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Chris Barnard

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- 12 CFR Part 1221; RIN 2590-AA45
- Margin and Capital Requirements for Covered Swap Entities

Dear Mr. Pollard.

Thank you for giving us the opportunity to comment on your Notice of proposed rulemaking on Margin and Capital Requirements for Covered Swap Entities.

The OCC, Board, FDIC, FCA, and FHFA (the Agencies) are seeking comment on a proposed joint rule to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator. This proposed rule implements sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which require the Agencies to adopt rules jointly to establish capital requirements and initial and variation margin requirements for such entities and their counterparties on all non-cleared swaps and non-cleared security-based swaps in order to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

In principle I support two-way margining for non-cleared swaps and non-cleared security-based swaps. I also support that the requirements should not impose margin requirements on non-financial entities entering into non-cleared swaps and non-cleared 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

I note that that the 2013 International Framework also requires universal two-way margining.³ However, a well-designed margin system should ensure the safety and soundness of covered swap entities, and be appropriate for the risks associated with non-cleared swaps and non-cleared security-based swaps. I would 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 entities to use approved internal models to calculate the initial margining requirements for non-cleared swaps and non-cleared security-based swaps, subject to a suitably conservative alternative method based on a standardised initial margin schedule for those covered 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 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 one or more non-cleared swaps or non-cleared security-based swaps are executed pursuant to an eligible master netting agreement between a covered swap entity and its counterparty that is a swap entity or financial end user: "a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate net basis with respect to all non-cleared swaps and non-cleared security-based 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 pursuant to §__.3 on an aggregate basis with respect to all non-cleared swaps and non-cleared security-based 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.

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 §__.4(d).

⁶ See proposed §__.8(b)(2).

Model calibration

It is entirely appropriate that approved internal models should determine initial margins prudently. I agree with proposed § __.(8)(d)(1) that: “Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the non-cleared swap, non-cleared security-based swap or netting set of non-cleared swaps or non-cleared security-based 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 non-cleared swap or non-cleared security-based swap”. The ten business day time horizon reasonably allows for the lower liquidity of non-centrally-cleared derivatives compare 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 non-centrally-cleared 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 agree that assets collected as collateral for initial and variation margin purposes should be high quality, liquid assets “that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based ‘haircut,’ during a severe economic downturn”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 entities 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 § __.10 Documentation of margin matters, a covered swap entity would be required to maintain documentation that specifies: “The methods, procedures, rules, and inputs for determining the value of each non-cleared swap or non-cleared security-based swap for purposes of calculating variation margin requirements”. Although the proposal does not prescribe a specific valuation method, the agreed methods, procedures, rules and inputs

⁷ See proposed § __.(8)(d)(2) and proposed § __.(8)(d)(13).

⁸ See the Notice of proposed rulemaking, 79 FR 57355.

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

should be required to constitute a complete and independently verifiable methodology for valuing each non-cleared swap or non-cleared security-based swap transaction entered into between the covered swap entity and its relevant counterparties. I believe that this would increase transparency, operational efficiency and assist in the early and objective resolution of non-cleared swap and non-cleared security-based swap valuation disputes.

Physically-settled foreign exchange transactions

I support that In the case of a non-cleared cross-currency swap, “the covered swap entity’s initial margin 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 non-cleared cross-currency swap”⁹. Such physically-settled foreign exchange transactions pose limited systemic risk as their primary purpose is to transfer ownership rather than price risk.

Yours sincerely

C.R.B.

Chris Barnard

⁹ See proposed § __.(8)(d)(4).