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Re: BCBS/CPMI/IOSCO Consultative Report: Review of Margining Practices

We appreciate the opportunity to provide input on the BCBS/CPMI/IOSCO Consultative Report on the Review of Margining Practices (the "Consultative Report").[1] As noted in the report, global financial markets were resilient during the Covid-19 market turmoil of March 2020, underlining the importance of the reforms implemented following the 2008 financial crisis. Nevertheless, this episode of extreme market volatility served to highlight areas meriting further review by policymakers, including margining practices in both centrally cleared and non-centrally cleared markets. While significant attention has appropriately been paid to the design and functioning of centrally cleared margin models, further international work to continue to similarly evaluate the performance of non-centrally cleared margin models and the related regulatory framework is equally warranted.

In particular, the Consultative Report found that *regulatory*-required initial margin ("IM") on non-centrally cleared products remained "relatively stable" during March 2020, despite the extreme market volatility.[2] In contrast, "*discretionary*" IM calls (i.e. those not subject to the regulatory framework for non-centrally cleared margin requirements) significantly increased.[3] This observed disparity between (i) *regulatory*-required IM calls and (ii) "*discretionary*" IM calls raises questions regarding whether the Standard IM Model ("SIMM") and the overarching regulatory framework are appropriately calibrated to achieve the regulatory objectives of mitigating systemic risk and promoting central clearing. Below, we discuss issues related to the design and coverage of SIMM that merit further policymaker analysis.

I. SIMM Response to Market Volatility

As noted above, regulatory-required IM calculated pursuant to SIMM remained "relatively stable" during March 2020. The Consultative Report suggests this is "likely to be an intended consequence of the conservative design of SIMM."[4] However, it is equally likely that this indicates that the SIMM model is not conservatively designed and/or results in under-collateralization in times of stress.

In fact, quantitative analysis has failed to substantiate that SIMM is more conservatively

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD686.pdf ("Consultative Report").

[2] *Id.* at page 2.

[3] *Id.* at page 18. The report notes that "the total cumulative value of non-centrally cleared margin rose from $1.6 trillion equivalent in February 2020 to $5.7 trillion in March, a $4.1 trillion or 249% increase" and that "VM calls and netted non-centrally cleared discretionary margin calls far exceeded collateral posted to meet regulatory non-centrally cleared IM calls during March 2020." While these figures also include VM, they are based on an Acadia dataset which the report notes "defines variation margin to be the total posted collateral balance in relation to the approximate cumulative fair value (i.e. mark-to-market) of the underlying portfolios, not "a daily 'flow' measure of payments made to meet margin requirements related to changes in fair value of the underlying portfolios." Notwithstanding this, the data suggest that the IM component of non-centrally cleared margin rose from $0.7 trillion in February to $2.0 trillion in March.

[4] *Id.* at page 2.

designed than centrally cleared margin models. Instead, this data suggests that SIMM may be *less conservative* than expected, generating IM calculations that are very similar to, and in many cases *less than*, cleared IM requirements for the same portfolio. For example:

- U.S. CFTC research concluded that, for 32% of the firm portfolios analyzed, non-cleared IM calculated pursuant to SIMM was *less than* corresponding cleared IM requirements (and could be as low as 54% of cleared IM requirements for the same portfolio);[5] and

- The quantitative data contained in the Derivatives Assessment Team report on "Incentives to centrally clear OTC derivatives" further illustrates this dynamic, finding that: "though the [margin period of risk] is longer in the case of bilateral trades, the ten-day SIMM market risk measure does not necessarily exceed the five-day CCP measure, with portfolio composition playing an important role in the relative size of the margin requirements."[6]

This data appears inconsistent with the assumption that SIMM is conservatively designed and raises additional questions regarding why SIMM did not react in a similar manner to other margin models (including both cleared and "discretionary" non-cleared IM models) during March 2020. To the extent SIMM is not appropriately responsive to recent market stresses, non-cleared positions may be undercollateralized (leading to systemic risk concerns) and lower non-cleared IM requirements overall may reduce incentives to centrally clear. As a result, we recommend that policymakers further investigate the design of the SIMM model, and compare SIMM with cleared IM models and "discretionary" (or so-called "house") non-cleared IM models across different market conditions.

II. Coverage of SIMM

The Consultative Report also found that "discretionary" IM calls, which are not subject to the SIMM model or the regulatory framework for non-centrally cleared margin, were more than *6 times* greater than SIMM IM calls during March 2020, accounting for average daily gross balances of $320 billion.[7] This significant disparity between "discretionary" IM and SIMM IM raises questions regarding whether the regulatory framework for non-centrally cleared margin is sufficiently comprehensive in coverage in order to achieve the regulatory objectives. Two areas merit particular attention.

(a) Application of the IM Threshold

The regulatory framework for non-centrally cleared margin permits covered entities to apply

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[5] Roberson, M., "Cleared and uncleared margin comparison for Interest Rate Swaps," CFTC staff paper (April 2018) at page 10, available at: https://www.cftc.gov/sites/default/files/idc/groups/public/%40economicanalysis/documents/file/dcr_cleared_uncleared_margin.pdf.

[6] Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (Nov. 19, 2018) at page 39, available at: http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf ("DAT Report").

[7] Consultative Report at page 17.

a threshold of 50 million (USD or EUR, as the case may be) before beginning to exchange regulatory-required IM.[8] If the threshold is applied, the counterparty relationship does not become subject to regulatory IM requirements until new trading activity generates a SIMM IM amount that exceeds the threshold. However, in practice, the threshold is often used as a mechanism to allow dealers to continue to apply "discretionary" IM requirements to in-scope counterparty relationships, thereby limiting the scope of the non-cleared margin rules and depriving clients of important regulatory protections.

In particular, dealers appear to be granting the 50 million threshold to some clients solely to deem the counterparty relationship as out-of-scope for regulatory-required IM, but then still requiring those clients to post one-way "discretionary" IM pursuant to a "house" margin model without the same 50 million threshold being applied. In these circumstances, from the client's perspective, the threshold is simply used to exempt the counterparty relationship from the non-cleared margin rules, as it does not affect the amount of IM required to be posted. Therefore, even though the counterparty relationship is ostensibly covered by the non-centrally cleared margin rules, and the client continues to post IM without a 50 million threshold being applied in practice, the client does not benefit from important protections in the non-cleared margin rules relating to two-way posting, segregation, valuation, reconciliation, and dispute resolution.[9] Further, on a system-wide basis, the positions associated with these counterparty relationships are effectively only half-collateralized, since typically only one-way, not two-way, IM is being posted.

The regulatory framework for non-centrally cleared margin is a central pillar of the post-crisis reforms, designed to prevent the accumulation of under-collateralized bilateral exposures that can serve as a source of contagion and transmit risk in the event of a significant counterparty default. The significant disparity between the collected amounts of "discretionary" IM and SIMM IM raises the concern that too many in-scope counterparty relationships have been permitted to remain outside of the approved SIMM model and related regulatory requirements through the opportunistic application of the 50 million threshold. We, therefore, recommend policymakers analyze the percentage of in-scope counterparty relationships that remain below the threshold and the typical application of "house" margin models to these relationships. In addition, policymakers may consider requiring that any IM threshold be consistently applied across both SIMM and "house" margin models before being used to exempt a counterparty relationship from the non-centrally cleared margin rules.

(b) Counterparty Coverage

The non-centrally cleared margin rules are expected to be fully phased-in for in-scope clients by September 2022. However, clients with less than 8 billion (USD or EUR, as the case may be) in outstanding non-cleared notional remain exempt. In light of the significant disparity between the collected amounts of "discretionary" IM and SIMM IM, it is appropriate to consider whether the 8 billion threshold is appropriately calibrated. In particular, we recommend that policymakers analyze (i) the percentage of financial counterparties under the threshold, and (ii) the percentage

[8] BCBS-IOSCO Margin requirements for non-centrally cleared derivatives (March 2015) at page 10, available at: https://www.bis.org/bcbs/publ/d317.pdf.

[9] This may help to explain why "discretionary" IM amounts are observed to be so much higher than SIMM IM.

of daily trading activity in non-cleared OTC derivatives that these counterparties represent.

Research suggests that counterparties under an 8 billion threshold in outstanding non-cleared notional can account for a significant percentage of daily trading activity in OTC derivatives. Specifically, when the EU applied this same 8 billion threshold to determine the scope of the clearing obligation, research found the clearing rate for new interest rate derivatives was under 50%,[10] a figure that contrasted sharply with the US clearing rate of 88%, where such a threshold was not applied.[11] Since the product scope of both the EU and US clearing obligations was largely identical, this disparity in clearing rates could only be explained by the different scope of covered counterparties. As a result, financial counterparties under an 8 billion threshold appear to account for a material percentage of daily trading activity in OTC derivatives.

While the non-cleared trading activity and exposures of any given smaller financial firm may not present systemic risk concerns in isolation, the number of bilateral exposures exempted from non-cleared initial margin requirements can create systemic risk in aggregate, particularly in the event of a default of a systemically important dealer counterparty. As a result, it is important that the non-centrally cleared margin rules cover a sufficient number of bilateral counterparty relationships. In addition, ensuring the non-centrally cleared margin rules are sufficiently comprehensive in coverage is critical to promoting central clearing. The Derivatives Assessment Team report found that the non-cleared margin rules incentivize central clearing more than any other post-crisis reform,[12] and that trading centrally cleared derivatives is typically more costly than trading non-cleared derivatives if the non-cleared IM requirements do not apply (but variation margin requirements do).[13] Appropriately incentivizing voluntary clearing is particularly important in jurisdictions where either a clearing mandate has not been fully implemented or does not apply to the dealer-to-client segment of the market.

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[10] Fiedor, P., "Clearinghouse-Five: determinants of voluntary clearing in European derivatives markets," ESRB Working Paper No. 72 (March 2018) at Figure 1 (page 7), available at: https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp72.en.pdf?87d519a1fd278d359b6d5a33499d0e26.

[11] "Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market," ISDA (July 2018) at page 3, available at: https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf.

[12] DAT Report at Figure D.1 (page 26).

[13] *Id.* at pages 36-37.

We appreciate the opportunity to share our perspectives on the Consultative Report on margining practices in both centrally cleared and non-centrally cleared markets. Please feel free to call the undersigned at (646) 403-8200 with any questions regarding these comments.

Respectfully,

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