28 September 2012

Submitted by email to baselcommittee@bis.org

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel Switzerland

Re: MSCI comments on the Consultative Document—Margin requirements for non-centrally-cleared derivatives

To the Committee members:

We are pleased to offer these comments to the Basel Committee and the International Organization of Securities Commissions on the recent Consultative Document Margin requirements for non-centrally-cleared derivatives.

MSCI is an active participant in the financial marketplace as a vendor of risk management and equity portfolio analytics (under the RiskMetrics and Barra brands), corporate governance services (under the ISS brand) and equity index data. Our risk management clients include many of the world’s largest banks, hedge funds, institutional asset managers and asset owners.

In our comments, we would like to discuss the role of third party risk analytics providers in the margining process for non-centrally-cleared derivatives. We draw on our experience in servicing banks both for internal risk modeling and for calculating risk-based margin, particularly in their prime brokerage operations. We wish to make the committees aware of the factors that drive bank decisions to use third party risk providers, and to demonstrate that the case for third party vendors is particularly compelling for margining.

For internal risk management—which we take to include regulatory capital modeling—a bank’s decision to outsource the risk model to a third party is a classic “build versus buy” decision, that is, an act of balancing the cost savings of using an outside provider with the reduced control the bank has over the final product. In establishing an internal risk process, however, the bank is in need of more than a system. It is also in need of expertise: in implementing a system or model, in running and maintaining the model, and in working with regulators to gain approval of the model. A bank’s assessment of a third party vendor is not just a matter of the system they would buy, but also of the vendor’s capability to help the bank build this expertise.

For margining, the same build versus buy arguments apply. As with an internal model, a bank will need to assess a vendor in terms of both its system and its expertise. But margining has a number of other aspects that distinguish it as a use case from the internal risk model. Crucially, margin impacts not just the bank, but its clients in derivative transactions. As such, the client is likely to demand independence,
or at very least transparency of the margin model. A client is unlikely to accept margin requirements when there is even a hint of mystery in the calculation.

This demand for independence and transparency is why we see many large banks using a third party to calculate margin, even if they build their own internal risk model. In such cases, the bank heavily influences the calibration of the third party model, ensuring that the margin definition is acceptably close to what their internal model would produce. Additionally, the bank demands more expertise from the vendor, particularly in terms of documentation, to assist them in communicating the margin model to clients in order to demonstrate the model’s independence. Finally, a bank may look for a third party vendor who services their clients as well, in order to facilitate those clients reproducing the margin calculations. We see this as particularly effective between prime brokers and hedge funds.

It is possible for a bank to achieve many of these aspects without recourse to a third party, and an internal model has proved a viable choice in some cases. But whereas risk model development may well be a competitive advantage of the bank, model transparency may not be, and to the most cynical clients, a bank’s internal model will never be a truly independent margin calculator.

In the near future, as both central clearing and the requirements on non-cleared derivatives under discussion here come into effect, we anticipate that banks will seek to provide a full suite of derivatives services to their clients. We note that in preparation for central clearing, a number of banks are working toward platforms on which they can provide “what if” tools in order to assist clients in determining where a trade might be cleared most efficiently, and in anticipating how the margin requirements for a set of trades might evolve through time or under market stress. We believe that banks will wish to service non-centrally cleared derivatives through a similar platform. The calculation of margin under a number of different models is a task well suited to outsourcing to third party vendors.

Our final comment does not relate specifically to third party vendors, but to the model approval process generally. We do acknowledge the need for a rigorous approval process of margin models. We do wish to stress that this process comes at a cost, and we encourage the committees to streamline the process to the extent possible. In particular, we believe it would be sensible to combine the approvals of internal models for trading book regulatory capital and for margining, since the risks to be covered in the two cases are similar.

We applaud the efforts of the committees in establishing the requirements in this Consultative Document, and for allowing the industry the opportunity to comment. We are available for further comment or clarification, if necessary.

Sincerely,

Christopher C. Finger
Executive Director
Applied Research

christopher.finger@msci.com