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

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Your Ref: Comment letter on Consultative Document
- Margin requirements for non-centrally-cleared derivatives

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on: Margin requirements for non-centrally-cleared derivatives. In general I support your key principles. I agree with you that margin requirements should cover all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardised and bespoke) that are not centrally cleared by a central counterparty (CCP) for any reason. I also support that the requirements should not impose margin requirements on non-financial entities entering into non-centrally-cleared derivatives that are used for hedging or mitigating commercial risk, given that such transactions pose little or no systemic risk.[1]

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]

[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.
[2] See commentary in CFTC Notice of proposed rulemaking: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 28 April 2011.

However, a well-designed margin system should ensure the safety and soundness of covered entities, and be appropriate for the risks associated with non-centrally-cleared derivatives. 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-centrally-cleared derivatives, 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,[3] 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 agree that "the initial margin model may consider all of the derivatives that are approved for model use that are subject to a single, legally enforceable netting agreement", and that "variation margin should be calculated and collected for non-centrally-cleared derivatives subject to a single, legally enforceable netting agreement with sufficient frequency".[4] This is entirely appropriate. Each covered entity should prepare documentation specifying in advance material terms, including how margin is calculated, and the methods, procedures, rules and inputs for determining the value of each derivative at any time. This process will increase transparency, operational efficiency and assist in the early and objective resolution of derivative valuation disputes.

Model calibration

It is entirely appropriate that approved internal models should determine initial margins prudently. I support the proposal that initial margin "should reflect an extreme but plausible estimate of an increase in the value of the instrument that is consistent with a one-tailed 99 percent confidence interval over a 10-day horizon"[5]. The 10-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", 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 include specific wording stating that both the models and methodology, including calibration data and stress data, should be regularly validated by an independent third party.

[3] Similar to the approach adopted by Basel for banks, and e.g. Solvency II for European insurers.
[4] Quotes taken from pages 18 and 19 respectively of the Consultative Document.
[5] Quote taken from page 17 of the Consultative Document.

Eligible collateral for margin

I agree that assets collected as collateral for initial and variation margin purposes should be highly liquid, and “be able to hold their value in a time of financial stress”. Therefore I agree that cash 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 period of financial distress.

Yours faithfully

C.R. Barnard

Chris Barnard