



International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isdaeurope@isda.org
website: www.isda.org

14 September 2005

Dear Mr. Ian Pickering,

FSA Quarterly consultation (No. 5)

The International Swaps and Derivatives Association (ISDA)¹ welcomes this opportunity to comment on the Quarterly consultation paper. Our comments focus on the particular concerns of our member firms, which enter into privately negotiated (off-market) derivative transactions with insurance undertakings.

Our main concerns relate to PRU 4.3.34 and PRU 4.3.35, and the proposed changes set out in the above consultation paper. Under these proposals, an insurance company's over-the-counter (OTC) derivatives transactions will only be on "approved terms" if, before the transaction is entered into, the insurer's counterparty has agreed that it will, on request, close out that transaction at any time, at a price to be determined in accordance with an agreed pricing mechanism.

We are concerned that many counterparties that currently engage in OTC derivatives transactions with insurance companies will be unable or unwilling to enter into transactions on the required terms or will only be willing to do so on terms which impose significant additional costs on insurance companies. This would have a significant adverse effect on liquidity in the market and on the ability of insurance companies to engage in risk management. We consider that there should be more time to debate the purpose behind these amendments, their potential impact and possible alternative ways of achieving their objectives and that accordingly the transitional period specified in PRU TR 23 should be further extended. In particular, we consider that there should be an appropriate cost benefit analysis for these proposals.

¹ ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, and leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants. ISDA's structure presently counts 17 different committees covering four main areas: issues of industry infrastructure; products; oversight and supervision; and region-specific issues. These committees, together with related working groups, play an important role in facilitating the exchange of ideas, the examination of policy issues, and the flow of information among its members.

In addition, we are concerned that the proposal to bring these provisions into force on 31 December 2005 gives insurance companies too little time to negotiate amendments to existing contracts to reflect the new provisions or, where counterparties are unwilling to agree to the changes, to put in place alternative arrangements. In any event, the wording of the proposals would appear to require insurance companies to replace all outstanding transactions with new transactions on the required terms, since a transaction would only be on approved terms if the counterparty has entered into the required undertaking "before the transaction is entered into" - it seems that it would not be sufficient to agree an amendment to an existing agreement. At the very least, there should be grandfathering arrangements for existing transactions.

Overall objectives

We question whether it is necessary or appropriate to impose these requirements on all OTC derivatives contracts entered into by insurance companies. This approach is not, for example, consistent with the approach taken in relation to the valuation for solvency purposes of derivatives transactions entered into by banks and investment firms, where reliance is placed on the use of appropriate accounting measures and appropriate governance in the application of those measures. It is also not consistent with the approach taken in relation to the valuation of securities, where there is no equivalent requirement for there to be liquidity provided using agreed pricing mechanism. The price of the securities will depend on current market conditions, which may deviate from those predicted using models or other criteria.

We consider that the comparison with collective investment schemes is not appropriate, as those schemes offer daily liquidity and, in part for that reason, will tend to enter into a narrower range of more straightforward derivative transactions. Imposing these requirements on all derivatives transactions of insurance companies could significantly restrict the range of transactions which they will be able to enter into and the range of risk management practices which they can adopt.

New requirements are likely to be burdensome

The previous valuation of assets rules for insurance companies contemplated that OTC derivative transactions would not be given an admissible value unless the insurer reasonably believed that the transaction could be readily closed out. In practice, approved derivatives counterparties would generally be able to offer a close out price, on request, based on current market conditions.

The adopted rules go further by requiring a legally binding commitment to close out the transaction at any time on request based on current market conditions and the proposed rules add to this by requiring that the close out pricing be based on a pricing mechanism agreed in advance between the parties. This requires the counterparty to give a formal, legally binding commitment to provide immediate liquidity on a basis agreed in advance.

We consider that it is unlikely that counterparties will be able to provide such a commitment at no additional cost for any but the simplest types of transactions. Normally, a counterparty would expect to apply a number of different factors, which may vary over time, in the pricing of OTC derivatives transactions in the light of current market conditions. It is likely to be difficult for any

formula to replicate the pricing process in a realistic way, without oversimplification and without introducing rigidity into what would typically be a flexible process of negotiation. For example, in many cases, the counterparty would use its own estimates of complex variables for which no independent data is available (for example, implied volatility skew, implied correlations and long dated equity implied dividends used in pricing put options). The appropriate parameters may themselves vary over time.

In addition, especially for larger and longer dated transactions, a commitment to provide immediate liquidity involves the firm accepting significant risks about its ability to unwind their positions in the market, which may be difficult to factor into any agreed pricing mechanism. A requirement for immediacy will generally involve some adjustment to the price to reflect the risks in providing that service, which would normally be negotiated by reference to market conditions at the time.

If a counterparty commits to a pricing mechanism which could produce a close out price which diverges from the actual pricing which it would otherwise have applied and it is willing to take on the associated market risks of committing to immediate execution at that price, the counterparty is likely to make additional valuation adjustments against the committed liquidity on its own books. This could affect its regulatory capital requirements and the cost of the trade to the insurance company. In some cases, counterparties will determine that the magnitude of this additional, unhedgeable risk is such that they simply will not enter into the transaction with the insurance company at all.

Accordingly, we would urge the FSA to reconsider these proposals. If you have any questions on this, please contact Gianluigi Gugliotta of ISDA at the number given above.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jonathan Taylor', written in a cursive style.

Jonathan Taylor
Chair of the European Regulatory Committee