



March 15, 2013

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Second Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives.

Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to comment on matters identified in the above-captioned consultative document ("Consultative Document") of the Basel Committee on Banking Supervision ("BCBS," "Basel Committee") and the Board of the International Organization of Securities Commissions ("IOSCO"). The Consultative Document builds on a previous consultative document released in July 2012 ("Previous Proposal") and addresses issues relating to margin requirements for non-centrally cleared Over-the-Counter ("OTC") derivatives.

INTRODUCTION

Un-cleared OTC derivatives played a central role in the financial crisis of 2008. Inadequate capital and margin combined with a lack of transparency led to a complete breakdown of markets, with sudden collateral calls bringing financial institutions to the brink of collapse. The Consultative Document seeks to address this vulnerability by ensuring that participants in OTC derivatives markets collect and post adequate margin against their derivatives exposures, and manage that collateral in a prudent manner.

The Consultative Document makes some key recommendations that are absolutely necessary if the systemic risk posed by un-cleared derivatives is to be kept to a reasonable level. However, there are crucial respects in which the proposals must be strengthened if they are to fulfill the intention of BCBS and IOSCO to protect the global

¹ Better Markets, Inc. is an independent nonprofit organization that promotes the public interest in the international capital and commodity markets.

financial system from another financial meltdown and the need for more massive government and taxpayer-funded bailouts.

SUMMARY OF COMMENTS

We offer comments on Key Principles 1-3, 5, and 7-8.

Key Principle	Comment
1. Scope	Margin requirements should be extended to physically settled FX forwards and swaps.
2. Universal 2-Way Margin	The \$8 billion <i>de minimis</i> exemption and \$50 million initial margin “threshold” should be removed from the final document.
3. VaR	Proprietary models should not be permitted for calculating margin requirements: the risk of underestimating appropriate collateral levels is too great.
5. Treatment of Collateral	Rehypothecation should in no case be permitted for either initial or variation margin. Collateral should be calculated for gross notional exposure, not net.
7. International Harmonization	International harmonization must lead to a universally high standard of regulation rather than a race to the bottom.
8. Phasing-In	The proposed schedule for implementation must be accelerated: the risk of leaving OTC derivatives un-margined is simply too great.

DISCUSSION

Key Principle 1 - Appropriate margining practices should be in place with respect to all derivatives transactions that are not cleared by Central Counterparties (“CCPs”).

The principle as it stands is clear and succinct. However, in the analysis contained in the Consultative Document, BCBS and IOSCO indicate they are considering differential treatment for physically settled foreign exchange (“FX”) forwards and swaps.² This stands in contrast to the Previous Proposal, which correctly recognized that “physical settlement” is irrelevant when it comes to credit and price risk FX transactions.³ In stressed market conditions, counterparties gain no additional protection against price risk (exchange rate fluctuations) by virtue of the physical settlement and full notional transfer of currencies in FX transactions. While it is true that the full exchange of principal at the outset of a physically settled FX swap mitigates counterparty risk, the replacement cost in the case of default is still dependent on the health of the FX markets. As we saw in the last financial crisis, the FX markets are just as vulnerable as other derivatives markets in times of stress.

Foreign exchange derivatives constitute a highly leveraged funding market that is a major factor in the interconnectedness of financial institutions, and a major source of systemic risk.⁴ Therefore, this type of derivative, at least as much as any other, should be subject to proper risk management. Nor does the exchange of physical currencies change this in any way. Unlike physical commodities, the value of which resides in their consumption, the physical currencies used to settle FX swaps are subject to potentially vast swings in exchange rates. For a leveraged swap, even a modest swing in exchange rates can cause large losses to accrue suddenly. It is for just this reason that proper margining must be required for un-cleared FX derivatives.

Some observers have asserted that the foreign exchange market did not play a role in the financial crisis of 2008. However, in September of 2008, the foreign exchange swaps market virtually shut down. The Federal Reserve Bank (“Fed”) intervened by opening enormous, and ultimately unlimited, transatlantic swap lines with foreign central banks, thus reinforcing the foreign exchange swap markets and

² Consultative Document, at 6.

³ Previous Proposal, at 12.

⁴ Even the financial industry confirms this: “In addition to being the world’s largest financial market, the foreign exchange market underpins other financial markets and the global economy generally.” Comment Letter from the self-described Global FX Division to United States Department of the Treasury, at 7 (Nov. 15, 2010) (herein referred to as “Global Industry Letter”). And, the Foreign Exchange and Currency Derivatives Dealers are a who’s who of the very large, complex, and interconnected banks. *See id.* at 14 n. 27.

defusing the crisis.⁵ Although a meltdown was averted, this experience makes it clear that these markets must be subject to the same regulatory requirements as other OTC derivatives.

Data released by the Fed in December of 2010 proves that the foreign exchange markets were on the verge of collapse days after the financial crisis began in September of 2008. This data also proves that only a massive emergency intervention in the foreign exchange markets by the Fed prevented a collapse. This episode of profound instability, crisis, and ultimately near collapse refutes the claim that the foreign exchange markets performed well during the financial crisis and do not need to be fully regulated. These events are documented and analyzed in a letter submitted by Better Markets to the United States Treasury in February 2011.⁶

At the height of the crisis, the FX markets froze due to counterparty credit fears, creating a shortage of dollars in Europe. To avert catastrophe, the Fed provided a rolling facility of unlimited foreign exchange swaps to backstop the markets for a period of several months following Lehman's collapse. These swaps totaled \$2.9 trillion in October 2008 alone and more than \$5.4 trillion in the three months following the Lehman bankruptcy.⁷ On several days, the total notional value of outstanding foreign exchange swaps provided by the Fed to bolster the market exceeded \$700 billion.⁸ The Fed's maximum net notional daily exposure in the foreign exchange markets was greatest on October 22, 2008, when it reached \$823.1 billion.⁹

While these multi-trillion dollar amounts were massive, they actually dramatically understate the role of the Fed, which guaranteed the entire market when it removed all limits on the ability of foreign central banks to access the Fed for foreign exchange transactions in October 2008. Between the collapse of Lehman and mid-October, the Fed increased its intervention in the foreign exchange markets by more

⁵ Naohiko Baba & Frank Packer, *From turmoil to crisis: dislocations in the FX swap market before and after the failure of Lehman Brothers*, BIS Working Paper, No. 285 (July 2009), available at <http://www.bis.org/publ/work285.pdf?frames=0>.

⁶ Better Markets Letter to United States Treasury, "New Information on the Proposed Exemption of Foreign Exchange Swaps and Futures: Fed Data Show Collapse of Foreign Exchange Markets During Financial Crisis," (Feb. 25, 2011) ("FX Swaps Letter"), available at <http://www.bettermarkets.com/sites/default/files/Treas-%20Comment%20Letter%20%28followup%29-%20Forex%20Swaps%202-25-11.pdf>.

⁷ Total notional value of new swaps opened through the Fed's central bank liquidity swaps line between the Fed's first use of the line after the Lehman Bankruptcy (Sept. 18, 2008) and 3 months later (Dec. 18, 2008). See FX Swaps Letter.

⁸ Calculated from newly released Fed data as the total notional value of swaps opened (traded) by close of business on a given date, minus the number matured by close of business on that date.

⁹ Using the newly released data from the Fed, the maximum net exposure was calculated as the sum of all opened trades minus all closed trades as of the close of business. The Fed calculates its net exposure in the foreign exchange markets slightly differently. It uses the settlement date of the first leg of new trades rather than the date the trade was made, thereby lowering the number by netting. Thus, some data indicate that the high water mark was \$586.1 billion. However, both figures are accurate. See FX Swaps Letter.

than 700 percent. Even that action was insufficient to stop the crisis as spreads continued to widen and liquidity continued to evaporate. The foreign exchange markets were rapidly spiraling toward collapse, forcing the Fed to take even greater emergency action: in early October 2008, the Fed announced that it had removed all limits on its intervention, informing the markets that it would effectively guarantee the entire market.

Only after this wholesale Fed backstop for the entire foreign exchange market did the crisis begin to ebb and the market begin to stabilize. As in the repo, commercial paper, and other markets, the Fed's emergency intervention stopped the market's death spiral.¹⁰

There is a substantial body of independent research and analysis by experts at internationally recognized institutions that supports these conclusions. These authorities agree that after the Lehman bankruptcy, the FX markets froze, were on the verge of collapse, and would have collapsed but for the Fed's intervention.¹¹ This argument is amply supported in the independent, professional literature.¹²

It is also apparent that the underlying loss of liquidity in the foreign exchange markets was attributable to fears about counterparty creditworthiness and the inability of bank participants to enter additional foreign exchange transactions given the state of their balance sheets. These are precisely the hazards that a comprehensive margin regime for un-cleared derivatives is designed to address.

The industry arguments being made in support of an exclusion for physically settled FX swaps and forwards echo remarkably similar anti-transparency and anti-regulatory claims that were made in the decade leading up to the crisis of 2008. As was the case then, those arguments spring from a desire to preserve a profitable status quo, not from the merits of the exemption on legal or policy grounds.

¹⁰ See FX Swaps Letter.

¹¹ "Global funding market pressures were evident in the virtual shut-down of the FX swap market." Naohiko Baba & Frank Packer, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers*, BIS Working Paper No. 285, at 6 (July 2009), available at <http://www.bis.org/publ/work285.pdf>.

¹² See, e.g., Tommaso Mancini-Griffoli & Angelo Ranaldo, *Limits to Arbitrage During the Crisis: Funding Liquidity Constraints and Covered Interest Parity*, Swiss National Bank (Feb. 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1569504; Matthew S. Yiu et al., *Liquidity Crunch in Late 2008: High-Frequency Differentials between Forward-Implied Funding Costs and Money Market Rates*, Hong Kong Institute for Monetary Research (Oct. 2010); Cho-Hoi Hui et al., *Funding Liquidity Risk and Deviations From Interest Rate Parity During the Financial Crisis of 2007-2009*, International Journal of Finance and Economics (July 2010); Linda S. Goldberg et al., *Central Bank Dollar Swap Lines and Overseas Dollar Funding Costs*, Federal Reserve Board of New York (Staff Report) (Jan. 2010) available at <http://www.newyorkfed.org/research/epr/11v17n1/1105gold.pdf>; Patrick McGuire & Goetz von Peter, *The US Dollar Shortage in Global Banking and the International Response*, BIS Working Paper 291 (Oct. 2009), available at <http://www.bis.org/publ/work291.htm>; Ingo Fender and Jacob Gyntelberg, *Overview: Global Financial Crisis Spurs Unprecedented Policy Actions*, BIS Quarterly Review (Dec. 2008), available at http://www.bis.org/publ/qtrpdf/r_qt0812a.pdf.

It has been reported that the foreign exchange market was the single largest source of revenue for bank derivatives and cash trading businesses in the second quarter of 2010.¹³ In 2012, due to a number of factors including a decline in volatility and volume, FX revenues were down. However, FX revenues from only 10 large banks still totaled \$7 billion.¹⁴

These facts suggest a motive for industry participants who oppose transparent trade-matching and clearing, since profitability always suffers from greater transparency.

The real question is whether we want financial markets that are more transparent, more stable, and more competitive. If the answer is yes, then the proposed exclusion for physically settled FX derivatives from margin requirements must be abandoned.

The Consultative Document references BCBS's updated supervisory guidance for managing settlement risk in FX transactions that covers margin requirements for physically-settled FX forwards and swaps.¹⁵ In this supervisory guidance, BCBS points out that the widespread implementation of payment-versus-payment ("PVP") arrangements have mitigated **some** of the principal risk. However, it also notes that many bank participants "underestimate their principal risk and other associated risks by not taking into full account the duration of exposure between trade execution and final settlement."¹⁶

In its Forex Swaps and Forwards comment letter, dated June 6, 2011, Better Markets explored the weakness of the PVP system as follows:

"Most importantly, the [CLS's PVP] obviously offers no central counterparty services, which are essential to mitigate counterparty credit risks. The [CLS's PVP] system holds funds paid in performance of one side of a forex swap until the other side has performed by transferring funds to CLS as well. It only protects against the risk of performance by one party without

¹³ Robert Schmidt & Silla Brush, *Banks Push U.S. Treasury to Exempt Foreign Exchange Swaps from Dodd-Frank*, BLOOMBERG, Nov. 24, 2010; *see also* OCC, Quarterly Report on Bank Derivatives Activities, available at <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html> (accessed Mar. 8, 2013).

¹⁴ *FX Revenue At Major Banks Shrank in 2012 – Research*, FOX BUSINESS, Feb. 14, 2013, available at <http://www.foxbusiness.com/news/2013/02/14/fx-revenue-at-major-banks-shrank-in-2012-research/>.

¹⁵ Consultative Document, at 6.

¹⁶ Basel Committee on Banking Supervision, Bank for International Settlements, Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (Feb. 2013), at 3 available at www.bis.org/publ/bcbs241.htm.

reciprocal performance by the other. It in no way addresses the economic consequences of any other type of default, and it cannot be considered adequate as a substitute for mandatory clearing.”¹⁷

While Better Markets’ comment letter was written in a “mandatory clearing” context, the same argument can be made here to rebut the industry’s claim that the PVP settlement arrangements are sufficient to address most, if not all, risks that arise from FX transactions.

Key Principle 2 - All covered entities (i.e., financial firms and systemically-important non-financial entities) that engage in non-centrally cleared derivatives must exchange initial and variation margin to mitigate counterparty risks.

BCBS and IOSCO rightly recognize that initial margin and variation margin work together to provide necessary buffers against counterparty credit risk.¹⁸ It is entirely appropriate that the Consultative Document preserves the universal two-way margining of the Previous Proposal.¹⁹ This requirement will apply to financial institutions and systemically important end-users also.

There are two issues with the proposed approach, however. The first is the *de minimis* exemption, which allows firms with less than €8 billion in annual notional trading to avoid the posting requirements.²⁰ This is deeply problematic because a firm engaging in substantially less than €8 billion of swaps transactions in a year can play a systemically important role. The €8 billion figure appears to be modeled after the CFTC’s \$8 billion so-called *de minimis* threshold for swap dealer registration. However, the figure as used in that context was meant to capture only the very largest swap dealers. Even there, the figure was too high, and will be phased down to \$3 billion over the next few years. In the present context – determining who will post collateral on un-cleared swaps – using a figure designed to exclude the vast majority of market participants is clearly inappropriate. The *de minimis* threshold must be lowered to a more appropriate level of not more than €2.5 billion (roughly equivalent to the \$3 billion level to which the CFTC swap dealer rule will gradually be lowered).

Second, the “threshold” approach to initial margin would substantially weaken the proposals to require universal two-way margin for un-cleared swaps.²¹ Under this “threshold” system, market participants would be allowed a 10 percent forbearance level of initial margin (i.e., if the models require 15 percent only 5 percent must be posted; if the models require 20 percent, only 10 percent is required, etc.). Although the

¹⁷ Better Markets Letter to United States Treasury, “Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act”, (June 6, 2011), available at <http://www.regulations.gov/#!documentDetail;D=TREAS-DO-2011-0004-0019>.

¹⁸ Consultative Document, at 8.

¹⁹ Previous Proposal, at 6.

²⁰ Consultative Document, Principle 2(g).

²¹ Consultative Document, Principle 2(h).

maximum threshold deduction is €50 million with any one (consolidated) counterparty, this will still drain a significant amount of collateral from the system. No justification is given for this arbitrary reduction in margin requirements other than that it will be less “burdensome” to the industry. Indeed, this is clearly the reason for the “broad support” cited in the Consultative Document: the threshold approach will allow large financial institutions to put up less margin than is prudent, thus enabling greater leverage and lowering the “costs” associated with proper risk management.

Any rule or proposal can quickly become less “burdensome” and gain “broad support” from the industry if it is gutted or weakened to a sufficiently low level. That, however, simply cannot be a basis for a rule. The criterion has to be whether or not it achieves the objectives of lowering risk, systemic instability, and the need for taxpayer and government backstops.

Key Principle 3 - The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the particular portfolio of non-centrally cleared derivatives at issue and (ii) ensure that all counterparty risk exposures are covered fully with a high degree of confidence.

The proposal rightly requires a 99 percent confidence interval (some of the riskier trading desks today use a 95 percent interval, which can grossly understate the actual risk of their book). However, a 10-day holding period – while appropriate for some instruments – is far too low for many OTC derivatives. In an illiquid market, it may take a market participant considerably longer than 10 days to liquidate a derivatives position.²²

The Consultative Document acknowledges in its footnote 12 that there may be a situation where variation margin is not exchanged daily. If that is the case, it proposes that the minimum should be equal to 10 days plus the number of days in between variation margin exchanges. However, there are many cases where a greater-than-10 day holding period for calculating initial margin is warranted even if variation margin is exchanged daily, so the proposal in the footnote is not sufficiently wide reaching.

Moreover, the type of VaR model used can lead to widely divergent estimates of risk.²³ Variance/Covariance, Historical Simulation, and Tail-Index Based methods on the same data set can diverge so much as to characterize the very same portfolio as either

²² Golaka C Nath and G.P. Samanta, *Value at Risk: Concept and Its Implementation for Indian Banking System*, (Dec. 1, 2003), available at http://golak.tripod.com/var_utl.pdf is one interesting angle.

²³ *Id.*

risk free or potentially fatal.²⁴

Finally, allowing market participants to use their own proprietary models to assess VaR is a dangerous approach that has failed in the past. Large derivatives users have a financial incentive to keep their VaR estimates low, as this will reduce the amount of collateral they are required to post. Despite the optimistic pledge in the Consultative Document that domestic regulators will approve and monitor these models, the fact is they are unlikely to have the expertise or resources to rigorously evaluate them. Unless proprietary models are open to full public scrutiny, they should not be permitted. The regulators, and even the derivatives users themselves, are unlikely to see anything wrong with their VaR estimates until it is too late.

For example, in the run up to the financial crisis, when the five United States stand-alone investment banks were rapidly increasing their leverage, their Unit VaR measures did not reflect increasing risk to the banks or to the financial system.²⁵ Similarly, AIG reported a very low “capital markets trading” VaR immediately prior to the financial crisis.²⁶

The recent decisions by Deutsche Bank and Morgan Stanley to “refine” or recalibrate their VaR models is another case in point.²⁷

For Deutsche Bank, “tweaking [its risk] models accounted for about a quarter of the 55 billion euro reduction in Deutsche Bank’s risk-weighted assets in the fourth quarter” of 2012.²⁸ In effect, Deutsche Bank was able to make €13 billion of risk “vanish” just by changing their models. By their own estimates, actual leverage did not decrease.²⁹ Yet, for regulatory purposes they now appear more sound. This clearly demonstrates the malleability of VaR models to fit a trader’s changing whims.

Morgan Stanley reduced its average VaR in the third quarter of 2012 by approximately one third, compared to the value that would have been reported before the model was changed. Does this reflect a better measurement of VaR, or does it

²⁴ This is especially the case for derivatives portfolios with embedded convexity. The famous “12 sigma events” of 2008 are a case in point. See Nassim N. Taleb, Distinguished Professor of Risk Engineering, NYU-Polytechnic Institute, Testimony before the House Financial Services Committee, July 14, 2011, available at <http://financialservices.house.gov/uploadedfiles/071411nassim.pdf>.

²⁵ Tobias Adrian & Hyun Song Shin, *Procyclical Leverage and Value-at-Risk*, Federal Reserve Bank of New York Staff Report, No. 338 (2012), available at http://www.newyorkfed.org/research/staff_reports/sr338.pdf.

²⁶ Michael G. Wacek, *Derivatives AIG and the Future of Enterprise Risk Management*, Society of Actuaries (2008), available at www.soa.org/library/essays/rm-essay-2008-wacek.pdf.

²⁷ *M Stanley shows the ‘flaky’ side of value at risk model*, FIN. TIMES, Oct. 19, 2012.

²⁸ See Dominic Elliot, *Deutsche Bank’s Capital Trick Will Be Hard To Repeat*, NY Times (Jan. 21, 2013), available at <http://dealbook.nytimes.com/2013/01/31/deutsche-banks-capital-trick-will-be-hard-to-repeat/?emc=eta1>.

²⁹ *Id.*

reflect an intent to economize on regulatory capital requirements? Can anyone outside Morgan Stanley answer this question with confidence?

That is precisely the fault with internal VaR models: JP Morgan Chase's recent multi-billion dollar loss from the so-called "London Whale" trade happened while many claim to have been managing and watching VaR very closely.³⁰ At the start of 2012, shortly before the trade exploded, JP Morgan changed its VAR model, only to change it back three months later right after earnings had been disclosed. When the old model was restored, JP Morgan's average daily VaR for the first quarter of 2012 almost doubled from the level reported with earnings, to \$129 million.³¹

Whether the adjustment to the VaR model was done with a deliberate intent to hide the riskiness of the trade is not clear. What is clear, however, is that tinkering with the VaR model caused the true risks to be underestimated by a full 50 percent.

What is also clear is that the complexity of JP Morgan's VaR model allowed several spreadsheet errors to go unnoticed.³² These errors also contributed to underestimating the actual risks of the London Whale positions. A fully vetted standardized model would not be vulnerable to such mistakes.

A recent report by the United States Senate Permanent Subcommittee on Investigations concluded, "In contrast to JPMorgan Chase's reputation for best-in-class risk management, the whale trades exposed a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements."³³ The fact that a bank considered to be among the industry leaders in risk management was susceptible to such improper, if not illegal, treatment of un-cleared derivatives risks is a damning indictment of the practice of letting financial firms use their own internal risk models.

The report also notes that the CIO's office, where the Whale trades were executed, changed their VaR model to "[assign] different values to identical credit derivative holdings . . . resulting in collateral disputes peaking at \$690 million."³⁴ In other words, analysts with no incentive to distort valuations came up with a risk estimate while

³⁰ Matt Levine, *JPMorgan Dissects A Whale Carcass*, Dealbreaker (Jan. 16, 2013), available at <http://dealbreaker.com/2013/01/jpmorgan-dissects-a-whale-carcass/>.

³¹ L. Carver, *JPMorgan's London Whale Losses Spark VaR Debate* (May 14, 2012) <http://www.risk.net/risk-magazine/news/2174445/jp-morgans-london-whale-losses-spark-var-debate>.

³² See Report of JPMorgan Chase & Co. Management Task Force Regarding 2012 CIO Losses, at 128, available at http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf.

³³ *JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*, Majority and Minority Staff Report Permanent Subcommittee on Investigations United States Senate ("PSI Report"), at 7.

³⁴ PSI Report, at 12.

traders who stood to gain personally from excessive risk taking came up with another, much lower one. When the very same portfolio can be valued over half a billion dollars higher in one division of a bank than in another, there simply can be no doubt that allowing such institutions to determine collateral using proprietary models is a wholly inappropriate regulatory approach.

Several commentators from within the derivatives world have made it clear they consider VaR to be an inadequate tool. For example, David Einhorn, founder of Greenlight Capital, has stated that VaR is “relatively useless as a risk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an air bag that works all the time, except when you have a car accident.”³⁵

Additionally, a former Morgan Stanley risk manager has stated that “[VaR-based] Risk modeling didn’t help as much as it should have,”³⁶ and NYU’s Nassim Taleb has labeled VaR “a fraud.”³⁷

Given what happened to all the banks and firms using VaR in the years before the financial crisis, can anyone seriously dispute this?

Any standard VaR-based model will fail to adequately account for tail-risk. Yet it is that very tail-risk that is at issue when it comes to protecting the financial system from another derivatives-fueled collapse. Instead of relying on **the very same failed risk modeling techniques** to account for the risks posed by un-cleared OTC derivatives, BCBS and IOSCO should require the use of standardized requirements across the board and ensure that they are sufficiently calibrated to reflect the demonstrated dangers of un-cleared OTC derivatives markets.

Moreover, all such models should be publicly disclosed and the banks’ application of those models should also be disclosed, after some appropriate but limited time, if necessary to prevent the premature disclosure of specific, genuinely confidential information. Only by subjecting the models and the application of the models to independent public scrutiny, analysis, and debate, will regulators ever have a basis for believing that the models are in fact robust and working to properly identify and test for the right risks under the right circumstances.

As an alternative to the quantitative portfolio margin model, the Consultative Document proposes a standardized margin schedule for calculating initial margin. This look-up table approach is an inherently less accurate approach. Initial margin amounts are intended to reflect market liquidity and volatility which

³⁵ Joe Nocera, *Risk Mismanagement*, NY TIMES, (Jan. 4, 2009), available at <http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?pagewanted=all&r=0>.

³⁶ *Id.*

³⁷ *Id.*

change constantly depending on market conditions. In contrast, look-up tables are static. As a result, the look-up table amounts must be high enough to provide a cushion for those changing market conditions.

For example, the standardized margin schedule recently published by BCBS has initial margin requirements of as low as 1 percent and 2 percent for short-tenor interest rate and credit derivatives respectively.³⁸ While this may be appropriate for run-of-the-mill standardized FX and credit products, more complex and concave derivatives will warrant higher margin thresholds. Moreover, it is imperative that margin requirements for un-cleared derivatives are not set so low that they incentivize market participants to trade standardized derivatives bilaterally simply because they can get away with less margin. As the G-20 has acknowledged, central clearing is safe, efficient, and effective for the vast majority of standardized products, and the margin schedule for un-cleared products must not undermine the commitment to bring as much as possible onto CCPs.

For these reasons, we suggest a more granular minimum margin schedule, which avoids setting the same minimum margin levels for complex derivatives as for standardized ones within the same category (credit, commodity, interest rate, etc.). It is also important that BCBS and IOSCO add a requirement that the minimum margin requirements be increased in cases where similar products are operating with higher margin requirements on listed exchanges and CCPs. An un-cleared product is inherently riskier than the same product centrally cleared. Therefore, in no circumstances should the former be assessed a lower rate of initial margin.

Key Principle 5 - Because the exchange of initial margin on a net basis may be insufficient to protect two market participants with large, gross derivatives exposures to one another if one of those firms fails, the gross initial margin between such firms should be exchanged. 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 the counterparty's default, and (ii) the collected margin must be subject to arrangements that protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law. Jurisdictions are encouraged to review the relevant local laws to ensure that collateral can be sufficiently protected in the event of bankruptcy.

The importance of this section cannot be overstated. BCBS and IOSCO have wisely observed that netting of derivatives exposures for margin purposes constitutes a wholly inadequate approach to risk management.

Unlike securities markets where liquidity conditions for fungible securities tend to be relatively consistent, liquidity conditions for un-cleared OTC derivatives

³⁸ Basel Committee on Banking Supervision, Bank for International Settlements, Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, at 34 (Feb. 2013), available at www.bis.org/publ/bcbs241.htm.

and their hedge equivalents can vary widely even for contracts that appear fungible. Therefore, even if two positions appear to offset one another, the liquidity conditions, replacement costs, and counterparty credit risk may vary considerably.³⁹ If a market participant operates a balanced book, the net exposure of the portfolio will appear very small. However, if a counterparty to a significant portion of one side of that book defaults, the dealer faces a potentially large replacement cost, or is left completely unhedged with respect to the positions the defaulting contracts previously offset.

For this reason, BCBS and IOSCO should resist any pressure to allow restricting margin to netted exposures only.

Beyond this, the Consultative Document also explicitly seeks comment on the issue of rehypothecation.⁴⁰ Here too, BCBS and IOSCO must stand firm on the reasonable line they have taken in the Consultative Document: rehypothecation should not be allowed under any circumstances.

The Consultative Document reiterates the position articulated in the Previous Proposal, noting that “The legal capacity in which initial margin is held or exchanged can have a significant influence on how effective that margin is in protecting a firm from loss in the event of the default of a derivatives counterparty.”⁴¹ Indeed, this is an understatement. The manner in which initial (and variation) margin is segregated and invested can be the determining factor behind whether a firm is able to survive in stressed market conditions.

Indeed, this point is crucial: neither initial nor variation margin should be rehypothecated, since the two work in tandem to mitigate risk. Initial margin is a statistical estimate of the potential consequences of a default, based on a defined methodology. Derivatives counterparty risk is defined by these potential consequences. Variation margin is best viewed as a daily recalibration of the risk estimation device which calculates initial margin: as losses accrue, the impact of a potential default increases commensurably (and may in fact accelerate), so variation margin is accrued and collected to offset this increased potential impact. The initial margin and variation margin thus work together to provide a (relatively) up-to-date safety barrier to guard against default. They must therefore be treated together with respect to segregation and rehypothecation rules.

³⁹ Especially in the case of un-cleared swaps, but even for offsetting cleared swaps if they are cleared through different DCOs.

⁴⁰ Consultative Document, at 19.

⁴¹ Previous Proposal, at 24.

LCH.Clearnet has clearly articulated this joint role of initial and variation margin in risk-mitigation:

To ensure that LCH.Clearnet Ltd only faces market risk in the event of the default of one of its clearing members, it needs to ensure that market risk ahead of that default event is fully covered (i.e. to keep LCH.Clearnet's risk current). Variation margin, which is a daily collect/pay in cash or collateral, covers this risk by accounting for the change in price since the previous day. Variation margin cannot take account of price moves after a default event since the defaulting member is, by definition, not in a position to pay variation margin. Instead initial margin – previously deposited by the defaulting member – covers that risk.⁴²

In a stressed situation, losses accrue on multiple fronts in short time periods. The capacity of the system to survive such an event depends on the absolute level of collateral present in the system relative to the magnitude of the losses, as well as the speed with which this collateral can move to where it is required. The fact that derivatives are ultimately a zero sum game does not change the fact that significant price moves in a short time period can cause the entire system to collapse. A dealer or large swap trader who is ultimately “flat” may still find himself unable to pay out on his obligations if he has collected insufficient collateral on his positions (even if they are net positive) if the counterparties on those positions default. In this way, defaults become contagious.

For the abovementioned reasons, BCBS and IOSCO must resist any and all calls to permit rehypothecation of either initial or variation margin.

Key Principle 7 – Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions.

The principle of international harmonization is crucial to the success of the new global regulatory regime for derivatives. It is essential that it be used as a means to maintain high standards across the globe rather than to cause a regulatory race to the bottom.

The proposals set forth in the Consultative Document are largely reasonable. For equivalent regimes, the rules that will be applied are those that can most straightforwardly be characterized as governing the place in which the trade was executed. However, it is important that true equivalence be established. Equivalence

⁴² LCH.Clearnet, *Variation Margin*, http://www.lchclearnet.com/images/lch%20clearnet%20ltd%20-%20variation%20margin_tcm6-44528.pdf.

must be present in substance as well as form, and the guiding principle of 7(b) that a trade executed in a less well-regulated jurisdiction which nevertheless impacts the interests of a better-regulated jurisdiction should be held to that higher standard is key to preventing a race to the bottom.

Key Principle 8 - The requirements described in this paper should be phased-in in a manner that appropriately trades off the systemic risk and incentive benefits with the liquidity, operational, and transition costs associated with implementing the requirements. In addition, the requirements should be reviewed on a regular basis so as to evaluate their efficacy, soundness, and relationship to other existing and related regulatory initiatives.

The Consultative Document recognizes that "Margin requirements on non-centrally cleared derivatives will represent a significant policy change for most market participants. Initial margin requirements, in particular, are not currently applied to a large number of transactions across many market participants. Such requirements will require significant operational enhancements and will also require significant amounts of collateral for which liquidity planning will be required."⁴³

Moreover, the Consultative Document also recognizes that "the changes that will be required as a result of universal margin requirements are important for limiting systemic risks." Finally, it is noted that any benefits accruing to industry participants from a slow phase-in "must be weighed against systemic risks that are left un-attenuated during any transition period."⁴⁴

In light of this, the proposed pace of the roll-out must be accelerated. Under the current proposal, proper margining practices will not be fully implemented until 2019.⁴⁵ This is simply too long to wait – the risks are far too great. It must never be forgotten that the recent financial collapse was the worst since the Great Crash of 1929 and has caused the worst economy since the Great Depression. The costs of that have been crippling, as an economic, fiscal, and human matter, and that is what gave rise to the current initiative to reform derivatives regulation.

Better Markets performed an analysis that showed the dollar cost of the recent financial crisis and economic wreckage it caused will be more than \$12.8 trillion in just the United States.⁴⁶ Of course, dollar amounts, no matter how large, can never capture or reflect the incalculable and devastating human suffering from lost jobs, homes, retirements, educations, and so much more. On top of all that, local, state, and national budgets have

⁴³ Consultative Document, at 20.

⁴⁴ Consultative Document, at 21.

⁴⁵ Consultative Document, at 22.

⁴⁶ See BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN \$12.8 TRILLION (Sept. 15, 2012), available at <http://bettermarkets.com/sites/default/files/Cost%20of%20The%20Crisis%200.pdf>.

been decimated because financial crises cause revenues to plummet at the same time the need for spending on urgent social needs skyrockets.

That is what is at stake in properly regulating un-cleared OTC derivatives. No amount of financial industry lobbying or talking their book to protect their business lines and profits should ever be allowed to eclipse those facts and the human suffering they have caused across the globe, much of which continues to this day. That is why it is so overwhelmingly important to get reform right and not to weaken or delay the important protections put forth in the Consultative Document.

Yes, time is warranted and balance is necessary, but the cost and risks of delay must be properly weighed, allowing six more years before full compliance is simply not justifiable.

CONCLUSION

We hope these comments are helpful.

Sincerely,



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