U.S. Commodity Futures Trading Commission

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Chairman

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Hon. Randal K. Quarles,
Vice Chair for Supervision
Federal Reserve Board of Governors
Constitution Ave. & 20th Street, NW
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Dear Randy,

I want to follow up on a recent conversation about "Phase Five" implementation requirements for initial margin on uncleared swaps scheduled for September 2020 ("Phase Five Implementation"). As we discussed, the CFTC's Office of Chief Economist has analyzed market data in light of concerns of many small market participants that will be brought into scope in the Phase Five Implementation.[1] CFTC staff has also reviewed additional data from market participants and industry organizations.

Based on the CFTC analysis, I would like to recommend that:

i) US regulators issue regulatory guidance clarifying that a US regulated entity need not have in place systems and documentation to exchange initial margin on uncleared swaps with a given counterparty if its calculated bilateral initial margin amount with that counterparty is less than $50 million; and

ii) Global regulators commit to further engagement with BCBS/IOSCO to reflect in global principles its recent confirmation that the implementation framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold.[2]

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[1] See Haynes, Lau, and Tuckman (2018).

[2] "The Basel Committee and IOSCO note that the framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does exceed the framework's €50 initial margin threshold. It is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded." See "BCBS/IOSCO statement (BCBS/IOSCO Statement) on the final implementation phases

Uncleared margin rules in the United States clearly recognize that small market participants should be granted some form of relief from initial margin requirements. This is because small entities contribute little to systemic risk, and would, in any case, exchange only small amounts of initial margin. Therefore they should be spared the significant costs of establishing custodial services, documenting margin relationships, and operationalizing margin exchange.[3]

Regulators ultimately decided that initial margin amounts of $50 million or less were "small" for this purpose. Current rules, therefore, set an initial margin threshold of $50 million, meaning that entities do not have to post any initial margin unless their required posting would exceed $50 million.[4]

At the same time, however, regulators wanted to set a simple, transparent, "material swaps exposure" threshold, in terms of notional amount, below which small entities would be entirely out of scope of the rules. Entities under that threshold would then have legal certainty that they need not expend any resources on preparations to exchange margin.[5]

This material swaps exposure threshold was eventually set at $8 billion. The original idea was to set the material swaps exposure threshold so as to be consistent with the initial margin threshold. For example, if portfolios with $8 billion notional amount drew margin requirements of $50 million, then the two thresholds would achieve the same objective. Entities calculating that their margin requirements would be less than $50 million would not have to exchange margin. Alternatively, entities could reach the same conclusion through the much simpler calculation that their notional amounts were less than $8 billion.[6]

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of the margin requirements for non-centrally cleared derivatives," March 5, 2019. Available at https://www.bis.org/press/p190305a.htm.

[3] "Requiring covered swap entities to subject financial end users with exposures that would generally result in initial margin requirements substantially below $65 million could create significant operational burdens, as the initial margin collection amounts would need to be calculated on a daily basis even though no initial margin would be expected to be collected..." Department of the Treasury *et al.* (2014), p. 57366. "The Agencies believe that allowing covered swap entities to apply initial margin thresholds of up to $50 million is consistent with the rule's risk-based approach, as it will provide relief to smaller and less systemically risky counterparties while ensuring that initial margin is collected from those counterparties that pose greater systemic risk to the financial system." Department of the Treasury *et al.* (2015), p. 74863:

[4] Department of the Treasury *et al.* (2015), p. 74863.

[5] "... the Agencies have adopted a simple and transparent approach to defining material swaps exposure that depends on a counterparty's gross notional derivative exposure for non-cleared swaps... gross notional... is broadly related to a counterparty's overall size and risk exposure and provides for a simple and transparent measurement of exposure that presents only a modest operational burden." Department of the Treasury *et al.* (2014), p. 57366. And, p. 57368, "... the operational benefits of using a simple and transparent gross notional measure to define the material swaps exposure amount are substantial."

[6] Department of the Treasury *et al.* (2014), pp. 57366-8, uses data on initial margin and notional amounts to argue that the proposed $65 million threshold is more consistent with a $3 billion material swaps exposure than with one at $11 billion or €8 billion.

Unfortunately, this line of thinking was conceptually flawed: across portfolios with the same notional amount, initial margin can vary dramatically. A relatively risky portfolio, for example, which is receiving fixed on $8 billion of 30-year interest rate swaps, would have a calculated margin greater than $50 million. In contrast, a relatively safe $8 billion notional portfolio, which is both receiving and paying fixed on 3-month interest rate swaps, would have a calculated margin less than $50 million.

The conceptual problem of relating notional amount to margin is important as market participants anticipate "Phase Five." As of September, 2020, a very large number of entities with notional amounts between $8 and $750 billion are scheduled to become subject to the uncleared margin rules. And many of these entities are realizing that, while their notional amounts exceed $8 billion, their calculated initial margin amounts are less than $50 million. In other words, they will soon be required to incur the expenses of preparing to exchange initial margin even though they will never actually be required to exchange margin.

This problem is exacerbated by a significant quirk in the rules: physically-settled FX swaps are included in the calculation of notional amount even though they are exempt from initial margin requirements. An entity doing nothing but $8 billion of physically-settled FX, for example, would have to prepare to exchange initial margin even though its entire portfolio is exempt from margin requirements.

Not surprisingly, then, the prospect of futile preparations and costs have spurred requests for regulatory relief.

One form of relief would be to raise the material swap exposure threshold from $8 billion notional to some higher level, say $50 billion. The CFTC's data analysis indicates, however, that this change might raise concerns about risks to the financial system not intended by the current regulatory structure. More specifically, some entities with notional amounts between $8 and $50 billion would drop out of scope despite having calculated initial margin amounts greater than $50 million.

A different form of relief, however, does not have this drawback: issuance of clarificatory guidance that entities need not have in place systems and documentation to exchange initial margin if their calculated bilateral initial margin requirements are less than $50 million.

This solution has many favorable characteristics:

1. Entities that have calculated margin greater than $50 million and swap notional amounts greater than $8 billion still will be required, as under the current rules, to have in place systems and documentation to exchange margin.

2. Entities with notional amounts greater than $8 billion but calculated margin less than $50 million—which currently do not have to exchange margin—will be spared the expense of preparing to exchange margin.[7]

3. Entities with notional amounts less than $8 billion will, as under current rules, have a simple and transparent means of demonstrating that they are out of scope.

4. Physically-settled FX swaps are exempt from initial margin requirements and, therefore, are excluded when calculating margin. Hence, entities with calculated margin less than $50 million from positions in other products will not be pushed into having to prepare for margin exchange simply because they have positions in physically-settled FX products.

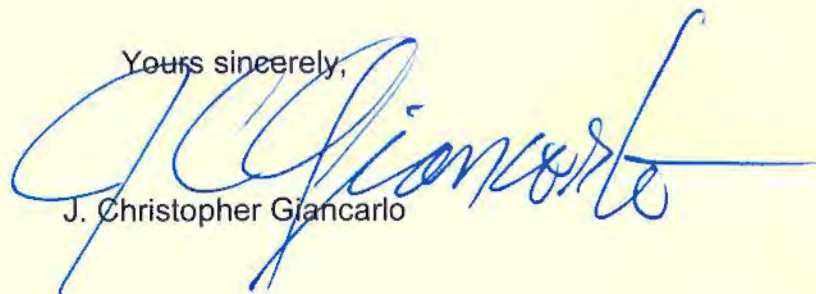
5. This solution is consistent with the recent BCBS/IOSCO statement of policy.[8] In fact, this proposal calls for incorporating that statement into global principles.

For these reasons, I recommend making the relatively modest adjustment of clarifying that an entity need not have in place systems and documentation to exchange initial margin on uncleared swaps with a given counterparty if the calculated bilateral initial margin amount with that counterparty is less than $50 million.

I hope you find this recommendation salutary. I look forward to discussing it with you further.

I copy our colleagues at the FCA, the Bank of England and ESMA. Due to the significant public interest in this matter, the CFTC will post a copy of this letter on its website.

Yours sincerely,



J. Christopher Giancarlo

Cc: Jon Cunliffe, Bank of England
Andrew Bailey, FCA
Stephen Maijoor, ESMA
Heath Tarbert, U.S. Treasury

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[7] Note that under both current rules and the proposed change, an entity does not have to post initial margin on uncleared swaps if it has divided its trades across several counterparties such that no relationship has calculated bilateral initial margin greater than $50 million.

[8] *Id.*, BCBS/IOSCO Statement.

References

Department of the Treasury, Office of the Comptroller of the Currency, Board of Governors of The Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, Federal Housing Finance Agency, "Margin and Capital Requirements for Covered Swap Entities," Proposed Rule, *Federal Register* 79(185), September 24, 2014, pp. 57348-57400.

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Haynes, R., Lau, M., and Tuckman, B. (2018), "Initial Margin Phase 5," Office of the Chief Economist, Commodity Futures Trading Commission, October 24.