margin is exchanged between counterparties.

## **Eligible Collateral for Margin**

The BCBS and IOSCO propose a somewhat broad set of eligible collateral. The Consultation Paper provides that the assets collected as collateral should be highly liquid and should be able to hold their value in a time of financial stress to ensure that the assets can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect the collecting entities from losses in the event of a counterparty default. The Consultation Paper includes a non-exhaustive list of eligible collateral as examples: cash; high quality government and central bank securities; high quality corporate bonds; high

quality covered bonds; equities included in major stock indices; and gold. Moreover, the BCBS and IOSCO would permit eligible collateral to be denominated in any currency in which payment obligations under the non-centrally-cleared derivative may be made or in highly-liquid foreign currencies subject to appropriate haircuts to reflect the inherent foreign currency risks. The BCBS and IOSCO would permit either internal or third-party quantitative model-based haircuts or schedule-based haircuts. A standardized schedule of haircuts is included as Appendix B to the Consultation Paper.

## **Treatment of Provided Margin**

The BCBS and IOSCO propose that initial margin should be exchanged on a gross basis. According to the Consultation Paper, initial margin collected should be held in such a way to ensure that (1) the margin collected is immediately available to the collecting party in the event of the counterparty's default and (2) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law. The BCBS and IOSCO propose not to permit collateral collected as initial margin to be re-hypothecated or re-used.

The Consultation Paper also notes that there are many different ways to protect provided margin but that each carries its own risk. The use of third party custodians, for example, may generally be considered to offer the most robust protection but the Consultation Paper observes that there have been cases where access to assets held by third party custodians has been limited or practically difficult.

## **Interaffiliate Transactions**

The BCBS and IOSCO propose to require exchange of full variation margin between affiliates. For initial margin, the Consultation Paper states that local supervisors should review their own market conditions and put in appropriate requirements.

## **Cross-Border Transactions**

The BCBS and IOSCO propose that the margin requirements in a jurisdiction should be applied to legal entities established in that local jurisdiction, which would include locally established subsidiaries of foreign entities. The Consultation Paper provides five illustrative examples to demonstrate the proposed requirement. For example, in a derivatives transaction between a US bank and a German bank, the Consultation Paper states that the US bank would be subject to margin rules of the relevant US regulator and the German bank would be subject to the margin rules of the relevant German regulator.

The BCBS and IOSCO also propose that home-country supervisors should permit a counterparty to comply with the margin requirements of a host-country margin regime as long as the home-country supervisor considers the host-country margin regime to be consistent with the proposed margin requirements in the Consultation Paper.

## endnotes

[1] 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> (“Consultation Paper”).

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, RIN 3038-AC97, 77 FR 41109 (July 12, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16983.pdf>.

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