

Basel Committee and IOSCO Release Final Policy Framework for Uncleared Derivatives Margin

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The Basel Committee on Banking Supervision (“**BCBS**”) and the International Organization of Securities Commissions (“**IOSCO**”) on September 2 released their **final policy framework** on margin requirements for uncleared derivatives (the “**Framework**”). The Framework, which follows two proposals on the topic from BCBS and IOSCO (the “**Proposals**”), is intended to establish minimum standards for uncleared derivatives margin rules in the jurisdictions of BCBS and IOSCO’s members, which includes the United States.

The Framework is designed to provide guidance to national regulators in implementing G-20 commitments for uncleared derivatives margin requirements. In the United States, the Dodd-Frank Act, reflecting the same G-20 commitments, requires the SEC, CFTC and banking regulators to adopt initial and variation margin requirements for swap dealers and major swap participants (“**MSPs**”) under their supervision.¹ The U.S. regulators have proposed rules to implement these requirements (the “**U.S. Proposals**”), but have not yet adopted final rules, in part due to the ongoing BCBS/IOSCO efforts. The Framework is similar in concept to the U.S. Proposals, but differs in a number of significant respects. Appendix A summarizes the Framework and the three U.S. Proposals, highlighting a number of the key differences.

With the Framework finalized, we expect that U.S. regulators will work to issue final rules implementing uncleared swap margin requirements in the coming months.

The Framework: Key Principles 1 Through 8

The margin requirements in the Framework are presented as eight key principles, with related commentary and high-level standards for national regulators to incorporate into their rules.

1. Appropriate margining practices should be in place with respect to all uncleared derivatives transactions.

Under the Framework, most OTC derivatives, including those that are not “swaps” or “security-based swaps” under Title VII of the Dodd-Frank Act, by unaffiliated “covered entities” (as defined below), are subject to

¹ References in this memorandum to “swap dealers” and “MSPs” are intended to encompass both those regulated by the CFTC as well as SEC-regulated security-based swap dealers and major security-based swap participants.

initial and variation margin requirements. However, in a change from the Proposals, the Framework requires variation margin, but not initial margin, for physically-settled foreign exchange swaps and forwards.

2. *Financial firms and systemically important non-financial entities (“covered entities”) must exchange initial and variation margin.*

The Framework requires bilateral exchange of both initial and variation margin for uncleared derivatives between “covered entities.” The precise definition of “covered entity” would be determined by each national regulator in implementing the Framework. The Framework only applies to uncleared derivatives between two covered entities, and the Framework’s margin requirements therefore do not apply to transactions involving non-financial entities that are not systemically important. The Framework also does not apply margin requirements to transactions involving sovereigns, central banks, multilateral development banks or the Bank for International Settlements.

Covered entities must exchange the full amount of variation margin, with no threshold, on a daily basis, and must exchange initial margin subject to a €50 million threshold applied on a consolidated group basis.² In both cases, covered entities may use a minimum transfer amount up to €500,000, which was increased from €100,000 in the Proposals. This scope of coverage differs significantly from the U.S. Proposals, including that the U.S. Proposals (i) require swap dealers and MSPs to collect, but not necessarily post, initial and variation margin (unless facing another swap dealer or MSP), (ii) provide for thresholds for both initial and variation margin, (iii) limit the availability of thresholds from posting margin to certain enumerated types of entities and (iv) calculate the thresholds on a legal entity, rather than group consolidated, basis.

3. *The methodologies for calculating initial and variation margin should (i) be consistent across covered entities, and (ii) ensure that all counterparty risk exposures are covered with a high degree of confidence.*

Initial margin must be calculated based on a 99% confidence interval over a 10-day horizon (or longer, if variation margin is not collected daily) based on historical data that incorporates a period of significant financial stress.

Market participants may choose to base initial margin calculations on either internal models approved by a covered entity’s national regulator or on a standardized schedule, but may not “cherry pick” between the two for all derivatives in the same well-defined asset class. Models may allow for portfolio risk offsets where there is an enforceable netting

² The Framework clarifies that investment funds will not be considered to be part of a consolidated group so long as the funds are distinct legal entities that are not collateralized by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy.

Standardized Initial Margin Schedule	
Asset Class	Initial Margin Requirement (% of Notional Exposure)
Credit: 0–2 year duration	2%
Credit: 2-5 year duration	5%
Credit: 5+ year duration	10%
Commodity	15%
Equity	15%
Foreign Exchange	6%
Interest Rate: 0-2 year duration	1%
Interest Rate: 2-5 year duration	2%
Interest Rate: 5+ year duration	4%
Other	15%

agreement in effect, subject to approval by the relevant supervisory authority. However, the portfolio risk offsets may only be within, and not across, well-defined asset classes including currency/rates, equity, credit or commodities. The Framework sets out a recommended standardized schedule providing for initial margin requirements, as provided in the sidebar.

The Framework provides that a covered entity using the standardized schedule may apply the type of “net-to-gross ratio” that is used in bank capital rules to incorporate some netting efficiencies to all derivative positions in the same class that are subject to an enforceable netting agreement.³

Netting of notional amounts may be permissible for contracts having the same terms but that move in opposite directions.

Derivatives for which a firm faces no counterparty risk (e.g., where the seller of an option has collected the full option premium) may be excluded from initial margin calculations.

- 4. To ensure that assets collected as collateral can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect covered entities from losses in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.**

The Framework requires national supervisors to specify eligible collateral types. The Framework suggests possible collateral types that are broader than those contemplated in the U.S. proposal (including, for example, gold and certain corporate bonds and equities). The Framework also indicates that model-based haircuts for collateral should be permissible but also proposes a list of standardized haircuts that may be applied in the alternative to different types of collateral, as set forth in the sidebar on the following page.

- 5. Initial margin should be exchanged on a gross basis and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty’s default, and (ii) the collected margin must be subject to arrangements that fully protect the posting party.**

Unlike the Proposal, the Framework allows re-hypothecation of *customer* collateral, but only for the purpose of hedging customer positions and only subject to restrictive conditions. Since, for this purpose, “customers” include only “buy-side” financial firms and non-financial entities, but not dealers or market makers in derivatives, margin collected in the interdealer market may not be re-hypothecated.

³ Under this approach, standardized initial margin = 0.4 * gross initial margin + 0.6 * (net current replacement cost ÷ gross current replacement cost) * gross initial margin.

Suggested Standardized Haircut Schedule	
Asset Class	Haircut (% of Market Value)
Cash in same currency	0%
High-quality government and central bank securities: residual maturity less than one year	0.5%
High-quality government and central bank securities: residual maturity between one and five years	2%
High-quality government and central bank securities: residual maturity greater than five years	4%
High-quality corporate covered bonds: residual maturity less than one year	1%
High-quality corporate covered bonds: residual maturity greater than one year and less than five years	4%
High-quality corporate covered bonds: residual maturity greater than five years	8%
Equities included in major stock indices	15%
Gold	15%
Additional (additive) haircut on asset in which the currency of the derivatives obligation differs from that of the collateral asset	8%

Customer collateral collected as initial margin must be segregated from the initial margin collector's proprietary assets and the collector must give its customer the option to have its initial margin individually segregated. To the extent that the customer consents to re-hypothecation, the margin collector and the third party to which customer collateral is re-hypothecated would need to comply with additional requirements, including that:

- the re-hypothecation must be in connection with hedging positions arising out of transactions with customers (or where a customer's collateral is individually segregated, hedging positions arising out of transactions with that specific customer);
- the collateral may be re-hypothecated, re-pledged, or reused only once;
- collected collateral must be treated as customer assets and segregated from the initial margin collector's proprietary assets until re-hypothecated to a third-party and, once re-hypothecated, the third-party must segregate the collateral from its own proprietary assets;
- collateral of customers who have consented to re-hypothecation must be segregated from customers who have not so consented;
- collateral must only be re-hypothecated to, and held by, an entity that is regulated under similar rules and that is not an affiliate of the customer;
- the customer must provide express written consent to the re-hypothecation; and
- the level and volume of re-hypothecation must be disclosed to the authorities.

6. Transactions between affiliates are not subject to mandatory margining.

The Framework leaves the treatment of interaffiliate derivatives to national regulators. The U.S. Proposals do not discuss the treatment of interaffiliate swaps, other than a request for comment from the SEC.

7. Requirements for margining uncleared derivatives should be consistent and non-duplicative across jurisdictions.

The Framework provides that a home-country supervisor may permit a covered entity to comply with the margin requirements of a host-country's margin regime, provided that the home-country supervisors consider the host-country margin regime to be consistent with the Framework. A branch may be subject to margin requirements of either the jurisdiction where the headquarters is established or the host-country requirements.

8. Margin requirements should be phased in over an appropriate period of time.

The Framework includes a compliance schedule that (i) provides a *de minimis* level of uncleared derivatives exposure under which initial

margin requirements would not apply and (ii) phases in margin requirements between December 2015 and December 2019.

Covered entities must begin exchanging variation margin on December 1, 2015 with respect to new contracts entered into on or after that date. The date on which a given covered entity will be required to exchange initial margin depends on the notional amount of uncleared derivatives (including deliverable foreign exchange swaps and deliverable foreign exchange forwards) entered into by its consolidated group and that of its counterparty, as provided in the sidebar. Specifically, two covered entity counterparties to uncleared derivatives will be required to exchange initial margin if the consolidated group to which each belongs has an aggregate month-end average notional amount of uncleared derivatives exceeding a *de minimis* level that will decrease each year from 2015 through 2019. For 2019 and beyond, the *de minimis* level will remain at €8 billion. In all cases, the aggregate month-end average notional amount of uncleared derivatives is to be measured for June, July and August of each year. Initial margin requirements apply to all new contracts entered into during the periods described in the sidebar.

Initial Margin Phase-In Periods		
From	To	Thresholds for Initial Margin Phase-In
12/01/15	11/30/16	€3.0 trillion
12/01/16	11/30/17	€2.25 trillion
12/01/17	11/30/18	€1.5 trillion
12/01/18	11/30/19	€0.75 trillion
12/01/19	Ongoing	€8 billion

The Framework represents BCBS/IOSCO’s final recommendations and public comment has not been solicited. However, BCBS and IOSCO plans to establish a monitoring group to evaluate the margin standards against related regulatory initiatives that may develop alongside these requirements between now and 2014.

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Appendix A: Summary Comparison of Margin Proposals for Uncleared Derivatives

	Basel/IOSCO Framework	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
Counterparties Covered	<ul style="list-style-type: none"> ▪ All financial firms and non-financial firms that are systemically important, as those terms are defined by national regulators ▪ Margin not required of non-financial firms that are not systemically important ▪ Margin not required of sovereigns (which may include public sector entities), central banks, multilateral development banks, or the Bank for International Settlements 	<ul style="list-style-type: none"> ▪ All swap dealers (“SDs”) and major swap participants (“MSPs”) that are not prudentially regulated ▪ Margin not required of corporate end users, though SDs and MSPs must have a credit support or similar agreement in place 	<ul style="list-style-type: none"> ▪ All SDs, security-based swap dealers (“SBSDs”), MSPs and major security-based swap participants (“MSBSPs”) that are prudentially regulated ▪ SDs, MSPs, SBSDs and MSBSPs must set credit exposure limits and collect margin from commercial end users if exposure exceeds those limits 	<ul style="list-style-type: none"> ▪ All SBSDs and MSBSPs that are not prudentially regulated ▪ Exception from initial margin requirements for corporate end users, subject to an SBSD capital charge
Products Covered	<ul style="list-style-type: none"> ▪ All uncleared OTC derivatives, but only variation margin for physically settled FX forwards and swaps 	<ul style="list-style-type: none"> ▪ Uncleared swaps (excluding FX swaps and FX forwards) 	<ul style="list-style-type: none"> ▪ Uncleared swaps (excluding FX swaps and FX forwards) and uncleared security-based swaps 	<ul style="list-style-type: none"> ▪ Accounts holding uncleared security-based swaps
Unilateral or Bilateral Margin	<ul style="list-style-type: none"> ▪ Bilateral – both parties post margin to each other 	<ul style="list-style-type: none"> ▪ Unilateral – each SD/MSP must collect margin, including from other SDs/MSPs (effectively leading to bilateral margining between SDs/MSPs) 	<ul style="list-style-type: none"> ▪ Unilateral – each SD/SBSD/MSP/MSBSP must collect margin, including from other SDs/SBSDs and MSPs/MSBSPs (effectively leading to bilateral margining between SDs/MSPs) 	<ul style="list-style-type: none"> ▪ Unilateral for SBSDs ▪ Bilateral for MSBSPs with respect to variation margin (no initial margin collection requirements)
Initial Margin Calculation Methodology	<ul style="list-style-type: none"> ▪ Quantitative portfolio margin model, which must be consistent with a one-tailed 99% confidence interval over a 10-day horizon, based on historical data (not to exceed 5 years) that incorporates 	<ul style="list-style-type: none"> ▪ Models, which must set margin to cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation time 	<ul style="list-style-type: none"> ▪ Models, which must account for liquidation time horizon (99% confidence interval over a 10 day horizon) or ▪ Provided standardized grid 	<ul style="list-style-type: none"> ▪ For equity-based security-based swaps, margin amount must be determined according to standardized haircuts

	Basel/IOSCO Framework	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
	<p>a period of significant financial stress that is identified and applied separately for each broad asset class; or</p> <ul style="list-style-type: none"> Standardized margin schedule (with limited provisions for netting) Participants must make consistent choices between a model and the standardized schedule over time for all transactions within the same well-defined asset class (no cherry picking) 	<p>horizon; or</p> <ul style="list-style-type: none"> Standardized calculation: <ul style="list-style-type: none"> twice the margin for the cleared swap in the same asset class most similar to the uncleared swap if no similar swap, 4.4 times the cleared futures contract in the same asset class most similar to the uncleared swap If models are available, the choice of whether to use a model or the standard calculation is made by the SD/MSP 	<p>(with no offsets)</p> <ul style="list-style-type: none"> If models are available, the choice of whether to use a model or a standard calculation is made by the SD/SBSD/MSP/MSBSP 	<ul style="list-style-type: none"> For debt-based security-based swaps: SBSDs that are approved to use internal models to compute capital may use models for initial margin or may use the standardized haircuts. SBSDs not approved to use internal models to compute net capital must use standardized haircuts
Eligible Models	<ul style="list-style-type: none"> Must be approved by the relevant supervisory authority Third-party models must be approved for use within each jurisdiction and by each institution seeking to use the model Quantitative models must be subject to an internal governance process 	<p>Approved models are limited to:</p> <ul style="list-style-type: none"> those used for margining cleared swaps by DCOs; those used for margining uncleared swaps by an entity subject to prudential regulation; or those made available for licensing to any market participant by a vendor 	<p>Models must:</p> <ul style="list-style-type: none"> be approved by the prudential regulators prior to use; and satisfy the quantitative requirements dictated by the prudential regulators on an ongoing basis 	<ul style="list-style-type: none"> VaR models approved for capital purposes. Such models are also subject to certain qualitative and quantitative regulatory requirements
Portfolio Margining in a Model	<ul style="list-style-type: none"> May consider all of the derivatives that are approved for model use that are subject to a single, legally enforceable netting 	<ul style="list-style-type: none"> Allowed as long as the offset or reduction has “a sound theoretical basis and significant empirical support” 	<ul style="list-style-type: none"> Allowed within, but not across, the four broad risk categories (commodity, credit, equity and foreign exchange/interest rates), so 	<ul style="list-style-type: none"> For equity security-based swaps, portfolio margining permitted on the same basis as for securities under SRO rules (which allow portfolio

	Basel/IOSCO Framework	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
	<p>agreement</p> <ul style="list-style-type: none"> May account for diversification, hedging and risk offsets within but not across well-defined asset classes (currency and interest rate derivatives may be portfolio margined together as part of a single asset class) Incorporation of diversification, hedging and risk offsets will require approval by the relevant supervisory authority 	<ul style="list-style-type: none"> Portfolio-based reductions permitted within but not across asset classes (except between currencies and interest rates); no reduction may exceed 50% 	<p>long as the relevant swaps or security-based swaps are executed:</p> <ul style="list-style-type: none"> under the same qualifying master netting agreement; or on and/or after the effective date Seeks comment on but does not initially address the offsetting of risk within or among asset classes 	<p>margining based on the underlying security)</p> <ul style="list-style-type: none"> For debt security-based swaps, offsets allowed within the same underlying security and for specified maturity ranges For all types of security-based swaps, calculation for equity (variation margin) allows for netting of gross receivables and payables to a counterparty, provided the parties have entered into a qualifying netting agreement
Thresholds	<ul style="list-style-type: none"> No thresholds for variation margin €50 million threshold for initial margin between any two consolidated groups 	<ul style="list-style-type: none"> No thresholds allowed for trades between two SDs and MSPs or between a SD and a high-risk financial end user Initial and variation margin thresholds allowed for swaps between a SD and a low-risk financial end user, which will be the lesser of (i) a specific dollar amount, which will be set between \$15 million and \$45 million in the final rule; and (ii) a percentage of the Swap Entity's capital, which will be set between 0.1 and 0.3 percent in the final rule 	<ul style="list-style-type: none"> Same as CFTC 	<ul style="list-style-type: none"> No thresholds allowed
Eligible Collateral	<ul style="list-style-type: none"> Should be highly liquid and able to hold value in periods of financial stress. Includes, but is not limited to: 	<ul style="list-style-type: none"> Between two swap entities or a swap entity and a financial end user: 	<ul style="list-style-type: none"> Between two swap entities or a swap entity and a financial end user, solely in the form of: 	<ul style="list-style-type: none"> Cash, securities and/or money market instruments (except securities or money market instruments with "no

	Basel/IOSCO Framework	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
	<ul style="list-style-type: none"> ▪ cash; ▪ high-quality gov't and central bank securities; ▪ high-quality corporate bonds; ▪ high-quality covered bonds; ▪ equities included in major stock indices; and ▪ gold ▪ Haircuts apply 	<ul style="list-style-type: none"> ▪ cash; ▪ U.S. obligations; or ▪ senior GSE debt obligations or any obligation that is an "insured obligation" of a Farm Credit System bank (for initial margin requirements only) ▪ Commercial end users may post any collateral so long as its value is reasonably ascertainable on a periodic basis ▪ Haircuts apply 	<ul style="list-style-type: none"> ▪ cash, ▪ U.S. obligations; and/or ▪ senior GSE debt obligations or any obligation that is an "insured obligation" of a Farm Credit System bank (for initial margin requirements only) ▪ Haircuts apply 	<p>ready market"), subject to haircuts</p>
<i>Interaffiliate Swaps</i>	<ul style="list-style-type: none"> ▪ Decision left to national supervisors 	<ul style="list-style-type: none"> ▪ Not discussed 	<ul style="list-style-type: none"> ▪ Not discussed 	<ul style="list-style-type: none"> ▪ Comment sought on whether affiliates should be exempt from equity (variation margin) requirements
<i>Margin Requirements for Swaps Entered into Before Margin Rules are Effective</i>	<ul style="list-style-type: none"> ▪ Requirements apply only to new swaps entered into after the rules become effective under the applicable phase-in periods 	<ul style="list-style-type: none"> ▪ Requirements apply only to swaps entered into after the rules become effective 	<ul style="list-style-type: none"> ▪ Requirements apply only to swaps entered into on or after the rules become effective ▪ A bank swap entity may choose to, for a particular master netting agreement, either exclude all swaps entered into before, on, or after effectiveness of the rule, or include all swaps under a master agreement entered into before, on, or after effectiveness of the rule 	<ul style="list-style-type: none"> ▪ No requirements for "legacy accounts." Legacy accounts may not contain any security-based swaps entered into after the rules become effective

	Basel/IOSCO Framework	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
Collection Rules Effectiveness Date	<ul style="list-style-type: none"> Variation margin requirements become effective on December 1, 2015 Initial margin requirements subject to phase-in from December 1, 2015 to December 1, 2019 	<ul style="list-style-type: none"> CFTC does not provide an effective date 	<ul style="list-style-type: none"> 180 days after publication of the final rules in the Federal Register 	<ul style="list-style-type: none"> SEC provides 90, 120, 150 or 180 days as possibilities for comment