

March 25, 2019

The Honorable Mario Draghi
Chairman, Group of Governors and
Heads of Supervision (GHOS)
c/o Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

The Honorable Randal K. Quarles
Chairman, Financial Stability Board
c/o Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

The Honorable Pablo Hernandez de Cos
Chairman, Basel Committee on
Banking Supervision (BCBS)
c/o Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

The Honorable Ashley Alder
Chairman, International Organization of
Securities Commissions (IOSCO)
C/ Oquendo 12, 28006 Madrid
Spain

Dear Sirs:

RE: Margin Requirements for Non-Centrally Cleared Derivatives

ISDA, our board and our members¹ very much appreciate the recent statement by the BCBS and IOSCO on the final implementation phases of the margin requirements for non-centrally cleared derivatives. As the statement notes, “significant progress has been made to implement the framework for margin requirements for non-centrally cleared derivatives.” ISDA supports and has helped to drive this progress in derivatives margining and in the other key areas of the G20’s regulatory reform agenda. These reforms have helped to make the financial system safer and more robust.

We believe the clarifications offered by the BCBS/IOSCO statement with respect to the scope of the initial margin requirements (IM) will be helpful to market participants and to the continued safe, efficient functioning of derivatives markets. These clarifications include that the BSBS/IOSCO (1) do not believe that IM requirements should apply to contracts amended solely as the result of interest rate benchmark reforms, and (2) do not believe the IM framework requires certain documentation, custodial and operational arrangements to be in place if bilateral IM amounts do not exceed the framework’s €50 million IM threshold.

We also very much appreciate that, as per their statement, the BCBS and IOSCO “will continue to monitor the effect of meeting the final stage of the phase-in...” We understand in fact that they are currently engaged in further analysis of the Phase V requirements.²

¹ ISDA’s board of directors and members are listed in an annex attached to this letter.

² The Phase V threshold for inclusion in the IM requirements is an average annual aggregate amount of €8bn. Counterparties above that threshold will be required to post IM when it would exceed €50mm. About 1,100 counterparties are expected to come into scope under Phase V when it begins on September 1, 2020.

Toward this end, we have shared with policymakers an in-depth and comprehensive quantitative analysis that we conducted on behalf of our members on the impact of the Phase V requirements. This analysis is, to our knowledge, unique in its scope and depth. An overview of the initiative's methodology and process is included as an addendum to this letter.

Based on our analysis, it is clear that irrespective of the BCBS/IOSCO statement on documentation, custodial and operational requirements under the margin framework, the current Phase V requirements will impose significant costs on hundreds of market participants that pose little or no risk to the financial system and that would be required to post little or no IM. These costs will likely incentivize potential Phase V counterparties to decrease their use of derivatives as an effective hedging tool, notwithstanding their de minimis risk exposure or IM requirements. They would also significantly add to the legal and operational challenges that firms already face as a result of Brexit and benchmark reform.

We would consequently ask respectfully that policymakers consider re-calibrating the current margin framework in the following ways:

- ***Modify the current €8 billion notional threshold for inclusion in Phase V by making the threshold more risk sensitive in order to clearly exclude counterparty relationships that pose little or no systemic risk.*** Between 70% and 80% of Phase V relationships that exceed the current €8 billion notional threshold will not post regulatory IM at least two years into their obligations, if ever, as they will not exceed the €50mm IM exchange threshold. By moving to a more risk-sensitive approach, policymakers could ensure that counterparty relationships posing substantial or systemic risk challenges would still be covered by the margin framework, while at the same time avoid imposing costly and burdensome obligations on market participants with little exposure or risk.
- ***Eliminate physically settled FX swaps and forwards from the Phase V calculation.*** As you know, market participants are not required to post IM on these products. They are, however, required to include the notional amounts of such transactions in calculating whether they are in scope of the IM rules. A substantial number of Phase V firms -- 19% -- are in scope only because of this requirement. According to the study conducted by the Office of the Chief Economist, CFTC³, nearly 30% of Phase V firms in scope of their data analysis are subject to the IM requirements as a result of these FX transactions.

³ *Initial Margin Phase 5* by Richard Haynes, Madison Lau, and Bruce Tuckman, Oct. 24, 2018 available at https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/Initial%20Margin%20Phase%205%20v5_ada.pdf.

IM, Systemic Risk and Clearing Incentives

As policy-makers stated in their final policy paper on margin requirements for non-cleared derivatives, the margin rules have two main goals: reduction of systemic risk and promotion of central clearing.⁴

Based on the extensive data analysis ISDA has conducted, the current framework for IM Phase V appears to be misaligned and does not appropriately contribute to reduction of systemic risk:

- Approximately 1,400 counterparties are estimated to be in scope of the IM requirements under all five phases of the margin regulatory framework.
- Of these counterparties, a relatively small number (approximately 20%) will account for a large majority (approximately 76%) of the total IM that will be required to be posted. Conversely, 80% of the total number of counterparties will be responsible for posting in aggregate only 24% of the total required IM.
- Approximately 1,100 counterparties with approximately 9,500 bilateral relationships are expected to come into scope of the margin rules at the Phase 5 date.
- Depending on the method used to calculate the IM amount, between 70-80% of these Phase 5 relationships will not exceed the €50mm threshold at least two years into their regulatory IM obligation, if ever.
- More specifically, there are 3,958 counterparty relationships with between \$8 billion and \$25 billion in notional. Of these, 3,319 relationships or 83.9% would not be required to post IM as they are under the IM exchange threshold. Another 90 relationships would be required to post up to \$10 million in IM. At the other end of the scale, 251 relationships (6%) would be required to post more than \$100 million in IM.
- Similarly, there are in total 7,220 counterparty relationships with between \$8 billion and \$100 billion in notional. Of these, 5,932 or 82.2% will be under the \$50 million IM exchange threshold. Another 181 relationships would be required to post up to \$10 million in IM. At the other end of the scale, a total of 453 relationships (6%) would be required to post more than \$100 million in IM.

As these figures demonstrate, a relatively small number of counterparties account for a substantial majority of the IM required to be posted. We understand and support the move by policymakers to address large counterparty exposures through the IM framework. At the same time, it is clear that many counterparty relationships will have little exposure and will therefore post little or no IM, underscoring the fact that they pose little or no systemic risk.

⁴ The BSBS-IOSCO final policy on margin requirements for non-cleared derivatives were issued in September 2013 and revised in March 2015 to reflect an adjustment to the phase-in schedule. All references in this document to the final policy are to the March 2015 paper. *See supra* note 3.

These relationships should therefore be clearly excluded from the regulatory margin framework by making the threshold for inclusion in Phase V more risk sensitive.

With regard to the use of IM as a clearing incentive: IM is just one of many incentives (others include netting and capital considerations) that are highly interconnected and that encourage voluntary clearing. While IM may initially encourage clearing in certain market segments, other economic incentives have a significantly greater impact. This includes regulatory capital requirements for cleared vs. non-cleared derivatives, as well as the benefits that flow from the ability to net a large, diverse swaps portfolio with a single, central counterparty. Initial margin is considered only the 5th incentive to central clearing by dealers and 7th by clients, far behind regulatory capital costs or counterparty risk management considerations.⁵

In addition, an analysis by ISDA last year of US rates trading demonstrates that a greater percentage of rates trades are cleared than are required to be cleared.⁶ This is true both before and after the margin rules went into effect, underscoring the benefits of netting and indicating the limited role that IM plays in incentivizing clearing.

Phase V Operational Challenges

As noted above, the recent BCBS/IOSCO statement is helpful and clarifies that the IM framework does not require certain documentation, custodial and operational arrangements to be in place if bilateral IM amounts do not exceed the framework's €50 million IM threshold.

As a result, nearly 6,000 Phase V counterparty relationships would be able to delay some of these requirements because they do not breach the €50 million IM threshold. However, if this is the only relief provided, then these thousands of relationships will still be subject to the following significant ongoing risks and operational burdens that apply to all other Phase 5 firms:

- Running initial and ongoing AANA calculations (bi-annually due to global vs. US timings) on their swaps exposures;
- Initial advance self-disclosure by expected Phase V counterparty to its dealers, and disclosure of changes to Phase V qualification in one or more jurisdictions after each AANA calculation period;
- Implementation or employment of an IM calculator, identification of in-scope transactions, identify and tag trade features for IM calculation and regularly run an IM calculation (based on ISDA SIMM™ and/or regulatory schedule) to monitor whether the relationship is at risk of exceeding the allowable €50mm exchange threshold.

⁵ FSB, Incentives to Centrally Clear Over-The-Counter (OTC) Derivatives (Aug. 2018), *available at* <http://www.fsb.org/wp-content/uploads/P070818.pdf>.

⁶ ISDA Research Note, Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market, <https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf>.

The burden and risks associated with the above will incentivize the smaller Phase V counterparties to reduce their derivatives exposure, potentially limiting their ability to effectively hedge. For these reasons, ISDA does not believe that documentation relief alone is an appropriate re-calibration of the IM Phase V rules.

We believe the likely adverse impact on the derivatives market warrants enactment of the commitments under the margin framework to reconsider its “efficacy and appropriateness.”

Suggestions for Re-calibrating Phase V of the IM Rules

ISDA believes that recalibrating the margin rules to exclude firms posing little or no systemic risk is among the most important areas meriting reconsideration. As a result, we respectfully would like to reiterate our proposed solutions:

- Modify the current €8 billion notional threshold for inclusion in Phase V by making the threshold more risk sensitive in order to clearly exclude counterparty relationships that pose or little or no systemic risk.
- Eliminate physically settled FX swaps and forwards from the Phase V calculation.

On behalf of our board of directors and members, we appreciate your consideration of this important issue, and would happy to discuss with you any additional questions you might have.

Sincerely,



Scott D. O'Malia
Chief Executive Officer
ISDA



Eric Litvack
Chairman, ISDA
Managing Director, Societe Generale

cc: Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
(for GHOS and BCBS)

Mr. Dietrich Domanski
Secretary General
Financial Stability Board

Mr. Paul Andrews
Secretary General
IOSCO

Attachments:
List of ISDA Board of Directors
List of ISDA Members

ISDA’s Initial Margin Phase-In Analysis

In September 2018, ISDA shared its Initial Margin Phase-In Analysis with global regulators. The objective of the data analysis exercise was to quantify the potential scope of counterparties falling within the Phase 4 and 5 thresholds which may become subject to regulatory IM requirements in September 2019 and 2020, respectively, and assess the impact of the potential associated IM amounts. The purpose of the exercise was (i) to help the industry prepare for compliance with the regulatory IM requirements by understanding the scale of the implementation efforts and (ii) inform regulatory discussion regarding the practicability of the phase-in schedule and the value of the IM requirements to meet policy objectives.

The data collection and analysis was conducted at the request of, and with the participation of, a supermajority of ISDA members which became subject to global regulatory IM requirements in Phase 1 (September 1, 2016 or February 1, 2017) and data contribution from additional firms in Phase 2 (September 1, 2018) and beyond. These participants provided gross notional of derivatives (with and without physically settled FX swaps and forwards) and IM amounts (ISDA SIMM™ and regulatory schedule) for their counterparties which (i) are subject to regulatory variation margin requirements, (ii) did not come into scope for regulatory IM requirements in Phase 1 or 2, and (iii) had at least USD 100 million gross notional.

The anonymity of the underlying data was treated with the utmost caution to ensure that no person or party, including ISDA, would be capable of knowing the identity of the parties for which data had been provided or which were identified as potentially subject to the regulatory IM requirements. The collated data was not provided to any participant, but was only used by ISDA to produce the study results and only those results have been shared with the participating firms, regulators and others for the purposes stated above. All data related to the exercise was collated and held in a secure manner and was irretrievably deleted once the analysis was completed.

ISDA’s Initial Margin Phase-In Analysis was robust and broad, with data provided by 83 legal entities from 20 different consolidated groups and encompassing derivatives portfolios for 16,340 separate legal counterparties which have 34,680 relationships with the firms which provided the data. ISDA was uniquely positioned to conduct analysis of this breadth since its members have the capability to calculate the IM amounts on their portfolios. The Chief Economist’s Office at the CFTC and the FCA conducted studies on IM Phase 5, but their results were limited to the scope of counterparties subject to IM regulations. Although ISDA’s members had anecdotally anticipated an unprecedented scale for Phase 5, our analysis confirmed those expectations and provides specificity which has provided clarity to the industry and helped global regulators reach consensus on the need to address the associated implementation bottleneck for September 1, 2020 via the recent statement issued by BCBS and IOSCO. Our analysis on the impact of including FX swaps and forwards in the AANA calculation and our IM analysis which shows limited IM posted by counterparties qualifying for IM requirements close to the 8 billion threshold and a strong concentration of IM in within a limited number of in-scope entities are equally compelling and reliable to inform regulatory recalibration of the margin requirements.