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Commodity Futures Trading Commission
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- **17 CFR Parts 23 and 140**
- **RIN Number 3038-AC97**
- **Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants**

Dear Mr. Kirkpatrick.

Thank you for giving us the opportunity to comment on your Proposed rule on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.

You are proposing regulations to implement section 4s(e) of the Commodity Exchange Act (CEA), as added by section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This provision requires you to adopt initial and variation margin requirements for certain swap dealers (SDs) and major swap participants (MSPs). The proposed rules would establish initial and variation margin requirements for SDs and MSPs in order to offset the greater risk to such entities and the financial system arising from the use of swaps that are not cleared but would not require SDs and MSPs to collect margin from non-financial end users.

In principle I support two-way margining for uncleared swaps and uncleared security-based swaps. I also support that the requirements should not impose margin requirements on non-financial entities entering into uncleared swaps and uncleared security-based swaps that are used for hedging or mitigating commercial risk, given that such transactions pose little or no systemic risk.¹

¹ For completeness I would add that such derivatives should not be used to hedge or mitigate the risk of other derivative positions, unless those other positions themselves are held for the purpose of hedging or mitigating commercial risk.

Universal two-way margins

I fully support the concept of universal two-way margining. In principle this would meet the requirements of a well-designed margin system, as explicitly recognised by, among others, the Commodity Futures Trading Commission (CFTC):

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.²

In addition I note that that the 2013 International Framework also requires universal two-way margining.³ However, a well-designed margin system should aim to ensure the safety and soundness of covered swap entities, and be appropriate for the risks associated with uncleared swaps. I would therefore caution against the aggressive use of thresholds as a tool to manage the liquidity impact associated with margin requirements. Such thresholds are arbitrary, reduce market integrity and increase systemic risk.

Margin requirements

I support the proposal to allow covered swap entities to use approved internal models to calculate the initial margining requirements for uncleared swaps, subject to a suitably conservative alternative method based on a standardised initial margin schedule for those covered swap entities that are unable or unwilling to develop internal margin calculation models that meet regulators' requirements. This is very much the way to go,⁴ and will surely spur covered swap entities to develop and use the more risk-sensitive approved internal models compared to the conservative alternative method.

I also strongly agree that to the extent that more than one uncleared swap is executed pursuant to an eligible master netting agreement between a covered swap entity and a counterparty: "a covered swap entity may calculate and comply with the variation margin requirements of this section on an aggregate basis with respect to all uncleared swaps governed by such agreement"⁵; and further that, "a covered swap entity may use its initial margin model to calculate and comply with the initial margin requirements on an aggregate basis with respect to all uncleared swaps governed by such agreement"⁶. This will simplify risk management and improve efficiency and is therefore entirely appropriate.

² See commentary in CFTC Notice of proposed rulemaking: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 28 April 2011; excerpt also included in this proposed rule at 79 FR 59901.

³ See BCBS and IOSCO "Margin requirements for non-centrally cleared derivatives," (September 2013), available at <https://www.bis.org/publ/bcbs261.pdf>. Paragraph 2(d) under Element 2: Scope of coverage – scope of applicability, states that "the BCBS and IOSCO support margin requirements that, in principle, would involve the mandatory exchange of both initial and variation margin among parties to non-centrally cleared derivatives ('universal two-way margin')".

⁴ Similar to the approach adopted by Basel for banks, and e.g. Solvency II for European insurers.

⁵ See proposed § 23.153(c).

⁶ See proposed § 23.154(b)(2).

Model calibration

It is entirely appropriate that approved internal models should determine initial margins prudently. I agree with proposed § 23.154(b)(3)(i) that: “The model shall calculate an amount of initial margin that is equal to the potential future exposure of the uncleared swap or netting set of uncleared swaps covered by an eligible master netting agreement. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap”. The ten business day time horizon reasonably allows for the lower liquidity of uncleared derivatives compared with centrally-cleared derivatives.

Concerning your proposal that the initial margin amount should be calibrated based on historical data that incorporates a period of “significant financial stress”,⁷ I would request further clarification and / or guidance, as it is very subjective and possibly arbitrary to determine what is “significant financial stress”. 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 derivatives compared with centrally-cleared derivatives. Given this, I would additionally recommend that you should propose specific, stronger wording stating that both the models and methodology, including calibration data and stress data, should be regularly validated by an independent third party.

Eligible collateral for margin

I fully agree that assets collected as collateral for initial margin purposes “should be liquid and, with haircuts, hold their value in times of financial stress. The value of the assets should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the swap portfolio”⁸. Therefore I agree that cash / major currencies and high quality government, corporate and covered bonds should be eligible collateral, but I would caution against allowing equities as eligible collateral. Although I accept that diversification of collateral brings certain risk advantages, equities are too volatile and subject to jump risk, which therefore makes them unsuitable as collateral. Collecting parties would not be assured that their value would be sufficient to meet obligations, particularly during a severe economic downturn / period of significant financial stress.

Documentation of margin matters

Under proposed § 23.158 Margin documentation, a covered swap entity would be required to maintain documentation that specifies the methodology and data sources to be used to: value uncleared swaps and collateral; calculate initial margin; value positions; and calculate variation margin. Although the proposal does not prescribe a specific valuation method, the agreed methods, procedures, rules and inputs should be required to constitute a complete

⁷ See proposed § 23.154(b)(3)(ii) and proposed § 23.154(b)(3)(xiii).

⁸ See the Notice of proposed rulemaking, 79 FR 59912.

Please note that the comments expressed herein are solely my personal views

and independently verifiable methodology for valuing each uncleared swap or transaction entered into between the covered swap entity and its relevant counterparties. I support that this would increase transparency, operational efficiency and assist in the early and objective resolution of uncleared swap valuation disputes.

Physically-settled foreign exchange transactions

I support that In the case of an uncleared cross-currency swap, “the model need not recognize any risks or risk factors associated with the fixed, physically-settled foreign exchange transactions associated with the exchange of principal embedded in the cross-currency swap”⁹. I agree that such physically-settled foreign exchange transactions pose limited systemic risk.

Yours sincerely

C.R.B.

Chris Barnard

⁹ See proposed § 23.154(b)(3)(iv).