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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

Submitted via: baselcommittee@bis.org and wgmr@iosco.org

Re: Margin requirements for non-centrally-cleared derivatives

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (together "***BCBS IOSCO***") in response to their Consultative Document on *Margin requirements for non-centrally-cleared derivatives* (the "***Consultative Document***" or "***CD***").[2]

Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by a large number of market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.

Markit has been actively and constructively engaged in the debate about regulatory reform of the global OTC derivatives markets and the implementation of the Pittsburgh G20 commitments.[3] Over the last two years we have submitted close to 40 comment letters to regulatory authorities around the world, we have participated in numerous roundtables and we regularly provide the relevant authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements.

[1] Markit is a financial information services company with over 2,700 employees in Europe, North America, and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.
[2] Margin requirements for non-centrally cleared derivatives. Basel IOSCO Consultative Document. July 2012.
[3] "Leaders' Statement: The Pittsburgh Summit" (Sept. 24-25, 2009), available at http://www.g20.org/pub_communiques.aspx.

Executive Summary

Markit provides participants in global financial markets with state-of-the-art analytical services across asset classes, often in conjunction with our pricing and valuation services. These services support, for example, the calculation of regulatory capital requirements, including measures such as PFE, IMM EAD, IRC, CRM, and the CVA Capital VaR charge.[4] Based on our expertise in these areas numerous market participants have approached us to help them address upcoming challenges in relation to the calculation of initial margin ("***IM***") and variation margin ("***VM***") on both cleared and non-cleared transactions.

We welcome BCBS IOSCO's efforts to establish a framework for margin requirements for non-centrally cleared derivatives and we appreciate the opportunity to provide you with our comments on the Consultative Document.[5] We believe that mandatory margining for non-centrally-cleared derivatives could have a significant impact on the functioning of financial markets and potentially the stability of the financial system due not only to the demands on liquidity and collateral but also to the resulting operational challenges. Our recommendations aim at ensuring that margin calculations appropriately reflect the degree of risk posed by various derivative transactions and at facilitating an operationally efficient and timely implementation of the relevant margin requirements.[6] Specifically, we believe that BCBS IOSCO should design its margin regime in a manner that: (1) enables a larger number of counterparties to calculate IM on the basis of approved models; (2) allows counterparties to agree on the calculation of the IM amounts for a transaction in a non-centrally-cleared derivative to be performed by a third party provider or be based on the same set of inputs and calculation methodologies as provided by such third party; (3) allows for choice between the use of model-based or grid-based approach to IM calculation on a sufficiently granular level; (4) clarifies the frequency with which IM calculation and collection will be required; and (5) permits the use of effective procedures that facilitate agreement on VM amounts.

Furthermore, we believe that BCBS IOSCO, in its final margin regime, should recognize the value of customized, non-centrally-cleared derivatives as well as the end-user exception. Margin requirements for both cleared and non-centrally-cleared derivatives should be balanced fairly vis-à-vis each other and should leave sufficient room for appropriate contractual arrangements to take place between parties.

Comments

1. BCBS IOSCO Should Approve IM Models Developed and Supported by Third Parties in a Manner that Facilitates their Broader Use

The CD allows counterparties to choose between using a Quantitative Portfolio Margin Model ("***QPMM***", "***model-based",*** or ***"risk-based"*** approach) or a Standardized Initial Margin Schedule ("***SIMS***" or "***grid-based"*** approach) to calculate the amount of IM that they need to collect from their counterparties.[7] The model-based approach would apply a set formula to each swap or portfolio of swaps while the grid-based approach would

[4] PFE = Potential Future Exposure, IMM EAD = Internal Model Method Exposure At Default, IRC = Incremental Risk Charge, CRM = Comprehensive Risk Measure; and CVA = Counterparty Value Adjustment.

[5] Where appropriate, we refer to comments that we have submitted to the Commodity Futures Trading Commission ("***CFTC***") in relation to its proposed rule on margin requirements (the "***Proposed Rule***"). *See* Markit letter to the CFTC regarding the proposed rule "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (July 11, 2011) [hereinafter the "Prior Markit Comment Letter"], available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47793&SearchText=markit.

[6] We generally do not express any views on many of the more fundamental elements of the margin regime, such as the categories of counterparties that should be required to collect or post margin or whether and how thresholds for IM should be used.

[7] Element 3: Baseline minimum amounts and methodologies for initial and variation margin. *Margin requirements for non-centrally-cleared derivatives.*

approximate margin requirements based on a schedule setting forth margin requirements as a percentage of the notional exposure.

We generally support the use of risk-based models for IM calculation over any grid-based approach so long as the risk-based models are sufficiently robust and accurate. We believe that the grid-based approach based on general asset classes will likely result in inaccurate IM amounts that will be too great for some uncleared derivatives,[8] thereby locking up the limited supply of collateral that could be used more productively, or too small, thereby not sufficiently mitigating risk.[9] Further, as it would treat every transaction on a stand-alone basis and not allow for any portfolio offsets to be applied it would result in higher overall IM amounts for portfolios of non-centrally cleared derivatives.[10]

We understand the need for risk-based models to be evaluated by the relevant regulatory authorities before they can be used and we recognize that some time is necessary for such approvals. However, as we have voiced previously, while many market participants might not have the resources needed to receive individual approval for a model-based approach, others are concerned that the resources available to regulatory authorities to perform model approvals for them will not suffice to accommodate the expected wave of requests by individual firms in a timely fashion.[11] As a consequence, it could take a long time before even the largest and most sophisticated market participants can use a QPMM for their IM calculations, and many would likely be forced to rely on the grid-based approach for the foreseeable future. In addition to resulting in IM amounts that are inaccurate (on a transaction basis) and too high (on a portfolio basis), such situation could put different market participants at a competitive disadvantage as those who rely on grid-based IM calculations would have to collect significantly higher IM amounts from their counterparties vis-à-vis their competitors that had received approval to use model-based calculations.

Importantly, in contrast to the calculation of capital requirements, the calculation of IM for a non-centrally-cleared derivative is a transaction-based calculation that requires limited firm-specific input or judgment. We therefore believe that BCBS IOSCO could address the above tensions by allowing qualified third party providers of risk-based IM models (or of IM calculations that are based on those models) to supply those services to *all* firms in a jurisdiction once they have received approval from the relevant regulatory authority.[12] Such approach would offer the following significant benefits:

- A larger number of counterparties would be able to use a model-based approach much earlier. This would result in the calculation and collection of IM amounts that are more reflective of the actual risk posed by the specific transactions in a portfolio context, compared to those determined by the grid-based method. It would therefore reduce the overall liquidity and collateral demand in the financial system, as well as the cost of the margin regime for counterparties.

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[8] BCBS IOSCO itself describes the grid-approach as a "conservative alternative" to QPMMs. Element 3: Baseline minimum amounts and methodologies for initial and variation margin. BCBS IOSCO Consultative Document.

[9] This issue is exacerbated by the fact that the grid-based IM calculation does not respond to changes in market conditions, which is likely to further increase the degree of inaccuracy of the resulting IM amounts over time.

[10] The proposed BCBS IOSCO initial margin schedule (Appendix A) does not contemplate any additional variables, outside of asset class and tenor, in calculating IM, and does not account for hedging, diversification or netting benefits.

[11] *See* Prior Markit Comment letter to the CFTC, page 2 ("We believe that the approval of these models could create bottlenecks which would delay their use.").

[12] BCBS IOSCO seems to approve of a similar approach by allowing unregulated counterparties to use QPMMs that have been approved for use by a different firm. *See* BCBS IOSCO Consultative Document, Element 2: Scope of coverage. However, elsewhere, the CD seems to argue *against* such approach: "There will be no presumption that approval by one supervisor in the case of one or more institutions will imply approval for a wider set of jurisdictions and/or institutions". [T]he model "must be approved for use within each jurisdiction and by each institution seeking to use the model Element 3: Baseline minimum amounts and methodologies for initial and variation margin. Basel IOSCO Consultative Document.

- It would significantly reduce the overall time and resources needed by regulatory authorities to approve such models. It would hence speed up the implementation of the new margin regime, while also reducing the demands on the scarce resources of regulatory authorities around the globe. This would be true not only in the initial approval stage but also for ongoing monitoring and analysis thereafter.

- Over time, we would expect a limited number of benchmark models and methodologies for QPMMs that are provided by qualified third parties to emerge. Given the expertise and insights that regulatory authorities will develop during the approval process of such models, these models and methodologies will be well understood by regulatory authorities, thereby increasing transparency and supporting their oversight capabilities.

In order for this approach to be most effective the approval of a specific third-party-provided risk-based model should also be recognized *across* jurisdictions. We also believe that regulatory authorities should aim to pre-approve third party provided IM models that are expected to be widely used as this would facilitate the implementation of the regime to a significant extent.

We believe that third party providers of IM models can provide the relevant regulatory authority with the necessary transparency around their models, methodology and inputs. Further, such third parties would establish appropriate governance and business continuity procedures for the operation of their QPMMs. We believe that third parties acting within this framework will help to ensure the accuracy and timeliness of the IM regulatory requirements and will allow for effective and efficient implementation. We are open to discussing these issues with BCBS IOSCO in further detail to ensure that regulatory expectations can be met.

Finally, we believe that approval and use of third party models could also apply to the calibration of haircuts that might also be required as part of the margin regime.[13]

2. **BCBS IOSCO Should Minimize the Potential for Disputes about IM Amounts by Permitting Both Counterparties to a Transaction to Delegate IM Calculation to an Agreed-Upon Third Party or to Base their IM Calculation on a Set of Inputs and Methodologies Provided by Such Third Party**

Under the proposed margin regime, both counterparties will be responsible for calculating the respective IM amounts that they would collect from their counterparties.[14] However, as noted in several relevant consultations, this approach will increase the likelihood of disputes over IM since both counterparties are unlikely to arrive at the same IM amounts if they use different inputs and models.[15] These disputes will not only create costs for counterparties but will also reduce the timeliness of IM collection, resulting in increased systemic risk.

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[13] BCBS IOSCO proposes that "risk-sensitive quantitative models . . . could be used to establish haircuts so long as the model is approved by supervisors and is subject to appropriate internal governance standards." *See id.* at 23.

[14] "The methodologies for calculating initial margin and variation margin that must serve as the baseline for margin that is collected from a counterparty should be (i) consistent across entities covered by the proposed requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally-cleared derivatives at issue..." Key Principle 3. BCBS IOSCO Consultative Document.

[15] *See* Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs, and Trade Repositories. (March 6, 2012). The CFTC also commented that the previously-proposed rule 23.504 requires Swap Dealers ("***SDs***") and Major Swap Participants ("***MSPs***") to have swap trading relationship documentation in place with each counterparty including dispute resolution procedures. *See* Proposed Rule, 76 Fed. Reg. at 23734. It requested comment on whether rule 23.504 was sufficient to ensure that SDs and MSPs have sound legal basis for their swap documentation. It is unclear, though, whether such dispute resolution mechanisms would also apply to the IM amounts that are calculated by the counterparties.

Our discussions with market participants have shown that an effective way to avoid disputes would be for counterparties to agree pre-execution on the use of a third party for the calculation of their respective IM amounts or by agreeing to use a set of input data (including market data and scenarios) and calculation methodology (including models and software) as provided by a third party while still performing the actual IM calculation themselves.[16] Both of these approaches would result in IM amounts that are predictable for the counterparties, thereby reducing the potential for disputes, and improving the functioning of the global marketplace for collateral.

We believe that the use of an agreed-upon third party as calculation agent or as provider of inputs and calculation methodologies for IM for certain transactions between certain counterparties would be most appropriate for standardized and actively-traded non-centrally-cleared derivatives. In contrast, counterparties might not want to rely on the use of a third party for IM calculation for the more complex and less actively traded products. To provide counterparties with the necessary flexibility to establish efficient means of IM calculation, we therefore believe that BCBS IOSCO should explicitly allow counterparties to: (a) agree that their respective IM amounts for transactions between them will be either calculated by a third party provider agreed to by the counterparties or be based on inputs, scenarios, models and methodology provided by such a third party provider; and (b) apply such approach to specific products or categories of products in an asset class while using a "regular" QPMM (*i.e.*, a model-based IM calculation by the individual firms) or a grid-based approach for others. We further believe that any third party that wanted to play such role would need to provide the relevant regulatory authority with sufficient transparency about its models, inputs, governance, and procedures as explained in more detail above.

3. Parties Should Be Able to Choose Between Model-based and Grid-based IM Calculation on a Sufficiently Granular Basis

The CD permits counterparties to choose between the use of a model- and a grid-based approach for their IM calculation, but it prohibits parties to "switch between model- and schedule-based margin calculations in an effort to 'cherry pick' the most favorable IM terms."[17] It states that this choice should be made on a "consistent basis over time" and "for all transactions within the same well-defined asset class". In contrast, the CFTC Proposed Rule provided parties with more flexibility when they decide whether to use a model- or a grid-based IM calculation.[18] We urge BCBS IOSCO to adopt the flexibility embodied by the CFTC rule.

Given the multitude of derivative instruments that can fall into an "asset class", their varying degrees of complexity, and limits to modeling abilities, we believe that there will always be challenges to fit some products in an asset class into a model-based IM calculation. The proposed requirement would hence often result in entire asset classes not being eligible for a model-based approach which, we believe, would unnecessarily restrict its use. To allow a larger number of counterparties to make use of QPMM-based IM calculations with all of the benefits described in more detail above, they should be permitted to make this choice not only by overall asset class, but also by product category within an asset classes[19] or at least make use of an exemption within the asset class.[20]

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[16] Such third parties, that will be independent of the counterparties, would each use one set of market data, scenarios, analytics, and software to serve as the "IM calculation agent" for transactions between these counterparties.

[17] Margin requirements for non-centrally cleared derivatives. Basel IOSCO Consultative Document. July 2012.

[18] *See* Proposed Rule, 76 Fed. Reg. at 23737 ("If a model . . . is not used, margin must be calculated in accordance with a specified alternative method.").

[19] For example, a counterparty should be allowed to use a model-based approach in the asset class of interest rates/FX, while it might choose to use the grid-based approach for all option-based products in this asset class.

[20] I.e. a firm that generally used a model-based IM calculation in an asset class would be permitted to use a grid-based approach for the most complex products.

This would better reflect market realities[21] while enabling an overall increased use of model-based IM calculation, thereby reducing the overall cost of the introduction of the IM requirement. Such approach would also be in the interest of regulatory authorities, as it would allow counterparties to use the more conservative grid-based IM calculation for those products that, in their opinion, cannot be reliably modeled.

4. BCBS IOSCO Should Clarify the Frequency with which IM Calculation and Collection are Required

The CD states that "the amount of IM . . . can change over time, particularly where it is calculated on a portfolio basis and transactions are added to or removed from the portfolio on a continuous basis." It further clarifies that counterparties are expected to collect IM "at the outset of a transaction" and "thereafter on a routine and consistent basis upon changes in potential future exposure as trades are added to or subtracted from the portfolio."[22] In contrast, the CFTC's Proposed Rule required parties that have to collect IM to "monitor IM daily" and "collect additional IM if necessary to address the risk posed."[23]

We agree that the addition or removal of transactions to a portfolio of existing transactions will lead to changes in the overall IM amount. However, even if no transactions are added or removed, the overall IM amount for the portfolio may change, for example if existing transactions mature or the market experiences significant moves. We therefore encourage BCBS IOSCO to clarify: (a) how frequently portfolio IM needs to be *re-calculated* and (b) how often portfolio IM needs to be *collected* by the counterparties. This would clarify the circumstances under which IM re-calculation for an existing portfolio of transactions has to be performed even if no changes have been made to the trade population. Further, it would clarify when a change in calculated IM for the portfolio would require the counterparties to actually collect additional IM (or pay back excess IM). While regular re-calculations of portfolio IM might be appropriate even if the trade population has not changed, we believe that BCBS IOSCO should allow the use of a Minimum Transfer Amount ("***MTA***") for the actual IM payments, in line with what the CD proposed for the collection of VM,[24] to avoid creating unnecessary operational burden.

5. Counterparties Should be Permitted to Reference Third Parties for Dispute Resolution, Valuations, or Inputs in Relation to their VM Calculations

The CD proposes that counterparties would have to establish dispute resolution procedures to achieve agreement on valuations of their transactions in non-centrally-cleared derivatives as basis for the collection of VM.[25] We believe that, to ensure that valuation disputes can be resolved in a cost effective and timely manner, counterparties should be explicitly allowed to reference valuations or arbitration procedures performed by independent third parties.[26]

We note that the CFTC has established a requirement for SDs/MSPs to agree with their counterparties, pre-execution, on a process that could contain the methodology, inputs and fallbacks for the valuation of each non-centrally-cleared derivative. The resulting valuation would be used as basis for the exchange of VM.[27] If BCBS IOSCO decided to impose such a requirement we believe that it should also explicitly permit counterparties to

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[21] The most exotic products can sometimes not be reliably modelled.
[22] Element 3: Baseline minimum amounts and methodologies for initial and variation margin. BCBS IOSCO Consultative Document.
[23] *See* Proposed Rule, 76 Fed. Reg. At 23738.
[24] Element 3: Baseline minimum amounts and methodologies for initial and variation margin. BCBS IOSCO Consultative Document.
[25] Element 3: Baseline minimum amounts and methodologies for initial and variation margin. BCBS IOSCO Consultative Document.
[26] This is because third parties: (i) do not have any positions and hence do not have any inherently subjective financial interest in the prices they calculate; (ii) use multiple data sources which helps to remove management bias; and (iii) offer both parties in the dispute substantial transparency into the valuation inputs, methods and procedures so the parties can more effectively debate and resolve the dispute.
[27] Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012).

agree to reference these elements or the actual valuation as they are provided by a qualified third party. As we have explained in other response letters, we believe that such delegation might represent an effective manner for counterparties to comply with this requirement.[28]

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Markit appreciates the opportunity to comment on BCBS IOSCO's Consultation Paper *Margin requirements for non-centrally-cleared derivatives.* We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Yours sincerely

Kevin Gould
President
Markit North America, Inc.

[28] See Markit's comment letter to the CFTC's Proposed Rule Swap Trading Relationship Documentation for Swaps Dealers and Major Swap Participants (April 11, 2011). http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=35542&SearchText=markit