

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
United States
www.cftc.gov

Chris Barnard
Germany

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- **17 CFR Part 23**
- **RIN Number 3038–AC97**
- **Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants**

Dear Mr. Stawick.

Thank you for giving us the opportunity to comment on your notice of proposed rulemaking: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.

You are proposing regulations to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The proposed regulations would implement the new statutory framework of Section 4s(e) of the Commodity Exchange Act (CEA), added by Section 731 of Dodd-Frank, which requires the CFTC to adopt capital and initial and variation margin requirements for certain swap dealers (SDs) and major swap participants (MSPs). The proposed rules address initial and variation margin requirements for SDs and MSPs. The proposed rules will not impose margin requirements on non-financial end users. The CFTC will propose rules regarding capital requirements for SDs and MSPs at a later date.

I generally support your principles-based proposals, which would apply to relevant uncleared swaps entered into after the date the regulations come into force. I will make some general comments on the main issues here. I may revise my views once you have proposed rules regarding capital requirements for SDs and MSPs.

Margin requirements

I support the proposal to allow covered swap entities to use approved models to calculate the initial margining requirements for uncleared swaps, subject to an alternative method, which is based on multiplying the margin required for a comparable cleared swap by a specified factor, and which allows for limited offsetting of positions. The proposed factor for the comparable cleared swap is 2.0, and the proposed factor rises to 4.4 where there is no comparable cleared swap and a futures contract is used instead. These factors should appropriately allow for the greater risk of uncleared swaps. This is very much the way to go,¹ and will surely spur covered swap entities to use the more risk-accurate approved models compared to the alternative method. However, I would recommend that the CFTC should go further in the future, subject to having sufficient resources, and should allow covered swap entities to use approved internal risk management models in order to determine initial margins.

I also agree with the approach proposed for calculating variation margins, which would allow for aggregating transactions entered into with a counterparty under a documented netting agreement. This is entirely appropriate. In this case the proposed §§ 23.501 and 23.600 are sufficient to ensure that SDs and MSPs have a sound legal basis for their swap documentation, and I suggest that the CFTC does not need to adopt the concept of “qualifying master netting agreements” from existing banking regulations.

Model calibration

It is entirely appropriate that approved models should determine margins prudently. I support the proposal that models should set initial margin to cover at least 99% of price changes by product and portfolio over at least a 10-day liquidation time horizon. The 10 day time horizon reasonably allows for the lower liquidity of uncleared swaps compare with cleared swaps.

Concerning proposed § 23.155 (b)(2)(iv) the model “must incorporate a period of significant financial stress appropriate to the uncleared swaps to which the model is applied”. This requires further clarification and / or guidance, as it is very subjective and possibly arbitrary to come up with “significant financial stress appropriate to the uncleared swaps”. In my experience, the financial stresses that you experience in practice are rarely the ones anticipated, and I would expect this to be even more of a problem for uncleared swaps compared with cleared swaps. Given this, I would additionally recommend that specific wording should be added to (vii) stating that both the model and methodology, including calibration data and stress data, should be regularly validated by an independent third party.

Finally, section § 23.155 (b)(2)(viii) requires the methodology to be stated “with sufficient specificity” to allow external parties to calculate the margin requirement independently. I think that it is important to manage expectations here. I doubt that it would be easy for an external party to replicate margin requirements, and that this would be particularly difficult in times of “significant financial stress”, where such replication would be expected to be more controversial and critical.

¹ Similar to the approach adopted by Basel for banks, and e.g. Solvency II for European insurers.

Pre-effective date swaps

I agree that the proposed margin requirements should not apply to uncleared swaps executed prior to the effective date of these rules, as their original pricing reflects the conditions and credit arrangements under which they were executed. However, to the extent that the parties' swap trading relationship documentation would permit portfolio margining of swaps, SDs and MSPs should be permitted, but not required, to include swaps executed prior to the effective date of the proposed rules in their calculation of initial margin, provided that the parties would include all swaps covered by that documentation. This is reasonable, and would allow SDs and MSPs to appropriately reflect their business practice in this regard.

One-way margins

I cannot convince myself that one-way margining in trades between covered swap entities and financial entities is appropriate here. One-way margining is not consistent with sections 4s(e)(2)(B) or 4s(e)(3)(A) of the CEA. Furthermore, the CFTC states in its commentary that:

Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure.

One-way margining is counterintuitive here, and cannot be described as a "well-designed" margin system. It does not ensure the safety and soundness of SDs and MSPs, and is not appropriate for the risks associated with uncleared swaps.

Summary

In summary, I welcome your proposals. I agree with the principles-based approach that you have taken here. At the moment, I would only recommend that you add specific wording in § 23.155 (b)(2)(vii) that would require a regular independent validation of methodology, calibration and data, as well as the model, and that you reconsider the proposal for one-way margining in trades between covered swap entities and financial entities in favour of two-way margining.

Yours sincerely

Chris Barnard