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Steven J. Murphy
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Standard & Poor's
55 Water Street
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Dear Sir,

The International Swaps and Derivatives Association appreciates the opportunity to comment on the Debt Derivative Profiles (DDP) developed by Standard & Poor's to assess swaps associated with municipal debt issuance. As a general matter, ISDA concurs with and endorses the comments on the DDP criteria by The Bond Market Association. In this letter, we would like to focus on a subset of issues of particular concern to ISDA.

ISDA is a global trade association, comprising over 600 members in the privately negotiated derivatives industry. Since our establishment in 1985, our member firms have led efforts to promote legal certainty, sound risk management, market liquidity, and market efficiency. ISDA activities have led to the development of market conventions, some formal, others informal, which reflect industry consensus as to current practice. The ISDA Master Agreement and its associated documents, along with ISDA committee efforts in other areas such as risk management, collateral management, and operations, are examples of these efforts.

Given that both regulators and credit rating agencies are also concerned with these same areas, we seek whenever feasible to develop documents and standards that complement, rather than work at cross purposes to, efforts by regulators and credit rating agencies. At times, however, regulatory or rating agency standards arise that appear to diverge from market conventions and practices developing among ISDA members, and we seek to play a constructive role by attempting to bring about consistency between the parallel efforts.

We support S&P's efforts to encourage sound risk management by municipalities using derivatives, as embodied in the DDP standards. Most notably, the assessment in the DDP of an entity's Swap Management Plan could be very helpful to the market by focusing attention on issuers' awareness of the risks they are taking on and of how to manage those risks. One might

even argue that assessment of the Swap Management Plan alone might be a sufficient basis for a DDP rating. ISDA is concerned, however, with other aspects of the DDP standards because they might run counter to beneficial market practices and trends and could even be counterproductive. Even though the DDP standards are not mandatory, borrowers' desire to score the most favorable rating has led borrowers to insist upon deviations from standard and prudent market practices. And even though any one of the standards might be a small part of the overall DDP rating, the cumulative effect of the combined factors might have the unintended consequence of increasing the cost of hedging and of decreasing liquidity for municipal users of derivatives.

The following areas are of particular interest to the ISDA membership.

Asymmetric credit provisions. We understand that, under the DDP criteria, entities are effectively encouraged to negotiate lower downgrade thresholds and higher minimum transfer amounts for collateral for themselves than for their dealer counterparties. This asymmetry runs counter to sound management practice at dealers and could invite strong criticism not only by bank or securities regulators but by rating agencies as well. Further, we are concerned that widespread use of asymmetric criteria could lead to adverse selection in the form of competitive pressures on dealers—lower standards or lose the deal—similar to the problems that contributed to the market disruptions of 1998.

Of further concern to ISDA are criteria that encourage one-way collateral posting, which would conflict with market standards that evolved after the market disruptions of 1998. During that time, dealers and hedge funds recognized that, despite the asymmetry in financial condition, one-way collateral created liquidity pressures that could be eased by allowing collateral in both directions. As a result, two-way collateral is now the standard.

ISDA recognizes that there are specialized cases in which an issuer is truly liquidity constrained; in such cases one-way collateral might be in the best interests of the parties to the transaction. But encouraging routine use of one-way collateral by awarding a more favorable score will detract from the overall liquidity of the municipal swaps market and make liquidity crises more likely to occur. More generally, spread of one-way collateral in the municipal market could lead other sectors—large highly rated corporates, for example—to insist on one-way collateral as well and therefore impair overall liquidity in the market. We suggest that S&P make clear that one-way collateral is suggested only for very unusual situations and should not be the general policy.

Conflicts with documentation practice. Yet another concern is that the S&P DDP criteria appear to encourage reversion of municipal counterparties to outmoded credit conventions, in particular, First Method, more commonly known as limited two-way payments or a “walk-away” clause. As a general matter, First Method was not commonly used under the 1992 ISDA Master Agreement except in jurisdictions with high degree of uncertainty regarding treatment of creditors. First Method was consequently deleted from the 2002 ISDA Master Agreement, to which major dealers are shifting. Further, encouraging First Method runs counter to US and international bank regulatory policy, which denies netting benefits to hedges using swaps subject to First Method. (Also, we understand that AAA-rated derivative product companies (DPCs) tend not to allow dealing under First Method.)

Termination and collateral posting risk. The S&P program does not distinguish a borrower's collateral posting risk from its risk of financial loss and, as such, does not capture the benefit of the inclusion in swap documents of collateral posting terms. Further, some of the factors given favorable treatment by S&P to mitigate termination and collateral posting risk—asymmetric credit provisions and use of First Method, for example—might promote structuring and documentation changes that not only are contrary to established market practices, but are not necessarily in the best interests of each borrower.

But S&P has suggested other factors that will lead toward a more favorable rating. These factors include, for example, use by borrowers of shorter duration transactions, term-out provisions, non-reimbursable termination insurance policies, options for the issuer to terminate, and elimination of material events of default or termination. While none of these is in itself objectionable when it results from negotiation between the two parties, blanket adherence to all of these could subject individual borrowers to increased risk or cost. Further, term-outs (not mandated by a borrower's budgetary limitations) and use of the First Method may limit a borrower's access to certain providers (e.g., certain AAA DPCs).

As an alternative to basing DDP ratings on the factors discussed above, we suggest that S&P place more emphasis on an issuer's Swap Management Plan. The Swap Management Plan criteria already contain questions about issuer understanding of termination risks and other risks associated with swap issuance. We believe that discussion of these risks with issuers would help raise awareness of the risks and would be more productive than a "checklist" of risk mitigation measures that might conflict with established market standards.

Measures of exposure. When a municipal issuer uses swaps to manage the financial risks of a debt issuance, the entity in effect trades an unwanted risk—interest rate risk—for other risks such as counterparty credit risk and basis risk. We believe the Swap Management Plan part of the DDP is sufficient to evaluate these risks. S&P has chosen, however, to attempt to quantify such risks by such measures as the *swap exposure ratio*, which is the ratio of total issuer swap notionals to issuer debt outstanding, and the *swap counterparty exposure ratio*, which is the ratio of issuer swap notionals with a single swap provider to total issuer swap notionals.

Use of notional-based measures such as the swap exposure ratio and the swap counterparty exposure ratio causes concern for at least two reasons. First, notionals are not an accurate measure of credit exposure; the same notional amount can have vastly different credit exposures for swaps of different maturities, depending on market conditions. Second, the measure raises an unnecessary red flag for an entity that has taken the initiative to manage its interest rate exposure extensively because it would receive a high score. The result is that the entity could be discouraged from undertaking beneficial hedging measures.

Overall, we believe market conventions, including ISDA documentation, have passed the market test and contributed to the safety, efficiency, liquidity, and transparency of derivatives activity. We accordingly view with concern any standards, whether those of a regulatory agency or rating agency, that run counter to the evolution of the market.

Thank you for the opportunity to comment on the Debt Derivatives Profile criteria. We hope you find the above comments helpful, and look forward to further discussion. If you have questions, please contact me at 212-901-6020 or David Mengle, ISDA Head of Research, at 212-901-6017.

Very truly yours,



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