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28 September 2012

Mr. Wayne Byres, Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

**Re: Margin Requirements for Non-centrally Cleared Derivatives**

Dear Mr. Byres,

CFA Institute[1] appreciates the opportunity to comment on the Margin Requirements for Non-centrally Cleared Derivatives (the "Proposal") as proposed by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO"). The Proposal considers the treatment of initial and variation margins for non-centrally cleared derivatives globally. Reducing systemic risk and promoting central clearing are the overall goals of the Proposal.

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the integrity and accountability of global financial markets.

As a global organization of investment professionals, CFA Institute is particularly concerned with issues that create systemic turmoil and failure within financial markets. Consequently, we are strongly supportive of efforts to 1) increase transparency of the swaps and derivatives markets globally; 2) to carefully consider, manage and regulate central clearing of swaps; 3) to trade standardized and standardizable swap instruments on transparent organized trading venues; and 4) to ensure global coordination in the adoption and implementation of swaps regulations to reduce the frequency and effect of regulatory arbitrage.

[1] CFA Institute is a global, not-for-profit professional association of more than 110,000 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom nearly 101,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 58 countries and territories.

## Executive Summary

CFA Institute supports the objectives of the Proposal, namely to help standardize the process for margin requirements for non-centrally cleared derivatives globally. BCBS and IOSCO offer 7 key elements and related requirements to advance the objective, along with specific questions for public comment. We have identified several issues that are relevant to our members and the investment industry generally, and offer responses to the related questions.

The questions we have answered in the discussion section of this letter relate to the following issues:

1) Whether or not short-dated foreign exchange swaps and forwards should be exempted from margining requirements,
2) If and how different margin thresholds should be applied for various entities,
3) If margin requirements should apply to non-financial entities that are not systemically important, sovereigns, and/or central banks,
4) Eligible collateral for margin, and
5) Treatment of the margin that has been posted.

Generally, we do not support exemptions from providing margin for non-centrally cleared derivatives which was a significant contributor to the systemic risk disruptions during the 2008 financial crisis and continues to pose problems for the industry. Posting collateral for OTC derivatives transactions provides a critical buffer in the event of default of one of the counterparties, helps manage systemic risk, and enable central clearing - all concepts with which we firmly agree. However, we do note the difficulties of posting margin for short-dated foreign exchange swaps and forwards and the success of the existing Continuous Linked Settlement ("CLS") system, which may serve as an alternative to the collateral and clearing requirements proposed for other types of OTC derivatives in mitigating risk.

We also support allowing a broad range of collateral types used for margin requirements as long as they are liquid instruments and the appropriate valuation discounts are reflected. We encourage more standardized rules and widely agreed upon risk management criteria in determining such values.

Once margin has been posted it should be segregated by client. In the event of a default, the non-defaulting party in the transaction should be able to easily identify and apply the posted margin to offset any losses due to the default or the position close-out. Also, the structure we suggest would prevent the default of one counterparty from affecting the value of both parties to the transactions.

We discuss these matters more fully in the section below.

## Discussion

We strongly support the Proposal for cohesive margin requirements for non-centrally cleared derivatives that mitigate systemic risk and promote central clearing for standardized derivatives contracts globally. High-level regulatory and political agreements must be made in all G-20 markets to ensure that all the final requirements are applied in all jurisdictions to avoid regulatory arbitrage. Any good margining system for non-exchange products must reflect non-systemic risk of the counterparty, the risk and liquidity characteristics of the posted collateral, and the risk of the underlying transaction.

**Questions for Consideration**

Along with the Quantitative Impact Study ("QIS") to evaluate the liquidity impact of the Proposal, the BCBS and IOSCO request feedback on specific issues to determine final margin requirements for non-centrally cleared derivatives. Please see the questions and answers below for our opinion on some of the questions posed:

**Element 1: Scope of coverage – instruments subject to the requirements**

> *Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Generally, we do not believe there should be any exemptions from providing margins for any OTC derivatives transactions, regardless of the product or the counterparty. Foreign exchange swaps and forwards are central to many investment and hedging strategies beyond typical alternative and derivative strategies. Because any foreign exchange market disruption would be untenable, margin should conceptually be posted on all foreign exchange transactions, short-dated or otherwise.

However, many argue that in this case, an exception is warranted because the CLS serves a clearing function and has worked well over many decades to mitigate risk in foreign exchange. With all of the derivatives reform needed, it may not be necessary to make changes to a market that has never had any problems. Another argument for allowing exemptions for short-dated foreign exchange forwards and swaps is the amount of liquidity that would be needed to support margin requirements for foreign exchange swaps and forwards.

With so many competing factors to consider, we suggest that the QIS consider the liquidity impact of not allowing this particular exemption and use its findings to inform the decision about whether or not to exempt foreign exchange swaps and forwards from posting margin.

So far, it is not clear that major jurisdictions are all on the same page with the treatment of central clearing for foreign exchange swaps and forwards. In the European Securities and Markets Authority ("ESMA") consultation, foreign exchange forwards and swaps were proposed to be centrally cleared. The U.S. Commodity Futures Trading Commission ("CFTC") exempted such instruments from clearing requirements imposed on other types of OTC derivatives. While nothing has been finalized in the U.S. and Europe, if the regulators cannot agree on this issue and central clearing is not required, it will make margin requirements for foreign exchange swaps and forwards more important as a means of mitigating systemic risk.

*Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

We are not aware of any additional specific product exemptions that should be considered.

**Element 2: Scope of coverage – scope of applicability**

*Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g., G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g., notional amounts outstanding) be used to effectively determine an entity's systemic risk level?*

We do not believe that regulators should apply entity-based thresholds. Each bilateral transaction will have margin requirements based on the credit quality of the relevant counterparties. Also, thresholds may give an advantage to certain types of entities and work counter to the goal of centrally clearing the bulk of OTC derivatives.

*Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e., those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

We do not believe that such institutions should be exempt solely on the basis of their prudential oversight. Indeed, many of the problems created by the OTC derivatives markets in 2008 were the result of a single entity being permitted to engage in market activity without having to post margin or collateral in part due to the misguided belief that the regulatory structure under which it operated was sufficient to provide surety of performance without such requirements. We believe that in response to these events that all market participants should be subject to the margin requirements envisioned by the proposal.

*Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?*

As noted in our response to Q7, we believe that all entities should post margin based on the risk of the market movement of the specific instruments involved, and there should not be any exemptions.

## Element 3: Baseline minimum amounts and methodologies for initial and variation margin

*Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

As discussed in the Proposal, because "derivative portfolios are subject to offsetting risks that are both quantifiable and those that are more difficult to quantify, it is important to distinguish between the two categories when creating a model for calculating initial margin. Inter-relationships between derivatives in distinct asset classes, such as equities and commodities, are difficult to model and validate. Moreover, these types of relationships are prone to instability and more likely to break down in a period of financial stress."

However, we disagree with the requirement that initial margins may account for diversification, hedging, and risk offsets within well-defined asset classes such as currency/rates, equity, credit, and commodities, but not across such asset classes. While we recognize that many asset classes move together or are unpredictable in times of financial stress, we do not agree with the notion that posting margin within the same asset class of the

derivative would offer more diversification benefits than if margins were allowed to be posted across different asset classes. Moreover, experience has proven that the characteristics of diversification often disappear in periods of financial stress. Consequently, while we support greater diversification of collateral to limit asset concentrations, we do not believe it should be seen as a means of significantly reducing risk in market crises.

We agree that any initial margin model must be approved by the relevant supervisors.

We believe that any model for initial margin for non-centrally-cleared trades needs to be comparable to the methods used by central counterparties ("CCP"), for example in a VaR model using parameters such as a five-year history, five-day holding period and a high confidence level, plus market scenarios along with stress testing. Criteria should be set for such models used to determine initial margin along with a thorough testing approach for firms to use in establishing the suitability of a proposed model. Regulators should work with International Swaps and Derivatives Association ("ISDA") and other trade organizations to design and improve margin agreements to meet a high operational standard for covering liabilities and to avoid or mitigate disputes.

## Element 4: Eligible collateral for margin

*Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

The scope of eligible collateral is described in the Proposal, among other things, as "assets that can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities from losses on non-centrally cleared derivatives in the event of a counterparty default. These assets should be highly liquid and should, after accounting for appropriate valuation discounts, be able to hold their value in times of financial stress. The Proposal's set of eligible collateral is designed to recognize the changing behavior of assets in periods of financial stress and are intended to reduce exposure to excessive credit, market, liquidity, and f/x risk."

The Proposal then offers examples of the types of eligible collateral. The examples include but are not limited to:

- Cash;
- High-quality government and central bank securities;
- High-quality corporate bonds;
- High-quality covered bonds;
- Equities included in major stock indices; and
- Gold.

The scope of proposed eligible collateral is appropriate. We agree with allowing broader collateral beyond cash and high-quality government bonds while applying the appropriate haircuts based on volatility and volatility in times of stress.

*Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

In general, we concur with diversification of collateral, limits on collateral concentrations. However, we have concerns about the use of best practice valuation discounts that are based on the risk and volatility of an instrument. Further, as noted above in Q14, experience has shown that the benefits of diversification often disappear in periods of financial stress, thus reducing the value of diversification in reducing risk in such periods.

**Element 5: Treatment of provided margin**

*Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?*

The Proposal requires that initial margin should be exchanged on a gross basis and held in a manner that is consistent with the related Key Principle. The Key Principle states that the "initial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of a counterparty's default, and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under the applicable law."

We believe the proposed requirements are appropriate, though it is difficult to determine if they are adequate to protect and preserve utility of margin as loss mitigants in all cases. Nevertheless, we believe that these steps are necessary and important to safeguard parties engaging in OTC derivatives transactions.

Please note that this is another instance where the policies proposed by ESMA and the CFTC differ. Where the CFTC has finalized its policy, the ESMA standards have not yet been released. This will be another area where it is critical to get agreement across jurisdictions.

*Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

It would be difficult to require all firms to use a common model to determine net initial margin due to the different risk factors associated with each transaction type. Without a common model, there cannot be a reconciliation of each firm's initial margin calculations. We suggest that the BCBS and IOSCO consider the use of net margin with a supplemental safety buffer to provided added security to the counterparties, but reduce the amount of collateral that must be exchanged. This is an important consideration given the relative scarcity of potential collateral available. We also recognize that this would create a potential problem of concentration held at a small number of custodian banks. Such a problem would likely become evident if one or more of the custodian banks were to fail.

Therefore, it is incumbent upon these institutions to hold sufficient capital to safeguard against failure, and upon regulators to provide adequate oversight of such institutions. In both cases, the goal is to ensure that these institutions are managed and capitalized in a manner that reduces the risk of failure, and the potential consequences of such a failure.

*Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?*

Full, unrestricted rehypothecation has created difficulties for clients of Lehman Brothers and MF Global, who have been unable to receive their margin assets since bankruptcy. It is hard to see that a blanket ban on rehypothecation is useful as it may result in a global shortage of collateral assets. Yet full rehypothecation may have risks. Further work is needed to establish whether rehypothecation is necessary.

**Conclusion**

We appreciate the opportunity to comment on the BCBS/IOSCO Proposal on Margin Requirements for Non-centrally Cleared Derivatives. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Beth Kaiser, CFA, CIPM at beth.kaiser@cfainstitute.org or 434.951.5614.

Sincerely,

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