April 12, 2013

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Dear Sirs,

RE: Margin Requirements for Non-Centrally-Cleared Derivatives

We, the undersigned organizations, support the intent of global policymakers to develop a regulatory framework that improves the safety of the global over-the-counter (OTC) derivatives markets. In a number of critical areas of reform, ranging from improving regulatory transparency through trade repositories to reducing counterparty credit risk through increased clearing, we have collaborated extensively with policymakers and worked hard with market participants to help drive real progress.

We further recognize the need for and completely support proposals for robust variation margin requirements, particularly for systemically important firms.

In the areas of trade repositories, central clearing and variation margin, the benefits of market reform initiatives are clear. It is equally clear that those benefits outweigh any costs associated with those initiatives. For these reasons, we, and our members, have given complete support to these initiatives.

The margin requirements for non-centrally cleared derivatives that will be proposed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO) mark another important step in the regulatory reform effort. We recognize that such requirements are a G-20 imperative.

While we recognize that the proposals for margin requirements are considered to be "near-final," we still harbor grave concerns regarding the initial margin (IM) requirements. We therefore believe it is important to write to you separately from the responses we provided to the BCBS-IOSCO on the Second Consultative Document. We respectfully ask that you consider withdrawing or suspending any IM requirements until their consequences have been fully analyzed and clarified.

The IM requirements do not appear to meet any objective cost-benefit analysis. We also do not believe that as currently drafted, they will contribute to the shared goal of reducing systemic risk and increasing systemic resilience. In fact, the reverse might be true: the proposed requirements might significantly reduce market liquidity, tax the banking system and the global economy and introduce dangerous pro-cyclical risks. And all for no real tangible benefit.

We note that requirements for IM were not specifically part of the G-20 commitment on derivatives regulatory reform or on margining. Consequently, IM is only one of any number of options available to policyholders in developing "standards on margining for non-centrally cleared OTC derivatives" (as the G-20 Cannes Summit Communique states). We believe its usage as currently envisioned is not an effective option and that policymakers should consider others to achieve their goals.

We would also like to reiterate our strong support for a robust variation margin regime. If such a framework had been in place during the recent financial crisis, problems stemming from AIG – and the government bailout prompted by spillover concerns regarding AIG's counterparty risks – would have largely been avoided. And in all likelihood, OTC derivatives during the crisis would not have been perceived to have had the same systemic implications. In contrast, the experience of Lehman was very different. Lehman posted variation margin on a daily basis, and even though there were significant concerns at the time, total realized losses arising from the closeout of OTC derivative portfolios were not material on a systemic level.

We have several key concerns regarding the IM proposal:

- **As we have noted previously, the outright quantum of margin required even in "normal" market conditions is very significant. Increased IM requirements in stressed conditions will result in greatly increased demand for new funds at the worst possible time for market participants.**

- **The IM requirements could force market participants to forego the use of non-cleared OTC derivatives and either: (1) choose less effective means of hedging, or (2) leave the underlying risks unhedged, or (3) decide not to undertake the underlying economic activity in the first instance due to increased risk that cannot be effectively hedged.**

- **The IM requirements should not be used as a tool to meet objectives of policymakers to reduce risk by encouraging more clearing. No incentive is sufficient to safely clear non-clearable derivatives, and an incentive that seeks to encourage such practices is inconsistent with efforts to create robust and resilient clearinghouses.**

In short, the IM requirements will have a significant adverse impact on the global economy, systemic risk, financial market activity and liquidity and end-user risk management. These points are discussed further below.

We believe empirical evidence is important in order to accurately understand and assess the impact of the regulatory treatment of non-cleared OTC derivatives. Toward this end, we suggest three important research initiatives.

First, we urge BCBS-IOSCO to conduct another Quantitative Impact Study (QIS). Based on our analysis we are concerned that the original QIS may misstate -- perhaps significantly -- the level of margin required under the proposals as compared to our and the WGMR's analyses following our respective reviews of QIS data. This difference is due largely to a lack of specificity in the QIS, which resulted in various responders answering questions inconsistently and understating the level of IM required under the proposal. The additional IM that we estimate would be required is, of course, on top of existing estimates that put IM requirements at upwards of $850 billion. We would note that this estimate is based on the aggressive (and unlikely) assumption that all firms use validated internal models (as well as on a €50 million threshold); lower usage of internal models would significantly increase the IM requirement. The size, significance and impact of the IM requirements justify a new QIS in order to more accurately measure the cost of the proposals.

Second, alongside this second QIS which would more accurately assess the cost of the proposed IM requirements, an analysis of the benefits of initial margin should also be undertaken. This would enable policymakers to measure and compare both the costs and the benefits before the initiative is implemented. It would enable policymakers to assess what mandatory IM would actually achieve. Total counterparty losses following the Lehman default were very small compared to the proposed "remedy" of IM which will require hundreds of billions of dollars of margin with substantial funding costs.

Third, we believe that it is also important to analyze and quantify the economic value of non-cleared OTC derivatives before IM requirements that are likely to substantially reshape this market segment are put into effect. We expect that it would demonstrate the value that non-cleared OTC derivatives offer to end-users, the financial system and the global economy. We would welcome the opportunity to collaborate on this initiative with policymakers. We would ask that the empirical evidence from this and related research initiatives be factored into the final margin requirements.

We also believe it is important that the final margin requirements take into account the significant flaws that exist in three major policy concepts that may be weighing heavily on the regulatory treatment of non-cleared OTC derivatives. These concepts have arisen in a number of our discussions with supervisors and regulators around the world. They appear to be major drivers of the proposals and the IM requirements.

- **The first issue centers on the relative benefits and costs of the IM requirements. The near-universal belief in the value of IM leads to the view that its systemic rewards will be such that it should be implemented at any cost. We contend that the rewards of IM are minimal when considered on a systemic scale – and that the associated costs are enormous.**

- **The second issue has to do with the belief that IM is a necessary and effective measure which will incentivize market participants to clear their OTC transactions. We believe that you cannot incentivize the clearing of something if it is non-clearable. Legislation and appropriate supervision, on the other hand, will ensure that those trades that can be cleared are in fact cleared.**

- **The third and final issue has to do with the need to impose IM in order to ensure the playing field between cleared and non-cleared OTC derivatives is relatively level. We do not see the reason for such a goal, and the fact is, the playing field is already slanted towards cleared transactions. The IM requirements would significantly steepen the grade of the field.**

1st Conceptual Flaw: IM's Benefits Outweigh its Costs in All Circumstances

There is no question that IM would reduce OTC derivatives counterparty credit risk; it clearly would. The real questions, however, are: at what cost would it do so, and are those costs greater than, equal to or less than the benefits that would be derived from doing so. The economic analysis referred to earlier in our paper would help policymakers to add empirical evidence to their deliberations on this issue.

The evidence we have indicates that the relative benefits of imposing IM -- in markets with mandatory VM posting – would be quite limited. Losses in the OTC markets resulting from the failure of Lehman Brothers, for example, proved to be immaterial on a systemic scale; counterparty credit losses were manageable. This is due to the fact that Lehman calculated and posted VM daily.

The Lehman experience leads to an important question: if daily and robust VM effectively minimizes exposures and losses, then why should an additional requirement be put into place that will require posting material amounts of extra collateral from all counterparties?

To put this into perspective, consider the costs of posting IM compared to the benefits that it might offer. Assuming a total global IM requirement of $1 trillion, and a cost of funding that requirement in the range of 1.5% to 5% per annum, the global cost of IM would be $15 billion to $50 billion per year.

Contrast this with the potential benefits of IM, using Lehman as an example. One published report[1], estimates the aggregate exposure of the largest banks at $14 billion. Realized losses at those banks would have been much less due to the benefit of credit hedging of Lehman exposures and recovery payments from the Lehman estate. Assuming that a significant proportion of the $5 billion in open CDS positions at the time of the Lehman failure was held by bank counterparty hedging desks, and that recovery payments to OTC derivatives counterparties from the Lehman estate amount to 50%, this would put the level of big bank counterparty credit losses at less than $5 billion.

As this example shows, the annual cost of funding the mandatory IM regime would by far exceed the actual credit losses it is designed to protect against. The Lehman experience suggests that the costs of mandatory IM would be more than the combined realized OTC derivatives counterparty losses arising from the failure of three or more of the world's largest derivatives dealers each year. Contrast this with clearinghouse margining standards, where the goal is to insulate the clearinghouse from the simultaneous failure of two major counterparties. The extraordinarily high level of IM required under the proposal (on both absolute and relative bases) seems particularly incongruous given the considerable progress achieved in enhancing systemic resilience via increased clearing and trade reporting to repositories and improved capital and liquidity standards.

2nd Conceptual Flaw: IM as an Incentive to Clear

The Second Consultative Document states that:

> "In many jurisdictions central clearing will be mandatory for most standardised derivatives. But clearing imposes costs, in part because CCPs require margin to be posted. Margin requirements on non-centrally cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing…"

If IM is set high enough for a non-cleared transaction, the theory goes, then market participants will seek to convert it to a cleared transaction. Such treatment will also ensure that market participants do not alter contracts to avoid a clearing mandate.

[1] Interconnectedness and Contagion, Professor Hal Scott and the Committee on Capital Markets Regulation

These arguments, however, fail to take into account several important facts.

First and most importantly, firms cannot be incentivized to clear transactions that are not clearable (or else clearinghouses would be forced to accept unsuitable transactions). They can only be incentivized to shift from using non-cleared transactions to using cleared transactions.

This shift creates several significant problems for derivatives users. If users are forced to shift away from using non-cleared derivatives and instead employ imperfect hedges, they will be faced with residual unwanted risk. As a result, they may decide to forego their hedging strategy and choose to remain exposed to the risk they previously wished to manage.

Also, if specific hedges and hedge accounting treatment were not available, it is possible that firms may decide not to engage in previously productive activities that gave rise to the underlying risk in the first place. This could have a significant dampening effect on economic growth and capital investment.

Finally, the clearinghouses are now among the most systemically significant institutions. Using IM as an incentive to clear creates a dangerous bias, a bias that might put pressure on clearinghouses to accept unsuitable products for clearing. Incentives that put clearinghouses at risk could result in credit issues for the clearinghouse. A clearinghouse default would be catastrophic for markets.

The second often overlooked fact in the discussion about using IM as an incentive relates to the different types of non-cleared OTC derivatives – and why they are not cleared. The conventional wisdom is that the market consists of myriad bespoke transactions, all of which are entirely different from each other in one form or another. Some believe that there is a potential for market participants to tweak a contract, thereby making it a non-clearable instead of a clearable transaction, in order to avoid a clearing mandate.

The reality, however, is that it is already less expensive and more attractive to clear transactions that can be cleared than it is to not clear them. This fact is a key driver in the growth of cleared transactions ahead of any clearing mandates in the past few years. According to ISDA's Mid-year 2012 Market Analysis, approximately 54% of the interest rate swaps (IRS) market was cleared at that point in time, an increase of 150% since year-end 2007. Adjusted for the effects of portfolio compression on cleared IRS, nearly two-thirds of all transactions in the IRS market had been cleared already.

In addition, it is important to recognize that non-cleared OTC derivatives basically consist of two types of transactions. The first type includes products such as swaptions, options, inflation swaps and cross-currency swaps, most single-name credit default swaps and various types of equity and commodity swaps. Virtually all of these types of transactions do not fit the eligibility requirements of clearinghouses (CCPs) and putting them in CCPs would undermine the integrity of CCPs.

The second type includes a number of individual sectors of many otherwise clearable OTC derivative product classes. These individual sectors are non-cleared due to a lack of liquidity (and associated lack of valuation/pricing depth) in certain transactions. The lack of liquidity in these areas results from the economic terms (currency denominations, maturities, underlying reference rates, etc.) of such transactions, which are traded less than other transactions in those product classes.

3rd Conceptual Flaw: IM will Ensure a Relatively Level Playing Field

Because IM is required for cleared OTC derivatives, the thinking goes, it should also be required for non-cleared OTC derivatives. This is essential in order to ensure the playing field between the two market segments is relatively level.

As one of the stated intentions of the proposal is "promotion of central clearing," a relatively level playing field presumably represents one in which cleared transactions receive relatively more favorable treatment. This reflects the view, as expressed in the Second Consultative Document, that there is a "relatively higher level of risk" associated with these [non-cleared] derivatives."

We understand and support the goal of increasing central clearing as a means of reducing counterparty credit risk and systemic risk.

However, the IM proposal would reconstruct the playing field against non-cleared derivatives in an entirely disproportionate fashion. It would do so by imposing an IM framework that is appropriate for clearinghouses (who have little capital) on market participants (who have substantial capital requirements) for non-cleared transactions.

Clearinghouses themselves have little capital of their own. At the clearinghouse, defaults by members are covered by IM, VM and the default funds of members. Without IM, clearinghouses would not be creditworthy counterparties. They are very thinly capitalized. The creditworthiness of clearinghouses consists almost entirely of capital supplied by members in the form of IM and default fund contributions. Many bilateral OTC derivatives market participants, on the other hand, have substantial capital of their own and are creditworthy counterparties. This is particularly true of systemically important firms and their larger clients. Firms take on the credit risk of their counterparties (via derivatives, loans or other instruments) in the normal course of doing business. Defaults by their counterparties are covered by VM, capital and other actions they may take to manage their risks.

As a result, imposing an IM requirement from the cleared world on non-cleared transactions does not take into account why clearinghouses require it in the first instance – by necessity. Nor does it appear to sufficiently recognize the role of capital, which itself can drive a firm's decision to clear given the beneficial treatment of cleared trades for capital purposes. We recognize the point that capital and margin "perform important risk mitigation functions but are distinct in a number of ways," as stated in the Second Consultative Document. But the document seems to discount the value of a firm's capital in relation to non-cleared derivatives credit risk. We do not understand why this risk is any different from the credit risk of a loan to a counterparty (for which capital serves as an appropriate buffer).

On this reconstructed playing field, it's likely that many market participants would simply abandon their use of non-cleared derivatives and that, as a result, volumes and liquidity in the market would shrink dramatically. Such a development would be contrary to the goals and beliefs of policymakers, who have recognized that not all OTC derivatives can or should be cleared:

> "A substantial fraction of derivatives…will not be able to be cleared." (Second Consultative Document, "Margin requirements for non-centrally cleared derivatives," Basel Committee on Banking Supervision (BCBS) and the Board of Governors of the International Organization of Securities Commissions (IOSCO))
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> "Market participants looking to hedge a specific risk may not find a standardised product that would effectively match their exposure and instead may prefer to use a bespoke product…An implication of this analysis is that non-standardised bespoke products will continue to represent a portion of the OTC derivatives markets." (Financial Stability Board; Implementing OTC Derivatives Market Reforms: October 25, 2010)

In summary, we remain committed to working with policymakers to build safe, efficient OTC derivative markets. While we strongly support a robust VM framework, we believe the proposed initial margin requirements on non-cleared OTC derivatives have the potential to adversely affect market liquidity, economic activity, financial markets and end-user risk management. They will impose a severe cost burden on the global banking system and the global economy with minimal benefit. And as highlighted in previous communications, under current proposals initial margin requirements would increase in times of crisis, causing dangerous pro-cyclical new funding needs at the worst possible time.

As the financial crisis demonstrates – and as we continue to advocate – an effective regulatory framework can most effectively be achieved by improving regulatory transparency, ensuring effective regulatory supervision and through a three-pillar approach that includes:

- Mandatory and properly supervised clearing of sufficiently liquid and standardized OTC derivatives
- Robust variation margin (VM) for non-cleared OTC derivatives that involves daily valuations and daily collateral exchanges[2]
- An appropriate capital regime

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[2] As noted in previous letters to BCBS and IOSCO (ISDA-IIF-AFME Letter, December 12, 2013) in relation to VM, special consideration will need to be given to non-centrally-cleared derivatives with a structured finance or securitization special purpose vehicle, which are generally capitalized to the extent of their obligations, and do not have an operating business to generate free cash flow, for posting VM, much less IM.

We appreciate the opportunity to express our views on this important issue and we would be happy to discuss further or answer any questions you may have on this topic.

Sincerely,

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