

ICI VIEWPOINTS

JULY 22, 2011

ICI Recommends Fixes to Margin Proposals for Uncleared Swaps

By Heather Traeger

Proposals on margin requirements for uncleared swaps could create regulatory gaps that would work against the goal of ensuring fair and orderly swap markets, ICI said in recent [comment letters](#). We recommended changes to the proposals, which come from both banking regulators and the Commodity Futures Trading Commission (CFTC).

By way of background, a swap is a customized financial contract between two parties to exchange one asset or liability for another at a given point in the future. Consistent with their investment objectives, mutual funds use swaps (and other derivatives) to help manage their portfolios.

Swap transactions can either be conducted through clearinghouses or directly between two parties, with the latter known as “uncleared swaps.” For either type of transaction, parties must post collateral known as “margin.”

The proposals, issued under the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#), contemplate a risk-based approach to uncleared swaps margin requirements for swap dealers and other entities that are not banks. As the [proposal from the CFTC](#) notes:

Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure.

We agree, and we think regulators could improve the design of these proposals with several changes, notably the following:

- **Categorize funds as “low-risk financial end users”:** The proposals would categorize swap counterparties into four groups each with their own margin requirements: swap entities; high-risk financial end users; low-risk financial end users; and nonfinancial end users (or commercial end users). We recommend that funds be categorized as low-risk financial end users to reflect the fact that funds are highly regulated, financially sound counterparties.
- **Require “two-way margin”:** The proposals could open a regulatory gap in that they would not require swap dealers and other entities to post margin when their counterparties must do so. To better protect the swap markets and its participants, ICI recommends that the regulators require “two-way margin.” In other words, all counterparties to a swap transaction must post margin at the same level and in the same manner as required for the counterparty.
- **Harmonize regulation:** Given the global nature of the swap markets, the CFTC and banking regulators should pursue consistent and harmonized regulation domestically and internationally. Meaningful inconsistencies between proposals may result in unintended consequences, including fragmentation of markets and regulatory arbitrage. Overlapping or potentially conflicting rules for swap market participants could also produce uncertainty and reduce the confidence of market participants in the swap markets.

Heather L. Traeger is associate counsel for capital markets at ICI.

