MEMO# 27033

February 20, 2013

Basel Committee and IOSCO Publish Near-Final Proposal on Margin Requirements for Uncleared Derivatives and Request Comment on Several Discrete Issues

[27033]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 22-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 20-13
ICI GLOBAL MEMBERS
INTERNATIONAL MEMBERS No. 15-13
INVESTMENT ADVISER MEMBERS No. 16-13
SEC RULES MEMBERS No. 25-13 RE: BASEL COMMITTEE AND IOSCO PUBLISH NEAR-FINAL PROPOSAL ON MARGIN REQUIREMENTS FOR UNCLEARED DERIVATIVES AND REQUEST COMMENT ON SEVERAL DISCRETE ISSUES

On February 15, the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") published a second consultative document on the margin requirements for non-centrally cleared derivatives. [1] The Consultation Paper follows the first consultation paper issued in July 2012 and reflects the "near-final policy framework" for margin requirements for non-centrally cleared derivatives. [2] The Consultation Paper seeks comment on four questions on certain aspects of the framework. Specifically, the BCBS/IOSCO requests comment on issues relating to: (1) the treatment of physically-settled foreign exchange ("FX") forwards and swaps under the framework; (2) the ability to engage in limited re-hypothecation of collected initial margin; (3) the proposed phase-in schedule of the requirements; and (4) the adequacy of the quantitative impact study conducted by the BCBS/IOSCO. Comments on the Consultation Paper are due by March 15.

The near-final framework is articulated by the BCBS/IOSCO through key principles addressing eight main elements. Those eight elements are summarized briefly in this memorandum.

Instruments Subject to Requirements

The Consultation Paper proposes that the margin requirements apply to all non-centrally cleared derivatives. The BCBS/IOSCO seeks comment on whether the margin requirements should apply to physically-settled FX forwards and swaps. In particular, the Consultation Paper asks whether these instruments should be exempt from the initial margin requirements with variation margin required as a result of either BCBS' supervisory guidance for managing settlement risk in FX transactions [3] or national regulation. The Consultation paper also requests comment on whether physically-settled FX forwards and swaps with different maturities should be subject to different treatment.

Scope of Applicability

The Consultation Paper proposes that all financial firms and systemically-important non-financial entities (collectively, "covered entities") that engage in non-centrally cleared derivatives would be required to exchange initial and variation margin. All covered entities would be required to exchange, on a bilateral basis, the full amount of variation margin on a regular basis (e.g., daily).

All covered entities also would be required to exchange, on a bilateral basis, initial margin subject to a threshold (i.e., an amount under which a covered entity would have an option of not collecting initial margin) not to exceed €50 million. The threshold would be applied at the level of a consolidated group. [4] The threshold would be universal and would not be limited to certain types of covered entities as contemplated in the First Consultation Paper.

The BCBS/IOSCO proposes a minimum level of non-centrally cleared derivatives activity (€8 billion of gross notional outstanding amount) that would subject covered entities to the initial margin requirement.

Methodologies for Initial and Variation Margin

Initial Margin

For initial margin, the Consultation Paper proposes that the requirements reflect an extreme but plausible estimate of an increase in 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. Covered entities may choose between a model and schedule-based initial margin calculation, but the choice must be made on a consistent basis over time for all transactions within the same well-defined asset class. The Consultation Paper states that the specific method and parameters that would be used by each counterparty to calculate initial margin should be agreed upon and recorded at the onset of the transaction to reduce potential disputes.

With respect to the quantitative models, the Consultation Paper would permit covered entities to use internal or third-party quantitative models subject to certain conditions. Models may either be internally developed or may be provided by the counterparties or third party vendors but they must be approved by the appropriate supervisory authority. Moreover, third-party models must be approved for use within each jurisdiction and by each covered entity seeking to use the model. [5] Quantitative initial margin models also 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. Derivatives between counterparties that are not subject to the same, legally enforceable netting agreement must not be considered in the same initial margin model calculation.

As an alternative to the margin models, the Consultation Paper provides an initial margin schedule that could be used to compute the amount of initial margin required (attached as Appendix A). The required margin would be computed by referencing the standardized margin rates and by adjusting the gross initial margin amount by an amount that relates to the net-to-gross ratio pertaining to all derivatives in the legally enforceable netting set. The use of the net-to-gross ratio recognizes offsets that would not be recognized by strict application of a standardized margin schedule.

Variation Margin

For variation margin, the Consultation Paper proposes to require the exchange of the full amount necessary to fully collateralize the mark-to-market exposure of the non-centrally cleared derivative. According to the Consultation Paper, variation margin should be calculated and collected subject to a single, legally enforceable netting agreement with sufficient frequency (e.g., daily).

Eligible Collateral

The BCBS/IOSCO proposes that national supervisors develop their own list of eligible collateral assets based on the key principle described in the Consultation Paper. According to the BCBS/IOSCO, assets collected for collateral should be highly liquid and should, after accounting for an appropriate haircut, 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 collecting covered entities from losses on the non-centrally cleared derivatives in the event of a counterparty default.

As a guide, the Consultation Paper provides a non-exhaustive list of the types of eligible collateral that would satisfy the key principle, which include: (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.

The methods for determining appropriate haircuts include either internal or third-party quantitative model-based haircuts (subject to approval by regulators and appropriate internal governance standards) or schedule-based haircuts, which are included in the Consultation Paper as Appendix B.

Treatment of Provided Initial Margin

The Consultation Paper proposes that initial margin should be exchanged by the counterparties without netting of amounts. The initial margin exchange also should be held in such a way to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default and (ii) 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/IOSCO proposes that cash and non-cash collateral collected as initial margin should not be re-hypothecated, re-pledged or re-used. The BCBS/IOSCO specifically requests comment on whether re-hypothecation should be allowed to finance/hedge customer positions if re-hypothecated customer assets are provided certain protections.

Treatment of Transactions with Affiliates

The Consultation Paper proposes that transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework. The BCBS/IOSCO proposes to leave to local supervisors to determine whether to impose initial and variation margin requirements on transactions between affiliates.

Cross-Border Transactions

The BCBS/IOSCO is of the view that regulatory regimes should interact to provide consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions. The Consultation Paper proposes that the margin requirements in a jurisdiction should be applied to legal entities established in that local jurisdiction in relation to the initial and variation margin that they collect. According to the BCBS/IOSCO, home-country supervisors should permit a covered entity to comply with the margin requirements of a host-country margin regime with respect to its derivatives activities if the home-country supervisor considers the host-country margin regime to be consistent with the margin requirements described in the Consultation Paper.

Phase-In Requirements

Recognizing the need to balance the benefits of the new requirements in reducing systemic risk and promoting central clearing with the liquidity, operational, and transition costs associated with implementing the requirements, the BCBS/IOSCO proposes a multi-year phase-in schedule. First, the requirement to exchange variation margin would become effective on January 1, 2015 for all new contracts entered into after that date. [6]

The requirement to exchange two-way initial margin with a threshold of up to €50 million will be phased-in as follows:

- In 2015, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2014 exceeds €3.0 trillion would be subject to the requirements when transacting with another covered entity that meets that condition; [7]
- In 2016, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2015 exceeds €2.25 trillion would be subject to the requirements when transacting with another covered entity that meets that condition;
- In 2017, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2016 exceeds €1.5 trillion would be subject to the requirements when transacting with another covered entity that meets that condition; and
- In 2018, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2017 exceeds €.75 trillion would be subject to the requirements when transacting with another covered entity that meets that condition.

In 2019 and thereafter, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of the preceding year is less than €8 billion would not be subject to the initial margin requirements. Initial margin requirements would apply to all new contracts entered into after each of the dates specified above. Covered entities would not be required to apply the initial margin requirements to existing derivative contracts. The Consultation Paper requests comment on whether the proposed phase-in arrangements are appropriate.

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endnotes

[1] 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 ("Consultation Paper").

[2] 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 ("First Consultation Paper"). For a summary of the First Consultation Paper, see ICI Memorandum No. 26325 (July 23, 2012), available at http://www.ici.org/my_ici/memorandum/memo26325. For a summary of the comment letter submitted by ICI and ICI Global in response to the First Consultation Paper, see ICI Memorandum No. 26529 (Sept. 27, 2012), available at http://www.ici.org/iciglobal/pubs/memos/memo26529.

[3] The BCBS is updating the supervisory guidance for managing settlement risk in FX transactions, which will cover margin requirements for physically-settled FX forwards and swaps.

[4] According to the BCBS/IOSCO, the requirement that the threshold be applied on a consolidated group basis is intended to prevent the proliferation of affiliates and other legal entities within larger entities for the sole purpose of circumventing the margin requirements.

[5] An unregulated counterparty that wishes to use a model for initial margin purposes may use an approved initial margin model.

[6] Exchange of variation margin for other contracts would be subject to bilateral agreement.

[7] The computation will encompass all non-centrally cleared derivative activities of a consolidated group. Therefore, the threshold would apply to a group's aggregate amount.

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