April 17th, 2024

BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

Ref.: <u>BCBS and IOSCO Consultative Report on streamlining VM processes and IM responsiveness of margin models in non-centrally cleared markets</u>

Dear Sirs,

B3 S.A. – Brasil, Bolsa, Balcão (B3), a company incorporated under the laws of Brazil, is authorized in Brazil as an operator of a securities, commodities, and futures exchange and of an Over-The-Counter (OTC) market, and is also authorized as a clearinghouse, a foreign exchange clearinghouse, a central depository, and a trade repository.

B3 welcomes the opportunity to present comments on the Consultative Report on streamlining variation margin (VM) processes and initial margin (IM) responsiveness of margin models in non-centrally cleared markets CR02/24 published by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) in January 2024 (Consultative Report).

The requirement of margins aims to mitigate bilateral credit risk and the challenges are greater when it comes to operations under OTC environment, without Central Counterparty clearing (CCP), as transactions in these markets are often nonstandardized. This brings at least two challenges to credit risk management: (i) the margin call process and (ii) the model used for the calculations.

The first challenge is associated to legal and operational matters, while the second brings a challenge on the update of the model used for the margin call calculation, in a form that it is able to consider more recent stress scenarios.

These two challenges were addressed in BCBS-IOSCO report, and B3 believes that it can contribute mainly over the first item, by sharing its experience in the evolution of the topic in Brazil.

In recent years, our country has made significant progress in its legal framework to provide greater security in the formalization of financial assets and securities' collateral and also in the creation of specific mechanisms for margin management for OTC derivatives without a CCP. B3 has also developed services to assist the market when addressing credit risk reduction.

1. **Legal aspects:**

1.1 Lien and Encumbrance

The Brazilian Law 12,810 of May 15, 2013 established that the lien and encumbrance of financial assets and securities would be formalized before the Central Securities Depository (CSD) or Trade Repository (TR) where they were respectively deposited or registered, and attributed to the Central Bank of Brazil (Banco Central do Brasil - BCB) and the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários - CVM) the empowerment to regulate and define conditions for these activities. Previously, this process was formalized before Notary Offices across the country, which made information transparency difficult and increased the operational cost for the collateral.

In 2013, the CVM initiated regulatory developments by issuing CVM Instruction 541[1], which contemplated securities under legal regime of Centralized Deposit and OTC derivatives. As a result of this regulatory change, the registry of liens and encumbrances on these instruments were attributed to the CSD where the respective asset was deposited. CVM Instruction 541 was later revoked and updated by CVM Resolution 31 of May 20, 2021[2], but no relevant changes on said regime were made.

Similarly, the BCB published Circular 3,743/2015[3] and Circular 3,912/2018[4] (both revoked and updated by BCB Resolution 304/2023[5] with no material changes in the relevant matter), and the National Monetary Council (Conselho Monetário Nacional – CMN) published Resolution 4,593/2017[6], which established the rules for collateral over financial assets, to be formalized before the correspondent TR or CSD.

B3 carried out a thorough review of its rulebooks upon the release of the regulations

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[1] Available at https://conteudo.cvm.gov.br/legislacao/instrucoes/inst541.html
[2] Available at https://conteudo.cvm.gov.br/legislacao/resolucoes/resol031.html
[3] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Circular&numero=3743
[4] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Circular&numero=3912
[5] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Resolu%C3%A7%C3%A3o%20BCB&numero=304
[6] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Resolu%C3%A7%C3%A3o&numero=4593

to update the new competencies and procedures, and implemented the service of constitution of liens and encumbrances, covering the operational blocking of the instrument given as collateral and providing publicity before third parties through certificates upon request.

As a result, the legal framework in Brazil created a more dynamic path to ensure the collateral's legal security so that financial assets and securities (public and private) were enforceable, and B3 played a crucial role by making the operational process viable and efficient.

1.2 CMN Resolution 4,662/2018 (bilateral margin for OTC derivatives)

In addition to the regulatory changes related to the collateral formalization mentioned above, the BCB also implemented improvements related to the bilateral requirement of margin for OTC derivatives without a CCP. The change took place on May 25, 2018 with publication of CMN Resolution 4,662[7], which provides the requirement for a bilateral margin in operations with derivative financial instruments carried out in Brazil or abroad by financial institutions and other institutions authorized to operate by the BCB.

The purpose of this regulation was to align Brazilian legislation with international standards set by BCBS and IOSCO.

In the Brazilian case, best efforts were taken by authorities to make the necessary

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[7] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Resolu%C3%A7%C3%A3o&numero=4662

adjustments to avoid problems identified in other markets regarding the following key points:

1. Accepted collaterals: In Brazil, Time Deposit, Interbank Deposit and Brazilian Government Bonds are the main assets given as collateral, considering cash collateral is not admitted;

2. Affiliates: Given the particularities of the Brazilian market, there are many local intra-group operations, using "pass-through funds", for zeroing in offshore markets. Rules exempting transactions between affiliates from margin requirements would increase the cost of a series of operations (or make it unfeasible).

This Resolution along with BCB Circular 3,902 of May 30, 2018[8] established the procedures to avoid the key points mentioned above by defining a broad list of financial instruments that can be used as margin collateral, as well as the requirements for formalization of the collateral contract in compliance with the rules on liens and encumbrances mentioned above.

Another point addressed by the regulation was the definition of the types of derivative operations that are not considered covered or are exempted by the standard, such as hedge and derivative operations carried out between institutions that are part of the same prudential conglomerate.

[8] Available at https://www.bcb.gov.br/estabilidadefinanceira/exibenormativo?tipo=Circular&numero=3902

An important point of the standard concerns is the need to update the initial margin (every 10 business days) and the variation margin (daily). And for the variation margin, any payment made between the parties can be considered for purposes of determining the market value of the derivative – including payments made through the B3 service called DRRC, Derivative with Credit Risk Reduction, presented below.

2.1 Collateral Management

B3 offers a service called "Collateral Management", which provides an operational solution for the collaterals posted for any operations where there is bilateral credit risk. This service is highly customizable, allowing the parties to define parameters that govern collateral movements, such as thresholds, minimum transfer amounts and collateral haircuts.

In this solution, collateral management occurs immediately after updating the market value (MtM) of the exposure being covered between the parties. With this updated exposure information, B3 calculates the market value of the collateral provided by the parties and transfers the collateral to segregated accounts to which the parties do not have access. B3, as a third party, is responsible for moving the eligible collateral defined by the parties to cover bilateral credit risk. In addition to the operational blocking of the collateral, there is a direct connection with the liens and encumbrances solution mentioned above. As a result, the collateral is enforceable, and the proper transfer of financial assets or securities can take place at B3.

2.2 Derivative with Credit Risk Reduction (DRRC)

DRRC is a service created by B3 with the purpose of mitigating bilateral credit risk, to be used in OTC derivatives without a CCP. This service allows the parties to periodically evaluate the market value (mark to market) of the derivative contract and, if this value is above a certain level (threshold), the debtor party makes a cash payment of the excess to the counterparty. With this, the parties guarantee that the value of the derivative contract always remains within the established maximum limit.

This solution was created so that the parties could operationalize contractual clauses related to risk management, such as CSA (Credit Support Annex) type documents. In this sense, it is a complementary solution to the registration service for OTC derivatives contracts agreed without CCP.

Finally, B3 understands that the Brazilian regulatory framework addresses the recommendations by BCBS/IOSCO regarding the standardizing of the margin exchange process of variation.

B3 appreciates the opportunity to present comments to the Consultative Report and is available for any additional information and discussion that may be useful to BCBS and IOSCO.

Best regards,

B3 S.A. – Brasil, Bolsa, Balcão