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afme Finance for Europe

December 12, 2012

Mr. Stefan Ingves
Governor of Sveriges Riksbank and
Chairman, Basel Committee on Banking Supervision
Basel Committee on Banking Supervision
Bank for International Settlements,
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Mr. Masamichi Kono
Vice Commissioner for International Affairs, JFSA and
Chair of the IOSCO Board
International Organization Of Securities Commissions (IOSCO)
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Spain

Dear Sirs,

BCBS-IOSCO Proposal on Margin Requirements For Non-Centrally-Cleared Derivatives

While we, the undersigned organizations, completely support proposals for a robust Variation Margin (VM) framework, we believe the Initial Margin (IM) component of the WGMR proposals will severely impact liquidity in the vital uncleared OTC derivative markets, and could increase rather than decrease systemic risk. Phasing-in of rules will not alter this outcome.

The development and implementation of a consistent framework for margin requirements for non-centrally-cleared OTC derivatives (or uncleared derivatives) is an important step in the global capital markets. It is likely to have profound implications for a critical segment of the OTC derivative markets and for the thousands of companies, pension funds, asset managers and financial institutions who participate in it. As a result, it is of vital concern to our organizations – the International Swaps and Derivatives Associations (ISDA), the Institute of International Finance (IIF) and the Association for Financial Markets in Europe (AFME)[1] – and to our member firms. In this regard, in addition to the comments already provided by our organizations on this issue, we feel it is important for BCBS and IOSCO to consider the views presented in this letter.

[1] .A description of the undersigned associations is included in the Appendix to this letter.

As industry analysis has demonstrated[2], the proposal issued earlier this year (the Consultative Document) by the BCBS-IOSCO Working Group on Margining Requirements (WGMR) would have significant systemic consequences. The proposed IM framework would significantly impact liquidity in the OTC derivative markets. In so doing, it could harm important sectors of the global economy and potentially threaten, rather than strengthen, the global financial system. Furthermore, an IM regime that responds to market volatility would introduce pro-cyclical stress into the system.

We understand that as part of its review process, BCBS and IOSCO are considering substantial changes to its Consultative Document. In particular, we hope that BCBS and IOSCO have taken on board our grave concerns with regard to the IM framework, which we outline below. We urge BCBS and IOSCO to consult on their revised proposal. We would also suggest that you conduct a Quantitative Impact Study (QIS) amongst industry participants to gauge the impact of your revised proposal. Both steps would ensure a more robust public policy development process that is quite critical for such an important issue.

Given the tight deadline for finalizing your recommendations on this topic, you may wish to proceed with the VM aspects of your original proposal and consult on IM or other aspects of the original proposal which have been substantially amended compared to the Consultative Document.

In your deliberations, you might want to bear in mind that, while the Consultative Document is technically about margin for uncleared OTC derivatives, in reality it is about whether users of derivatives will be able to use non-standardized and non-cleared OTC derivatives to manage and transfer their risks.

The Consultative Document has rightly generated an enormous amount of public and media comment. We believe that several key misperceptions have surfaced that have the potential to impact the policy discussions regarding uncleared OTC derivatives, and that may be leading to a regulatory and margin framework for uncleared derivatives that works against the G-20's original intent. They include:

1. All OTC derivatives can and should be cleared. As the BCBS and IOSCO are aware, the G20 recognized in its Pittsburgh recommendations that only sufficiently liquid and standardized OTC derivatives can be safely cleared. Clearinghouses are the new systemic institutions and need to be carefully managed. Only those products which can be properly risk managed, valued and monitored daily by the clearinghouses, and which can be safely and quickly unwound in the event of a clearing member default, should be considered for clearing. It does not make sense to push transactions into them that do not fit these characteristics. These institutions need to be kept pristine and the product eligibility bar is a very high one – and rightly so. Failure to do so will endanger the clearinghouses, and their otherwise healthy clearing members, and increase rather than decrease systemic risk.

[2] Initial Margin For Non-Centrally Cleared Swaps: Understanding the Systemic Implications, November 2012, available at www.isda.org

2. If an OTC derivative can't be cleared, then perhaps it is too risky, and it should not exist. Measured by notional amount, most derivatives activity can be cleared. Measured by transaction type, most can not be cleared. The list of unclearable OTC derivatives includes many types of transactions that are of enormous social value. For instance, many end users *require* transactions that are not standard in all their economic terms – transactions that are tailored to suit the exact risk management needs of their institution. Further examples of uncleared derivatives include currency swaps that corporations use to enable capital raising in foreign markets; interest rate options that mortgage lenders use; single name CDS that banks and investors use in lending and corporate bond issuance; inflation swaps that pension funds use; and many others, all of which are vital to economic activity and growth. The clearing eligibility of an OTC derivative is not a proxy for its riskiness. Yet to some, the prevailing perception of uncleared derivatives is that they are all complex and risky; to others, uncleared derivatives should either be cleared or those markets should be eliminated. Given the vital importance of the uncleared derivatives markets to the global economy, we do not believe either BCBS or IOSCO supports this view and consequently should work to ensure the final margin regulations do not reflect this thinking or cause this outcome.

3. Market participants can easily find another alternative involving a standardized contract. End-users need to hedge unique and specific risks in order to manage the business risks that they want to take. Risks should be managed by those most willing and most able to manage them. If end-users have to hedge only with standardized derivatives, they would have an improper or imperfect hedge. The resulting financial risk exposures would lead to volatility and/or unmanaged losses in their financial results – with potentially damaging economic consequences, such as less investment and the correlated lower employment and lower contribution to public finances.

4. Cleared OTC derivatives require IM, and we need to ensure a level playing field, so IM should also be required for uncleared OTC derivatives. It appears that a misperception exists because there are IM and VM requirements for cleared swaps, and that as a result the standards for cleared swaps are higher.

We believe the following factors are more important. First, the capital requirement for uncleared OTC derivatives is significantly higher than for cleared OTC derivatives. The higher capital requirement captures the increased counterparty risk when trading with a bilateral partner compared to a clearing house.

With regard to margin, there is currently about $40 billion in IM posted at clearinghouses for over $300 trillion of cleared OTC derivatives. The current proposal for uncleared margin would require upwards of $800bn to $1.7 trillion in IM for $127 trillion in uncleared OTC derivatives. This disproportionate charge is not justified, since capital charges already reflect the risk differential, and will have damaging consequences, including severely impacting liquidity in those important sectors as noted above.

We believe the most effective way to address systemic risk is through:

1. Mandatory clearing of sufficiently liquid and standardized OTC derivatives
2. Robust VM for uncleared OTC derivatives that involves daily valuations and daily collateral exchanges[3]
3. An appropriate capital regime

Adding mandatory IM to this framework could increase rather than decrease systemic risk and harm liquidity in vital markets.

The AIG and Lehman situations demonstrate these principles at work. AIG did not post daily VM from day one and instead faced huge collateral calls when its ratings declined, triggering post-facto VM on a very large scale. This led to its downfall, to widespread fears about systemic contagion and to the government bailout.

Lehman posted VM daily (and did not post IM). It faced no large or sudden increase in collateral requirements. When it collapsed, there was a shock -- but one that was much lesser in magnitude -- there was no contagion in OTC markets and no bailout. The disruptions arising out of the Lehman situation had to do with the long process of resolving its positions and not market disorder as such. Uncleared derivatives positions were closed out immediately under ISDA protocols, and OTC derivatives margin was liquidated immediately (OTC margin was not held up at custodians as in other asset classes). Counterparties did incur losses over and above VM held (losses which would have been mitigated by IM) but those losses were tiny compared to the proposed "remedy" of mandated IM. IM has benefits, but comes at a cost. The benefits must be considered in relation to the costs involved.

5. The problems related to IM requirements can be mitigated through an implementation transition and calibration process. We understand that consideration is being given to phasing in the margin requirements, and appreciate that this represents an effort to mitigate their impact. The reality, however, is that a phase-in approach would not alter the extremely deleterious impact the IM requirements would have on uncleared OTC derivatives. Nor, as we have noted above, would it enable market participants to transition to other alternatives to non-standard, custom-tailored and uncleared OTC derivatives. Such alternatives do not exist.

We are particularly concerned that submitting major financial institutions to two-way segregated IM, even if phased in over time, could result in a withdrawal of market-makers in OTC derivative markets such as interest rate options or cross-currency swaps and could cause a liquidity collapse in these markets. Without the possibility of hedging the risks on the interbank market, market-makers will not necessarily be in a position to respond to end-user needs to hedge their currency or interest rate risks – or if they are, it may be at a very high cost – leaving many non-financial institutions and long-term investors with uncovered risks which could have damaging consequences in the coming years depending on market movements.

[3] While we fully support daily VM for the broader OTC derivative markets generally, deliverable foreign exchange swaps and forwards should be exempt from any *mandatory* margin regime for the reasons previously stated in our September 28, 2012 letter. Special consideration should also be given to 1) non-centrally-cleared derivatives with a structured finance or securitization special purpose vehicle, which are generally capitalized to the extent of their obligations, and do not have an operating business to generate free cash flow, for posting either VM, much less IM and 2) derivatives in certain jurisdictions where special situations, including local laws, govern margining practices

6. If IM for uncleared OTC derivatives is high enough, then market participants will be incentivized to clear more. If a transaction is not clearable, then no amount of IM can cause it to be cleared. If it is clearable, then legal mandates – and not punitive IM -- should drive clearing. If a high level of IM is the tool used to try to incentivize clearing, not only would such a strategy fail, but there would be three potential adverse ramifications. Liquidity will be drastically affected in the uncleared markets, end-users will be forced to use imperfect hedges, and market participants and clearinghouses will be incentivized to introduce products to the clearinghouse that are not suitable for clearing, as noted in point 1 above.

7. Segregated IM for uncleared OTC derivatives is a clean elimination of risk. Banks and other entities which will be required to post IM will need to borrow cash or securities to fund the IM requirement. In the case of cash, this will create additional exposure on the books of investors to the financial sector. In the case of securities, this will create additional exposures on the books of securities lenders. In addition, when cash IM is held at a third-party bank, a new risk is created to the third-party bank. Rather than eliminating exposures within the financial system, and reducing systemic risk, significant elements of this risk are merely transferred around the system, ending up in forms and locations where risks are less transparent and harder to measure.

In summary, we strongly support the efforts to build safe, efficient OTC derivative markets and appreciate the work of the BCBS and IOSCO in harmonizing global margin standards. We hope that you will consider our request to ensure the final recommendations provide a suitable basis for implementation by the relevant national authorities.

We would be happy to discuss further or answer any questions you may have on this topic.

Sincerely,

Robert G. Pickel Chief Executive Officer ISDA	Kevin Nixon Deputy Managing Director IIF	Simon Lewis Chief Executive AFME

Cc: Members of the Basel Committee on Banking Supervision
Mr. Wayne Byres, Secretary General, Basel Committee on Banking Supervision

Members of the IOSCO Board
Mr. David Wright, Secretary General, IOSCO

Appendix

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivative markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 840 member institutions from 59 countries on six continents. These members include a broad range of OTC derivative markets participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Institute of International Finance, Inc. (IIF) is a global association created in 1983 in response to the international debt crisis. The IIF has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability. Members include the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the IIF's Associate members are multinational corporations, consultancies and law firms, trading companies, export credit agencies, and multilateral agencies. All of the major markets are represented and participation from the leading financial institutions in emerging market countries is also increasing steadily. Today the IIF has more than 450 members headquartered in more than 70 countries.

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME advocates stable, competitive, sustainable European financial markets that support economic growth and benefit society AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available at: www.afme.eu.