

November 26, 2012

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Currency
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Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance
Corporation
550 17th Street, NW
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Re: Margin and Capital Requirements for Covered Swap Entities

Ladies and Gentlemen:

Markit¹ is pleased to submit the following comments to the Office of the Comptroller of the Currency (the "**OCC**"), the Board of Governors of the Federal Reserve System (the "**Board of Governors**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Farm Credit Administration, (the "**FCA**"), and the Federal Housing Finance Agency (the "**FHFA**" and, together with the other agencies, the "**Agencies**") in response to their re-opened Proposed Rule regarding *Margin Requirements for Covered Swap Entities* (the "**Proposed Rule**").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 numerous 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 past 18 months we have submitted more than 50 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also 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 mid-market 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. On the topic of margin requirements for uncleared derivatives, we have previously submitted comment letters to the CFTC, BCBS IOSCO and the Agencies.⁴

¹ Markit is a financial information services company with over 2,800 employees in North America, Europe, 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 and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (published May 11, 2011).

³ "Leaders' Statement: The Pittsburgh Summit" (Sept. 24-25, 2009), available [here](#).

⁴ Markit letter to the CFTC regarding the proposed rule "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (September 14, 2012) available [here](#); Markit letter to BCBS IOSCO on Margin requirements for non-centrally-cleared derivatives (September 28, 2012) available [here](#); Markit letter to the Agencies regarding the proposed rule "Margin and Capital

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, banks (including those that have received or are expecting to receive IMM approval) with the calculation of their regulatory capital requirements, including measures such as PFE, IMM EAD, IRC, CRM, and the CVA Capital VaR charge.⁵ Based on our expertise in these areas we have been approached by numerous buy-side and sell-side institutions to help them address upcoming challenges related to the calculation of initial margin (“*IM*”) and variation margin (“*VM*”) for their cleared and uncleared derivatives transactions.

We welcome the Agencies’ decision to re-open the comment period for the Proposed Rule in light of the publication of BCBS IOSCO’s Consultative Document on *Margin requirements for non-centrally cleared derivatives*⁶ and we appreciate the opportunity to provide you with our comments. We believe that mandatory margining for non-cleared swaps and non-cleared security-based swaps (together “*uncleared swaps*”) could significantly impact the functioning of financial markets and potentially the stability of the financial system due to the resulting operational challenges and demands on liquidity and collateral. Our recommendations therefore 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 margin requirements.⁷ Specifically, we believe that the Agencies should design their 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 an uncleared swap 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 and grid-based approach to IM calculation on a sufficiently granular level; (4) clarifies the frequency with which IM and VM calculations and collection will be required; and (5) permits the use of effective procedures that facilitate agreement on VM amounts.

Furthermore, we believe that, in general, the Agencies should seek to strike an appropriate balance for the margin requirements applicable to cleared and uncleared swaps (whether they be uncleared because of their customized nature or due to the end-user exception). Cleared and uncleared swaps both serve their purposes, and we believe that margin rules should leave sufficient room for appropriate contractual arrangements to take place between the parties.

Comments

1. In Addition to Internal Models, the Agencies Should Approve IM Models Developed and Supported by Third Parties in a Manner that Facilitates their Broader Use

The Proposed Rule allows Covered Swap Entities⁸ (“*CSEs*”) to choose between using an Internal Margin Model that meets several enumerated requirements and has been approved by one of the Agencies and a “standardized look up table” for their IM calculation.⁹ Similarly, BCBS IOSCO offered parties the choice between using a Quantitative Portfolio Margin Model (“*QPMM*” or “*model-based approach*”) or a Standardized

Requirements for Covered Swap Entities” (July 11, 2011) (hereinafter the “*Prior Markit Comment Letter*”), available [here](#). We are also considering filing a comment letter with the SEC regarding its proposed rule on margin requirements.

⁵ CVA = Counterparty Value Adjustment, PFE = Potential Future Exposure, IMM EAD = Internal Model Method Exposure At Default, IRC = Incremental Risk Charge, and CRM = Comprehensive Risk Measure.

⁶ Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Margin requirements for non-centrally-cleared derivatives (July 2012) (hereinafter the “*BCBS IOSCO Consultative Document*”), available [here](#).

⁷ We do not express any views herein on many of the more fundamental elements of the IM/VM regime, such as the categories of counterparties that should be required to collect or post margin or whether and how thresholds should be used.

⁸ CSEs are swap entities subject to regulation by the Agencies.

⁹ See Proposed Rule, 76 Fed. Reg. at 27590.

Initial Margin Schedule (a “**grid-based approach**”).¹⁰ The model-based approach would apply a set formula to each swap or portfolio of swaps while the grid-based approach would 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, and believe that several problems could arise if most counterparties had no choice but to use a standardized lookup table. This is because an IM requirement that is solely based on the asset class, maturity, and notional amount is unlikely to accurately reflect the risk of such swaps. It will therefore likely result in inaccurate IM amounts that will be too great for some uncleared swaps, thereby locking up the limited supply of collateral that could be used more productively, or too small, thereby not sufficiently mitigating risk. Further, since 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 uncleared swaps.¹¹

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.¹² However, it is likely that many market participants will not have the necessary resources to develop and receive approval for their individual IM model, while the resources available to regulatory authorities to approve IM models will probably not suffice to accommodate a wave of requests by individual firms in a timely fashion. As a consequence, it could take a significant amount of time before even the largest and most sophisticated market participants are allowed to use a QPMM for their IM calculations, while many other market participants 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 many market participants at a competitive disadvantage. This is because those parties that must rely on grid-based calculations will have to collect significantly higher IM amounts from their counterparties vis-à-vis their competitors that received approval to use model-based calculations.

Importantly, in contrast to the calculation of capital requirements, the calculation of IM for an uncleared swap is a transaction-based calculation that requires limited firm-specific input or judgment. We therefore believe that the Agencies 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 the relevant regulatory authority has provided approval for use of this model to one firm.¹³ Such approach would offer the following significant benefits:

- A larger number of counterparties, both buy-side and sell-side, 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 uncleared swap 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.

¹⁰ See BCBS IOSCO Consultative Paper, Element 3: Baseline minimum amounts and methodologies for initial and variation margin.

¹¹ On the other hand, we generally believe that using DCO models for the IM calculation for uncleared swaps is inappropriate because DCO models are unlikely to accurately reflect the risks associated with uncleared swaps. See Prior Market Comment letter, page 2 (“While DCOs may be well suited to provide valuations and IM for the more liquid and standardized swaps, we believe that it is not appropriate to apply a DCO IM model to swaps that are not cleared by DCOs.”).

¹² BCBS IOSCO would also require each individual firm to receive approval from its regulator before using a QPMM.

¹³ An initial application to the Agencies could be made by one or by several regulated firms that wanted to use the inputs, scenarios and methodologies as provided by a specific third party. If necessary, approval of the external model for broader use could be given by the Agencies only if individual firms comply with certain requirements such as having an appropriate risk management framework in place and understanding the inputs and methodologies that are used by the third party provider. In case that the Agencies believe that an approval of third-party provided IM models for broader use was not acceptable, at the very least they should consider allowing those firms that have received approval for the use of external IM models to perform IM calculations on that basis not only for themselves but also for their counterparties (if those counterparties so desire) because this would pre-empt disputes on IM amounts.

- It would avoid creating an unlevel playing field between larger and smaller CSEs that are competing for business in the marketplace. This is because not all CSEs will have sufficient resources to develop and receive approval for their own internal models and they would be forced to use the (disadvantageous) grid-based approach if the Agencies were not to allow a broader use of approved models.
- It would significantly reduce the overall time and resources needed by the Agencies to approve such models. It would therefore speed up the implementation of the new margin regime while also reducing the demands on the scarce resources of the Agencies. 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 inputs, models and methodologies for IM models provided by qualified third parties to emerge. Given the expertise and insights that regulatory authorities, including the Agencies, 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. Further, the emergence of some standardized approaches to the calculation of IM for categories of uncleared swaps will be beneficial in preparing them to be centrally cleared.

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 further 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 risk-based IM models (such as Markit or other, competing providers) can provide the Agencies 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, timeliness, and independence of the IM calculations while also allowing for an effective and efficient implementation. We are open to discussing these issues with the Agencies 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.¹⁴

2. The Agencies 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, counterparties will individually be responsible for calculating the respective IM amounts that they would collect from their counterparties. Many market participants are concerned not only about the operational challenges and significant cost that this approach would create, but also about the lack of predictability of IM amounts and the numerous disputes that are likely to arise between the counterparties on that basis. Importantly from the perspective of the Agencies, disputes about IM will also reduce the timeliness of IM collection, thereby creating systemic risk. The Agencies should note that this problem will not be adequately addressed by policies and procedures for dispute resolution and portfolio reconciliation that firms might establish because these procedures will only address a dispute once it has already arisen. Further, they would not in any way provide counterparties with an increased predictability of the IM amount that they are expected to post.

¹⁴ 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 BCBS IOSCO Consultative Paper at 23.

Our discussions with major buy-side and sell-side firms have shown that an effective way to avoid disputes about IM would be for counterparties to agree *pre-execution* on the use of a third party (such as Markit or one of the various competing providers) for the calculation of their respective IM amounts,¹⁵ 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 approaches would result in IM amounts that are predictable for the counterparties, significantly reduce the potential for disputes and improve the functioning of the global marketplace for collateral. Also, because such IM calculations would be based on independent third party data, scenarios and methods, they would provide independence and transparency to both counterparties while avoiding over-reliance on internal models and input data of the firms. We note that both the FHFA and FCA have considered explicitly permitting their regulated entities to delegate the IM calculation to independent third parties¹⁷ and we urge the other Agencies to also embrace this approach.

We believe that the use of an agreed upon third party as calculation agent or as provider of inputs and calculation methodologies for IM between certain counterparties will be most appropriate for the more standardized uncleared swaps.¹⁸ In contrast, counterparties might not want to rely on the use of a third party to determine their IM amounts for the more complex and less actively traded products. To provide counterparties with the necessary flexibility to establish efficient means of IM calculation, the Agencies should therefore 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 choosing to use “regular” QPMM (*i.e.*, a model-based IM calculation by the individual firms) or a grid-based approach for others.

We believe that the Agencies, as well as other regulatory authorities, could most effectively approve the use of a third party provided IM model based on a joint application from the firms that want to make use of such approach. Ideally, given the international nature of the derivatives markets, the approval process would be conducted jointly by the relevant regulatory authorities and a model approval would therefore apply across jurisdictions. Any third party that offers these services should provide the Agencies and other relevant regulatory authorities with sufficient transparency about its models, inputs, governance, and procedures as explained in more detail above.

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

BCBS IOSCO’s Consultative Document permits counterparties to choose between the use of a model-based and a grid-based approach for their IM calculation, but does not allow parties to “switch between model- and schedule-based margin calculations in an effort to ‘cherry pick’ the most favorable IM terms.”¹⁹ 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.”²⁰ In contrast, the Agencies’ Proposed Rule seems to provide parties with more flexibility when

¹⁵ 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.

¹⁶ Our experience has shown that the individual situation and preferences of the parties determine their preference for a “hosted” (where the actual calculation is performed by the third party) or a “deployed” solution (where the third party only provides “standardized” inputs, analytics and software to the counterparties that will perform the actual IM calculation themselves). Market practice today allows for banks to get approval for capital models provided by a third party and some approvals have been given to different banks that use the same model. We therefore believe that regulatory authorities should not only approve third-party models that are used internally, like for capital model purposes, but also extend approval to third-party IM models that are hosted by the third party.

¹⁷ See Proposed Rule, 76 Fed. Reg. at 27595, 27596.

¹⁸ We note that, similarly, CCPs routinely deliver scenario files to their clearing members on a daily basis to enable them to reproduce their IM calculations.

¹⁹ See BCBS IOSCO Consultative Paper, page 19.

²⁰ *Id.*

they decide whether to use a model- or a grid-based IM calculation.²¹ We urge the Agencies to maintain this flexibility rather than following the BCBS IOSCO approach for the reasons below.

Given the multitude of financial products 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 BCBS IOSCO approach might therefore 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 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 classes²² or at least make use of an exemption within the asset class.

We believe that this would better reflect market realities 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 allow the Agencies to require the use of more conservative grid-based models for those products that, in their opinion, cannot be reliably modelled.

4. The Agencies Should Clarify the Frequency with which IM Calculation and Collection are Required

The BCBS IOSCO Consultative Document 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.”²³ 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.”²⁴ In contrast, the Proposed Rule states that CSEs must review, and, “as necessary”, revise the data used to calibrate the initial margin model “at least monthly” and “more frequently as market conditions warrant.”²⁵

We agree that the addition or removal of swap transactions to a portfolio of existing transactions will lead to changes in the overall IM amount. However, the overall IM amount for the portfolio can also change even if no transactions are added or removed if, for example, existing transactions mature or significant market moves occur. We therefore encourage the Agencies 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-calculations for an existing portfolio of transactions have 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 the Agencies should allow for a minimum transfer amount for the actual IM payments as it proposed²⁶ to avoid creating an unnecessary operational burden.

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

BCBS IOSCO proposed that counterparties would have to establish dispute resolution procedures to achieve agreement on valuations of their uncleared derivatives transactions as a basis for the collection of VM. We

²¹ See Proposed Rule, 76 Fed. Reg. at 27567 (“With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A CSE may calculate its initial margin requirements using a lookup table...[or] using an initial margin model that meets certain criteria and that has been approved by the relevant prudential regulator”).

²² For example, we believe that the Agencies should allow a counterparty to use a model-based approach in the asset class of interest rates/FX, while it would choose to apply the grid-based approach for all option-based products in this asset class.

²³ See BCBS IOSCO Consultative Paper, Element 3.

²⁴ See *id.*

²⁵ See Proposed Rule 76 Fed. Reg. at 27591.

²⁶ See *id.* at 27575 (proposing the use of a USD 100,000 minimum transfer amount “to reduce transaction cost”).

agree that the existence of such dispute resolution procedures would be useful to ensure the timely agreement and collection of VM. To ensure they can be achieved in a cost effective and timely manner, we believe that counterparties should be explicitly allowed to reference valuations or arbitration procedures performed by independent third parties as they provide an efficient means for resolving valuation disputes. This is because third parties: (i) do not have any positions and therefore 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.

We note that the Agencies proposed requiring CSEs to execute trading documentation that specifies the methods, procedures, rules, and inputs for valuing swaps for the purpose of calculating variation margin requirements; as well as dispute resolution procedures concerning the valuation of swaps or assets collected as collateral for the same purpose.²⁷ As we have explained in other comment letters, we believe that these requirements would be less onerous on market participants if the Agencies allow counterparties to delegate these responsibilities to independent third party providers for VM calculation purposes.²⁸

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Markit appreciates the opportunity to comment on the Agencies' Proposed Rule: *Margin Requirements for Covered Swap Entities*. 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.

cc: Peter Y. Malyshev, Latham & Watkins LLP

²⁷ See *id.* at 27589.

²⁸ See for example, Markit letter to the CFTC regarding the proposed Rule "Swap Trading Relationship Documentation for Swaps Dealers and Major Swap Participants" (April 11, 2011), available [here](#).