

ISDA

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The Honorable Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Falcon:

ISDA would like to thank you for meeting with us last week to discuss OFHEO's Risk-Based Capital Rule and its impact on OTC derivatives. Please know that we appreciate having the opportunity to discuss with you and your staff the operation of the OTC derivatives markets and the importance of collateralization and netting in these markets.

We also appreciate the opportunity to comment on the OFHEO capital requirements. To that end, ISDA proposes a recommendation to OFHEO's Risk-Based Capital Rule that more fully reflects the effects of risk mitigation practices utilized in the OTC derivatives markets where daily marking-to-market, margin collateral, and netting are employed.

As we discussed last week, bilateral netting, which offsets positive mark-to-market values on transactions for one counterparty against negative mark-to-market values with the same counterparty, reduces exposure because it recognizes that counterparties may have gains and losses with each other that offset should one of them not perform.

Additionally, collateral practices such as marking-to-market and margining reduce exposure on OTC contracts because they dramatically reduce the time in which counterparties are exposed to the movement of interest or foreign exchange rates. Thresholds for movement of collateral are common and are usually triggered if the mark-to-market value of the transaction exceeds a specified threshold (value trigger) or when a counterparty is downgraded or when capital ratios fall below specified levels (event trigger). It is important to note that when a counterparty's rating declines, the threshold exposure declines and calls for collateral will occur more frequently. Counterparty credit risk is also reduced through assignment where counterparties agree that some transactions would be assigned to another counterparty when the mark-to-market value of the transactions exceeds a specified level.

As explained at the meeting, ISDA believes that it is entirely appropriate for firms using derivatives to hold capital against the various risks (market, counterparty) posed by these products. The capital amounts reserved should be calibrated to the risks effectively borne by the institutions. For regulated firms, the amount of regulatory capital assigned is partly a function of the purpose assigned to capital by the supervisors.

Our primary focus as far as the OFHEO rules are concerned is the counterparty risk charge applied on derivative transactions. This requirement seems, based on our experience, significantly out of proportion with risks effectively undertaken. No allowance is made for the fact that the great majority of transactions falling to be regulated by the OFHEO rules are on a fully portfolio margined basis. This simply reflects the modern norm for vanilla derivatives business between highly rated banking or agency entities.

Counterparty risk on derivatives can be presented as a simple function of the default probability of the counterparty over a given horizon (which we understand to be set at 10 years), and the size of the exposure at the time of default. We would like to focus our comments on the latter parameter of size of exposure at default.

The prevailing market practice for measuring derivative exposure utilizes: **current exposure**, the current market value of a derivative payable or receivable, and **potential future exposure**, the estimate of future changes in value over a given time period. Current exposure is calculated net, and taking into account any collateral available, where the institution documents its OTC derivatives trades using a legally enforceable Master Netting Agreement/ Credit Support Annex such as those promoted by ISDA.

Future exposure is limited by the widespread use of credit risk free (cash or government bonds) collateral. Where daily margining applies, which is common practice at a majority of our member firms, future exposure reflects changes in the value of the derivative occurring during the time necessary to liquidate the collateral. The liquidation period is, based on ISDA's surveys, limited to at most 10 days. Further, in almost all cases in question there is no liquidity issue as the transactions in the portfolio are liquidly traded (for example, this applies to interest rate swaps in all common currencies).

Specifically, a portfolio which is fully margined has the following characteristics: 1) margin is called by the counterparty having a net positive exposure on a portfolio basis. The margin agreement allows for frequent margin calls to cover the spot exposure and 2) netting rules used for the calculation of exposure and therefore of margin are supported by standard legal documentation ensuring that netting is actually applicable in the event of a claim arising.

The size of the exposure for margined transactions is hence very limited, and certainly small compared to the proposed 40% factor applied by OFHEO on the non-derivative charges to derive the derivative haircuts.

The value of trading supported by netting and margining agreements has long been recognized as one of the key benefits of exchange trading, but is equally present in the OTC market between market professional counterparties. It should be emphasized that these margined exposures are in economic terms equivalent to exchange traded derivatives, for which OFHEO does not propose to require any capital.

Based on the market mechanics described above, we recommend that OFHEO modify the haircuts under its framework to more accurately reflect the actual horizon over which the enterprises could be exposed to changes in the values of their derivatives contracts. As noted, major market participants assume a horizon of no more than 10 days in their own modeling. As a result, their internal counterparty credit risk capital requirements, which are conservatively set to ensure their own high credit quality in light of the market's demands, are 50 or more times lower than those proposed by OFHEO. Recognizing the very high prudential standard OFHEO must achieve, the capital charges in the table below conservatively reflect both the market and credit risk dynamics of collateralized interest rate derivative contracts over a two-week period.

ISDA Recommended Capital Charge
10-year single currency interest rate swap/10-year phase-in

	Notional
AAA	0.01%
AA	0.015%
A	0.03%
BBB	0.06%

We believe that the proposal contained in this letter accurately and conservatively reflects OTC derivatives exposure measurement and mitigation techniques used in the market. It is our hope that OFHEO will give this proposal favorable consideration and will accordingly modify the derivative haircut levels in the Risk-Based Capital Rule.

We welcome the opportunity to discuss our proposal further with you or your staff and would like to arrange a conference call to discuss our recommendations and their translation into the Risk-Based Capital Rule at your earliest convenience. Please contact Stacy Carey, Policy Director, in our New York office at (212) 332-1202 or Emmanuelle Sebtou, Head of Risk Management, in our London office at (207) 330- 3550.

Sincerely,



Robert G. Pickel
Executive Director and Chief Executive Officer