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Regulatory Developments: BCBS-IOSCO's Margin Requirements for Non-Centrally Cleared Derivatives

Background

On September 2, 2013, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions ("**BCBS-IOSCO**"), in consultation with the Committee on Payment and Settlement Systems and the Committee on the Global Financial System, published the final policy framework[1] (the "**Framework**") for the initial margin and variation margin requirements for derivatives that are not cleared through a central counterparty ("**non-centrally cleared derivatives**"). The Framework consists of eight key principles (as further discussed below) and is anticipated to be the base framework for the regulatory technical standards to be promulgated by the European Securities and Markets Authority. The Framework will likely also influence regulators in the United States as they prepare their final regulations.

Principle 1: Instruments Subject to the Framework

The Framework applies to all non-centrally cleared derivatives except for (1) indirectly cleared derivatives transactions that are intermediated through a clearing member on behalf of a non-member customer so long as (a) the non-member customer is subject to the margin requirements of the clearing house or (b) the non-member customer provides margin consistent with the relevant clearing house's margin requirements, and (2) physically settled foreign exchange ("**FX**") forwards and swaps (including, in respect of initial margin, those associated with the exchange of principal of cross-currency swaps). The BCBS-IOSCO has issued updated supervisory guidance,[2] consistent with the Framework, regarding appropriate variation margin standards for physically settled FX forwards and swaps.

Principle 2: Entities Subject to the Framework; Scope of Margin Requirements

The Framework applies to non-centrally cleared derivatives between non-affiliated financial firms or systemically important non-financial entities, as such terms will be defined by appropriate national regulation (and as further limited by the phase-in periods described in Principle 8 discussed below) (the "**Covered Entities**"). The Framework does not apply to

1 Available at: http://www.bis.org/publ/bcbs261.pdf.

2 Available at: http://www.bis.org/publ/bcbs241.htm.

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non-centrally cleared derivatives where a counterparty to the derivative transaction is (1) a non-financial, non-systemically important entity or (2) a sovereign (which may include, at the nation's discretion, a public sector entity), a central bank, a zero risk-weighted multilateral development bank or the Bank of International Settlements. Derivatives with affiliates are addressed in Principle 6 of the Framework, as described further below.

All Covered Entities are required by the Framework to exchange, on a bilateral basis, (1) an initial margin amount with a threshold not to exceed €50 million (applied on a consolidated group basis) at the outset of a transaction and whenever changes to measured potential future exposures occur, and (2) the full amount of variation margin on a regular basis, which, in each case, may be subject to a de-minimis minimum transfer amount not to exceed €500,000.

Principle 3: Calculation of Baseline Amounts for Margin Requirements

The Framework provides that all methodologies for calculating the baseline amounts to be collected from a counterparty should (1) be consistent across Covered Entities, (2) reflect both potential future exposure (initial margin) and current exposure (variable margin) associated with the particular portfolio of non-centrally cleared derivatives at issue and (3) ensure that all counterparty risk exposures are covered fully with a high degree of confidence. Given the complexity of calculating the baseline amounts for initial margin and variation margin, the Framework recommends that all counterparties maintain rigorous dispute resolution procedures for any potential margin disputes that may arise. The Framework also notes that national supervisors may wish to alter the Framework's margin requirements and BCBS-IOSCO is currently considering potential coordination issues between nations.

Initial Margin

The Framework provides that the baseline amount for initial margin should reflect an extreme, but plausible, estimate of the potential future exposure of the non-centrally cleared derivative that is consistent with a one-tailed 99 percent confidence interval over a horizon of 10 days (or, where the related variation margin for the transaction is not exchanged daily, 10 days *plus* the number of days between each exchange of variation margin), based on historical data that incorporates a period of significant financial stress. The baseline amount for initial margin may be calculated in reference to either (1) an approved quantitative portfolio margin model or (2) a standardized margin schedule (included as Appendix A to the Framework). An approved quantitative model must (a) be approved by the applicable supervisory authority, (b) be subject to an internal governance process that continuously assesses and tests the model's risk assessments, validates the model's applicability to the non-centrally cleared derivative for which it is being used and takes into account the complexity of the products covered, and (c) use appropriate weights and time periods for the data in the model. The quantitative model may also account for diversification, hedging and risk offsets *within* well-defined asset classes (such as currency/rates) for non-centrally cleared derivatives covered by the same legally enforceable netting agreement (and with approval from the relevant supervisory authority) but not account for such account for such diversification, hedging and risk offsets across such asset classes. The choice of whether to use the quantitative margin model or the Framework's standardized margin schedule should, in order to avoid the appearance of "cherry-picking" the more advantageous calculation method, be made consistently over time for all transactions within the same well-defined asset class and, if applicable, in compliance with any other requirements of the relevant supervisory authority. Initial margin should be collected on a routine and consistent basis when changes occur that effect a change in potential future exposure. Large discrete calls for additional initial margin due to "cliff-edge" triggers should be discouraged in order to mitigate the risk of procyclicality impacts. Likewise, margin levels should be sufficiently conservative even during periods of low market volatility.

Variation Margin

The Framework provides that the baseline amount for variation margin should reflect the full amount necessary to collateralize the mark-to-market exposure for the non-centrally cleared derivative and both calculated and exchanged subject to a single, legally enforceable netting agreement (supported by periodically updated legal opinions) on a daily, or otherwise regular, basis.

Principle 4: Eligible Collateral for Margin

The Framework provides that assets collected as collateral for either initial margin or variation margin should be highly liquid, reasonably diversified (across issuer, issuer type and asset type) and, after accounting for an appropriate haircut, be able to hold their value and liquidity in a time of financial stress. Such collateral should not be exposed to excessive credit, market and FX risk (including through differences between the currency of the collateral and the currency of the transaction settlement). Any such risk exposure should be recognized through risk-sensitive haircuts to the collateral's value, calculated, much like the calculation for the baseline amount of initial margin, in reference to either (1) an approved quantitative model or (2) a standard haircut schedule (included as Appendix B to the Framework), in each case, set conservatively and at a level high enough during good conditions to avoid the need for a sharp increase during times of financial or market stress. Any approved quantitative model should be risk-based, promote a conservative haircut and be calibrated appropriately to reflect the underlying risks that affect the value of the collateral, such as market price volatility, liquidity, credit risk and FX volatility, both during normal and stressed market conditions. Furthermore, the Framework states that the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected. As with the calculation of margin, counterparties should maintain rigorous dispute resolution procedures for any potential collateral valuation disputes that may arise.

While each national supervisor should develop its own list of eligible collateral assets, the Framework suggests the following examples (without limitation): cash, high-quality governmental and central bank securities, high-quality corporate bonds, high-quality covered bonds, equities included in major stock indices (except for securities issued by the counterparty or its related entities) and gold. Appropriate haricuts should be applied to reflect the inherent FX risk for any collateral denominated in a currency other than the currency for payments under the non-centrally cleared derivative.

Principle 5: Treatment of Collected Initial Margin

The Framework provides that initial margin exchanged and collected should be on a gross basis and (1) immediately available to the collecting party in the event of the counterparty's default and (2) subject to arrangements that protect the exchanging party to the extent possible under applicable law in the event that the collecting party enters bankruptcy. The collateral arrangements will also need to be supported by periodically updated legal opinions.

The Framework further provides that collateral collected as variation margin may be re-hypothecated, re-pledged or re-used by the collecting party to a third party, but collateral collected as initial margin may not, except upon satisfaction of certain conditions and only for purposes of hedging the collecting party's derivatives position with the exchanging party on transactions for which the collateral was collected and subject to any customer's rights laws over the collateral. Conditions for re-hypothecating, re-pledging or re-using collateral collected as initial margin include, but are not limited to, (a) notice to and written consent from the exchanging counterparty, (b) appropriate governmental regulation of the collecting party's liquidity risk, (c) segregation of such collateral, (d) treatment of such collateral as a customer asset, (e) adequate protection of such collateral from the risk of loss where the collecting party and/or the third party becomes insolvent, (f) prohibition of any further hypothecating, re-pledging or re-using the collateral by the third party, (g) legal enforceability of these conditions against the third party, (h) confirmation that the collecting party and the third party are not in the same group and (i) retention of sufficient records to show that these conditions have been met. The level and volume of any re-hypothecated, re-pledged or re-used collateral should also be disclosed to the appropriate regulatory authorities.

Principle 6: Transaction With Affiliates

The Framework provides that transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework. BCBS-IOSCO notes that the exchange of initial margin and variation margin between affiliates party to a non-centrally cleared derivative is not customary market practice.

Principle 7: Interaction of National Regimes in Cross-Border Transactions

The Framework provides that regulatory regimes in each jurisdiction should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives. "Home" jurisdictions may apply their margin requirements to legal entities established in that jurisdiction, including locally established subsidiaries of any foreign entities. Home jurisdictions may also allow a legal entity to comply with another "host" jurisdiction's margin requirements if such requirements are consistent with those of the home jurisdiction. The Framework suggests, however, that a branch of an entity is part of the same legal entity as the headquarters and may be subject to the margin requirements of either the home jurisdiction or its host jurisdiction.

Principle 8: Phase-In of Margin Requirements

The Framework provides that the margin requirements required thereunder shall be phased in and regularly reviewed for efficacy, soundness and relationship to other existing and related regulatory initiatives. The phase-in conditions and applicable effective dates are as follows:

- Requirement to exchange variation margin for derivative contracts entered into *before* December 1, 2015 is *subject only to bilateral agreement*.
- Requirement to exchange variation margin for new derivative contracts entered into *after* December 1, 2015: effective *December 1, 2015*.

- Requirement to exchange initial margin with a threshold of up to €50 million:for any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2015 exceeds €3.0 trillion (provided the counterparty also meets this condition): effective *December 1, 2015 to November 30, 2016*
  - for any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2016 exceeds €2.25 trillion (provided the counterparty also meets this condition): effective *December 1, 2016 to November 30, 2017*
  - for any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2017 exceeds €1.5 trillion (provided the counterparty also meets this condition): effective *December 1, 2017 to November 30, 2018*
  - for any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2018 exceeds €0.75 trillion (provided the counterparty also meets this condition): effective *December 1, 2018 to November 30, 2019* and
  - for any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of a year exceeds €8 billion (provided the counterparty also meets this condition), from December 1 of such year to November 30 of the following year: effective *December 1, 2019*

in each case, determined by aggregating all of the group's non-centrally cleared derivatives, including physically settled FX trades and swaps; *provided, however*, that the initial margin requirement only applies to new contracts formed after the applicable effective date listed above. The Framework's initial margin requirement does not apply to existing derivative contracts (or any amendments to existing derivative contracts not entered into for the purpose of avoiding the margin requirements).

- Any Covered Entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of a year is less than €8 billion will not be subject to the Framework until it satisfies one of the phase-in conditions described above.

Looking Ahead

BCBS-IOSCO will set up a monitoring group to evaluate the Framework next year. The group will evaluate and focus on the relationship between the margin standards and regulatory initiatives and changes to standardized credit risk approaches as well as the roll-out of capital requirements expected between now and 2014. The group will also consider among other things: (i) developments in establishing a global framework for cross-border interactions across varying regulatory initiatives, including margin and (ii) collateral and the benefits and risks of re-hypothecation. At the conclusion of such evaluation, the group will determine if additional work needs to be undertaken or if modifications are necessary to the Framework.

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