

March 18, 2013

Secretariat  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND  
Sent by email to: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Secretariat  
International Organization of Securities Commissions  
C/ Oquendo 12, 28006 Madrid, SPAIN  
Sent by email to: [wgmr@iosco.org](mailto:wgmr@iosco.org)

**Re: Second Consultative Document: "Margin Requirements For Non-Centrally-Cleared Derivatives"**

Dear Secretariats,

The International Swaps and Derivatives Association<sup>1</sup> ("**ISDA**") appreciates the opportunity to respond to the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") with respect to the Second Consultative Document "Margin Requirements For Non-Centrally Cleared Derivatives" (the "**Paper**" or "**BCBS 242**") of February 2013.

**Introduction**

ISDA supports the Paper's main goals of strengthening systemic resiliency in the over-the-counter ("**OTC**") derivatives market, promoting central clearing of OTC derivatives and preserving liquidity for transactions and collateral in the OTC derivatives market. Moreover, ISDA appreciates BCBS's and IOSCO's initiative in tackling these important issues on a global basis; we share your goal of minimizing the potential for regulatory arbitrage across regions.

---

<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

While ISDA supports the role of margin in reducing counterparty risk, we are gravely concerned that the proposals set forth in the Paper may instead undermine systemic resiliency by significantly diminishing liquidity in financial markets and also harming the general economy, while increasing systemic risk during times of market stress. Without careful consideration of their potential drawbacks, the regulations proposed by the Paper will result in a weaker and less liquid market that could be closed to market participants for whom centrally cleared derivatives do not fulfill their risk mitigation objectives.

We are also disappointed that the points made by us, as well as by other organizations, with respect to Initial Margin ("IM") have not been incorporated into the Paper. We reiterate our position that if a requirement to transfer Variation Margin ("VM") on a daily basis is implemented along with robust financial resources arrangements, IM for non-centrally cleared derivatives should be left to the discretion of the relevant parties.<sup>2</sup> Reliance on VM would greatly strengthen systemic resiliency without the problems that IM creates.

This response expresses our concerns and provides suggestions with respect to the proposals set forth in the Paper and provides answers to the questions raised by BCBS and IOSCO therein.

## **Executive Summary**

The following is a brief summary of some of our key points:

### **I. Initial Margin**

- A. Amount of Margin Requirement: The level of IM proposed by the Paper is extremely high and would severely reduce the use of uncleared OTC derivatives. In addition, the funds needed by market participants to acquire sufficient collateral to post IM for these uncleared OTC derivatives will reduce their overall business activities and this will damage the real economy by draining liquidity from Covered Entities (as such term is defined in the Paper) that enter into uncleared OTC derivatives. Non-Covered Entities will also suffer the impact due to the indirect cost of IM imposed on hedging transactions. Proposed IM requirements will also reduce liquidity and access to OTC derivatives that cannot be centrally cleared, which will severely impair market participants' ability to hedge their related risks.
- B. Pro-Cyclicality: A dynamic IM model, such as the one proposed in the Paper, will have a pro-cyclical effect, magnifying the negative pressures on markets in times of significant stress. IM requirements would rise by as much as 3 to 10 times from levels seen in low volatility markets, and this would force parties to acquire large amounts of collateral in an illiquid market, exacerbating the market dislocation.

---

<sup>2</sup> This response should be read together with ISDA's comment letter re: BCBS/IOSCO Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives, dated Sept. 28, 2012 ("**ISDA September Comment Letter**") and the follow-up letter submitted jointly by ISDA, IIF and AFME dated Dec. 12, 2012 which discusses certain points raised in the prior responses.

- C. Obstacles: Requiring IM will impose significant operational hurdles because many parties do not currently post IM. In addition, it will generate significant numbers of disputes, especially if value-at-risk ("VaR") models are used, and it will be time-consuming to develop methods to resolve such disputes. Also, each jurisdiction will need to harmonize its margin and capital rules to ensure a consistent and clear regulatory approach. Finally, some jurisdictions may not currently have legal frameworks that appropriately support IM.
- D. Effective Mitigation: In lieu of IM, which could destabilize the global markets, particularly during times of stress, systemic risk can effectively be mitigated by a three pillar approach: VM requirements, appropriate capital requirements (consistent with the tenets of Basel III), and mandatory clearing of liquid, standardized OTC derivatives. Non-centrally cleared OTC derivatives are already subject to, or will under Basel III become subject to, seven risk mitigants that we set forth in our discussion below. Ensuring a coherent and non-duplicative risk mitigating framework is therefore key in achieving the Paper's main goals.
- E. Future Alternate Compliance Mechanisms: The Paper proposes that IM requirements could be satisfied by either a standardized schedule approach or an approved internal models approach. We recommend that the Paper should also explicitly allow for alternative compliance mechanisms that might be submitted for approval to BCBS and IOSCO and/or national regulators in the future.

## II. Responses to the Four Questions Posed by the Paper

- A. Physically-Settled Foreign Exchange ("FX"):
  - 1. Physically-settled FX swaps and forwards should be exempt from any margin requirements. These OTC derivatives are highly liquid and the relevant risks are already subject to risk mitigation through "continuous linked settlement" ("CLS") and prudential regulation. Cross-currency swaps involving the exchange of two currencies are similar to physically-settled FX swaps and should be exempt from margin requirements.
  - 2. Imposing different margin requirements for physically-settled FX swaps and forwards with differing maturities will bifurcate the FX market and reduce liquidity for FX derivatives broadly.
- B. Rehypothecation: Customers should be permitted to choose between: segregation of IM at a third party; segregation of IM at the secured party; or allowing rehypothecation.
- C. Phase-in:
  - 1. Generally: ISDA supports phasing in IM requirements but the phase-in arrangements proposed in the Paper impose too short a timeframe. If implementation is too rapid it will exacerbate the liquidity, operational and other implementation issues posed by the IM requirement. The proposed

phase-in threshold should also exclude physically-settled FX swaps or forwards.

2. Phase-in Timing: The Paper proposes to begin the phase-in period in 2015. However, there is no assurance that most jurisdictions will have implemented margin rules by such time, so a "hard" date of 2015 may not give market participants sufficient time to put in place operational procedures and other requirements, such as internal model approvals, to post VM and IM. Therefore the phase-in dates should begin three years after all the G-7 regulators have promulgated margin rules.
3. VM: We are in favour of rapid implementation of VM as many market participants already exchange VM. However, there is a large segment of the market which currently is not utilizing VM and who will become subject to the new requirement. These entities might need some time to prepare. We ask that a proper study is undertaken to better understand the impact of such a change before determining the implementation date for such entities.

D. Accuracy and Applicability of the Quantitative Impact Study ("QIS"):

The QIS does not adequately capture the effects of IM requirements. The QIS fails to account for certain market features and, due to a lack of specificity, was answered differently by various responders. A new QIS is needed, and it should be done on the basis of a stress period, reflecting the amount of IM that would be required in the event of a market dislocation.

### III. New Issues Raised by the Paper:

A. Scope of IM Requirement:

1. € Billion Level: The minimum aggregate notional amount of € billion as a threshold for applying IM is not risk sensitive and as such is not meaningful. It is also too low and will impose IM requirements on market participants that are not systemically important. If this minimum threshold were to be applied, the € billion minimum amount should exclude hedge transactions, i.e., exclude the notional amount of the hedged asset and the relevant hedging instrument. The minimum aggregate notional amount should also exclude physically-settled forwards and swaps. The calculation of this limit should exclude physically settled FX swaps and forwards.
2. Timing of Calculation: We have significant concerns regarding the requirement that the € billion be calculated solely on the basis of the last three months of the preceding year. There is no reason to exclude the remainder of the year in assessing the size of participants. Also, as the calculation of this minimum amount can only be made on January 1, parties could not, as a practical matter, start posting IM until a further date.

B. IM Threshold:

1. Amount: The Paper proposes setting a €50 million threshold on the requirement to post IM. Given the very large amounts of IM proposed by the Paper, this threshold is too low. In view of the significant liquidity risks of IM, we request BCBS and IOSCO to set a higher threshold and further analyze the use of the threshold amount as a potential mitigant to such risks.
2. Consolidation: We are particularly concerned about the €50 million threshold being calculated on a consolidated basis, due to the different nature of the legal and business structures of various market participants. We also note that the application of consolidation varies between jurisdictions, so different regulators may require market participants to calculate IM based on significantly different consolidated groups. Therefore, we urge BCBS and IOSCO to permit Covered Entities to calculate IM requirements on an individual legal entity basis, or at least to provide market participants with more flexibility on threshold calculations. We also request that BCBS and IOSCO confirm that investment funds managed by the same manager would not be consolidated for these purposes.
3. FX: The Paper proposes to exclude physically-settled FX swaps and forwards from the IM requirement. For the same reasons, these FX transactions should be excluded from the €50 million threshold calculation, as they would not attract any IM.

C. Model/IM Schedule:

1. Model Parameters: It is not clear that the parameters of the IM requirement proposed by the Paper, such as the 10 day margin period for risk and the 99% confidence interval, are set at the correct levels. One of the objectives of a new QIS should be to determine more appropriate measures of these parameters, including taking into account relevant capital requirements.
2. Model Approval: The Paper provides that IM models will need to be approved by the home jurisdiction of each Covered Entity. VaR models currently being used should be "grandfathered" without the need for further approval and approval of a model by the Covered Entity's home jurisdiction should be sufficient for approval in other jurisdictions. Furthermore, once a model is approved by a regulator for use by one Covered Entity, the same model should be permitted to be used by other Covered Entities that purchase (or otherwise acquire) the model from the first Covered Entity.

3. IM Schedule: We support the Paper's proposal of permitting market participants to elect a standardized IM schedule. However, the schedule proposed in Appendix A of the Paper is more conservative than necessary, and we urge BCBS and IOSCO to prepare a more appropriate version.
- D. Cross-Product Netting/Portfolio Margining: If legally enforceable, firms should be allowed to use margin procedures that would allow them to operate one system for margining centrally cleared OTC derivatives, non-centrally cleared OTC derivatives and other securities and collateral.
- E. Haircuts/Eligible Collateral:
1. Haircuts: The haircuts set out in the appendix to the Paper do not align with current industry practice. We would like to work with BCBS and IOSCO to refine the haircuts so that they conform to industry practice and consider additional factors that are not presently addressed in the Paper, such as liquidity and concentration risk.
  2. 8% Currency Exposure Haircut – Proposal: While we recognize the cross-currency risk that is addressed by the 8% haircut, the proposed haircut is ill-considered. A fixed level of 8% is not appropriate for a risk that differs significantly between different currency pairs and the Paper fails to address how it will be implemented for different types of transactions.
  3. Herstatt Risk/Use of ISDA Standard Credit Support Annex (the “SCSA”): The use of different currencies, even if aligned to the derivative exposures, may give rise to cross-currency settlement risk (i.e. the risks arising from different times for settlement of different currencies), known as "Herstatt risk". We believe BCBS and IOSCO would want to avoid this. Market participants have developed the SCSA, which computes collateral requirements in each currency within the relevant portfolio of transactions. The SCSA offers the best currently available solution to a variety of risk concerns in the OTC derivatives market and we request that BCBS and IOSCO make clear that the 8% haircut would not apply to parties using an SCSA.
- F. Dispute Resolution: We strongly agree with the Paper that the development of robust dispute resolution procedures should be encouraged. However, there will be significant obstacles in implementing such procedures for IM, such as differences in the use of non-transparent proprietary models and regulatory differences between jurisdictions. Because market participants will not be able to rely on market valuation for IM disputes, it is crucial that dispute mechanisms are in place if/before IM is made mandatory.
- G. Special Purpose Vehicles: Special purpose vehicles ("SPVs") for structured finance and securitization transactions should be excluded from margin requirements.

- H. Inter-Affiliate Transactions: We support the Paper's decision to permit local jurisdictions to determine whether inter-affiliate transactions should be subject to margin requirements.
- I. Extra-Territoriality: We applaud the Paper's efforts to ensure consistency between the margin regulations of different jurisdictions. The implementation and timing of margin rules should also be coordinated and consistent across jurisdictions.

## Discussion

### I. Initial Margin

#### **A. The requirement to post IM will challenge the resiliency of the financial system and severely curtail the use of uncleared swaps for hedging.**

1. Impact of the proposals on the economy. The application of the proposed measures comes at a very high price in terms of their impact on market and collateral liquidity. Despite the envisioned use of thresholds (aimed at alleviating such demands on collateral, but of limited impact for financial counterparties), the proposed measures are likely to lead to substantial increases in additional collateral, leading to major disruptions in the market for collateral, exerting enormous pressure on market liquidity with the potential for significant economic dislocation.

Collateral plays a significant role in the provision of secured financing to financial institutions. As such, secured funding is a major source of liquidity to the global financial system. Removing collateral amounts in the contemplated quantities from the market –segregation and no-hypothecation implies precisely this – is tantamount to at least an equal amount of drainage to the global liquidity, and perhaps more (if the pledged collateral had been re-hypothecated). It is such drainage of the global liquidity that could have potentially significant (and unintended) economic implications. As an illustration, in 2007 the reduction in secured financing due to the reduction (however caused) in pledgeable collateral used by large banks and the associated re-use rate was estimated to be approximately \$4 trillion<sup>3</sup> and most likely, accounted for a large part of the resulting economic contraction that followed. Since then, the use of secured funding continues to remain below pre-Lehman level primarily because the re-use of collateral has been reduced. In this context, further reductions in available collateral caused by the contemplated proposals could result, through the secured finance channel, in significant economic dislocation.

The associated cost of using non-cleared OTC derivatives could discourage users, forcing them to abandon non-cleared OTC derivatives and instead employ imperfect hedges using only clearable risk-hedging tools, and confronting them with unwanted basis risk. Users might also find that their transactions do not qualify for hedge accounting treatment, which would introduce significant volatility to their income statements. There are also certain specific risks for which the appropriate hedge is not yet and may not in the future be available in cleared form. As a result, users may decide to forego their hedging strategy and remain exposed to the risks they

---

<sup>3</sup> 'The Changing Collateral Space', Manmohan Singh, International Monetary Fund, January 2013 (<http://www.imf.org/external/pubs/ft/wp/2013/wp1325.pdf>)

previously wished to manage away. They may also prefer to not take the underlying risks at all, which could have dampening effects on economic growth. For example, single name credit default swaps on borrowers that are not widely traded will not be cleared, and are often used by lenders. If their use is hindered, banks will be restricted from making loans and underwriting issuances of corporate bonds. Investors also use custom OTC derivatives tailored to match their investment or risk-management needs (e.g. tail expiry, knock-out barrier, dividend protection, etc.), which will not be clearable and which will become far more expensive for customers, prohibitively for some.

2. QIS results. The Paper's QIS results for IM requirements are comparable to ISDA's initial estimates presented in our prior responses. The Paper's results show that proposed IM requirements for universal 2-way posting would range between €0.7 trillion without threshold and €8.1 trillion when using the €50 million threshold, assuming all Covered Entities are using standardized schedules for IM calculation. IM requirements would range between €1.7 trillion without threshold and €0.7 trillion when using the €50 million threshold, assuming all Covered Entities are using models for IM calculation.<sup>4</sup> Even if the €50 million threshold was utilized by each party using internal models, the aggregate required quantum of IM would still be significantly large at €700 billion. According to QIS participants, this figure could increase to as high as €1.0 trillion if the €50 million threshold is being calculated on a consolidated group basis.<sup>5</sup>

3. Unencumbered assets. We think that the Paper significantly overestimates available "unencumbered assets" ("UAs") in Table 9 of Appendix C of the Paper as UAs reported by financial firms are not necessarily available for general use. When dealers require additional collateral, they will generally raise new liquidity since UA's are already managed to meet specific targets for liquidity reserves. . ISDA believes that only a very small fraction of the assumed €8.75 trillion (\$11 trillion) of available UAs is able to be posted as collateral for derivatives contracts, and that any new collateral requirements would generally need to be separately funded. This would decrease the liquidity of the collateral markets, especially in times of market dislocation (as discussed in B. below), and shift the risk being mitigated by IM to the collateral markets. Covered Entities will also be subject to funding risks due to the additional costs of acquiring so much collateral. This will reduce the capital available for lending and other commercial activities and further damage the economy.

In addition, the OTC derivatives that become centrally cleared will be subject to the IM requirements imposed by the central clearing counterparties and the supplemental clearing member IM requirements, which will further decrease UAs available to the non-centrally cleared derivatives markets. It should also be noted that unlike the IM proposal in the Paper, centrally cleared OTC derivatives are not subject to any thresholds for posting IM and the IM requirement

---

<sup>4</sup> We note that the Paper incorrectly describes one transaction, a European call option, as having "zero credit risk" and therefore requiring zero initial margin. Paper at p. 15. If that call option is subject to standard credit support arrangements, including the exchange of variation margin, then the option writer will be required to provide collateral and thereby will have credit risk to the purchaser.

<sup>5</sup> 'Banks claim €300 billion hole in margin study', Risk magazine, 14 Mar 2013 (<http://www.risk.net/risk-magazine/news/2254600/banks-claim-eur300-billion-hole-in-margin-study>)



applies to all customers, not just Covered Entities. This will significantly increase demand for eligible collateral, especially since some market participants that will now be required to post IM, such as pension schemes, have not posted IM in the past at all.

4. Clearing assumptions. The Paper also assumes that a large part of the OTC derivatives market will be centrally cleared by 2015 and thus not subject to the IM requirements. For instance, Appendix C Section 1(b) of the Paper assumes that "interest rate and equity derivatives are expected to exhibit the largest decline" in non-centrally cleared derivatives products. This assumption appears to result from the QIS guidance that "all equity options should be considered clearable" and "all single name equity swaps should be considered clearable". However, there is no central clearing counterparty currently offering clearing for equity swaps, which may never become clearable due to bespoke financing characteristics, so this assumption is not warranted. While the amount of centrally cleared OTC derivatives will undoubtedly increase by 2015, many OTC derivatives will not be clearable. We estimate the non-cleared OTC derivatives market will consist of the following:

- a) Several larger, relatively broad market segments, including the majority of interest rate swaptions and options (caps, collars, floors), cross-currency swaps, single-name credit default swaps and various types of equity and commodity swaps, will likely remain non-cleared, as they do not fit the eligibility requirements of Central Counter Parties (CCPs).
- b) A number of individual sectors (both small and large) of many otherwise clearable OTC derivative product classes will likely remain non-cleared due to a lack of liquidity (and associated lack of valuation/pricing depth) in certain transactions. The lack of liquidity in these areas results from the economic terms (currency denominations, maturities, underlying reference rates, etc.) of such transactions, which are traded less than others.
- c) Transactions involving corporations and other non-financial end-users in jurisdictions around the world where such market participants are exempt from clearing requirements will also remain non-cleared.

5. Legal aspects. The IM requirement proposed by the Paper will depend on central clearing being fully implemented in all relevant jurisdictions. At present, the clearing mandate for OTC derivatives (other than futures and options generally, as well as CDS indices and IRS in the US and Japan) has not been implemented in any jurisdiction. It is not yet clear how efficiently the market for centrally cleared OTC derivatives will function and how quickly central counterparties are able to clear all of the products the Paper assumes they will. It is unclear how market participants will be able to comply with IM requirements if the regulations governing centrally cleared OTC derivatives are not yet promulgated in their jurisdiction, which would significantly increase the OTC derivatives subject to the intentionally harsher IM regime.

## **B. The proposed IM guidelines are pro-cyclical and will increase market volatility.**

As discussed above, at least €700 billion of IM will be required during normal market conditions. However, significantly increased amounts of IM would be required during periods of financial stress as volatility increases, potentially posing severe systemic risks. The Bank for International Settlements ("BIS") calculated that IM requirements under high market volatility could be three

(3) times the IM requirements in low market volatility for cleared interest rate swaps and ten (10) times higher for credit default swaps.<sup>6</sup> If IM requirements had been set in 2005-2006 on a historic look-back basis of five years, market participants would have been forced to rapidly acquire very large amounts of additional collateral in a highly illiquid market during the market dislocation of the period 2007-2009. The following four events would combine under stressed markets conditions:

- Increased IM requirements by up to three to ten times;
- Increased VM requirements resulting from large shifts in OTC derivative positions' values;
- Reduced good quality collateral availability at a time when it is most needed; and
- Increased haircut on most types of collateral, further increasing the pressure on collateral availability.

As a result, proposed IM models would subject market participants to increased collateral demands at the very time when funding may no longer be available in the markets. Covered Entities would be subject to a liquidity call when their ability to obtain funding and/or liquidate assets would be constrained by market stresses. Asset managers, which generally hold low cash balances, would have to sell assets to meet collateral demands, placing downward pressure on asset prices and further exacerbating stresses in the market. Thus, there is significant potential that a downward economic spiral could be triggered or worsened by IM requirements.

In addition, thresholds may reduce collateral needs in the short term, but amplify the pro-cyclical nature of IM in the long term. A threshold with a model-based IM requirement would mean that IM requirements could go from zero to large amounts once the threshold is exceeded, which would likely happen during times of stress, when a sudden demand for collateral is likely to have a very destructive effect. For example, if the IM requirement is \$100 million and there is a threshold of \$50 million, then \$50 million of IM must be posted. In a high volatility market, using the 3 times multiplier, the gross IM requirement would rise to \$300 million. The threshold remains at \$50 million, so \$250 million in collateral would need to be posted, resulting in a multiplier of 5 times. Banks and other counterparties would be under pressure to find or obtain 5 times more collateral, on the order of tens of billions of dollars per major institution, in a high volatility, stressed market environment. In an environment when funding markets may well be shut down, this will significantly increase the likelihood of defaults in the banking sector.

**C. An IM requirement will impose significant operational and regulatory costs and may not be feasible for all jurisdictions.**

The OTC derivatives market has never operated on the basis of a bilateral IM posting requirement. Therefore market participants as well as regulators will need to spend significant

---

<sup>6</sup> See BIS Working Papers No 373, Collateral requirements for mandatory central clearing of over-the-counter derivatives, March 2012, p. 20.; available at <http://www.bis.org/publ/work373.pdf>

time and expend significant effort before a bilateral IM standard is feasible from an operational, regulatory and legal perspective.

1. Operational. Unlike transfers of VM, most market participants do not currently have the operational capabilities to post IM on a bilateral basis, and to the extent such infrastructure is in place, it would need to be significantly overhauled to account for the vast increase in scale the Paper proposes. Many parties in the OTC derivatives markets are also not accustomed to third party custody of any margin, and custodians would need to significantly enhance their operational capabilities to handle the increased IM requirements.

2. Regulatory. While capital rules are understandably not within the Paper's scope, both domestic and international capital regimes (such as Basel) would undoubtedly be greatly impacted by any requirement to post such significant amounts of IM. When implementing margin rules, each jurisdiction would also be required to harmonize these proposals with the relevant capital regime, which may present practical challenges. For instance, capital rules would need to ensure that capital requirements are reduced by the amount of posted IM to ensure that the margin rules accurately reflect such Covered Entity's actual capital position. In addition, while VM can be calculated by polling market participants, internal models would need to be approved by the regulators before any IM posting could be required, which would be a significant burden on regulators. This may be especially onerous with respect to market participants that have neither posted IM nor used VaR based models, such as pension funds.

3. Legal. The use of IM would require all Covered Entities to negotiate and amend their current derivatives documentation with each other and with many of their clients. Also, while we strongly support the proposal to allow internal models to be used to determine IM requirements, the use of such models is likely to dramatically increase disputes between parties. While Paragraph 3.12 of the Paper advocates the creation of "rigorous and robust dispute resolution procedures," this would require significant work to achieve in practice. In addition, the utilization of internal models would make any dispute resolution inherently more difficult, since market participants will not have recourse to a market valuation mechanism. Furthermore, in order to have a transparent dispute resolution procedure, more consideration needs to be given to the establishment of industry-wide cross-jurisdiction mechanisms that may require the creation of standardised margining and collateral valuation models, a time consuming and difficult process.

Finally, in order for the Paper's IM requirement to work, many jurisdictions would need to introduce new legislation with respect to netting and insolvency. For instance, close-out netting and collateral set-off is not currently enforceable in many Asian countries, so imposing an IM requirement would lead to market confusion and exacerbate the systemic risk IM proposes to ameliorate. Since it will be impractical to exchange IM in jurisdictions where close-out netting and collateral set-off is not currently enforceable, there should be no requirements to post margin to counterparties that are located in jurisdictions that do not legally support master netting agreements.

Considering all of the implementation challenges associated with IM, ISDA strongly urges BCBS and IOSCO to reconsider its proposed IM rules, especially in the context of the drawbacks discussed above.

**D. Systemic risk can effectively be mitigated by imposing robust VM requirements, implementing appropriate capital requirements and requiring the mandatory clearing of liquid and standardized OTC derivatives.**

ISDA strongly agrees with the goals of the Paper of reducing systemic risk and promoting central clearing. However, as discussed above, the IM proposals set forth in the Paper would increase systemic risk, decrease liquidity and have other negative consequences on the global markets and economy.

In lieu of IM, systemic risk could effectively be mitigated by the following approach: first, impose VM requirements with daily collection and zero thresholds; second, implement appropriate capital requirements (as Basel III envisions); and third, require clearing of liquid, standardized OTC derivatives.

1. VM: ISDA strongly agrees with the need for VM to be posted between Covered Entities. VM, with daily collection (subject to limited exceptions for illiquid collateral) and zero thresholds, effectively protects against accumulated and unrealized losses on non-centrally cleared OTC derivatives positions. The imposition of VM requirements as suggested here, without IM, would not lead to many of the significant negative consequences discussed above. As we have noted previously, IM is very inefficient as it assumes that both parties to a contract must be fully protected against each other's simultaneous default. This represents a poor use of scarce capital resources and ignores the portfolio effects of counterparty credit risk; these concerns would be better addressed by a robust VM model.

2. Capital: Appropriate capital requirements will protect against the risks that are not covered by VM. As both capital and IM cover potential future exposure, requiring both IM and increased capital for the same OTC derivatives positions will result in duplicative and unnecessary costs. Capital requirements call for capital on exposures specifically arising from non-centrally cleared OTC derivatives activity. The implementation of the currently proposed capital requirements will result in a significant increase in the amount of regulatory capital that prudentially regulated entities are required to hold. In particular, credit valuation adjustment ("CVA") capital charges are likely to add considerably to the capital requirements. CVA charges are extremely sensitive to counterparty quality and risk mitigants and therefore cover the risk of rating migration up to default very well. One argument that is sometimes made for IM for non-centrally-cleared OTC derivatives is that IM is required for clearing organizations. But this ignores the completely different context, as a clearing organization is *not* subject to the same capital requirements that apply to swap dealers.

To illustrate the duplicative aspects of the proposed framework, we note that non-centrally cleared OTC derivatives are already subject to, or will under Basel III become subject to, the following seven risk mitigants:

- a) A market participant's firm's own Core Equity Tier 1 (CET 1) Regulatory Capital,
- b) Transparency through trade repositories,
- c) Daily VM subject to an agreed threshold,

- d) Basel 1 Counterparty Credit Risk charges,
- e) Basel 2 and Basel 2.5 market risk charges,
- f) Basel III Credit Valuation Adjustment (CVA) charges, and
- g) Basel III Liquidity Coverage Ratio (LCR) which includes a specific add-on for changes to the mark to market value of OTC derivative portfolios.

Whilst we agree that only IM shifts the market to a “defaulter pays” model, the choice to use IM should be left to the parties and their considerations of their relevant risk appetites. We appreciate that the IM requirement proposed in the Paper practically eliminates counterparty credit risk, but it does so at a very heavy cost. For example, €100 of IM may reduce the derivatives exposure of a regulated financial entity by only €1.6 (assuming a 20% counterparty weight multiplied by an 8% capital ratio). In addition, IM can only collateralize exposure of individual counterparties at the netting set level, whereas capital is available to support all exposures on a portfolio basis. Since counterparty credit risk is already adequately mitigated by the Basel I counterparty credit risk charge and the proposed Basel III CVA charge, and the IM requirement is inefficient, requiring the posting of IM would, in the aggregate, hurt the market.

In addition, a market participant's financial strength, as indicated by the participant's capital and liquidity, should be considered in relation to an IM requirement. The stronger a firm's financial position, the less IM it should generally need to post. Therefore, while we should not preclude market participants from requiring IM from their counterparties, this decision should be left to the individual parties based on their evaluation of a counterparty's financial strength.

Furthermore, it is not correct to simply equate risks in the cleared OTC derivatives market with the non-centrally cleared OTC derivatives market. While CCPs have limited capital and risk mitigant capabilities, market participants in the non-centrally cleared OTC derivatives markets have the advantage of the seven risk mitigants described above. Rather than imposing IM (with all of its costs and inefficiencies) as an eighth mitigant, regulators and market participants should first identify which of the existing factors are failing and work towards better regulations and procedures to correct such failures.

3. Mandatory Clearing: Mandatory clearing of liquid, standardized OTC derivatives will shift a large volume of OTC derivative activity towards centralized clearing, further reducing systemic risk. To the extent that punitive IM levels are motivated by a desire to encourage clearing, this is an ill-conceived measure. Punitive IM would directly harm those critical markets and financial services vital to the real economy such as housing and corporate financing, without necessarily increasing the likelihood of clearing. Instead, mandatory clearing requirements could achieve this more effectively for swaps for which clearing is appropriate.

ISDA and its members believe that this three-pillar approach is appropriate for ensuring systemic resiliency.

## **E. Future Alternative Compliance Mechanisms**

The Paper proposes that IM requirements could be satisfied by either a standardized schedule approach or an approved internal models approach. The flexibility afforded by this dual compliance structure is useful but need not be limited to just two compliance mechanisms. We recommend that the Paper should also explicitly allow for alternative compliance mechanisms that might be submitted for approval to BCBS and IOSCO and/or national regulators in the future.

We believe that new thinking on IM will emerge in the future. Indeed, ISDA and member firms have been actively working on alternative mechanisms that might avoid the many disadvantages and issues posed by the proposals contained in the Paper. This new thinking holds great promise that may, in the fullness of time, develop to provide a natural complement to CCPs that can address risk in the uncleared hemisphere of the OTC derivative market in a manner that is superior to the more traditional IM concepts contained in the Paper. We have suggested that more time be provided so that these ideas might be developed further; however the timetable imposed by BCBS and IOSCO has not allowed these ideas to be explored fully. Nevertheless, we think it is highly likely that alternative ideas will emerge in the future which fully achieve regulatory objectives in a more efficient and practical manner than the current proposals. The final proposals should not foreclose this possibility, and should provide for alternative compliance mechanisms to be reviewed and approved.

## **II. Responses to the Four Questions posed by the Paper**

### **A. Question 1:**

*1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation?*

Physically-settled FX swaps and forwards should be exempt from any mandatory exchange, collection or posting of margin between transacting parties. We view as persuasive and compelling the position and supporting arguments presented by the GFMA Global FX Division in its separate submission in response to the July 2012 First Consultative Paper from the BCBS and IOSCO<sup>7</sup>, as well as its submission to the Paper.<sup>8</sup>

The unique characteristics and role of physically-settled FX products distinguish them from other non-centrally cleared OTC derivatives. For instance, in its determination to exempt physically-settled FX swaps and forwards from most requirements of the new derivatives regulation regime, the United States Department of the Treasury noted that the settlement amounts of FX products do not change, making them "more similar to funding instruments, such as repurchase

---

<sup>7</sup> <http://www.gfma.org/correspondence/item.aspx?id=367>

<sup>8</sup> See GFMA Global Foreign Exchange Division comment letter re: Margin requirements for non-centrally-cleared derivatives, Second Consultative Document, February 2013, dated March 15, 2013.

agreements" and that "are distinguished from other derivatives, widely used by supervised banks for bona fide funding transactions".<sup>9</sup>

Consistent with the key principles set out in the Paper, the risks associated with the FX market are appropriately mitigated under the current regime through prudent supervision, guidelines and regulatory capital requirements. The predominant risk associated with non-centrally cleared physically-settled FX swaps and forwards is settlement risk, which has been dramatically reduced through use of Continuous Linked Settlement ("CLS"), the "predominant global PVP (payment versus payment) settlement system,"<sup>10</sup> an initiative developed by the private sector. Replacement cost risk has also been appropriately mitigated for these products through collateral exchanged under CSAs, the usage of which is increasing. In addition, operational risk for non-centrally cleared FX swaps and forwards has been mitigated through the market's strong operational infrastructure, which has a proven track record of withstanding widespread capital markets disruption. Furthermore, in many emerging markets, credit support annexes are not widely used for physically-settled FX transactions. Requiring all parties to enter into CSAs and post collateral would be highly disruptive to what are already liquid and well functioning markets.

In light of the above, margin requirements should not apply to physically-settled FX swaps and forwards. Failure to provide an exemption for physically-settled FX swaps and forwards could very well increase rather than decrease potential systemic risk by dis-incentivizing participants from using methods such as CLS, and artificially and unnecessarily increasing the cost of managing their funding needs and hedging FX risk, both activities that are integral to global economic activity and used extensively by a wide array of market participants, including end-users.

In addition, BCBS and IOSCO should extend their exemption for physically-settled FX swaps and forwards to cross-currency swaps that involve the exchange of two different currencies. Cross-currency swaps differ from FX swaps because cross-currency swaps involve interest payments.<sup>11</sup> The interest component does not detract from the arguments above. These arguments, as to the distinctive characteristics and liquidity of FX products, apply to cross-currency swaps in the same way that they apply to FX swaps and forwards.

## ***2. Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?***

Imposing different margin requirements on physically-settled FX forwards and swaps with different maturities would bifurcate the FX market. This bifurcation could result in significantly less liquidity for FX derivatives of certain maturities, and could potentially open the market to arbitrage with respect to maturity.

---

<sup>9</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774-25782 (proposed May 5, 2011) at 25776; and 77 Fed. Reg. 69694-69705 (final November 20, 2012), at 69705.

<sup>10</sup> 77 Fed. Reg. 69694-69705 (final November 20, 2012), at 69696, 69698 and 69701.

<sup>11</sup> See Joint SEC and CFTC Release, Product Definitions, 76 FR 29818, fn. 137.

## B. Question 2:

*Should re hypothecation be allowed to finance/hedge customer positions if re hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re hypothecation be allowed under strict conditions such as (i) collateral can only be re hypothecated to finance/hedge customer, non proprietary position[s]; (ii) the pledgee treats re hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.*

Customers that are parties to an OTC derivative transaction should be able to choose between (i) segregation of IM at a third party; (ii) segregation of IM at the secured party; and (iii) allowing re-hypothecation. Giving the parties such a choice will enable them to make an economically appropriate assessment between the need to protect collateral and the costs of segregation. From the perspective of the secured party, all of the options provide credit protection: the collateral will be available, if segregated, as long as the secured party has control rights and the value of collateral will be available, if it is re-hypothecated, because the secured party can offset the value of the collateral against the obligations of the pledgor. From the perspective of the pledgor, if there is meaningful concern about the creditworthiness of the secured party, then the pledgor can opt for segregation. This proposal is consistent with approach proposed by the SEC which, in its margin proposal, permits a counterparty to an OTC derivatives (swap) dealer to choose between: waiving segregation (i.e. permit re-hypothecation); omnibus segregation on the books of the dealer; or individual segregation at a third party custodian.<sup>12</sup>

Segregation at the secured party should be offered as an option in addition to segregation at third parties because, in many jurisdictions, such collateral will not be the property of the secured party if properly held. As a result, the pledgor will not have credit risk on the secured party with respect to the segregated IM. The pledgor might therefore choose secured party segregation in order to benefit from efficiencies of time and cost because no third party is involved.

If the regulators were to ban re-hypothecation, the assets used as IM for OTC derivatives transactions would not be available to the market to facilitate lending to businesses for capital improvements, business expansion and economic and employment growth, will not be available. Allowing re-hypothecation of collateral will permit market participants to use it to provide more capital to the economy. Moreover, since collateral re-use through re-hypothecation is a common practice in the market, prohibiting re-hypothecation is likely to reduce the supply of collateral available to the market at a time when demand for collateral will go up, due to the proposed IM requirements and the forthcoming Basel III proposals. The combination of reduced supply and increased demand with respect to collateral could lead to the equivalent quantitative tightening of several USD trillion with unpredictable consequences for the real economy.

Preventing voluntary re-hypothecation is inconsistent with current market practice, and it would exacerbate the significant collateral needs envisioned by the application of these proposals. The result would be significantly increase the costs of OTC derivatives for market participants, including end-users, which would ultimately deter participants from using these products to

---

<sup>12</sup> 77 FR 70214 (Nov. 23, 2012), at 70275, 70350.



hedge economic risks. A party collecting IM should offer segregation as an option, but the parties should be free to agree to allow rehypothecation of the collateral.

In addition, we emphasize that jurisdictions have different standards for the protection and segregation of collateral, and is subject to legal considerations such as insolvency and netting considerations. In this context, a universal approach would be counterproductive, as in some jurisdictions any protection purported to be provided by segregation would be illusory. Parties should therefore generally be permitted to choose the level of protection they want for their collateral, to the extent permitted by law in the relevant jurisdiction.

### **C. Question 3:**

#### ***1. Are the proposed phase-in arrangements appropriate?***

We fully support a phase-in period for IM, if implemented, on grounds of the quantum of the changes and the need to build and test systems and alter business models. However, the timeframes proposed in the Paper are too short. In particular, we are concerned that the proposed phase-in period fails to consider that margin regulations for non-centrally cleared OTC derivatives are not yet in place in most jurisdictions, and may not be in place by 2015. Market participants would need time after the enactment of the relevant regulations to put in place operational and legal procedures, develop a model and have it approved by a regulator and to consider the relevant capital implications, and they cannot predict when the regulations will be implemented. Therefore, the phase-in period should begin three years after the last G-7 regulator promulgates its margin rules for non-centrally cleared swaps. This would give market participants sufficient time to put in place the necessary steps to post IM to, and to accept IM from, counterparties.

In addition, the IM threshold of €50 million (or the appropriately higher threshold determined after a new QIS) should also be phased-in from a significantly higher amount so as to give market participants time to implement proper systems and comply with the regulations. This would ensure that market participants which are very close to the threshold and pose less systemic risk are given more time to put their systems in place. The phased-in threshold would also ensure that there is a gradual increase in the demand for collateral which will decrease dislocation in the collateral markets and reduce pressure on market liquidity. Finally, since physically-settled forwards and swaps should be excluded from the IM requirement, they should not be included for the purposes of determining the IM threshold.

#### ***2. Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements?***

The proposed phase-in requirements are welcome as they provide moderate relief to a large number of smaller market participants without sacrificing systemic resiliency although the phase-in does not address the concerns expressed above with respect to IM. Given the very large quantum of margin that would be required as soon as the rules become effective, it is vital to include a phase-in period in order to allow the markets to adjust as well as possible to the potential liquidity shock of the IM requirements.

***3. Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements?***

The proposed phase-in triggers and dates unnecessarily disadvantage larger market participants. Because the triggers are set so low, all large OTC derivatives trading institutions will likely be subject to the rules on the first possible date, which would disadvantage them, as clients would seek to trade with smaller dealers to delay their own IM requirements for as long as possible. The proposal in paragraphs 8.1 to 8.10 of the Paper would place large OTC derivatives dealers at a competitive disadvantage for a number of years and work against the principle of a “level playing field”.

In addition, as many smaller market participants may not yet be subject to the margin requirements, this will incentivize larger dealers to conduct a "race to the bottom", and enter into transactions with smaller and less sophisticated entities. This would reduce liquidity in the market, since transactions between large dealers would be less economically advantageous due to margin requirements and would be avoided by the large dealers. It would also cause dislocation in the markets by transferring risk to parties that are less able to bear it without being subject to IM or VM requirements.

***4. Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested?***

Because of the need to adopt systems and agreements for VM that meet the requirements of the final margin rules, it is crucial that parties have adequate time from the enactment of the margin requirement by the last G-7 regulator before they are required to post VM. However, because VM is more widely used than IM and more of the systems are in place for market participants, we do not feel that a graduated phase-in is needed.

***5. Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk?***

As explained above, we are in favour of rapid implementation of VM as many market participants already exchange VM. However, there is a large segment of the market which currently is not utilizing VM and who will become subject to the new requirement. Because of the significant and complex financial, operational and technological requirements that mandatory VM would impose, we ask that a proper study is undertaken to better understand the impact of such a change before determining the implementation date for such entities.

***6. Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?***

Differences of market circumstances, such as readiness of market participants and relatively small volumes of OTC derivatives trading in emerging markets, require a flexible phase-in treatment. As we have noted, many emerging market jurisdictions do not yet have netting and insolvency regimes that are consistent with the netting and set-off that are crucial for the efficient operation of the margin requirements. Requiring market participants from these jurisdictions to post and receive IM would not only subject a large amount of collateral to an unclear regulatory regime, further reducing liquidity, but would also render any protection granted by such margin posting illusory, since parties would not know if they could rely on it. Further, there are some markets that are not yet sufficiently liquid to permit central clearing. Until these markets mature, imposing margin requirements on derivatives that cannot be cleared would prevent market participants in such jurisdictions from hedging their FX exposure, increasing systemic risk. Therefore, we urge BCBS and IOSCO to give additional consideration to increased phase-in periods for market participants in applicable jurisdictions.

**D. Question 4:**

***The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above***

**1. A new QIS is necessary.**

We strongly recommend that a further QIS should be undertaken to examine the following issues:

- a) The effect of thresholds higher than €50 million;
- b) The effect of the proposed €8 billion notional amount threshold;
- c) The quantum of unencumbered assets which are truly available for use as eligible collateral;
- d) The procyclicality of IM, examined by looking at the IM that market participants would have held in January 2007, based on a historic look back, against the actual requirements through 2008 and 2009;
- e) The table of clearable contracts (Table C) in the QIS includes many single name CDS which attract “wrong way risk”, are not sufficiently liquid or have bespoke features, and so will not be clearable.

In addition, the QIS failed to take into account the cost of custodial services, as well as the expense for custodians and Covered Entities of setting up or upgrading their systems to comply with the IM requirement. Finally, many of the respondents were unsure as to whether they should use their individual legal entity or the consolidated group, which skewed the results. Industry participants believe QIS results could increase the aggregate amount of IM to be posted

by 25% to 75% (depending on the number of dealing entities within a corporate group) if the €50 million threshold is being calculated on a consolidated group basis.<sup>13</sup>

## 2. The QIS should be calculated during a stress period.

The Paper clearly provides that IM should be calculated on the basis of market stress, but the detailed instructions which accompanied the QIS are silent on this point. Some respondents have confirmed that they used a standard proprietary methodology, which assumed a period of stress, while others have indicated that their responses were not made within the context of a stress period. For example, one respondent indicated that it used the standard schedule and assumed that the inherent conservativeness functioned as a proxy for a period of stress.

Since many respondents did not assume a stress period, the results of the QIS significantly understate the actual amount of IM that would be required:

- a) Many proprietary IM models look back over a historic period of one to five years. A five year period would clearly include the stress periods of 2008 and 2009. However, many models use exponential smoothing which gives greater weight to more recent periods and dampens the effect of earlier periods.
- b) Many IM models utilize current volatility levels to scale historic levels of volatility which, in the current benign environment, would reduce the effects of the stress period.
- c) Almost all IM models consider credit spreads to be subject to percentage volatility moves: in other words, potential future moves (and hence margin) are proportional to current levels of spread. Assessing margins in the current environment, with credit spreads reflecting appetite for credit, will not reflect margin levels under the same model in times when credit spreads are, for instance, double what they are today.

After speaking with a number of respondents, there appears to be substantial evidence that if estimates of IM had been made under market conditions observed in 2006 or early 2007, they would have underestimated the additional IM required from September 2008 to January 2009 by as much as €1.1 trillion which is approximately the equivalent of twice the size of the Troubled Assets Relief Program in the US. This is yet an additional reason why another QIS is essential so that a proper analysis of the additional quantum of IM required can be made.

### III. New Issues Raised by the Paper.

#### A. Scope of IM Requirement:

1. € Billion Level: The Paper provides that Covered Entities will only be required to post IM if their derivatives notional exposure exceeds € billion for a period of three months. This minimum amount is excessively low. For many OTC derivatives products, the notional amount of the exposure does not accurately reflect the volume of risk. Therefore, some market participants that generally trade in liquid and relatively straightforward derivatives that cannot be centrally cleared may find themselves subject to the IM requirement, despite posing a

---

<sup>13</sup> 'Banks claim €300 billion hole in margin study', Risk magazine, 14 Mar 2013 (<http://www.risk.net/risk-magazine/news/2254600/banks-claim-eur300-billion-hole-in-margin-study>)

significantly lesser risk than other market participants. A further QIS would be extremely helpful in determining the appropriate level this threshold should be raised to.

Furthermore, most Covered Entities use OTC derivatives to hedge exposures, so the notional amount of their OTC derivatives does not accurately reflect the risk of those positions. A simple notional amount threshold provides an unrealistic perspective of the actual risks posed by a Covered Entity's positions and would cause significantly more IM to be posted than is necessary. If this minimum threshold were to be applied, the €8 billion minimum amount should exclude the hedged item and the hedging instrument of hedged transactions. Because physically-settled swaps and forwards should be excluded from the IM requirement, the €8 billion minimum amount should also exclude the notional amounts of physically-settled forwards and swaps.

2. Timing of Calculation: ISDA opposes the requirement that the €8 billion notional amount be calculated at the end of the final three months of the calendar year. There is no reason that the size of a swap book should be measured exclusively over the last three months of the year while ignoring the previous nine. Also, the Paper proposes that margin be required to be posted as of January 1 of the following year, which would present significant operational, liquidity and capital issues for Covered Entities. A market participant cannot be certain whether it would exceed the minimum amount until the final days of the preceding year. If it is required to post IM, it would need to acquire sufficient IM, transfer it and comply with all of its other regulatory requirements within one day. This would severely dislocate markets, as multiple parties would either rush to acquire collateral or, conversely, rush for its return if they fall under the minimal amount. In addition, there would be massive operational difficulties with effecting such a massive flow of funds on one day for so many parties. A delayed period of compliance is absolutely necessary to allow the markets for collateral as well as the capital markets to adjust.

## **B. IM Threshold:**

1. Amount: The Paper proposes setting a threshold of €50 million on the requirement to post IM. This is too low. As we commented above, the IM requirements proposed by the Paper would create additional demands that are substantial relative to the overall collateral available in the market; and consequently create a significant drain on liquidity in the markets. Therefore, this threshold should be raised significantly to ensure that many market participants that fall just above this threshold are not required to post IM and thereby sap the liquidity in the collateral markets.

Furthermore, we are concerned that the €50 million amount does not accurately represent the impact of IM. We note that in their responses to the QIS, market participants were asked to consider the effect of various thresholds up to €50 million. However, this does not mean that a higher threshold is not more appropriate, merely that it was not analyzed by the QIS. The threshold should be higher in order to better mitigate the impact IM requirements would have on liquidity, and we urge BCBS and IOSCO to set a higher threshold and to request that market participants consider the effect of a higher threshold in a subsequent QIS.

2. Consolidation: Multiple market participants that responded to the QIS applied the €50 million threshold on an individual legal entity level rather than a consolidated basis. The calculation of margin requirements on an individual entity basis is not uncommon in the OTC

derivatives market, and we urge BCBS and IOSCO to apply thresholds on an individual basis for multiple reasons. For example, industry participants believe QIS results could increase the aggregate amount of IM to be posted by 25% to 75% (depending on the number of dealing entities within a corporate group) if the €50 million threshold is being calculated on a consolidated group basis.<sup>14</sup> Therefore, we strongly recommend that BCBS and IOSCO commission another QIS so that regulators and market participants understand the true scope of potential IM requirements.

- a. Many market participants simply do not generally calculate OTC derivatives exposure on a consolidated basis. Each affiliated entity is subject to the capital requirements and insolvency regimes of its legal jurisdiction, so it does not need to determine its exposure on a consolidated basis. In addition, since each affiliated entity has its own OTC derivatives exposure, it is not clear how a consolidated margin threshold would be allocated to various entities; perversely, this could result in the least creditworthy affiliated entity posting no IM, which would contravene the principles of the Paper as well as the local regulator. Conversely, if such entity were required to post IM per local regulations, the calculation of the threshold on a consolidated basis would be rendered meaningless.
- b. The concept of consolidation is not uniform across all jurisdictions. This may cause counterparties to fundamentally disagree on which entities should be included in the calculation if their home jurisdictions interpret consolidation differently, and it is not clear how such a dispute could be resolved.
- c. An entity level threshold is unlikely to lead to regulatory arbitrage. Each affiliated entity that enters into OTC derivatives would be subject to the capital adequacy requirements of each jurisdiction, which would generally increase capital requirements on a consolidated basis. In addition, OTC derivatives counterparties are unlikely to trade with an entity that is thinly capitalized and not otherwise supported by its parent, and would likely demand recourse to a more creditworthy entity. Each affiliated entity would also be required to register with the relevant regulator and to meet all other legal requirements, and it is highly unlikely that regulators would grant regulatory approval to entities established for the purpose of evading margin rules.

In addition, it is not clear whether the Paper would consider that investment vehicles and funds managed by one manager to be a part of a "consolidated group." We would like BCBS and IOSCO to confirm that common management would not cause such vehicles to be "a consolidated group" that would be exposed to these onerous margin requirements.

3. **FX:** The Paper proposed that physically-settled FX swaps and forwards should not be subject to IM requirements. We support this position, as the FX markets have historically had deep liquidity and been generally stable. The logical extension of this approach is to exclude the notional amounts of such FX transactions from the threshold calculation.

---

<sup>14</sup> 'Banks claim €300 billion hole in margin study', Risk magazine, 14 Mar 2013 (<http://www.risk.net/risk-magazine/news/2254600/banks-claim-eur300-billion-hole-in-margin-study>)

### **C. Model:**

1. Model: If an IM requirement is imposed, we urge BCBS and IOSC to give significant further consideration to the parameters of the proposed model, such as the 10 day margin period for risk and the 99% confidence interval. A new QIS will allow further refinements to the model and its parameters, including taking into account any relevant capital rules. We look forward to working with BCBS and IOSCO on the new QIS as well as the parameters of a new model.

2. Approval: The Paper proposes that VaR models may be used for determining IM exposure. Many market participants are already required to use VaR models for risk management purposes, and have had these models approved by regulators. Such models should not need to be re-approved for the purposes of calculating IM.

The Paper also provided that the approval of IM models will be driven by the "host country." We disagree with this approach and would like BCBS and IOSCO to confirm that once approved in the "home country," the model would not need to be re-approved by any other jurisdiction in which the relevant party does business. This would eliminate the need for market participants to seek the consent of regulators in each jurisdiction where they operate, which would be a wasteful, duplicative and expensive process. We would also like BCBS and IOSCO to confirm that if a model is approved for use by one Covered Entity, and then sold or transferred to another Covered Entity, the model would not need to be re-approved.

Significant time and effort will be required by both regulators and market participants to establish and implement a model approval process that conforms to the proposed approach. Further, once a process has been implemented, it is important that there be ongoing dialogue between regulators and market participants to monitor and refine the approval process.

3. IM Schedule: We support the position that market participants should have the choice to elect to post IM by reference to a proprietary model or a standardized IM schedule. However, such IM schedule needs to reflect the markets' general approach to IM so that market participants view it as a legitimate option alongside proprietary models. The IM Schedule proposed by the Paper is unnecessarily conservative, and would not present a viable option. Therefore, we look forward to working with BCBG and IOSCO to prepare a more appropriate IM schedule.

### **D. Cross-Product Netting/Portfolio Margining:**

1. Cross-Product Netting: Many market participants have been developing procedures that would allow them to accurately margin their OTC derivatives exposure with a counterparty across multiple products. This type of margining would be a more accurate reflection of the actual exposure of each counterparty, and would eliminate the posting of redundant margin, which would only decrease liquidity in the derivatives markets. In addition it may be difficult to determine the relevant asset class for a given derivative. For example, an OTC derivative may have both equity and interest rate components, which will complicate netting systems, which need to work as automatically as possible in order to process the volume of additional margin calls. This is especially critical if IM must be posted on a same-day basis. For these reasons, we encourage BCBS and IOSCO to permit market participants to margin their exposure to specific

counterparties across individual products, subject to such margining (including cross-product netting) being legally enforceable.

2. Netting Generally: Market participants should also be permitted to net OTC derivatives exposure against any other exposures (including exposures under products that are not derivatives) if such netting is legally enforceable. Netting is a critical risk reduction tool that is widely used in the market and that has been recognized by regulators. If netting of a wide range of transactions is legally enforceable, there is no reason to limit netting to OTC derivatives, and regulations should encourage broad-based, legally enforceable netting as a valuable means of reducing systemic risk. Failing to recognize netting for margin purposes will create less incentive for parties to use netting to reduce risk.

### **E. Haircuts/Eligible Collateral:**

1. Haircuts: The haircuts set out in the appendix to the Paper do not align with current industry practice and do not reflect the markets' view of the relative risks of such collateral types. For instance, additional factors such as liquidity and concentration risks need to be further considered. These haircuts should be revised in cooperation with the industry and market participants.

2. 8% Currency Exposure Haircut – Proposal: We recognize the cross-currency risk that arises from having collateral and the underlying obligations in different currencies. However, the proposed designation of 8% as a fixed haircut is blunt and insensitive to risk. For example, as proposed it would apply equally to a Hong Kong Dollar (HKD) swap collateralized in US dollars (USD) (where the exchange rate is actually pegged and shows almost no volatility) and to a South African Rand (ZAR) swap collateralized in USD (where the exchange rates have shown considerable historical volatility), thus potentially harming markets such as the HKD swap market and failing to cover the risk of other markets.

In addition, implementation of the 8% haircut as proposed raises significant issues. The application of the haircut is particularly problematic in the case of any swap which contains more than one currency (for example, a currency swap) or any swap which is settled in one currency but whose economics reference other currencies (for example, a quanto swap). On a practical level, such swaps cannot be disaggregated or partially collateralized in different currencies.

We recommend, therefore, that (outside the context of currency-aligned collateral documents, which we propose below should be exempt from any additional haircut) further consideration be given to whether the concept of an additional haircut can be made to work in a manner that avoids introducing market distortions.

3. 8% Currency Exposure Haircut - Herstatt Risk/Use of SCSA: The 8% cross-currency haircut will encourage market participants to settle collateral in each currency independently. This could lead to cross-currency settlement risk (known as Herstatt risk in the FX market) in the market.<sup>15</sup> We believe that BCBS and IOSCO would want to avoid such a result. As described in

---

<sup>15</sup> Consider a multi-currency swap portfolio where collateral is computed and settled in each of the underlying currencies, for example USD, GBP, CHF, EUR, JPY. If the settlement of each currency is made in an independent manner then the effect of settlement cycles across global time zones will mean that a party paying



prior comment letters, market participants have developed a documentation template, the SCSA, that computes collateral requirements in each currency within the relevant portfolio of transactions, consistent with the intent of the BCBS and IOSCO proposal, but uses net single currency settlement to avoid Herstatt risk, plus a currency conversion process to ensure that collateral, once settled, is risk-aligned to the underlying transaction currency and the overall risk of the arrangement is minimized as much as practicable. The SCSA accrues interest at the relevant interest rate in that underlying transaction currency.<sup>16</sup> The Industry is currently examining other solutions to the settlement of different currencies in ways which avoid timing differences. In the meantime, the SCSA offers the best currently available solution to a variety of risk concerns in the OTC derivatives market, and has been received positively in discussions with international supervisors and regulators. However, we are concerned that the Paper could be interpreted to subject parties using the SCSA to the 8% haircut, and therefore we would request that BCBS and IOSCO make clear that parties who are using an SCSA should not be subject to the 8% cross-currency haircut.

#### **F. Dispute Resolution:**

The Paper proposed that market participants can use models, such as VaR, as well as haircut tables to calculate the required IM. While we are very supportive of the Paper's goal of providing choices to market participants, this would make the implementation of dispute resolution mechanisms significantly more difficult. Unlike VM, where the exposure for any derivative position can generally be determined pursuant to a dealer poll, VaR models are proprietary and are dependent upon individual assumptions made by the relevant market participant, such as, data calibration, time horizons and stress scenarios. Differences between models in one or more factors may cause differences in margin results. In addition, VaR models are generally proprietary, so market participants would be reluctant to detail their IM calculations. While we strongly support the Paper's position that proprietary models can be used to determine IM requirements, in order for market participants to agree on IM issues, a simple transparent industry-wide model needs to be developed, agreed and implemented. Such a model also needs to be risk sensitive, as otherwise the amount of collateral required would be prohibitive, as demonstrated by the results of the QIS when using the standardized schedule.

In addition, we note that various jurisdictions may disagree on certain other fundamental aspects of margin requirements, such as the nature of consolidation. As discussed previously in this response, if certain jurisdictions disagree on the application of consolidation, it is not clear how such disputes would be resolved, as counterparties would calculate exposures on fundamentally different bases. Nor is it entirely clear how parties would calculate margin requirements if some of the counterparty exposure was in a jurisdiction that did not have the necessary netting or insolvency laws to support a robust IM requirement. These factors will significantly hinder the

---

out amounts in early-settling currencies (e.g. JPY) and expecting to receive amounts in later settling currencies (e.g. USD) will be at risk in the event that the counterparty fails before all settlements for the day in question can be completed. This is identical to the settlement risk experienced in the FX market, which was brought to light by the failure of Herstatt Bank in 1974. As a result, the risk arising from this timing gap is known as Herstatt risk.

<sup>16</sup> See ISDA September Comment Letter at pp. 45 - 46.

implementation of a dispute resolution mechanism for IM, and urge IOSCO and BCBS to delay implementation until this issue can be resolved.

**G. Special Purpose Vehicles ("SPVs") should be exempt from margin requirements:**

SPVs should not be required to post or collect margin. There are a number of other ways in which credit risk can be, and currently is, mitigated in transactions with SPVs for structured finance or securitization transactions. For example, the documentation for SPVs generally provides that: (i) the OTC derivatives counterparty has a security interest over all the assets of the SPV; (ii) the OTC derivatives counterparty has first priority with regard to cash flow payments; and (iii) SPVs are bankruptcy-remote vehicles. Hence, there is no need to impose margin requirements to protect against credit risk. In addition, SPVs have limited functionality and resources and are generally unable to comply with the burden of requirements to post collateral. Imposing margin requirements on SPVs would generally prevent SPVs from entering into swaps which would deprive securitization and structured finance of a valuable hedging tool and significantly impair the securitization markets.

**H. Local regulators should determine margin requirements for inter-affiliate transactions :**

We support the proposal in the paper to leave the margin requirements for inter-affiliate OTC derivatives to local regulators. Inter-affiliate trades are used for internal hedging and risk management and do not increase systemic risk or threaten the safety and soundness of entities under common control, and, as the CFTC and SEC have stated, "simply represent an allocation of risk within a corporate group."<sup>17</sup> As result, it is appropriate let local regulators determine their treatment consistent with local laws and requirements.

**I. Margin requirements should be consistent across difference jurisdictions:**

Regulators in different jurisdictions should interact to ensure that margin regulations are sufficiently consistent and non-duplicative and create a level playing field among market participants. We support the Paper's efforts towards the creation of a harmonized global margin infrastructure. To the extent inconsistencies in market infrastructure and regulation exist between jurisdictions, a margin requirement may increase rather than decrease risk to one or more of the counterparties.


\* \* \*

---

<sup>17</sup> See CFTC and SEC joint proposed rule, "Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 244 at 80183.

ISDA appreciates the opportunity to provide these supplemental comments on the BCBS/IOSCO study on margin requirements for non-centrally-cleared OTC derivatives. We trust this submission is helpful to the group working on margin issues. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

A handwritten signature in black ink, reading "Robert C. Pickel". The signature is written in a cursive style with a large, prominent initial "R".

Robert Pickel  
Chief Executive Officer