Basel Committee and IOSCO Release Second Consultative Paper on Uncleared Derivatives Margin

February 25, 2013

The Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") on February 15 released a second consultative paper on margin requirements for uncleared derivatives (the "**Second Consultative Paper**"). The proposal is intended to establish minimum standards for uncleared derivatives margin rules, which would be implemented by national regulators. Comments on the Second Consultative Paper are due by March 15, 2013.

Modifications Made in the Second Consultative Paper

BCBS and IOSCO have made several changes in the Second Consultative Paper to their initial proposal in response to public comment and their quantitative impact study of the effect of the initially proposed margin requirements on 39 large financial institutions. The changes made in the Second Consultative Paper reflect the concerns expressed by many market participants about the high levels of collateral that would have been needed to meet the margin requirements and the resulting negative impact on liquidity. Most significantly, BCBS and IOSCO have revised the proposed initial margin requirements to:

- apply only to entities in consolidated groups with more than €8 billion of uncleared derivatives exposure;
- allow for a €50 million initial margin threshold between consolidated groups; and
- phase in initial margin requirements between 2015 and 2019, beginning in 2015 with swaps between consolidated groups that each have more than €3 trillion in notional swaps outstanding.

Importantly, the proposed BCBS and IOSCO regime would apply to all uncleared derivatives, including those that are not "swaps" or "security-based swaps" subject to Title VII of the Dodd-Frank Act, such as options on securities. BCBS and IOSCO have, however, requested comment on whether to exempt physically settled foreign exchange forwards and swaps from the margin requirements that apply to other non-centrally cleared derivatives, consistent with the U.S. Treasury Secretary's exclusion of these instruments from most swap regulation, including uncleared margin requirements. BCBS and IOSCO have proposed exempting sovereigns, central banks, multilateral development banks and the Bank for International Settlements from margin requirements.

Implementation in the United States

The Second Consultative Paper reflects the continuing efforts of regulators worldwide to adopt and implement a coordinated margin regime across jurisdictions. It remains unclear, however, to what extent U.S. and international regulators will adopt margin rules consistent with the final recommendations. In the United States, the Dodd-Frank Act requires the SEC, CFTC and banking regulators to adopt initial and variation margin requirements for entities under their jurisdictions. Each of these regulators has issued proposed rules, which differ in significant ways from each other and from the Second Consultative Paper's framework. The attached chart summarizes these four proposed regimes, highlighting a number of the key differences between them.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Summary Comparison of Margin Proposals for Uncleared Derivatives

	Basel/IOSCO Paper	CFTC Proposal	Bank Regulator Proposal	SEC Proposal
Counterparties Covered	▪ All financial entities and non-financial entities that are systemically significant, as those terms are defined by national regulators ▪ Margin not required of non-financial entities that are not systemically significant ▪ Margin not required of sovereigns, central banks, multilateral development banks, or the Bank for International Settlements	▪ 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	▪ 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	▪ 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	▪ All uncleared OTC derivatives. ▪ Comment sought on whether FX swaps and FX forwards should be covered	▪ Uncleared swaps (excluding FX swaps and FX forwards as defined in Sections 1(a)(24) and 1(a)(25) of the Commodity Exchange Act)	▪ Uncleared swaps (excluding FX swaps and FX forwards) and uncleared security-based swaps	▪ Accounts holding uncleared security-based swaps
Unilateral or Bilateral Margin	▪ Bilateral – both parties post margin to each other	▪ Unilateral – each SD/MSP must collect margin, including from other SDs/MSPs	▪ Unilateral – each SD/SBSD/MSP/MSBSP must collect margin, including from other SDs/SBSDs and MSPs/MSBSPs	▪ Unilateral for SBSDs ▪ Bilateral for MSBSPs with respect to variation margin (no initial margin collection requirements)
Initial Margin Calculation Methodology	▪ Quantitative portfolio margin model, which must be consistent with a one-tailed 99% confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress or ▪ Standardized margin schedule	▪ 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 horizon or ▪ Standardized calculation: ▪ twice the margin for the	▪ Models, which must account for liquidation time horizon (99% confidence interval over a 10 day horizon) or ▪ Provided standardized grid (with no offsets) ▪ If models are available, the	▪ For equity-based security-based swaps, margin amount must be determined according to standardized haircuts ▪ For debt-based security-based swaps: SBSDs that are approved to use internal models to compute capital may use models for initial

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	(proposed by BCBS/IOSCO, 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 asset class (no cherry picking)	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	choice of whether to use a model or a standard calculation is made by the SD/SBSD/MSP/MSBSP	margin or may use the standardized haircuts. SBSDs not approved to use internal models to compute net capital must use standardized haircuts
Eligible Models	▪ 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	▪ Approved models are limited to: ▪ 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	▪ Models must: ▪ be approved by the prudential regulators prior to use and ▪ satisfy the quantitative requirements dictated by the prudential regulators on an ongoing basis	▪ VaR models approved for capital purposes. Such models are also subject to certain qualitative and quantitative regulatory requirements
Portfolio Margining in a Model	▪ May consider all of the derivatives that are approved for model use that are subject to a single, legally enforceable netting agreement ▪ May account for diversification, hedging and risk offsets within but not across well-defined asset classes	▪ Allowed as long as the offset or reduction has "a sound theoretical basis and significant empirical support" ▪ Portfolio-based reductions permitted within but not across asset classes (except between currencies and interest rates);	▪ Allowed within. but not across. the four broad risk categories (commodity, credit, equity and foreign exchange/interest rates), so long as the relevant swaps or security-based swaps are executed: ▪ under the same qualifying	▪ For equity security-based swaps, portfolio margining permitted on the same basis as for securities under SRO rules (which allow portfolio margining based on the underlying security) ▪ For debt security-based swaps, offsets allowed within the same underlying security and for

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	▪ Incorporation of diversification, hedging and risk offsets will require approval by the relevant supervisory authority	no reduction may exceed 50%	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	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	▪ No thresholds for variation margin ▪ €50 million threshold for initial margin between any two consolidated groups	▪ 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	▪ Same as CFTC	▪ No thresholds allowed
Eligible Collateral	▪ Should be highly liquid and able to hold value in periods of financial stress. Includes, but is not limited to: ▪ cash; ▪ high-quality gov't and central bank securities;	▪ Between two swap entities or a swap entity and a financial end user: ▪ cash; ▪ U.S. obligations; or ▪ senior GSE debt obligations or any obligation that is an	▪ Between two swap entities or a swap entity and a financial end user, solely in the form of: ▪ cash, ▪ U.S. obligations; and/or ▪ senior GSE debt obligations or any obligation that is an	▪ Cash, securities and/or money market instruments (except securities or money market instruments with "no ready market"), subject to haircuts

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	▪ high-quality corporate bonds; ▪ high-quality covered bonds; ▪ equities included in major stock indices; and ▪ gold ▪ Haircuts apply	"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	"insured obligation" of a Farm Credit System bank (for initial margin requirements only) ▪ Haircuts apply	
Interaffiliate Swaps	▪ Decision left to national supervisors	▪ Not discussed	▪ Not discussed	▪ Comment sought on whether affiliates should be exempt from equity (variation margin) requirements
Margin Requirements for Swaps Entered into Before Margin Rules are Effective	▪ Requirements apply only to swaps entered into after the rules become effective	▪ Requirements apply only to swaps entered into after the rules become effective	▪ 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	▪ No requirements for "legacy accounts." Legacy accounts may not contain any security-based swaps entered into after the rules become effective
Collection Rules Effectiveness Date	▪ Variation margin requirements become effective January 1, 2015 ▪ Initial margin requirements subject to phase-in from 2015 to 2019	▪ CFTC does not provide an effective date	▪ 180 days after publication of the final rules in the Federal Register	▪ SEC provides 90, 120, 150 or 180 days as possibilities for comment