ISDA | Safe, Efficient Markets

January 23, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number S7-08-12; RIN 3235-AL12

Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers – Comments on Margin Requirements

Ladies and Gentlemen,

The International Swaps and Derivatives Association[1] ("**ISDA**") appreciates this opportunity to provide comments to the Securities and Exchange Commission (the "**SEC**" or "**Commission**") regarding the recently released proposed rule concerning capital, margin and segregation requirements for non-cleared security-based swaps and the implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

This letter comments on the proposed margin requirements.

Executive Summary

The following is a brief summary of some of our key points:

I. Initial Margin ("**IM**")

A. Negative consequences of IM. Imposition of an IM requirement will severely curtail the use of uncleared swaps for hedging, which would disrupt key financial services, such as those that facilitate wider availability of home loans and corporate finance. Further, the IM proposals will have detrimental pro-cyclical effects because they will increase collateral demands in times of market stress.

B. Proposed alternative. In lieu of IM, systemic risk can be effectively mitigated by: imposing variation margin ("**VM**") requirements with daily collection (subject to

[1] ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

limited exceptions) and zero thresholds; implementation of appropriate capital requirements, and mandatory clearing of liquid standardized security-based swaps ("**SBS**").

C. Quantitative Impact Study ("**QIS**"). Before finalizing its margin rules, if the SEC determines that IM is necessary, it should conduct a QIS to determine the effect of imposing IM requirements.

II. Process

A. Consistency. Because the SEC is one of the leading global regulators, the SEC's margin rules should be coordinated and consistent with those of other regulators, domestic and foreign. In particular, the SEC should ensure that margin rules for SBS are compatible with rules issued by the Commodity Futures Trading Commission (the "**CFTC**") for swaps. Because of the interplay between the swap and SBS markets, certain entities will be registered as both a securities-based swap dealer ("**SBSD**") and swap dealer ("**SD**") and inconsistent margin rules will be extremely difficult to implement and will create an unlevel playing field.

B. International coordination. The SEC and other U.S. regulators should continue their efforts to coordinate the development of margin rules on a global basis. U.S. regulators should not establish margin requirements in advance of positions being taken by regulators in other jurisdictions. The SEC should re-propose its rules on margin after it has had the opportunity to review and consider the final findings of the BCBS/IOSCO Working Group on Margining Requirements[2] ("**WGMR**").

C. Phase-In/Clearing. When the rules first become effective, proprietary models used by SBSDs (that are eligible to use models) should be deemed provisionally approved for calculation of IM. SBSDs should not be required to use the standardized approach until final approval is granted. Compliance with the margin requirements should be phased-in over time. The effective date for margin requirements for a given asset class should follow the implementation of mandatory clearing for that asset class.

III. Scope

A. End-Users. We support the exclusion of commercial end-users from margin requirements.

B. SPVs and government entities. We recommend that special purpose vehicles ("**SPVs**") and state and municipal government entities be excluded from the margin requirements.

[2] The Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") formed the Working Group on Margining Requirements ("**WGMR**") to propose rules covering margin for uncleared swaps. WGMR also commissioned a Quantitative Impact Study ("**QIS**") on the impact of such proposals.

C. Inter-affiliate trades. Inter-affiliate trades should be excluded from margin requirements. SBS between affiliates do not add systemic risk. Such trades are used to internally allocate risk and encourage centralized risk management. Imposition of margin requirements on inter-affiliate trades would add cost and inefficiency to internal risk management.

D. Legacy SBS. We ask that the SEC correct the rule to make it clear that SBS entered into prior to the rules' effective date ("**legacy SBS**") are exempt from VM requirements (as well as IM requirements).

IV. Margin Calculation –

A. IM – Model. We strongly recommend that the collection of IM not be required. While the Dodd-Frank Act provides for IM requirements for SBSDs, the SEC has latitude in how it addresses that reference to IM and should consider the severe negative consequences of the proposed IM requirements. If the SEC finds it necessary to require the collection of IM, we prefer Alternative A to Alternative B, because Alternative A provides that SBSDs are not required to collect IM from SBSD counterparties. As noted above, IM has negative consequences and systemic risk could more effectively be addressed by other means. Further, if IM is required, it should be collected on a static basis, the amounts should be low and the thresholds should be allowed as determined by the SBSDs.

B. IM – Model – Equity. We oppose the proposed bar on using a model to calculate IM for equity SBS and urge the SEC to allow a model to be used for all SBS product types, subject to approval. IM models approved by other regulators, domestic and foreign, should be permitted.

C. IM – Standardized approach. The proposed standardized approach would result in excessive IM requirements. Based on our review of aggregated QIS data from eight leading banks (which represent 45-50% of the total notional amount of the swap market), ISDA estimates that the amount of IM required using the standardized approach as proposed by the SEC would be over $7.6 trillion under Alternative B and $2.5 trillion under Alternative A, over 5 to 6 times that required if an IM model were used instead.[3] Please refer to the copy of ISDA's comments to the Prudential Regulators' proposed margin rules, dated November 26, 2012, in Appendix I which sets out the basis for these estimates in more detail. The standardized approach used to calculate margin should be updated and consistent with those established by other regulators. In particular, the Theoretical

[3] These estimates assume that IM requirements will be consistent and similar across jurisdictions and applicable to all swap products. The analyses contained in this presentation were derived from member QIS responses that were developed prior to the issuance of the exemption for foreign exchange ("**FX**") forwards and swaps by the U.S. Treasury on November 16, 2012. We estimate the Treasury exemption would reduce IM requirements under the U.S. Prudential Regulators' proposals by 15% to 20%. If FX forwards and swaps are excluded globally as per the U.S. Treasury exemption, we estimate that adjustments of a similar magnitude would need to be made to the estimated IM requirements under the proposal published by the WGMR.

Intermarket Margining System ("**TIMS**"), which will be used for equity SBS as a result of the standardized approach, is inadequate and inefficient for proper IM calculation and effective portfolio margining. We urge the SEC to update and enhance TIMS to incorporate factors such as volatility shocks and concentration risk and accommodate portfolio margining on a broader basis.

D. Cross-margining and netting. While we support the SEC's proposal to allow cross-margining between certain equity positions and to allow netting if a model is used, the SEC should permit all cross-margining and netting that is legally enforceable. In particular, even if the standardized approach is used, the SEC should allow netting across product types (including swaps and SBS).

E. Eligible collateral. We agree with the SEC's flexible approach towards eligible collateral. Applicable haircuts should be determined by the SBSDs.

V. Segregation

A. Choices. We agree with providing counterparties with the option to choose between full segregation, omnibus segregation and no segregation. In particular we support the SEC's proposal that omnibus segregation be available (i.e., that margin be held in a separate account under the control of the SBSD). However, there should not be a capital charge on collateral held with a third party custodian.

B. Use of IM for hedging. We support the SEC's proposal to allow an SBSD to use IM posted by its counterparties for hedging transactions, but the SEC should broaden the scope of permissible hedging transactions.

VI. Cross-Border Trades – The SEC's forthcoming rulemaking on the treatment of cross-border SBS should specifically address the treatment of margin and provide for recognition of sufficiency of host country regulations.

Discussion

I. Initial Margin ("IM")

A. As proposed, the IM requirement will severely challenge the resiliency of the financial system and will severely curtail the use of uncleared swaps for hedging.

For purposes of this letter, we use the terms "initial margin" and "IM" to refer to the margin required to cover the potential future exposure to the counterparty.[4] Similarly, we use the terms "variation margin" and "VM" to refer to the margin required to cover current exposure to the counterparty.

Based on its review of aggregated QIS data from eight leading banks (which represent 45-50% of the total notional amount of the swap market), ISDA has estimated the potential impact of IM

[4] These terms also refer to the margin amounts mentioned in §240.18-3(c)(1)(ii)(B) and calculated per §240.18-3(d) of the proposed rules.

requirements (as described in more detail in our comments to the Prudential Regulators' margin proposal, attached as Appendix I). The SEC and other U.S. and foreign regulators are working in coordination to develop margin rules that will be consistent. Therefore, to gauge the potential global impact of IM requirements we assume that these requirements will be similar across jurisdictions and products, and that the QIS data can be used to estimate the potential impact. Assuming the use of standardized schedules (as opposed to models), zero thresholds and estimated notional of unclearable derivatives, the IM requirements for universal 2-way posting (as proposed in the study published by the WGMR)[5] would be $10.2 trillion, and for dealer collection only, as proposed by the SEC, $7.6 trillion.[6] Even assuming that IM models are used for all derivatives, the amount of IM required in non-stressed markets is exceptionally burdensome. Based on the data we have obtained, and assuming the use of models, zero thresholds and estimated notional of unclearable derivatives, the IM requirements would be $1.7 trillion for universal 2-way posting and $1.2 trillion for dealer collection only. If regulators allow thresholds, and assuming the full use of models, this estimate could fall to $800 billion for universal 2-way posting; the SEC's proposal does not provide for thresholds. However, the SEC's proposal does provide for Alternative A, under which dealers would not be required to collect margin from other dealers. Under this framework, we estimate that total IM requirements would drop to $2.5 trillion, assuming the full use of the standardized approach, and $500 billion, assuming full use of models.[7] These estimates address a range of IM requirements. The actual IM required should fall within the range, as IM will be calculated using both the standardized schedule and IM models.

Our review of the data establishes two fundamental concerns: first, without widespread use of IM models, dealers and their counterparties could not fund the IM requirements as proposed; second, if IM models are used, the IM requirements would increase systemic risk because additional IM would be required at times of stress.

Turning to each of these points in more detail: first, as described above, without IM models, the amounts of required IM ($7.6 trillion) would vastly exceed the amount that the market could post. Second, if IM models are used as proposed, increased amounts of IM would be required as volatility increases, which would pose severe systemic risks. In its study on collateral requirements, the Bank for International Settlements ("**BIS**") calculated that, for cleared over-the-counter ("**OTC**") interest rate swap portfolios of the fourteen major derivatives dealers, IM requirements under high market volatility would be about three (3) times the IM requirements in low market volatility.[8] For credit default swaps, the IM requirement in a high volatility environment is ten (10) times higher than in a low volatility environment.[9] If the same ratios held true in the uncleared sector, proposed IM models would make market participants subject to

[5] See Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions consultative document on "Margin requirements for non-centrally cleared derivatives" dated July 2012 (the "**WGMR Study**"),

[6] See footnote 2 above and **Appendix II** attached.

[7] See footnote 2 above and **Appendix II** attached.

[8] See BIS Working Papers No 373, *Collateral requirements for mandatory central clearing of over-the-counter derivatives*, March 2012, p. 20.; available at http://www.bis.org/publ/work373.pdf

[9] Ibid.

increased collateral demands at the very times that collateral becomes most expensive. Dealers would be subject to a liquidity call when their ability to obtain funding would be constrained by market stresses. Asset managers, who generally hold low cash balances, will have to sell assets to meet collateral demands, placing downward pressure on asset prices and further exacerbating stresses in the market. Thus, there is a significant potential that a downward economic spiral could be triggered or worsened by the IM requirements.

Constraint on Uncleared SBS Market. In addition to the systemic risks posed by model-based IM, the IM proposal would also severely impact liquidity in the uncleared SBS market and make uncleared SBS significantly more expensive because of the costs of IM. These costs include not only the costs of the actual IM itself, but also the operational burdens of complex daily posting and reconciliation of IM. While we support the development of clearing for liquid, standardized SBS, we believe that severely constraining the uncleared SBS market would have serious negative economic consequences. The IM requirements would be particularly harmful to SBS that are inherently unclearable but are critical for risk management.

OTC markets are critical to the functioning of the global economy. They promote economic growth through a better allocation of risk and resources throughout the economy, effectively reducing overall systemic risk, by enabling participants to hedge (and thus reduce) a vast array of economic risks. For example, certain single name credit default swaps ("**CDS**") cannot be cleared. Such SBS are heavily used by lenders to hedge loans and by investors to manage the risk of corporate bond holdings. If the use of single name CDS is hindered, it would restrict the ability of banks to make loans and it would hinder the issuance of corporate bonds. Another example of uncleared SBS that are critical for financial markets arises because U.S. investors are constrained from direct investment in certain non-U.S. equity markets (due to exchange controls and other restrictions), but are able to obtain exposure to those markets and diversify their investment exposure via equity SBS. It is unlikely that such SBS on non-U.S. equities will be clearable by a U.S. clearinghouse. Investors also use custom SBS tailored to match their investment or risk-management needs (e.g. Asian-tail expiry, knock-out barrier, dividend protection, etc.). Such bespoke SBS will not be clearable; imposition of IM requirements on such SBS will increase investors' cost of risk management and discourage hedging and diversification. In addition, banks, insurance companies and other institutions regularly issue equity-linked debt to their customers and hedge the equity risk using SBS. The terms of the SBS are matched to the debt issuance so are also too specific for clearing. The addition of IM requirements would effectively add to the funding cost for the issuing entity and either dampen issuance or reduce hedging or both, thereby reducing market liquidity and/or increasing systemic risk. These are just some examples of unclearable SBS that are critical to key sectors of the global economy that would be harmed by the imposition of IM requirements.

B. Systemic risk can be effectively mitigated by: imposing robust VM requirements, implementation of appropriate capital requirements, and mandatory clearing of liquid standardized SBS.

ISDA believes that in lieu of IM, systemic risk can be effectively mitigated, and the goals of the Dodd-Frank Act achieved, by the following approach: first, impose VM requirements with daily collection and zero thresholds; second, implement appropriate capital requirements, and third, require clearing of liquid standardized SBS.

VM: VM, with daily collection (subject to limited exceptions for illiquid collateral) and zero thresholds, effectively protects against accumulated and unrealized losses in over-the-counter ("**OTC**") derivatives positions. The imposition of VM requirements as suggested here, without IM, would not incur the significant negative consequences as discussed above. In addition, the infrastructure for VM collection is currently in place as many market participants already use the bilateral exchange of VM to mitigate risk. This proposed structure for VM is premised on a margin regime that does not include the collection of IM. If the SEC determines that IM collection is required, we would recommend a different structure for the collection of VM.

Capital: Appropriate capital requirements will protect against the risks that are not covered by IM. Both capital and IM cover potential future exposure. Requiring both IM and capital for the same SBS will result in duplicative and unnecessary costs. Capital rules will require capital for exposures specifically arising from OTC derivatives activity and will apply to all SBS (unlike IM, which does not apply to pre-existing SBS). Implementation of the SEC's proposed capital requirements will result in significant capital requirements for SBSDs. We refer the SEC to a letter to be submitted by the Securities Industry and Financial Markets Association ("**SIFMA**") with comments on the SEC's proposed capital rules. One argument that is sometimes made for IM for uncleared SBS is that IM is required for clearing organizations, but this ignores the fact that a dealer is subject to capital requirements in ways that simply do not apply to clearing organizations.

Mandatory Clearing: Mandatory clearing of liquid standardized SBS will shift a large volume of SBS activity towards centralized clearing, further reducing systemic risk. To the extent that punitive IM levels are motivated by a desire to encourage clearing, it is an ill-conceived and unnecessary measure. Punitive IM will directly harm those critical markets and financial services vital to the real economy such as the housing and corporate financing markets described above. Instead, mandatory clearing requirements can achieve this more effectively for SBS for which clearing is appropriate.

Structuring IM: The Dodd-Frank Act gives the SEC discretion in how the SEC approaches IM. We strongly recommend that if the SEC imposes IM requirements that such requirements be structured so as to minimize the negative consequences described above. Possible steps include the following. First, in order to avoid pro-cyclicality, the amount of IM required should be static, not dynamic. Second, in order to allow uncleared SBS markets to continue, the static level of IM should be low enough to permit realistic pricing of uncleared SBS. Third, collection of IM should only be mandatory for certain types of counterparties. If the SEC deems it necessary to require IM, we prefer proposed Alterative A to Alternative B, because Alternative A provides for no IM requirements for transactions between SBSDs and we estimate that it would reduce total IM requirements from $7.6 trillion to $2.5 trillion, assuming full use of the standardized approach, and from $1.2 trillion to $500 billion, assuming full use of internal models. As discussed above, the imposition of IM requirements has negative consequences and there are better ways available to address systemic risk. With daily collection of VM, appropriate capital requirements and mandatory clearing, there is no need for IM collection between SBSDs. Fourth, SBSDs should be allowed to establish their own IM requirements and relevant thresholds. SBSDs are in the best position to assess the risk of their counterparties and already do so for loans and other extensions of credit. The absence of a requirement that SBSDs collect IM from

all counterparties does not preclude SBSDs from determining on a counterparty by counterparty basis that IM is an appropriate means to mitigate counterparty risk.

C. Before finalizing its margin rules, if the SEC determines that IM is necessary, it should conduct a QIS to determine the effect of imposing IM requirements.

ISDA recommends that if the SEC finds that IM is necessary, it should conduct a QIS to assess the potential impact of IM requirements and different alternatives to IM. Other regulators have conducted a QIS for margin. The examples above are just some approaches that may be considered by the SEC in considering alternatives to the current proposal. ISDA and its members would be happy to assist the SEC in its study and in the effort to identify feasible alternatives and analyze the potential impact to the financial system to determine a safer, affordable margin framework.

II. Process

A. Because the SEC is one of the leading global regulators, the **SEC's margin rules should be coordinated and consistent with the margin requirements of the CFTC and other regulators, domestic and foreign.**

Because of the interplay between the swaps and SBS markets, a number of key market participants will be required to register as both an SBSD and swap dealer ("**SD**") and will be subject to regulation by both the SEC and the CFTC. It is therefore critical that the SEC and CFTC ensure that their rules, including margin, be consistent and manageable so that dually registered market participants may continue to provide needed liquidity to the swap and SBS markets. It is also critical that the rules on segregation of collateral be consistent and harmonized. For example, under the SEC proposal, in the absence of counterparty election, the default for SBS is omnibus account requirements. However, for CFTC-regulated swaps, the only requirement is that the SD offer segregation. As a result, a swap dealer registered with both the CFTC and the SEC may have to enter into separate segregation arrangements with the same counterparty. Further, non-swaps with the same counterparty may be subject to yet a third segregation regime. For dealers dually registered as an SD and SBSD, inconsistent capital, margin and segregation rules would have the unduly harsh result of requiring such dual registrants to develop and maintain at least two, if not more, sets of models, processes, policies and procedures for compliance. Although distinguished for purposes of regulation and oversight, the swap and SBS markets are very similar and complementary so the respective margin and segregation rules should also be comparable.

B. The SEC should re-propose its rules on margin after it has had the opportunity to review and consider the final findings of the WGMR.

The SEC and other U.S. regulators should continue their efforts to coordinate the development and implementation of margin rules on a global basis. U.S. regulators should not establish margin requirements in advance of positions being taken by regulators in other jurisdictions. The Dodd-Frank Act calls for harmonization and consistency of global regulation of swaps and SBS.[10] One of the key principles set forth in the study published by the WGMR on margin is that

[10] Dodd-Frank Act, §752.

"[r]egulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions".[11] As discussed further below, cross-border SBS will not be possible if two jurisdictions impose conflicting margin requirements. Consistency is therefore critical to enable cross-border transactions. As noted in the WGMR Study, "the effectiveness of margin requirements could be undermined if the requirements were not consistent internationally".[12]

The principle of consistency can only be served if the SEC waits to finalize its margin rules until it has had the opportunity to review and consider the final margin policies determined by the WGMR. It is more efficient for the SEC to await finalization of the WGMR policies than to go through the amendment process to remedy inconsistencies and duplicative requirements that may arise after finalization. Pre-adoption review of such relevant policies would also help avoid confusion and disruption in the markets that may result from such inconsistencies or duplication and subsequent amendments. After consideration of the final findings of the WGMR, the SEC should re-propose its rules on margin for review and comment. We have submitted comments on the WGMR Study to the WGMR[13].

In keeping with our request that the SEC review the rules of the other regulators, we ask that where there are inconsistencies between the SEC's requirements and those of the WGMR, the CFTC and the PRs, that the SEC provide guidance on how SBSDs are to address such inconsistencies as a practical matter.

C. Implementation and timing of the SEC's margin rules should be also be coordinated and consistent with those of the CFTC, the PRs and regulators in other jurisdictions.

Inconsistencies in implementation of the margin rules may create opportunities for arbitrage between regimes, which may cause disequilibrium in market pricing and demand. Time differences in compliance puts participants in the jurisdiction with the earlier deadline at risk of loss of competitive position, where lost market share may be unrecoverable. Different treatment of cross-border trades, determined at different times, may create operational and cost inefficiencies for parties that prepare for compliance with one regime and later must adjust to comply with another. We ask the SEC to align implementation of its margin requirements with those of other jurisdictions.

D. The SEC should provide a staged implementation schedule and margin requirements should become effective no earlier than the clearing requirements for the same asset class.

As proposed, the SEC's margin rules will necessitate the development and testing of margin models, risk management systems, technological requirements for interfacing with custodians

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[11] See WGMR Study, p. 4.

[12] See WGMR Study, p. 28.

[13] See ISDA comment letter re: *BCBS/IOSCO Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives*, dated Sept. 28, 2012 ("**ISDA BCBS/IOSCO Margin Letter**"). See also supplemental comments in ISDA's letter to BCBS/IOSCO, dated November 28, 2012.

and the modification and execution of new collateral support arrangements and custodial agreements; all of which will require significant commitment of time and resources. In ISDA's comments to the Prudential Regulators' proposed margin rules (please see Appendix I), we estimated that it would take almost two years and over $94 million, per covered swaps entity, just to establish necessary collateral arrangements to comply with those proposals. We estimate that the time and cost required, per SBSD, to establish necessary collateral arrangements to comply with the SEC's proposed margin rules would be the same, or slightly less if collateral arrangements were being amended or established to comply with the SEC's margin rules at the same time as the Prudential Regulators' margin rules. In addition, risk management systems must be recalibrated and models and output will need to undergo various stages of testing before implementation.

The infrastructure for VM is already in place for many market participants so imposition of VM requirements will not require as much incremental development. However, imposition of IM requirements would require significant development as the systems and processes in place for VM collection are not necessarily applicable or appropriate for use for IM calculation and collection.

Unless a staged compliance schedule is provided, there will be a rush to compete for the limited resources available to accomplish the tasks necessary for compliance in the time allotted. This refers to resources internal to the SBSDs as well as external resources, e.g. at the custodians, the SEC, which are all necessary to achieve full compliance.

Therefore, we urge the SEC to establish a schedule for compliance that provides reasonable implementation time frames for the amount of infrastructure development that will be necessary. As margin requirements are closely intertwined with the clearing requirements, they should be applied in a manner consistent with the development of the clearing market over time. Margin requirements should be imposed on uncleared SBS of a given asset class only after clearing becomes mandatory for SBS of that asset class. Imposing margin requirements on transactions that are uncleared if there is no liquid cleared market for those transactions is unduly punitive.

E. When the rules first become effective, proprietary models used by the SBSDs (that are eligible to use models) should be deemed provisionally approved for calculation of IM, subject to further review by the SEC.

Under the proposal, SBSDs who have not yet been approved to use a model are required to use the standardized approach to calculate IM, which would generate higher IM requirements and cause counterparties to divert their trades to other SBSDs who are able to use a model.[14] ISDA disagrees with the proposed requirement to collect IM, but if IM is required, upon implementation of the margin rules, proprietary models by SBSDs eligible to use models should be automatically deemed provisionally approved for all SBS product types, subject to further review by the SEC. This would reduce operational risk introduced by requiring SBSDs to switch from established models to new models within a short time frame for compliance. Models used or developed by the SBSDs are very sophisticated and have been subject to long-term application and regular testing. Without automatic approval on a provisional basis provided to all SBSDs

[14] See SEC Proposal, 77 FR 70214 at 70261.

while model reviews are being conducted by the SEC, SBSDs whose models are earlier in the queue for review will have an unfair market advantage over those later in the review schedule. Provisional automatic approval would provide the SEC more time to conduct model review. In addition, as described below, the SEC should recognize models approved by other regulators.

III. Scope

A. ISDA supports the exclusion of commercial end-users from margin requirements.

ISDA strongly agrees with the SEC's proposal to exclude commercial end-users from the margin requirements. As noted in the WGMR Study and the SEC proposal, end-users do not pose systemic risk and the imposition of margin requirements on end-users may hinder their ability to hedge their commercial risk.[15] Similarly, the CFTC has exempted end-users from the clearing requirements in order to allow end-users "to continue using non-cleared swaps to hedge risks associated with their underlying business."[16]

B. We recommend that SPVs and state and municipal government entities be excluded from the margin requirements.

With regard to structured finance SPVs and state and municipal governmental entities, we recommend that they be exempted from margin requirements as such entities primarily enter into SBS for risk mitigation purposes and generally are not in a position to post collateral. In addition, SBS with structured finance SPVs generally have provisions that mitigate credit risk, such as: (i) the SBS counterparty has a security interest over all of the SPV's assets; (ii) the SBS counterparty has first priority with regard to cash flow payments; and (iii) SPVs are bankruptcy-remote vehicles.

Sovereigns and central banks are specifically excluded from requirements to collect or post margin in the WGMR Study.[17] Also, the Dodd-Frank Act defines "swaps" (and thereby, SBS) to exclude SBS executed by Federal Reserve banks, the U.S. Federal Government and any Federal agency backed by the full faith and credit of the U.S.[18] Nonetheless, it is ISDA's position that sovereigns and central banks should post margin. In addition, for international comity and to achieve a level playing field for U.S. swap entities, we urge the SEC to provide for global

[15] WGMR Study, p. 9; see SEC Proposal, §240.18a-3.

[16] See CFTC final rule, *End-User Exception to the Clearing Requirement for Swaps*, 77 FR 42559 at 42560.

[17] WGMR Study, p. 9. We expressly support the inclusion of multilateral development banks and other similar organizations and their affiliates in this exemption, including the International Monetary Fund, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency, the African Development Bank, the African Development Fund, the Asian Development Bank, the Inter-American Development Bank, the Bank for Economic Cooperation and Development in the Middle East and North Africa, the Inter-American Investment Corporation, the Council of Europe Development Bank, the Nordic Investment Bank, the Caribbean Development Bank, the European Investment Bank, the European Investment Fund and the Bank for International Settlements, as well as any other similar international organizations and all agencies, affiliates and pension plans of these entities.

[18] CEA §1a(47)(B)(ix) and Dodd-Frank Act §761(a).

consistency in the application of margin requirements for sovereigns and central banks. Unilateral action by a regulator in the U.S. or any other jurisdiction would be damaging to market participants and market liquidity.

C. Uncleared SBS between affiliates should be excluded from the margin requirements.

The SEC's proposed rules do not directly address inter-affiliate trades. We ask that the SEC specifically exclude such trades. The CFTC recently proposed rules to exempt certain inter-affiliate swaps from the clearing requirement.[19] The CFTC "recognizes that there may be advantages for the corporate group and regulators if risk is appropriately managed and controlled on a consolidated basis and at a single affiliate".[20] In that release, the CTFC seeks comments on whether uncleared swaps between affiliates should be subject to margin requirements.[21] Inter-affiliate SBS do not add systemic risk. Losses in the trade that accrue to one affiliate are equally offset by gains to the other affiliate. Such trades are used as a internal risk allocation tool and foster centralized risk management. Imposing margin requirements would increase the cost and decrease the efficiency of using swaps for internal risk management.

The WGMR Study noted that these trades "frequently serve risk management or other purposes that are different from non-centrally-cleared derivative transactions with third parties" and that the imposition of IM requirements on these trades "could tie up substantial liquidity".[22] Hence, the WGMR chose not to impose IM requirements on inter-affiliate trades, instead leaving it to the discretion of national supervisors.[23] The WGMR Study requires the exchange of VM between affiliates but we believe that the imposition of a VM requirement on inter-affiliate trades is unnecessary and undesirable. The fact that VM posting routinely occurs does not mean that it occurs uniformly in all circumstances or that its regulatory imposition would not needlessly increase costs.

D. We ask the SEC to correct the rule to make it clear that legacy SBS are exempt from VM requirements as well as IM.

We ask the SEC to clarify in its final rules that legacy SBS are excluded from VM requirements (as well as IM requirements). The release accompanying the proposed rules states that legacy SBS are exempt from margin requirements for both negative equity/current exposure (VM) and margin amount/potential future exposure (IM).[24] However, the language of proposed rule

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[19] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 .

[20] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 at 50427.

[21] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 at 50430.

[22] See WGMR Study, p. 28.

[23] See WGMR Study, pp. 27-28.

[24] See SEC Proposal 77 FR 70214 at 70269. See text in the first column and footnote 590: both discuss the exception from negative equity (current exposure) and margin amount (for potential future exposure) for legacy SBS. Also, we note that footnote 592 in the release says that the prudential regulators proposed to exclude legacy swaps from IM and not VM. We do not agree with this reading of the prudential regulators' proposed

240.18a-3(c)(1)(iii)(D) exempts legacy SBS for SBSDs from IM requirements but not VM.[25] Specifically, we ask that the SEC correct the language in §240.18a-3(c)(1)(iii)(D) to refer to the requirements of paragraph (c)(1)(ii) instead of (c)(1)(ii)(B). This will mirror the reference in §240.18a-3(c)(2)(iii)(C) for the exemption for legacy swaps from both IM and VM by major security-based swap participants ("**MSBSPs**").

IV. Margin Calculation

A. IM - The collection of IM should not be required, but if IM is required we have the following comments regarding the calculation of IM.

1. IM should be collected on a static, not dynamic, basis, amounts should be low and thresholds allowed.

While the Dodd-Frank Act mentions the imposition of IM requirements on SBSDs and MSBSPs for uncleared SBS, it does not prescribe any specifics as to the nature or scope of the requirements.[26] The SEC therefore has latitude in how it addresses this issue. We urge the SEC to consider the severe negative consequences of the proposed IM requirements as discussed above and not to impose requirements to collect IM. However, if the SEC determines that IM collection is necessary, as discussed in section IB, in order to avoid pro-cyclicality, IM should be collected on a static basis. Also, in order for the OTC markets to remain viable, the amounts of IM collected should be kept low. In addition, thresholds should be allowed for all counterparties and determined by the SBSDs. Thresholds may be used to ease the costs for parties that are active in swaps that are inherently unclearable, thereby mitigating the negative impact of IM requirements as discussed in IA above. Otherwise, in times of stressed markets, the amount of IM required will escalate and increase the stress on market participants.

2. The SEC should clarify that IM models based on methods other than VaR are permitted.

The proposed rules provide that eligible broker-dealer SBSDs and stand-alone SBSDs may use approved models to calculate IM.[27] The rules do not specify that the IM model must use a VaR methodology, but the rules and the release discuss the use and requirements for approval of a VaR model in detail.[28]

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margin rules. Each of the agency-specific rules explicitly provide that the rules apply to "any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after" the date "that is 180 days after publication of the final rule in the Federal Register". See prudential regulators' proposed rule on Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 at 27592 – 27595. The language from the prudential regulators proposed rules cited in footnote 592 at 76 FR 27569 refers to the treatment of legacy swaps under the same master netting agreement as non-legacy swaps. The prudential regulators would allow inclusion of legacy swaps for netting purposes, provided that the swap dealer comply with the VM requirements for all swaps under the agreement, including the legacy swaps.

[25] See SEC Proposal §240.18a-3(c)(1)(iii)(D).

[26] Dodd-Frank Act §764.

[27] See SEC Proposal §240.18a-3(d)(2) .

[28] See SEC Proposal §240.18a-1(d)(9), 77 FR 70214 t 70237 – 40.

The SEC should clarify that an SBSD is allowed to use risk measurement methodologies other than VaR for the calculation of IM. The proposal contemplates VaR models that are risk sensitive and calculate IM on a dynamic basis. As discussed earlier, use of such a VaR model would have pro-cyclical affects in volatile market environments that would magnify the negative pressure on the market. IM requirements would multiply by as much as 3 to 10 times from levels in low volatility markets.

Because all models are subject to regulatory approval, the SEC will have a chance to review any methodology chosen by an SBSD. One example of a commonly-used risk measurement method other than VaR is stressed-based modeling. Stress-based models combine margin requirements associated with multiple risk factors to arrive at an overall portfolio margin number. Another example of a widely used risk measurement method is the measurement of the counterparty's margined exposure profile over the life of the transactions of the counterparty's portfolio. This method measures the potential increase in the value of the portfolio, at a specified confidence level, over a large set of margin periods of risk over the remaining life of the counterparty's portfolio, assuming no additional trades. This approach is used to calculate the counterparty's expected positive exposure profile ("**EPE**"), under the internal model method of Basel II and should be permitted for the calculation of initial margin.

Stress-based modeling and exposure profile methodologies are just two examples of alternative methods that should be permitted for initial margin models. Another alternative would be VaR models that are calibrated to generate static IM levels. Models based on other valid risk methodology that satisfy robust standards should also be permitted. The objective is to allow models that are efficient like VaR-based models (in contrast to standardized approaches which are not efficient) and which do not present the risk of causing pro-cyclical effects in stressed markets. ISDA and its members would be happy to help regulators develop appropriate standards.

3. IM models approved by other regulators, domestic and foreign, should be permitted.

Margin models approved by foreign regulators should be permitted, following the principle of international comity as expressed in Section 752 of the Dodd-Frank Act. Other regulation accepts the use of models approved by other regulators: for example, valuation models approved by foreign regulators are allowed. If there is no deference, and foreign regulators do not agree with the model approved by the SEC or the margin rules in general, then foreign financial institutions would potentially be shut out of the U.S. market, resulting in less liquidity, less competition and greater costs. Foreign governments may respond by requiring U.S. institutions to seek local approval thereby fragmenting the global financial market.

Accordingly, we urge the SEC to liaise with foreign regulators in order to develop an effective harmonized international framework. Diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Close international cooperation between various supervisory bodies including banks, supervisors, systemic risk supervisors and supra-national standard-setters would mitigate these risks.

Also, the rules should recognize models approved by the CFTC or PRs. The financial system will be best served by coordination among regulators. In addition, if the SEC does not recognize models approved by other regulators, a significant burden will be placed on entities that need to obtain approvals from foreign home regulators, the CFTC, the PRs and potentially also the SEC. Entities that are registered as both an SD and SBSD may be required to develop, use and maintain different models for margin for swaps and SBS if the SEC and CFTC do not recognize models approved by the other regulator. In addition to imposing an operational burden on such entities, it may hinder the ability to net exposures across swap products.

4. Use of IM models should be permitted for all SBS product types, including equity SBS.

The proposed rules specifically provide that for equity SBS, an internal model may not be used to calculate IM and only the standardized approach may be used. We disagree with this proposal and strongly recommend that the SEC permit the use of an approved internal model to calculate IM for equity SBS. SBSDs should be permitted to choose the calculation method for equity SBS that is most appropriate for the SBSD's situation. In the commentary to the proposed rules, the SEC explains that its proposal is designed to establish a margin requirement for SBS that is consistent with existing portfolio margin rules for equity securities.[29] However, this rationale does not justify a requirement to use the standardized approach. Portfolio margining can be used with equity SBS in a model-based determination. Portfolio margining is widely used in the swaps market and netting is permitted in the SEC proposal for credit default swaps. The SEC should allow eligible dealers to use models for equity SBS and to apply portfolio margining, which reduces systemic risk, to the extent such netting is enforceable. No other jurisdiction (or other U.S. regulator) has proposed to prohibit the use of models for specific asset classes. If the SEC adopts the proposed provision regarding equity SBS, U.S.-based SBSDs would be placed at a competitive disadvantage in the market.

5. The standardized approach would result in excessive IM requirements.

The proposed rules provide a standardized approach that may be used to calculate IM in lieu of using an IM model and must be used for equity SBS. The standardized approach sets out percentages to be applied to the SBS notional amount. There are a number of issues with this approach which lead to excessive margin requirements.[30] First, the percentages are applied to gross notional amounts and only limited netting is allowed. In particular, use of the standardized approach for equity SBS is likely to result in the application of the Theoretical Intermarket Margining System ("**TIMS**") (which is currently used by self-regulatory organizations for equity derivatives). In its present state, TIMS is inadequate and inefficient for proper IM calculation and does not sufficiently recognize portfolio margining. Also, because TIMS does not incorporate critical factors such as volatility, IM on equity SBS would likely be insufficient in times of stressed markets. Further, the current system and the proposed approach limit the extent to which portfolio margining may be employed. Further offsets within the equity asset class and

[29] See SEC Proposal 77 FR 70214 at 70261.

[30] See ISDA comment letter to the WGMR Study, dated Sept. 28, 2012, response to question 15, pp. 30-31. See also supplemental comments in ISDA's letter to BCBS/IOSCO, dated November 28, 2012.

across other asset classes should be recognized. We urge the SEC to allow use of a more appropriate system or modernize TIMS to incorporate key risk factors such as volatility and concentration risk. Second, the approach for CDS is based on time to maturity for CDS. As a result, application to more complex products is unclear (e.g. for a 2x10 swaption, is the tenor 2, 10 or 12 years). We also ask that the standardized approach be enhanced to accommodate portfolio margining on a broader basis than as currently proposed.

As discussed above, we estimate that the amount of IM required using the standardized approach in the WGMR Study would be over $10.2 trillion and using the standardized approach in the SEC Proposal would be over $7.6 trillion, over 6 times that required if an IM model were used instead.[31] Our analysis demonstrates that the method used in the standardized approach overestimates the amount of IM that needs to be collected. If IM collection is required, we recommend that the SEC conduct further analysis to determine more appropriate levels of standardized percentages or use of another method. The standardized approach and percentages used to calculate margin should be consistent with those established by other regulators. Also, as discussed further below, we urge the SEC to allow netting that is legally enforceable, including when the standardized approach is used.

B. VM – If IM is not required, we support daily collection of VM. However, if IM is required, the frequency of valuation and collection of VM should be based on collateral liquidity and determined by the SBSD. However, we oppose mandatory collection of VM more frequently than on a daily basis.

The SEC has proposed that VM be valued and collected on a daily basis and more frequently during periods of extreme volatility and for accounts with concentrated positions.[32] The SEC should allow SBSDs to determine the appropriate frequency for all counterparties, based on the type of collateral. The WGMR Study does not prescribe a minimum frequency. The WGMR proposes that VM be calculated and collected with "sufficient frequency", giving daily frequency as an example.[33] In their discussion paper on margin, the European Supervisory Authorities asked whether daily exchange of VM should be required if daily valuation of VM is required. We commented that in current practice, valuation of liquid instruments is conducted on a daily basis, but may be less frequent for illiquid collateral.[34] Therefore, the frequency of margin valuation and collection should not be based solely on counterparty type, but also on the type and liquidity of the particular collateral. SBSDs are best placed to determine the frequency appropriate for the counterparty and collateral involved.

We oppose the proposal to collect VM more frequently than daily during periods of extreme volatility and for accounts with concentrated positions. Such a requirement may aggravate market stresses at times of crisis. Just as dynamic IM would have pro-cyclical effects in a

[31] See footnote 7 above.

[32] See SEC Proposal, §240.18a -3(c).

[33] See WGMR Study, p. 19.

[34] See ISDA response to the European Banking Authority, European Securities Markets' Association and European Insurance and Occupational Pensions Authority (the "**ESAs**") Joint Discussion Paper on Risk Mitigation Techniques, dated April 3, 2012, p. 20.

volatile market, the imposition of intra-day collection of VM may have similar effects by accelerating the pace and amount of margin calls amongst market participants at times when participants are least able to meet the additional burdens of such margin calls.

C. Cross-margining and netting - The SEC should permit all cross-margining and netting that is legally enforceable. The SEC should also allow netting across product types (including swaps and SBS) if the standardized approach is used.

Under the SEC's proposal, when using the standardized approach, an SBSD may net an SBS position against an offsetting position in the reference security. For example, netting may be recognized in offsetting positions among an equity SBS, option and the related cash equity. We support the SEC's recognition of this offset. However, an SBSD using the standardized approach could not net SBS across asset classes and could not net SBS against swaps or other products. Such netting is an effective risk reduction tool and should be recognized by the SEC in determining margin amounts. This issue is exacerbated by the requirement that the standardized approach be used to determine margin for equity SBS.

The proposal allows netting for IM when a model is used and for VM across derivatives under a qualified netting agreement.[35] We support the SEC's recognition of netting. We ask that the SEC clarify that this permits all netting and portfolio margining that is legally enforceable, including netting between swaps and SBS and with non-swap products. Netting is a critical risk reduction tool that is widely used in the market that has been recognized by the regulators. The SEC has acknowledged the benefits and importance of portfolio margining and recently issued an exemptive order that allows portfolio margining for certain customer-related positions in CDS that are SBS and swaps.[36] For dealers that are dually registered as an SBSD and an SD, it is essential that the SEC's and CFTC's rules allow such dealers to net across swap and SBS positions.

D. Eligible collateral - We agree with the SEC's flexible approach towards eligible collateral. Applicable haircuts should be determined by the SBSDs.

We support the SEC’s proposed approach to eligible collateral. The determination of what constitutes appropriate collateral is one that should be made based on conditions surrounding the relevant swap. As a result, SBSDs should be allowed to assess and incorporate factors such as liquidity, availability, cost, enforceability and client preference. These factors are dynamic and the SBSD is in the best position to determine eligible collateral and applicable haircuts.

We also commend the WGMR's proposal to take a principles-based approach to collateral eligibility. The WGMR Study states that eligible collateral should "have good liquidity… [and] not be exposed to excessive credit, market and FX risk".[37] It also notes that liquidity of assets

[35] See SEC Proposal, 77 FR 70214 at 70261 and §240.18a-3(c)(5).

[36] See SEC Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps; Release No. 34-68433; File No. S7-13-12; dated December 14, 2012.

[37] See WGMR Study, p. 22.

can change rapidly as market conditions change.[38] SBSDs are highly attuned to the impact of market changes on liquidity and other risk factors and should be allowed to adjust the universe of eligible collateral and haircuts on a timely basis as conditions change. The WGMR Study provides a list of types of eligible collateral, which includes: cash; high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices; and gold.[39] This list is only a guide and the WGMR Study makes a point of noting that the list "should not be viewed as being exhaustive" and "assets and instruments that satisfy the key principle" may also be deemed eligible collateral.[40] We support the SEC's approach, which is similar to the WGMR Study's principles based approach.

The SEC proposes a specific schedule for haircuts.[41] Because SBSDs are best placed to assess the relevant factors determining the haircut, the SEC should allow SBSDs to determine the appropriate haircuts. The WGMR Study allows haircuts determined by a model that is approved by a regulator, in addition to a proposed schedule.[42]

V. Segregation

A. We agree with providing counterparties with the option to choose between full segregation, omnibus segregation and no segregation. In particular we support the SEC's proposal that omnibus segregation be available (i.e., that margin may be held in a separate account under the control of the SBSD).

We support the SEC's proposed approach to segregation of customer collateral. Counterparties should have the ability to determine and elect the appropriate level of segregation.

The SEC proposal provides that margin is to be held in an account under the control of the SBSD, although the counterparty may elect third party segregation.[43] This is consistent with the approach taken in the WGMR Study, which proposes that all collected margin must be held so as to ensure that the collateral is "immediately available" to the collecting party and subject to arrangements that protect the posting party if the collecting party defaults.[44] The WGMR Study does not require third party custody and only proposes that IM be "immediately available".[45]

The Dodd-Frank Act only mandates that counterparties be notified of their right to request segregation of collateral.[46] If the counterparty requests segregation, then the SBSD must agree to

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[38] See WGMR Study, p. 22.

[39] See WGMR Study, p. 22.

[40] See WGMR Study, p. 22.

[41] See SEC Proposal, §240.18a-3(c)(3).

[42] See WGMR Study, p. 23.

[43] See SEC Proposal, §240.18a-4. IM is required to be segregated at a third party custodian only when collected for swaps between SBSDs.

[44] See WGMR Study, p. 25.

[45] See WGMR Study, p. 25.

[46] Dodd-Frank Act, Section 763 (new Securities Exchange Act Section 3E(f)).

segregate the collateral. Counterparties may opt for segregated accounts for the higher level of protection they afford and indeed some already do as a matter of industry practice.

B. The SEC should not impose a capital charge on collateral held with a third party custodian.

The proposed capital rules require that SBSDs take a deduction from their net worth calculation for collateral that is held at a third party custodian. We disagree with this additional capital charge for segregated collateral. Adequate protection may be established through agreements that provide the SBSD with effective contractual access to the collateral, thereby eliminating the need for a capital charge. An additional capital charge creates a disincentive for SBSDs to trade with counterparties that elect third party segregation. If fewer SBSDs are willing to trade with such counterparties, those counterparties to have to choose between the risk of reduced market liquidity for their transactions or forego the extra protection of third-party segregation. In addition, proposed Alternative B requires SBSDs to collect IM from SBSD counterparties and to segregate that IM with a third party custodian. We strongly oppose Alternative B as it not only requires the exchange of IM between SBSD counterparties, but the penalty on such trades is compounded by the imposition of a capital charge on the collateral which must be segregated pursuant to the same rule.

C. We support the SEC's proposal to allow an SBSD to use IM posted by its counterparties for hedging transactions, but the SEC should broaden the scope of permissible hedging transactions.

ISDA supports the SEC's proposal to allow re-hypothecation of VM and IM under an omnibus segregation regime. However, re-hypothecation of IM for omnibus segregation is limited to specific purposes, including certain hedging transactions.[47] We request that the SEC allow SBSDs to use IM posted by counterparties under a broader range of hedging transactions.

VI. Cross-Border Trades

The SEC's forthcoming rulemaking on the treatment of cross-border SBS should specifically address the treatment of margin and provide for recognition of sufficiency of host country regulations.

The SEC has announced that it will propose rules regarding extraterritorial treatment of SBS in a separate rulemaking. We ask that those rules specifically address the application of margin requirements for cross-border SBS. Further, for SBS involving multiple jurisdictions, the rules should recognize non-U.S. regulation. For SBSDs outside the U.S., for example, the SEC should recognize local margin requirements. Also, the rules should be flexible enough to permit SBSDs to structure credit support arrangements to meet the specific legal requirements of the relevant jurisdiction if the SBSD or its counterparty is overseas. Such requirements may differ from the U.S. legal requirements for collateral or netting. The SEC should coordinate with the CFTC and other regulators, domestic and foreign, to achieve consistency in the treatment of swaps and SBS involving multiple jurisdictions.

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[47] See SEC Proposal, §240.18a-4(a) and (b).

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ISDA appreciates the opportunity to comment further on the proposed margin requirements. As the SEC progresses in its on-going effort to finalize the rules and harmonize the proposed approach with those of other regulators, we would welcome the opportunity to assist in that process.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA

Appendix I

November 26, 2012

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, D.C. 20219

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
500 17th Street, NW
Washington, DC 20429

Re: Docket No. OCC-2011-0008/RIN 1557-AD43; Docket No. R-1415 /RIN 7100 AD74; RIN 3064-AD79; RIN 3052-AC69; RIN 2590-AA45

Re-Opening of Comment Period re: Margin and Capital Requirements for Covered Swap Entities – Comments on Margin Requirements

Ladies and Gentlemen,

The International Swaps and Derivatives Association[1] ("**ISDA**") appreciates this opportunity to provide further comments to the Prudential Regulators[2] (the "**PRs**") regarding the notice of proposed rulemaking and request for comments ("**NPR**") concerning margin and capital requirements for non-cleared swaps and non-cleared security-based swaps and the

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[1] ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

[2] The Prudential Regulators are: the Treasury Department (Office of the Comptroller of the Currency) ("**OCC**"); Board of Governors of the Federal Reserve System ("**Federal Reserve**"); Federal Deposit Insurance Corporation ("**FDIC**") ; Farm Credit Administration ("**FCA**"); and the Federal Housing Finance Agency ("**FHFA**").

implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

The Prudential Regulators initially requested comments to their proposed rules on margin and capital requirements for non-cleared swaps and non-cleared security-based swaps in early 2011.[3] ISDA and SIFMA responded in a letter dated July 6, 2011 in which we provided comments and recommendations on the proposed margin rules.[4] In light of the recently published study by the Basel Committee on Banking Supervision ("**Basel**") and Board of the International Organization of Securities Commissions ("**IOSCO**") on margin requirements for uncleared swaps (the "**Study**"), the subsequent Quantitative Impact Study ("**QIS**") by Basel/IOSCO, the proposed rules on capital, margin and segregation recently released by the Securities and Exchange Commission (the "**SEC**")[5] and the Prudential Regulators' additional request for comments[6], we have the additional comments set out in this letter on margin requirements. This letter does not comment on the proposed capital requirements.

For purposes of this discussion, swap dealers and major swap participants are "Swap Entities" and a Swap Entity that is subject to regulation by a Prudential Regulator is a "Covered Swap Entity" or "CSE".

<u>Executive Summary</u>

The following is a brief summary of some of our key points:

I. <u>Initial Margin ("**IM**")</u>

A. Negative consequences of IM. As proposed, the IM requirement could severely challenge the resiliency of the financial system and will severely curtail the use of uncleared swaps for hedging, which would disrupt key financial services, such as those that provide for wider availability of home loans and domestic and international corporate finance.

B. Proposed alternative. In lieu of IM, systemic risk can be effectively mitigated by: imposing VM requirements with daily collection (subject to limited exceptions) and zero thresholds; implementation of appropriate capital requirements, and mandatory clearing of liquid standardized swaps.

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[3] See Prudential Regulators proposed rule, *Margin and Capital Requirements for Covered Swap Entities*, 76 FR 27564 ("**PR Proposal**").

[4] See ISDA and SIFMA comment letter re: Margin and Capital Requirements for Covered Swap Entities, dated July 6, 2011 ("**ISDA/SIFMA Margin Letter**"). Available at http://www2.isda.org/dodd-frank/page/3

[5] See SEC proposed rule, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Release No. 34-68071; File No. S7-08-12 ("**SEC Proposal**").

[6] See Prudential Regulators, *Reopening of Comment Period*, available at http://www.gpo.gov/fdsys/pkg/FR-2012-10-02/pdf/2012-24276.pdf

II. Process

A. Timing and Consistency. The Prudential Regulators' margin rules should be coordinated and consistent with the margin requirements of the CFTC, the SEC and regulators in other major financial jurisdictions. The Prudential Regulators should re-propose their rules on margin after they have had the opportunity to review and consider the final findings of the Basel/IOSCO Working Group and the SEC's proposed margin rules.

B. Phase-In/Clearing: Compliance with the margin requirements should be phased-in over time and no earlier than the clearing requirements for the same asset class. The proposed time period of 180 days for implementation of the final rules is insufficient. The effective date for margin requirements for a given asset class should follow the implementation of mandatory clearing for that asset class.

III. Scope: Entities – We re-emphasize the recommendation that end-users, special purpose vehicles ("**SPVs**") and state and municipal government entities be excluded from the margin requirements. ISDA's position is that all sovereigns and central banks should post margin in order to achieve international comity. Unilateral action by a regulator in the U.S. or any other jurisdiction would be damaging to market participants and market liquidity.

IV. Margin Calculation - We strongly recommend that the collection of IM not be required. While the Dodd-Frank Act provides for IM requirements for bank swap dealers, the Prudential Regulators have latitude in how they address that reference to IM and should consider the severe negative consequences of the proposed IM requirements. If the Prudential Regulators find it necessary to require the collection of IM, IM should be collected on a static basis, the amounts should be low and thresholds should be allowed as determined by the CSEs. In addition, calculation and posting of IM on or before execution date should not be required.

The proposed standardized tables would result in excessive IM requirements. Based on our review of aggregated QIS data from eight leading banks (which represent 45-50% of the total notional amount of the swap market), ISDA estimates that the amount of IM required using the standardized tables as proposed in the Study and the PR Proposal would be over $10.2 (in the Study)/7.6 (in the PR Proposal) trillion, over 6 times that required if an IM model were used.[7] One way to address this issue would be to allow netting. The current proposal does not allow netting when the standardized table is used

[7] The analyses contained in this presentation were derived from member QIS responses that were developed prior to the issuance of the exemption for foreign exchange ("**FX**") forwards and swaps by the U.S. Treasury on November 16, 2012. We estimate the Treasury exemption would reduce IM requirements under the U.S. Prudential Regulators' proposals by 15% to 20%. If FX forwards and swaps are excluded globally as per the U.S. Treasury exemption, we estimate that adjustments of a similar magnitude would need to be made to the estimated IM requirements under the Basel/IOSCO proposal.

to calculate IM, whereas the Study and SEC proposals allow some netting with use of the standardized table.

V. Netting – In general, netting that is legally enforceable should be permitted. The Prudential Regulators should also allow portfolio-based margining across cleared and uncleared swaps, other products and across legal structures. The Study allows netting within asset class when a model is used, and across comparable contracts with the schedule is used. The Prudential Regulators should also consider the approach proposed by the SEC, which allows broad netting for margin.

VI. Collateral

A. Eligible collateral. Eligible collateral and applicable haircuts should be determined by the CSEs. At a minimum, the rules should adopt a broader range of eligible collateral as proposed by the Study. Alternatively, the Prudential Regulators' final rules may avoid specifying types of products and securities as eligible, as proposed by the SEC, subject to prescribed haircuts.

B. Segregation. If IM is required, segregation and third party custody for IM should be at the agreement of the parties and not be required by regulation.[8] CSEs should be allowed to offer asset protection mechanisms other than third party segregation that would provide that collateral be "immediately available" as recommended by the Study; e.g. segregation on the books of the CSE. The SEC proposal provides that SBSDs hold collateral in an account under the control of the SBSD and third party segregation is at the election of the counterparty that is not an SBSD. Parties posting collateral should have the option to allow the CSE to re-hypothecate the collateral.

VII. Inter-Affiliate Swaps - As stated in the prior letter to the Prudential Regulators, inter-affiliate trades should be excluded from margin requirements. Swaps between affiliates do not add systemic risk. Such trades are used to internally allocate risk and encourage centralized risk management. Imposition of margin requirements on inter-affiliate trades would add cost and inefficiency to internal risk management.

VIII. Cross-Border Trades - Affiliates of U.S. persons should not be treated as U.S. persons under the margin rules, as proposed by the CFTC in its cross-border guidance. For swaps involving multiple jurisdictions, non-U.S. regulatory regimes should be recognized.

Discussion

I. Initial Margin ("IM")

A. As proposed, the IM requirement will severely challenge the resiliency of the financial system and will severely curtail the use of uncleared swaps for hedging.

[8] We recognize that if two CSEs are collecting IM from each other, it may be necessary to impose certain segregation or customer protection arrangements.

Based on its review of aggregated QIS data from eight leading banks (which represent 45-50% of the total notional amount of the swap market), ISDA has estimated the potential impact of IM requirements (as detailed in Appendix 1) would be as follows. Assuming: use of standardized schedules (as opposed to models), zero thresholds and estimated notional of unclearable swaps, then the IM requirements for universal 2-way posting (as proposed by the Study) would be $10.2 trillion and for CSE collection only (as proposed by the Prudential Regulators) $7.6 trillion.[9] Even assuming that IM models are used for all swaps, the amount of IM required in non-stressed markets is exceptionally burdensome. Based on the data we have obtained, and assuming use of models, zero thresholds and estimated notional of unclearable swaps, the IM requirements would be: for universal 2-way posting (as proposed by the Study), $1.7 trillion and for CSE collection only (as proposed by the Prudential Regulators), $1.2 trillion. If the regulators allow the use of thresholds, and assuming full use of models, this estimate could fall to $800 billion for universal 2-way posting (as proposed by the Study) and $600 billion for CSE collection only (as proposed by the Prudential Regulators). These estimates provide a range of IM requirements. The actual IM required will fall in between the range as IM will be calculated using both the standardized schedule and IM models.

Our review of the data establishes three fundamental concerns: first, without widespread use of IM models, dealers and their counterparties could not fund the IM requirements as proposed; second, if IM models are used, the IM requirements would increase systemic risk because additional IM would be required at times of stress; and third, while thresholds make the IM requirements more affordable in ordinary markets, they increase the procyclicality of IM by magnifying the IM requirements at times of stress.

Turning to each of these points in more detail: first, as described above, without IM models, the amounts of required IM ($10.2 trillion/ $7.6 trillion) would vastly exceed the amount that the market could post.

Second, if IM models are used as proposed, increased amounts of IM would be required as volatility increases and such increase would pose severe systemic risks. In its study on collateral requirements, the Bank for International Settlements ("**BIS**") calculated that, for over-the-counter ("**OTC**") interest rate swap portfolios of the fourteen major derivatives dealers, IM requirements under high market volatility would be about three (3) times the IM requirements in low market volatility.[10] For credit default swaps, the IM requirement in a high volatility environment is ten (10) times higher than in a low volatility environment.[11] As a result, proposed IM models would make market participants subject to increased collateral demands at the very times that collateral becomes most expensive. CSEs would be subject to a liquidity call when their ability to obtain funding would be constrained by market stresses. Asset managers, who generally hold low cash balances, will have to sell assets to meet collateral demands, placing downward pressure on asset prices and further exacerbating stresses in the market. Thus, there is a significant potential that a downward economic spiral could be triggered or worsened by the IM requirements.

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[9] See footnote 7 above.

[10] See BIS Working Papers No 373, *Collateral requirements for mandatory central clearing of over-the-counter derivatives*, March 2012, p. 20.; available at http://www.bis.org/publ/work373.pdf

[11] Ibid.

Third, setting thresholds does not solve the problems described above. Thresholds can help reduce the cost of IM in ordinary markets. However, a threshold with a model-based IM requirement will mean that IM requirements can go from zero to large amounts once the threshold is exceeded, which is likely to happen at times of stress, when a sudden demand for collateral is likely to have a destructive effect. For example, if gross IM requirement is $100 million and there is a threshold of $50 million, then $50 million IM must be posted. In a high volatility market, using the 3 times multiplier, the gross IM requirement would rise to $300 million. The threshold remains at $50 million, so $250 million in collateral would need to be posted, a 5 times multiplier. Banks and other counterparties would be under pressure to find or obtain 5 times more collateral, in a high volatility, stressed market environment.

Constraint on Uncleared Swap Market. In addition to the systemic risks posed by model-based IM, the IM proposal would also severely impact liquidity in the uncleared swap market and make uncleared swaps significantly more expensive because of the costs of IM. These costs include not only the costs of the actual IM itself, but also the operational burdens of complex daily posting and reconciliation of IM. While we support the development of clearing for liquid, standardized swaps, we believe that severely constraining the uncleared swap market would have serious negative economic consequences. OTC markets are critical to the functioning of the global economy. They promote economic growth through a better allocation of risk and resources throughout the economy, effectively reducing overall systemic risk, by enabling participants to hedge (and thus reduce) a vast array of economic risks. The IM requirements would be particularly harmful to swaps that are inherently unclearable but are critical for risk management. For example, interest rate swaptions are difficult to clear because there is large dispersion of settlement prices for options with out-of-the-money strikes. If the use of interest rate swaptions is impeded, it would have negative repercussions on the cost of financing home loans and the housing market. This product is used extensively by Federal National Mortgage Association ("**FNMA**") and Federal Home Loan Mortgage Corp. ("**FHLMC**") in the risk management of their asset pools. Also, the majority of single name credit default swaps ("**CDS**") cannot be cleared. Such swaps are heavily used by lenders to hedge loans and by investors to manage the risk of corporate bond holdings. If the use of single name CDS is hindered, it would restrict the ability of banks to make loans and slow down the issuance of corporate bonds. Currency swaps are not accepted for clearing by clearing houses because of the risks associated with final settlement and other reasons. These swaps are used by corporations, banks and governments globally in their capital markets funding activities and as such the currency swap market is vitally important to the economies of many countries. Currency swaps are used by sovereigns and supranational organizations (e.g. International Bank of Reconstruction and Development ("**IBRD**"), European Bank for Reconstruction and Development ("**EBRD**"), European Investment Bank ("**EIB**")) in their financing and funding activities. Finally, treasurers and risk managers globally use custom swaps tailored to the asset and liability management requirements of their institutions, including pension funds, insurance companies, banks and corporations. These are just some examples of the ways in which unclearable swaps are critical to key sectors of the global economy which would be harmed by the imposition of IM requirements.

B. Systemic risk can be effectively mitigated by: imposing robust VM requirements; implementation of appropriate capital requirements, and mandatory clearing of liquid standardized swaps.

ISDA believes that in lieu of IM, systemic risk can be effectively mitigated, and the goals of the Dodd-Frank Act achieved, by the following approach: first, impose VM requirements with daily collection and zero thresholds; second, implement appropriate capital requirements, and third, require clearing of liquid standardized swaps.

VM: VM, with daily collection (subject to limited exceptions for illiquid collateral) and zero thresholds, effectively protects against accumulated and unrealized losses in over-the-counter ("**OTC**") derivatives positions. The imposition of VM requirements as suggested here, without IM, would not incur the significant negative consequences as discussed above. In addition, the infrastructure for VM collection is already in place as many market participants already use the bilateral exchange of VM to mitigate risk. This proposed structure for VM is premised on a margin regime that does not include the collection of IM. If the Prudential Regulators determine that IM collection is required, we would recommend a different structure for the collection of VM.

Capital: Appropriate capital requirements will protect against the risks that are not covered by IM. Both capital and IM can cover potential future exposure. Requiring both IM and increased capital for the same swaps will result in duplicative and unnecessary costs. Capital requirements will call for capital on exposures specifically arising from OTC derivatives activity and will apply to all swaps (unlike IM, which does not apply to pre-existing swaps). Implementation of currently proposed capital requirements will result in a significant increase in the amount of regulatory capital that prudentially regulated entities are required to hold. In particular, credit valuation adjustment ("**CVA**") capital charges are likely to add considerably to the capital requirements. CVA charges are extremely sensitive to counterparty quality and risk mitigants and therefore cover the risk of rating migration up to default very well. One argument that is sometimes made for IM for uncleared swaps is that IM is required for clearing organizations. But this ignores the fact that a dealer is subject to capital requirements in ways that simply do not apply to clearing organizations.

Mandatory Clearing: Mandatory clearing of liquid standardized swaps will shift a large volume of swap activity towards centralized clearing, further reducing systemic risk. To the extent that punitive IM levels are motivated by a desire to encourage clearing, that is an ill-conceived measure. Punitive IM will directly harm those critical markets and financial services vital to the real economy such as housing and corporate financing described above. Instead, mandatory clearing requirements can achieve this more effectively for swaps for which clearing is appropriate.

Structuring IM: The Dodd-Frank Act gives the Prudential Regulators discretion in how they approach IM. We strongly recommend that if the Prudential Regulators impose IM requirements that such requirements be structured so as to minimize the negative consequences described above. Possible steps include the following. First, in order to avoid procyclicality, the amount of IM required should be static, not dynamic. Second, in order to allow uncleared swap markets to continue, the static level of IM should be low enough to permit realistic pricing of uncleared swaps. Third, collection of IM should only be mandatory for certain types of counterparties. It is worth considering the SEC's alternative proposal that provides for no IM requirements for transactions between SBSDs. Fourth, CSEs should be allowed to establish their own IM

requirements and the relevant thresholds. CSEs are in the best position to assess the risk of their counterparties and do so for loans and other extensions of credit.

These are just some approaches that may be considered by the Prudential Regulators in considering alternatives to the current proposal. ISDA and its members would be happy to assist the Prudential Regulators in the effort to identify feasible alternatives and analyze the potential impact to the financial system to determine a safer, affordable margin framework.

II. Process

A. Implementation and timing of the Prudential Regulators' margin rules should be coordinated and consistent with the margin requirements of the CFTC, the SEC and regulators in other jurisdictions. The Prudential Regulators should re-propose their rules on margin after they have had the opportunity to review and consider the final findings of the Basel/IOSCO Working Group and the SEC's proposed margin rules.

One of the key principles set forth in the Basel/IOSCO Working Group study on margin is that "[r]egulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions".[12] Inconsistencies in implementation of the margin rules may create opportunities for arbitrage between regimes, which may cause disequilibrium in market pricing and demand. Time differences in compliance puts participants in the jurisdiction with the earlier deadline at risk of loss of competitive position, where lost market share may be unrecoverable. Different treatment of cross-border trades, determined at different times, may create operational and cost inefficiencies for parties that prepare for compliance with one regime and later must adjust to comply with another. As discussed further below, cross-border swaps will not be possible if two jurisdictions impose conflicting margin requirements. Consistency is therefore critical to enable cross-border transactions. As noted in the Study, "the effectiveness of margin requirements could be undermined if the requirements were not consistent internationally".[13] We ask the Prudential Regulators to align implementation of its margin requirements with those of other jurisdictions.

The principle of consistency can only be served if the Prudential Regulators wait to finalize their margin rules until they have had the opportunity to review and consider the final margin policies determined by the Basel/IOSCO Working Group, the CFTC and the SEC's proposed margin rules. It is more efficient for the Prudential Regulators to review the SEC proposed rules and await finalization of the Basel/IOSCO Working Group policies and the CFTC's margin rules than to go through the amendment process to remedy inconsistencies and duplicative requirements that may arise after finalization. Pre-adoption review of such relevant policies would also help avoid confusion and disruption in the markets that may result from such inconsistencies or duplication and subsequent amendments. After consideration of the final findings of the Basel/IOSCO Working Group and the SEC proposed rules, the Prudential Regulators should re-propose their rules on margin for review and comment. We have submitted comments on the

[12] See Study, p. 4.

[13] See Study, p. 28.

Study to the Basel/IOSCO Working Group[14] and will submit comments to the SEC in a separate letter.

In keeping with our request that the Prudential Regulators review the rules of the other regulators, we ask that where there are inconsistencies between the Prudential Regulators' requirements and those of BCSB/IOSCO, the CFTC and the SEC, that the Prudential Regulators provide guidance on how CSEs are to address such inconsistencies as a practical matter.

B. The Prudential Regulators should provide a staged implementation schedule and margin requirements should become effective no earlier than the clearing requirements for the same asset class.

As stated in our prior letter, the proposed time period of 180 days for implementation of the Prudential Regulators' final rules is insufficient.[15] As proposed, the Prudential Regulators' margin rules will necessitate the development and testing of margin models, risk management systems, technological requirements for interfacing with custodians and the modification and execution of new collateral support arrangements and custodial agreements; all of which will require significant commitment of time and resources. The Study does not directly address timing for implementation nor does it provide relief from the burden of re-documentation. We estimate that it will take almost two years and over $94 million, per CSE, just to establish necessary collateral arrangements. In addition, risk management systems must be recalibrated and models and output will need to undergo various stages of testing before implementation.

The infrastructure for VM is already in place for many market participants so imposition of VM requirements will not require as much incremental development. However, imposition of IM requirements would require significant development as the systems and processes in place for VM collection are not necessarily applicable or appropriate for use for IM calculation and collection.

Unless a staged compliance schedule is provided, there will be a rush to compete for the limited resources available to accomplish the tasks necessary for compliance in the time allotted.[16] This refers to resources internal to the CSEs as well as external resources, e.g. at the custodians, the Prudential Regulators, which are all necessary to achieve full compliance.

Therefore, we urge the Prudential Regulators to establish a schedule for compliance that provides reasonable implementation time frames for the amount of infrastructure development that will be necessary. As margin requirements are closely intertwined with the clearing requirements, they should be applied in a manner consistent with the development of the clearing market over time. Margin requirements should be imposed on uncleared swaps of a given asset class only after clearing becomes mandatory for swaps of that asset class. Imposing margin requirements on

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[14] See ISDA comment letter re: *Basel/IOSCO Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives*, dated Sept. 28, 2012 ("**ISDA Basel/IOSCO Margin Letter**"). See also supplemental comments in ISDA's letter to be submitted to Basel/IOSCO.

[15] See ISDA/SIFMA Margin Letter, pp. 29-30.

[16] See ISDA/SIFMA Margin Letter, p. 30.

transactions that are uncleared if there is no liquid cleared market for those transactions is unduly punitive.

C. When the rules first become effective, proprietary models used by the CSEs should be deemed provisionally approved for calculation of IM, subject to further review by the relevant Prudential Regulator.

The proposed rules require that models used to calculate IM have prior approval by the relevant Prudential Regulator.[17] ISDA disagrees with the proposed requirement to collect IM, but if IM is required, upon implementation of the margin rules, proprietary models should be automatically deemed provisionally approved, subject to further review by the relevant Prudential Regulator. This would reduce operational risk introduced by requiring CSEs to switch from established models to new models within a short time frame for compliance. Models used or developed by the CSEs are very sophisticated and have been subject to long-term application and regular testing. Without automatic approval on a provisional basis provided to all swap dealers while model reviews are being conducted by the Prudential Regulators, CSEs whose models are earlier in the queue for review will have an unfair market advantage over those later in the review schedule. Provisional automatic approval would provide the relevant Prudential Regulator more time to conduct model review.

III. Scope: Entities

ISDA recommends that end-users, SPVs and state and municipal government entities be excluded from the margin requirements. We also recommend that all sovereigns and central banks should post margin in order to achieve international comity.

The Prudential Regulators should specifically exempt end-users from its margin requirements, including the requirement that CSEs enter into credit support agreements with all counterparties.[18] The Study only imposes requirements to collect and post margin on financial firms and systemically important non-financial firms ("**covered entities**")[19] and specifically exempts swaps to which non-financial entities that are not systemically important are a party.[20] Both the Study and the SEC propose to exempt end-users from margin requirements as they do not pose systemic risk and the imposition of margin requirements on end-users may hinder their ability to hedge their commercial risk.[21] Similarly, the CFTC has exempted end-users from the clearing requirements in order to allow end-users "to continue using non-cleared swaps to hedge risks associated with their underlying business."[22]

With regard to structured finance SPVs and state and municipal governmental entities, we affirm our prior recommendation that they be exempted from margin requirements as such entities

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[17] See PR Proposal, §_.8.

[18] See PR Proposal, §_.5.

[19] Study, p. 4.

[20] Study, p. 9.

[21] Study, p. 9; See SEC Proposal, §240.18a-3, p. 481 and commentary on pp. 181-183.

[22] See CFTC final rule, *End-User Exception to the Clearing Requirement for Swaps*, 77 FR 42559 at 42560.

primarily enter into swaps for risk mitigation purposes and generally are not in a position to post collateral. In addition, swaps with structured finance SPVs generally have provisions that mitigate credit risk, such as: (i) the swap counterparty has a security interest over all of the SPV's assets; (ii) the swap counterparty has first priority with regard to cash flow payments; and (iii) SPVs are bankruptcy-remote vehicles.

Sovereigns and central banks are specifically excluded from requirements to collect or post margin in the Study.[23] Also, the Dodd-Frank Act defines "swaps" to exclude swaps executed by Federal Reserve banks, the U.S. Federal Government and any Federal agency backed by the full faith and credit of the U.S.[24] Nonetheless, it is ISDA's position that sovereigns and central banks should post margin. In addition, for international comity and to achieve a level playing field for U.S. swap entities, we urge the Prudential Regulators to provide for global consistency in the application of margin requirements for sovereigns and central banks. Unilateral action by a regulator in the U.S. or any other jurisdiction would be damaging to market participants and market liquidity.

IV. Margin Calculation

A. IM - The collection of IM should not be required, but if IM is required we have the following comments regarding the calculation of IM.

1. IM should be collected on a static, not dynamic, basis, amounts should be low and thresholds allowed.

While the Dodd-Frank Act mentions the imposition of IM requirements on banks for uncleared swaps, it does not prescribe any specifics as to the nature or scope of the requirements.[25] The Prudential Regulators therefore have latitude in how they address this issue. We urge the Prudential Regulators to consider the severe negative consequences of the proposed IM requirements as discussed above and not to impose requirements to collect IM. However, if the Prudential Regulators determine that IM collection is necessary, as discussed in section IB, in order to avoid procyclicality, IM should be collected on a static basis. Also, in order for the OTC markets to remain viable, the amounts of IM collected should be kept low. In addition, thresholds should be allowed for all counterparties and determined by the CSEs. Thresholds may be used to ease the costs for parties that are active in swaps that are inherently unclearable, thereby mitigating the negative impact of IM requirements on housing finance and international

[23] Study, p. 9. We expressly support the inclusion of multilateral development banks and other similar organizations and their affiliates in this exemption, including the International Monetary Fund, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency, the African Development Bank, the African Development Fund, the Asian Development Bank, the Inter-American Development Bank, the Bank for Economic Cooperation and Development in the Middle East and North Africa, the Inter-American Investment Corporation, the Council of Europe Development Bank, the Nordic Investment Bank, the Caribbean Development Bank, the European Investment Bank, the European Investment Fund and the Bank for International Settlements, as well as any other similar international organizations and all agencies, affiliates and pension plans of these entities.

[24] CEA §1a(47)(B)(ix).

[25] Dodd-Frank Act §731.

and domestic financing as discussed in IA above. Otherwise, in times of stressed markets, the amount of IM required will escalate and increase the stress on market participants.

2. IM should not be required to be calculated and posted on or before execution date.

The Prudential Regulators proposed that IM be posted on or before execution date. As stated in our prior letter, the proposed time frame for delivery is too short and may be operationally infeasible.[26] For example, for some swaps, information necessary to calculate margin may not be available until after the swap is executed. The common industry practice is to have marks fed into systems overnight and collateral calls are made the next day; also allocations for funds may not be determined until close of business on the trade date. In addition, there are significant practical issues. For example, payment and settlement systems have intra-day cut-off times and some cross-border trades may be executed at a time when U.S. systems are closed. We suggest that collateral calls be made by T+1 and delivered in accordance with the terms of the relevant credit support arrangement.

3. The standardized tables would result in excessive IM requirements.

The proposed rules provide a table that may be used to calculate IM in lieu of using an IM model. The table relates percentages to be applied to the swap notional amount. As noted in our response to the Study, which proposes a similar approach and table, there are a number of issues with this approach which lead to excessive margin requirements.[27] First, the percentages are applied to gross notional amounts and no netting is allowed, within or across asset classes. Second, the table is based on time to maturity for CDS and IRS. As a result, application to more complex products is unclear (e.g. for a 2x10 swaption, is the tenor 2, 10 or 12 years).

As discussed above, we estimate that the amount of IM required using the standardized tables in the Study and PR Proposal would be over $10.2/7.6 trillion, over 6 times that required if an IM model were used.[28] Our analysis demonstrates that the approach taken in the standardized tables overestimates the amount of IM that needs to be collected. If IM collection is required, we recommend that the Prudential Regulators conduct further analysis to determine more appropriate levels of standardized percentages or use of another method. Also, as discussed further below, we urge the Prudential Regulators to allow netting that is legally enforceable, including when the standardized table is used. The Study and the SEC proposal permit netting even when standardized tables are used.

B. VM – If IM is not required, we support daily collection of VM. However, if IM is required, the frequency of valuation and collection of VM should be based on collateral liquidity and determined by the CSE.

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[26] See ISDA/SIFMA Margin Letter, pp. 27-28.

[27] See ISDA comment letter to the Basel/IOSCO Study, dated Sept. 28, 2012, response to question 15, pp. 30-31. See also supplemental comments in ISDA's letter to be submitted to Basel/IOSCO.

[28] See footnote 7 above.

The Prudential Regulators have proposed that VM be valued and collected on a daily basis for all counterparties other than non-financial entities, and weekly for non-financial entity counterparties.[29] The Prudential Regulators should allow CSEs to determine the appropriate frequency for all counterparties, based on the type of collateral. The Study does not prescribe a minimum frequency, the Basel/IOSCO Working Group proposes that VM be calculated and collected with "sufficient frequency", giving daily frequency as an example.[30] In their discussion paper on margin, the European Supervisory Authorities asked if daily valuation of VM is required should daily exchange of VM also be required. We commented that in current practice, valuation of liquid instruments is conducted on a daily basis, but may be less frequent for illiquid collateral.[31] Therefore, the frequency of margin valuation and collection should not be based solely on counterparty type, but also on the type and liquidity of the particular collateral. CSEs are best placed to determine the frequency appropriate for the counterparty and collateral involved.

V. Netting

Netting that is legally enforceable should be permitted. The Prudential Regulators should also allow portfolio-based margining across cleared and uncleared swaps, other products and across legal structures.

For IM, the Prudential Regulators propose to allow recognition of offsets under a qualifying master netting agreement, but only when a model is used and then only within broad risk categories that correspond to asset classes.[32] The proposed rules do not allow any netting when the standardized table is used to calculate IM.[33] The Study allows netting within asset class when an IM model is used and allows netting across comparable contracts using the Schedule method, with regulatory approval.[34] In its proposed margin rules, the SEC does not limit netting when a model is used to calculate IM and allows recognition for netting when the standardized method is used to calculate IM and allows netting for VM.[35]

ISDA strongly disagrees with the proposal to limit netting to specific asset classes.[36] As recommended and discussed in more depth in our prior letter, we ask the Prudential Regulators to permit netting of any exposures for IM and VM, if the netting is legally enforceable.[37] This

[29] See PR Proposal, §_.4.

[30] See Study, p. 19.

[31] See ISDA response to the European Banking Authority, European Securities Markets' Association and European Insurance and Occupational Pensions Authority (the "**ESAs**") Joint Discussion Paper on Risk Mitigation Techniques, dated April 3, 2012, p. 20.

[32] The risk categories as defined in the proposed rules are: commodity, credit, equity and foreign exchange/interest rate. PR Proposal, §_.8(d)(3).

[33] See PR Proposal, §_.2(k), see also commentary at 76 FR 27564 at 27572-3.

[34] See Study, pp.18-19.

[35] See SEC Proposal, re: VM, p. 484; re: standardized method, pp. 484 and 429.

[36] See ISDA/SIFMA Margin Letter, pp. 17-20.

[37] See ISDA/SIFMA Margin Letter, pp. 17-20.

would include netting between swaps and security-based swaps and with non-swap products. Netting is a critical risk reduction tool that is widely used in the market that has been recognized by the regulators. The margin rules should encourage broad-based, legally enforceable netting as a valuable means of reducing systemic risk. Limiting the use of netting for margin would create less incentive for parties to use netting to reduce risk. Many products and their hedges cross traditional product silo definitions (e.g., convertible bonds), often involve multiple swap dealer legal vehicles, and bridge cleared and OTC transactions and markets (e.g., swaps vs. swaptions, foreign exchange ("**FX**") and precious metals trading through futures, exchange traded funds and OTC). Commodity swaps are also routinely hedged with commodities and equity swaps/options are hedged with listed futures/options. Markets will continue to evolve to include new product types and new structures. Regulations should include the flexibility to recognize legitimate hedges, and require appropriately scaled initial margin. In particular, as swaps migrate to central clearing, we will continue to see the need for cleared products to hedge more complex transactions that will remain in the OTC marketplace, and such netting should be recognized to the extent legally enforceable. We resubmit the specific recommendation that the Prudential Regulators allow offsets of IM against VM and vice versa (subject to any segregation requirements), this would allow margin to more accurately reflect the credit risk that exists between the parties. Expanding the scope of netting permitted under the final margin rules, including allowing appropriate offsets between IM and VM (subject to any segregation requirements), would mitigate the negative impact of the new margin requirements on market liquidity and capital while achieving the goal of reducing system risk.

We also recommend that the Prudential Regulators permit portfolio-based margining across cleared and uncleared swaps, other products (including prime brokerage, futures and listed options) and other legal structures.[38] Portfolio-based margining is routinely used by market participants to hedge portfolios. If market participants are unable to employ this hedging method, they will be subject to increased risk and hedging costs.

The Prudential Regulators should recommend that the Basel/IOSCO Working Group adopt this broader position on netting.

VI. Collateral

A. Eligible Collateral

Eligible collateral and applicable haircuts should be determined by the CSEs. If the Prudential Regulators will not permit determination by a CSE, we recommend that the Prudential Regulators at least adopt a broader range of eligible collateral as proposed by the Study.

The Prudential Regulators has proposed to limit eligible collateral to cash, direct obligations of (or guaranteed by) the U.S. government and senior debt of certain U.S. government sponsored entities for all counterparties except for non-financial entities.[39] For non-financial entity

[38] See ISDA/SIFMA Margin Letter, pp. 17-20.

[39] See PR Proposal, §_.6.

counterparties, eligible collateral would be as determined by the parties in the credit support arrangement.[40]

The list of eligible collateral proposed by the Prudential Regulators is too limited and will raise liquidity issues with respect to U.S. Treasury and agency securities.[41] The determination of what constitutes appropriate collateral is one that should be made based on conditions surrounding the relevant swap. As a result, CSEs should be allowed to assess and incorporate factors such as liquidity, availability, cost, enforceability and client preference. These factors are dynamic and the CSE is in the best position to determine eligible collateral and applicable haircuts.

We commend the Basel/IOSCO Working Group's proposal to take a principles-based approach to collateral eligibility. The Study states that eligible collateral should "have good liquidity… [and] not be exposed to excessive credit, market and FX risk".[42] It also notes that liquidity of assets can change rapidly as market conditions change.[43] CSEs are highly attuned to the impact of market changes on liquidity and other risk factors and should be allowed to adjust the universe of eligible collateral and haircuts on a timely basis as conditions change. The Study provides a list of types of eligible collateral that is notably broader than that proposed by the Prudential Regulators. Specifically, the Study lists: cash; high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices; and gold.[44] This list is only a guide and the Study makes a point of noting that the list "should not be viewed as being exhaustive" and "assets and instruments that satisfy the key principle" may also be deemed eligible collateral.[45] At a minimum, we urge the Prudential Regulators to adopt a principles based approach, with a sample list of eligible collateral, as provided by the Study.

Alternatively, the Prudential Regulators' final rules may avoid specifying types of products and securities as eligible, as proposed by SEC, subject to prescribed haircuts. The SEC proposal takes a flexible approach towards eligible collateral and provides that "cash, securities and/or money market instruments" shall be delivered as collateral, subject to certain requirements such as liquidity and transferability, and prescribed haircuts but does not otherwise limit the type of collateral that is to be posted.[46]

The Prudential Regulators propose a specific schedule for haircuts.[47] Because CSEs are best placed to assess the relevant factors determining the haircut, the Prudential Regulators should allow CSEs to determine the appropriate haircuts.[48] The Study allows haircuts determined by a

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[40] See PR Proposal, §_.6; see also commentary at 77 FR 27564 at 27578.

[41] See ISDA/SIFMA Margin Letter, pp. 25 - 27.

[42] See Study, p. 22.

[43] See Study, p. 22.

[44] See Study, p. 22.

[45] See Study, p. 22.

[46] See SEC Proposal, §240.18a-3(c)(4), pp. 483-484.

[47] See PR Proposal, §_.6

[48] See ISDA/SIFMA Margin Letter, pp. 25-26.

model that is approved by a regulator, in addition to a proposed schedule.[49] If the Prudential Regulators do not allow CSEs to determine appropriate haircuts, we ask that the final rules allow the use of model-determined haircuts and adopt a schedule that conforms to that proposed by the Study.

B. Segregation

If IM is required, segregation and third party custody for IM should be at the agreement of the parties and not be required by regulation.

Under the Prudential Regulators' proposed rules, CSEs entering into swaps with other CSEs must collect IM from each other and that margin must be segregated with an independent third party custodian.[50] The Study proposes that all collected margin must be held so as to ensure that the collateral is "immediately available" to the collecting party and subject to arrangements that protect the posting party if the collecting party defaults.[51] The Study does not require third party custody and only proposes that IM be "immediately available".[52] The SEC proposal provides that margin is to be held in an account under the control of the SBSD, although the counterparty may elect third party segregation.[53]

In light of this discrepancy, ISDA recommends that segregation and custody be determined by the parties.[54] The Dodd-Frank Act only mandates that counterparties be notified of their right to request segregation of collateral.[55] If the counterparty requests segregation, then the CSE must agree to segregate the collateral. Counterparties may opt for segregated accounts for the higher level of protection they afford and indeed some already do as a matter of industry practice.

We also suggest that the Prudential Regulators allow CSEs to offer asset protection mechanisms other than third party segregation that would provide that collateral be "immediately available" as recommended by the Study; e.g. segregation on the books of the CSE. The SEC's proposal defaults to such an approach, "commingled" segregation, in the absence of counterparty election for third party segregation.[56] Further, parties posting collateral should have the option to allow the CSE to re-hypothecate the collateral.

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[49] See Study, p. 23.

[50] See PR Proposal, §§_.3 and _.7.

[51] See Study, p. 25.

[52] See Study, p. 25.

[53] See SEC Proposal, §240.18a-4. pp. 487 – 497. IM is required to be segregated at a third party custodian only when collected for swaps between SBSDs.

[54] We recognize that if two CSEs are collecting IM from each other, it may be necessary to impose certain segregation or customer protection arrangements.

[55] Dodd-Frank Act, Section 724 (new CEA, Section 4s(l)); Section 763 (new Securities Exchange Act Section 3E(f)).

[56] See SEC Proposal, p. 217; §240.18a-4, pp. 487 – 497.

VII. Inter-Affiliate Swaps

Uncleared swaps between affiliates should be excluded from the margin requirements.

Inter-affiliate trades should be excluded from margin requirements.[57] The CFTC recently proposed rules to exempt certain inter-affiliate swaps from the clearing requirement.[58] The CFTC "recognizes that there may be advantages for the corporate group and regulators if risk is appropriately managed and controlled on a consolidated basis and at a single affiliate".[59] In that release, the CTFC seeks comments on whether uncleared swaps between affiliates should be subject to margin requirements.[60] As discussed in our prior letter to the Prudential Regulators[61] and our response to the CFTC's proposal to exempt inter-affiliate trades from clearing requirements[62], inter-affiliate swaps do not add systemic risk. Losses in the trade that accrue to one affiliate are equally offset by gains to the other affiliate. Such trades are used as a internal risk allocation tool and foster centralized risk management. Imposing margin requirements would increase the cost and decrease the efficiency of using swaps for internal risk management.

The Study noted that these trades "frequently serve risk management or other purposes that are different from non-centrally-cleared derivative transactions with third parties" and that the imposition of IM requirements on these trades "could tie up substantial liquidity".[63] Hence, the Basel/IOSCO Working Group chose not to impose IM requirements on inter-affiliate trades, instead leaving it to the discretion of national supervisors.[64] The Study requires the exchange of VM between affiliates but we believe that the imposition of a VM requirement on inter-affiliate trades is unnecessary and undesirable. The fact that VM posting routinely occurs does not mean that it occurs uniformly in all circumstances or that its regulatory imposition would not needlessly increase costs.

VIII. Cross-Border Trades

A. Non-U.S. affiliates of U.S. entities should be excluded from the margin requirements.

We strongly recommend that the Prudential Regulators exclude non-U.S. affiliates of U.S. entities from the margin requirements. As discussed in the prior letter, issues regarding

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[57] See ISDA/SIFMA Margin Letter, pp. 28-29.

[58] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425.

[59] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 at 50427.

[60] See CFTC proposed rule, *Clearing Exemption for Swaps Between Certain Affiliated Entities*, 77 FR 50425 at 50430.

[61] See ISDA/SIFMA Margin Letter, pp. 28-29.

[62] See ISDA and SIFMA comment letter re: Clearing Exemption for Swaps Between Certain Affiliated Entities, dated Sept. 20, 2012.

[63] See Study, p. 28.

[64] See Study, pp. 27-28.

jurisdictional scope, international harmonization, consistency with existing transaction-level regulation and the competitive position of U.S. SDs and MSPs are raised if margin requirements are imposed by the Prudential Regulators on non-U.S. affiliates of U.S. entities.[65]

Subsequent to the Prudential Regulators' release of their proposed margin rules, the CFTC released its proposed guidance on cross-border swaps. The CFTC excludes foreign affiliates of U.S. persons.[66] We ask that the Prudential Regulators consider the CFTC's proposed guidance and the final findings of the Basel/IOSCO Working Group and re-propose their rules on cross-border swaps before finalization.

B. The Prudential Regulators' final margin rules should recognize non-U.S. regulation for swaps involving multiple jurisdictions.

For swaps involving multiple jurisdictions, the rules should recognize non-U.S. regulation. For CSEs outside the U.S., for example, the Prudential Regulators should recognize local margin requirements. Also, the rules should be flexible enough to permit CSEs to structure credit support arrangements to meet the specific legal requirements of the relevant jurisdiction if the CSE or its counterparty is overseas. Such requirements may differ from the U.S. legal requirements for collateral or netting. The Prudential Regulators should coordinate with the CFTC and other regulators, domestic and foreign, to achieve consistency in the treatment of swaps involving multiple jurisdictions.

* * *

ISDA appreciates the opportunity to comment further on the proposed margin requirements. As the Prudential Regulators progress in their on-going effort to finalize the rules and harmonize the proposed approach with those of other regulators, we would welcome the opportunity to assist in that process.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA

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[65] See ISDA/SIFMA Margin Letter, pp. 5-7.

[66] See CFTC proposed rule, *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*, FR 77 41214 at 41218 ("**CFTC Cross-Border Guidance**").

Initial Margin For Non-Centrally Cleared Swaps

Understanding the Systemic Implications

November 2012

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Introduction

Current regulatory proposals call for the posting of initial margin (IM) for swaps that are not centrally cleared. This document discusses the economic and systemic consequences of current regulatory proposals.

This is a new analysis, enabled by recently available data from member responses to the Quantitative Impact Study (QIS) that was coordinated by the Working Group on Margin Requirements.[1]

The analysis shows that the proposed IM framework could have dangerous pro-cyclical risks.

ISDA believes that a three pillar framework is appropriate for ensuring systemic resiliency:

- Robust variation margin framework
- Mandatory clearing for liquid, standardized products
- Appropriate capital standards

Adding mandatory IM to this framework could harm the economy and potentially threaten, rather than strengthen, the global financial system.

Non-Cleared OTC Products are Important to the Global Economy

The non-cleared OTC markets play a vital role in the global economy. Some examples of activities that need these markets include:

- Many international corporations rely on the currency swap market to be able to finance their operations
- Interest rate options are needed for the proper functioning of the housing markets, particularly in the US, where the GSEs need them to hedge their mortgage risks and to maintain the availability of home mortgages
- Banks and investors use CDS to hedge their exposures in the corporate loan and corporate bond markets; CDS facilitates activity in this important sector of the economy
- Treasurers and risk managers globally use specific solutions tailored to the asset and liability management needs of their institutions, which include pension funds, insurance companies, banks and corporations
- Sovereigns and supranational organizations (IBRD, EBRD, EIB, etc.) use unclearable swaps in their financing and funding activities

Large sectors of the OTC derivatives markets – including interest rate options, many single-name CDS and currency swaps – are not currently clearable and some might never be appropriate for central clearing.

Initial Margin Estimate Based on BCBS/IOSCO Proposal

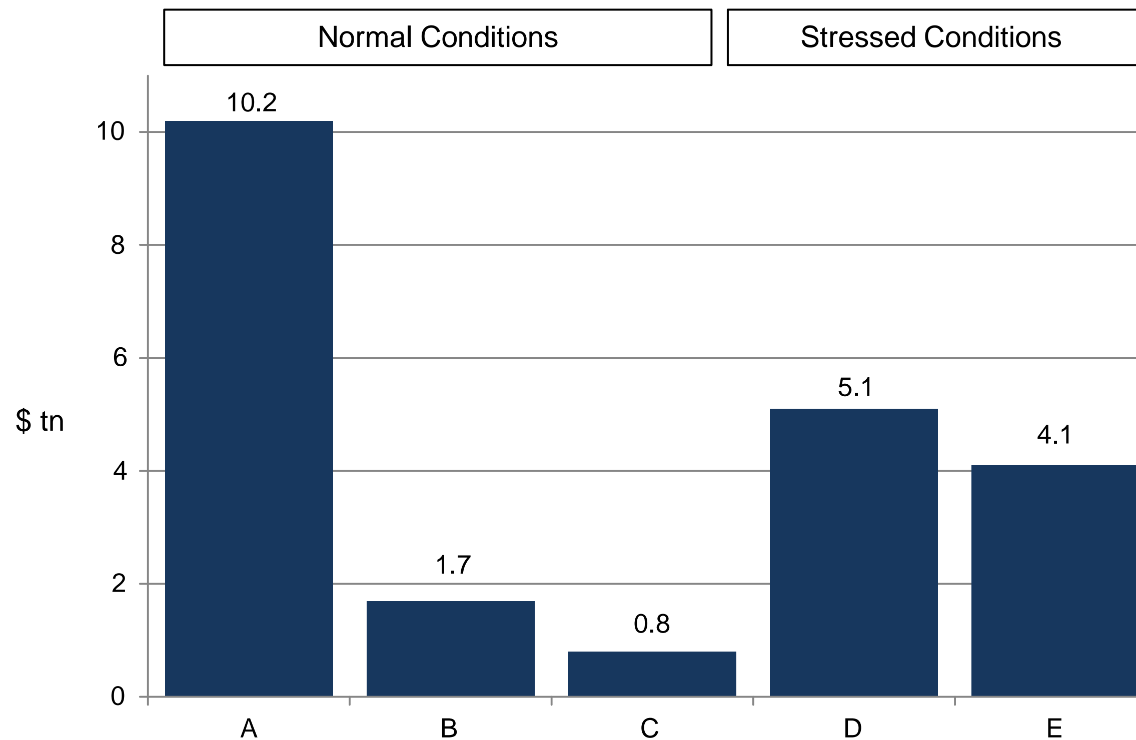
Using member responses, and based on ISDA's analysis of OTC derivatives outstanding that are unclearable ($127tn[2]), the Association estimates the following impact:

- Total IM, without thresholds, in the global system would range from $1.7tn to $10.2tn depending on usage of approved internal IM models
- With a €50mm per counterparty threshold, IM requirements could be reduced to $800bn (assuming all firms use approved internal IM models)

The analysis highlights three concerns for the industry:

1. The outright quantum of margin required even in "normal" market conditions is very significant
2. Increased IM requirements in stressed conditions will result in greatly increased demand for new funds at the worst possible time for market participants
3. Thresholds, while helpful from an initial quantum perspective, add to this pro-cyclicality in stressed markets

Initial Margin Estimate Based on BCBS/IOSCO Proposal



A All firms using standard margin schedule, no threshold
B All firms use internal models; no threshold
C All firms use internal models; €50mm threshold
D All firms use internal models; no threshold; stressed conditions
E All firms use internal models; €50mm threshold; stressed conditions

BCBS/IOSCO includes mandatory universal two-way IM posting; estimates based on $127tn of unclearable OTC derivatives.

ISDA's Concerns about the IM Proposals:

1) Quantum

Even with all firms using internal IM models, the amount of margin needed in normal market conditions presents a very significant challenge for the industry.

- Banks do not have unencumbered assets available for delivery as margin
- Similarly, banks do not hold cash liquidity in excess of targets specifically designed to meet future funding needs through a cycle

To meet new margin requirements, banks will either need to:

- Generate incremental funding through the capital markets, or
- Divert funding from other activities (such as lending or market making), or
- Decrease or cease activity in non-cleared OTC markets

Each of these routes has serious implications for the global economy.

ISDA's Concerns about the IM Proposals: Quantum (continued)

Individual banks and the global system would be challenged to generate incremental financing through the capital markets of IM funding requirement.

- The average amount of IM required to be posted by each bank in the ISDA QIS analysis is in the range of $23bn (with €50mm thresholds) to $49bn (with no thresholds)
- Financing requirements of this scale would present significant challenges to the industry

Diverting funding from other activities to finance IM will be harmful to those activities and harmful to the broader economy.

- At the individual bank level, the IM would be segregated and could not be used for any other purpose; funds used for IM could otherwise have been put to use by the bank in the economy, through lending and other activities
- At the global macroeconomic level, segregation of cash of the order of $800bn to $1.7tn is a form of extreme quantitative tightening at a time when monetary policy is generally oriented in the opposite direction

Reduction or cessation of trading activity in non-cleared OTC markets could have an adverse effect on critical economic sectors, including housing and corporate funding.

ISDA's Concerns about the IM Proposals:

2) Pro-cyclicality

An increase in IM requirements in stressed market conditions will result in increased demand for new funds at the worst possible time for market participants. Risk-sensitive IM, contemplated by the VaR approach in the proposals, could have major adverse systemic implications.

- IM requirements can increase in stressed market conditions, perhaps by a factor of three[3]

- This is pro-cyclical for the banking system:
  - There is a real possibility some banks might fail to raise sufficient funds. In 2008 raising single-digit billions of USD was very challenging. Raising multiple tens of billions of USD might not be possible.

- This is also pro-cyclical for markets:
  - Forced selling of assets by sell-side and/or buy-side to generate more cash to fund IM calls during market disruptions adds to economic and market stresses. A loop effect may result. Asset price declines caused by asset sellers could further increase volatility, resulting in increased IM calls, more asset sales, and so on.

ISDA's Concerns about the IM Proposals:

3) Pro-cyclicality Compounded by Thresholds

The pro-cyclical nature of risk sensitive IM is further amplified by use of thresholds

Consider a single margin relationship:

- IM requirement without threshold: $100mm
- IM requirement in market stressed condition, due to increased market volatility: $300mm
- This is the 3X multiplier as contemplated on the previous slide

Now consider the effect of a $50mm IM threshold:

- The net margin call would grow from $50mm to $250mm
- This is a 5X multiplier

At the industry level this effect could drive total margin from $800bn to $4.1tn.

- This will place great stress on the system in a down cycle
- Banks would not have the capacity to generate this incremental funding

Potential Solutions to Pro-Cyclical Risks: Maintain Fixed Levels of IM

Pro-cyclicality can be cured by moving to a regime where margin amounts are fixed at the time of transaction and not changed as markets move to a stressed condition.

Two possible approaches include:

- Set a very high IM at the time of transaction, even in normal market conditions. The amount of margin would be large enough to cover margin needs even in a stressed market. Such an approach would remove pro-cyclicality.

  The effect of such a measure, however, would be to severely impair liquidity in the uncleared markets. The funding costs of IM would be so high that many of these critical markets would be effectively shut down. Significant adverse economic consequences would result.

- Set a fixed low or zero IM. This is the current situation. Potential future exposure would not be completely covered by margin. This is an acceptable outcome, however, since risks not covered would be covered by capital. Parties would negotiate commercial arrangements with regard to IM margin as they do today. Variation margin would be exchanged daily.

IM Estimate Based on US Prudential Regulators Proposals

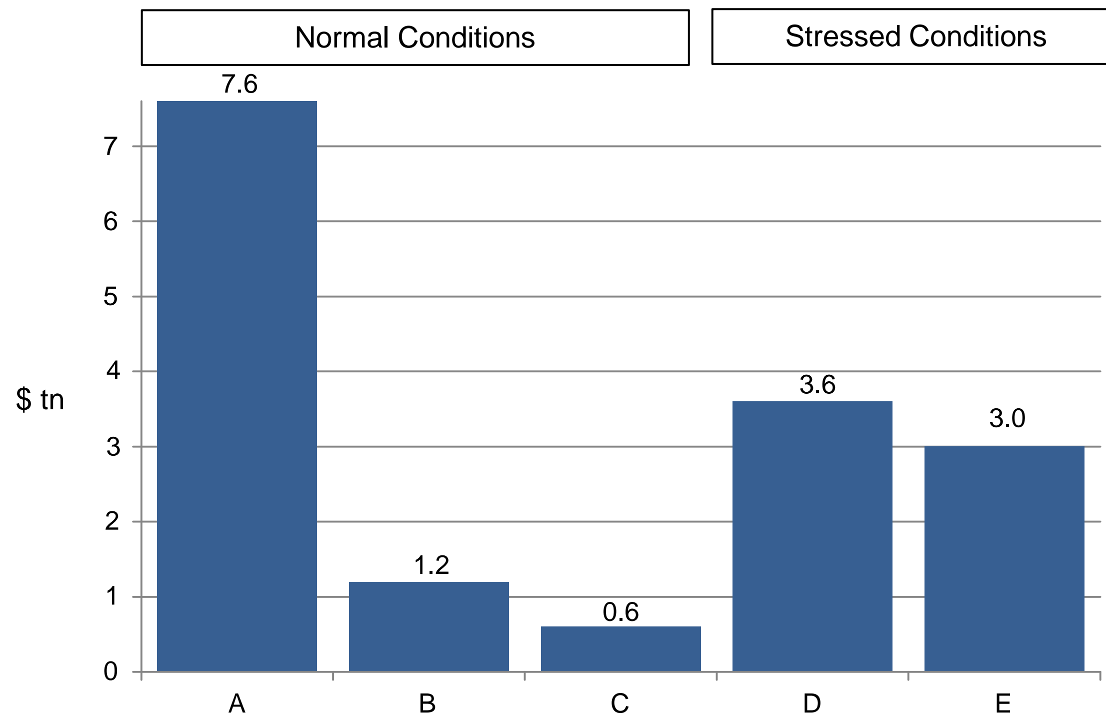
For comparison, US prudential regulators made proposals in 2011 that are in many respects similar to WGMR proposals.

- One major difference under the US proposal was that while swap dealers must post IM to each other, they would not post IM to non-dealer counterparties

Adjusting solely for one-way posting of margin between dealers, the range of outcomes generated by ISDA QIS studies under US rules is shown on the following page.

- Global IM impact is somewhat smaller than the WGMR impact:
  - $10.2tn (standardized) becomes $7.6tn
  - $1.7tn (full model usage) becomes $1.2tn
  - $800bn (full model usage with threshold) becomes $600bn
- The initial margin requirements for dealers is reduced:
  - Amount per bank falls to a range of $15bn (with thresholds) to $20bn (no thresholds)
- Pro-cyclical effects remain:
  - Margin in stressed conditions rises to $3tn or more

IM Estimate Based on US Prudential Regulators Proposals[4]



- **A** All firms use margin schedule, no threshold
- **B** All firms use internal models, no threshold
- **C** All firms use internal models, €50mm threshold
- **D** All firms use internal models, no threshold, stressed conditions
- **E** All firms use internal models, €50mm threshold, stressed conditions

The IM proposals from US prudential regulators include mandatory one-way posting of margin between swap dealers. The estimates are based on $127tn of unclearable OTC derivatives as per the ISDA analysis of member QIS data. For comparative purposes only with the BCBS/IOSCO estimates, this chart also estimates IM requirements with a €50mm threshold.

Summary & Conclusion

The unclearable OTC derivative market plays an important role in the global economy. Application of mandatory risk-sensitive IM to this market would increase, rather than decrease, systemic risk.

IM is pro-cyclical; it would dramatically impact liquidity, reduce the availability and liquidity of vital risk management tools and could potentially lead to a funding shock that could severely damage the banking system and the real economy.

The value of IM is that it makes each node in the system less vulnerable to defaults at adjacent nodes; but this comes at a cost, IM posted out makes each node weaker, since it consumes liquidity resources at the node:

- Market stress potentially exposes this weakness to a critical degree
- IM introduces institutions to potentially dangerous obligations under the guise of protecting those institutions

Somewhat counter-intuitively, thresholds, while making the IM challenge more affordable in normal conditions, cause a dangerous leveraging effect in stressed markets, greatly increasing pro-cyclicality.

Summary & Conclusion (continued)

We believe that a three-pillar approach is appropriate for ensuring systemic resiliency:

- Robust variation margin framework
- Mandatory clearing for liquid, standardized products
- Appropriate capital standards

APPENDIX

- **ISDA: Committed to Safe, Efficient, OTC Derivatives Markets**
- **Why Can’t All OTC Derivatives Be Cleared?**
- **ISDA’s Analysis of the WGMR’s QIS Responses**
- **Are the QIS IM Estimates Already Stressed?**
- **Why do IM Estimates Vary?**

ISDA: Committed to Safe, Efficient, OTC Derivatives Markets

ISDA strongly supports G20 goals to reduce systemic risk and is committed to working aggressively with industry and regulators toward this end.

- ISDA has led the way in standardizing OTC derivatives to enable clearing
- Trading activity in standardized, liquid OTC derivatives between systemically important parties is now almost entirely centrally cleared
- Trades that are reported to central Trade Repositories give regulators transparency into global OTC markets on a scale and with an international comprehensiveness never before seen in the financial markets. The vast majority of transactions between systemically important parties have now been reported to a repository (and in the future all will be reported).

As a result of these efforts, the OTC derivatives markets and the financial system are now safer, more transparent and more robust than ever before.

Why Can't All OTC Derivatives Be Cleared?

While greater use of central clearing is a key goal of policymakers and market participants, it's important to recognize that only certain liquid, standardized products can be cleared.

- Clearinghouses are the hubs at the center of the new market structure. Over half of all interest rate and credit derivatives currently outstanding are now cleared.
- In addition, estimates today indicate that approximately 80% of the current OTC derivatives notional outstanding can be cleared
- Given this, a default by a clearinghouse would be catastrophic to markets
- In times of crisis, clearinghouses need to respond rapidly to member defaults. Positions held by defaulting members must be hedged or liquidated in a very short time frame; otherwise clearinghouses could sustain damaging losses in deteriorating markets.
- The product set offered by a clearinghouse must therefore be of the highest quality from a liquidity perspective
- Requiring clearinghouses to accept products that are not sufficiently liquid or are not suitable for clearing for other reasons would put them at risk, and increase rather than decrease risk in the system
- Products suitable for clearing are few in number – primarily IRS and the most liquid CDS

So, while a high proportion of the OTC derivatives market in *notional terms* can be cleared, the vast majority of *transaction types* cannot be cleared.

ISDA's Analysis of the WGMR's QIS Responses

The Group of Twenty (G20) initiated a reform program in 2009 to reduce the systemic risk in markets.

In 2011, the G20 agreed to add margin requirements on non-centrally-cleared derivatives to the reform program.

The Working Group on Margin Requirements (WGMR) was formed in October 2011 to develop, for consultation, consistent global standards for these margin requirements.

The WGMR issued its consultative document, with preliminary proposals on margin requirements, in July 2012.

The WGMR coordinated a quantitative impact study (QIS) of "primarily internationally active institutions" to gauge the impact of its margin proposals. In particular, the QIS would assess the amount of margin required on non-centrally cleared derivatives.

While results of the official QIS study are not in the public domain, ISDA members also submitted QIS responses to ISDA anonymously through an independent third-party.

Are the QIS IM Estimates Already Stressed?

The QIS IM estimates based on internal models were, according to the WGMR's Consultation Paper, to reflect a 99 percent confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress.

An analysis of the QIS estimates indicates they are relatively low when compared to IM for cleared OTC derivatives.[5]

- The QIS IM estimate for non-cleared IRS is 18bps of non-cleared IRS notional. This compares to an IM estimate for cleared IRS that is 21bp of cleared IRS notional calculated using a 5-day horizon. Using a 10-day horizon and allowing for stressed conditions (a 2x multiplier), the IM estimate for cleared IRS increases to 60bp of cleared IRS notional.
- The QIS IM estimate for CDS is 94bps of non-cleared CDS notional. This compares to IM for cleared CDS that is 153bp of cleared CDS notional at the ICE clearinghouse. Using a 10-day horizon and allowing for stressed conditions (a 2x multiplier), the IM estimate for cleared CDS increases to 510bp of cleared CDS notional.

As a result, IM estimates in the QIS will not cover exposures in more volatile times.

Why do IM Estimates Vary?

Various public policy proposals differ in their assumptions and IM estimates. This variability is due to several principal factors:

- ***The extent to which netting is allowed***. Netting is a powerful risk reduction concept and the industry has devoted very significant efforts to perfect its market practice. Margin proposals do not allow for firms to realize the maximum benefits of netting where it is legally enforceable.

- Use of ***approved internal models vs. standardized models.*** Internal models calculate credit exposure on a net basis for transactions within a particular asset class and their usage lowers IM estimates. The proposed standardized schedule is to be applied on gross activity (gross notional amounts), leading to a vast overestimation of margin requirements. Diversification (and thus netting) across products is not possible.

- ***Data assumptions*** regarding populations as well as percentages of cleared vs. uncleared, asset classes, geographic scope, BIS "unallocated" swaps. Less cleared / broader scope increases IM.

- ***Calculation methodologies,*** such as allowing netting across asset classes (which reduces IM estimate), one-way or two-way posting (two-way posting increases the estimate)

- ***Threshold*** levels regarding the level of counterparty exposure at which IM would begin to be required. A higher threshold means a lower IM estimate.

Footnotes

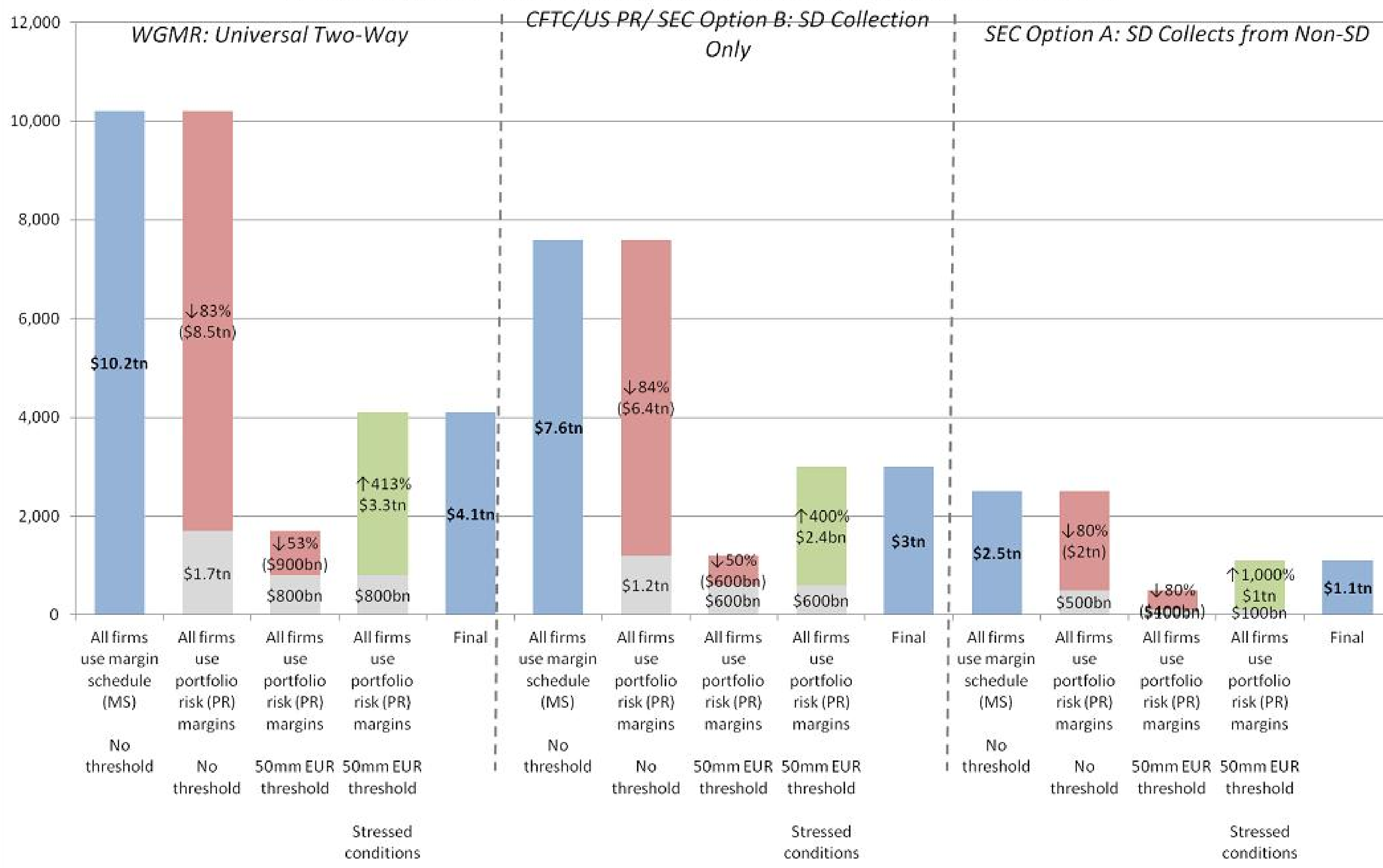
[1]The ISDA analysis is based on data submitted by member firms to the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements (WGMR), as part of the WGMR's Quantitative Impact Study (QIS). Members submitted their QIS responses to ISDA for analysis anonymously through an independent third-party. These firms represent 45% to 50% of the global OTC derivatives market.

[2] The $127tn of unclearable OTC derivatives is an ISDA estimate based on data provided by the QIS respondents as to the current portion of their uncleared OTC derivatives portfolios that can not be cleared.

[3] Source: BIS Working Paper 373, "Collateral requirements for mandatory central clearing of over-the-counter derivatives," page 20. The paper notes that for cleared portfolios, "Across the G14 dealers, initial margin requirements on IRS portfolios total $15 billion in an environment of low market volatility, rising to $29 billion if market volatility increased to medium and $43 billion if it increased to high. For CDS, total initial margin requirements jump from $10 billion in an environment of low market volatility to $51 billion and $107 billion as volatility rises to medium and high." For this analysis, ISDA applied the estimate that IM could rise 3x in stressed conditions across the portfolio of unclearable swaps.

[4] The analyses contained in this presentation were derived from member QIS responses that were developed prior to the issuance of the exemption for FX forwards and swaps by the US Treasury on November 16, 2012. We estimate the Treasury exemption would reduce IM requirements under the US prudential regulators proposals by 15% to 20%. If FX forwards and swaps are excluded globally as per the US Treasury exemption, we estimate that adjustments of a similar magnitude would need to be made to the estimated IM requirements under the BCBS/IOSCO proposal.

[5] Sources: ISDA Response to BCBS-IOSCO Study on Margin, September 28, 2012, page 6, at www.isda.org; ISDA analysis



Initial Margin (IM) Requirements for Non-Clearable Derivatives
WGMR: Universal Two-Way
CFTC/US PR/ SEC Option B: SD Collection Only
SEC Option A: SD Collects from Non-SD
12,000
10,000
8,000
6,000
4,000
2,000
0
$10.2tn
↓83% ($8.5tn)
$1.7tn
↓53% ($900bn)
$800bn
↑413% $3.3tn
$800bn
$4.1tn
$7.6tn
↓84% ($6.4tn)
$1.2tn
↓50% ($600bn)
$600bn
↑400% $2.4bn
$600bn
$3tn
$2.5tn
↓80% ($2tn)
$500bn
↓80% ($400bn)
↑1,000% $1tn
$100bn
$1.1tn
All firms use margin schedule (MS) No threshold
All firms use portfolio risk (PR) margins No threshold
All firms use portfolio risk (PR) margins 50mm EUR threshold
All firms use portfolio risk (PR) margins 50mm EUR threshold Stressed conditions
Final