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Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Comments submitted via: www.regulations.gov

Re: Advance Notice of Proposed Rulemaking: Authority to Designate Financial Market Utilities as Systemically Important

Dear Sir or Madam:

The International Swaps and Derivatives Association, Inc[1] ("**ISDA**") is writing in response to the Financial Stability Oversight Council's (the "**Council**") advance notice of proposed rulemaking ("**ANPR**") regarding the criteria and analytical framework that should be applied by the Council in designating financial market utilities ("**FMU**") as systemically important under Sections 112(a)(2)(J) and 804(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**DFA**").

We do not comment on every question raised by the Council, but wish to address some of the issues raised in the ANPR which are relevant to ISDA member firms[2]. Accordingly, the letter contains two parts. First, ISDA provides comments to those questions (using the Council's numbering)[3]. Second, ISDA raises related comments for the Council's consideration before concluding.

[1] ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 54 countries on six continents. These members include most of the world's institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.
Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.
[2] We do not address questions 4, 6, 7, 8 in the ANPR.
[3] ISDA gratefully acknowledges the assistance of the report prepared by staff of the Financial Stability Board, International Monetary Fund and Bank for International Settlements of October 2009 titled "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations – Background Paper, Report to the G-20 Finance Ministers and Central Bank Governors" in the preparation of this letter.

ISDA commends the Council for its careful consideration of these issues and welcomes further dialogue with the Council on this letter.

Given the efforts being made to increase the use of central counterparties ("**CCPs**"), which will profoundly affect the role of the CCP in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves become a major source of systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

Background

The Council was established by section 111 of the DFA and has various duties, including identifying those FMUs that should be designated by the Council as systemically important and subject to enhanced examination, supervision, enforcement and reporting standards and requirements.

Under section 804(a)(2) of the DFA, in making a determination on whether an FMU should be designated as systemically important, the Council must consider:

> *(A) The aggregate monetary value of transactions processed by the financial market utility;*
> *(B) The aggregate exposure of the financial market utility to its counterparties;*
> *(C) The relationship, interdependencies, or other interactions of the financial market utility with other financial market utilities or payment, clearing or settlement activities;*
> *(D) The effect that the failure of or a disruption to the financial market utility would have on critical markets, financial institutions, or the broader financial system; and*
> *(E) Any other factors that the Council deems appropriate.*

I. Questions Posed in the ANPR

> *1. What quantitative and qualitative information should the Council use to measure the factors it is required to consider in Section 804(a)(2) when making determinations under Section 804 of the DFA? How should quantitative and qualitative considerations be incorporated into the determination process?*

Quantitative and qualitative considerations should be considered together in the determination process so that a variety of techniques are used to assess systemic relevance. This might range from static measures for identifying risks, sophisticated dynamic/network models, and qualitative criteria, such as through market intelligence.

Accordingly, we recommend that the Council develop qualitative and quantitative criteria for systemic importance where individual measures are indicative, but by themselves are not independently determinative. In terms of identifying systemically important institutions, we consider that various risk factors may be helpful and note the following two factors as being of particular importance in this context, which will be discussed in detail below:

- size; and
- interconnectedness.

Size: could refer to an entity's consolidated net balance sheet, the number or notional amount of transactions processed, or the size of an entity's net exposure to, for instance, markets and instruments. As noted below, the rate of change of and leverage in an entity's balance sheet may also be associated risk factors.

Interconnectedness: may relate to the number and size of counterparty net exposures or the entity's role in a market or transaction, including the effect that that entity's bankruptcy could have on the market, credit, operational, legal and settlement risk in a market or on related markets.

We believe this approach informed by risk factors is appropriate for the following three reasons:

Firstly, systemic importance may change over time depending on the structure of the financial system, conditions of individual markets and balance sheets, and external events. The systemic impact of a malfunction of one component may depend critically on the functioning of other elements, such as the robustness of markets and market infrastructure, and the institutional framework for crisis management when they occur. For example, robust crisis resolution frameworks and clearing and settlement systems can mitigate the potential effects on the rest of the financial system due to failures in institutions and markets. The presence of such elements may act as potential mitigants or amplifiers of the systemic importance of FMUs. In addition, systemic importance may depend significantly on the specifics of the economic environment at the time of assessment.

Secondly, categorical designations or certain quantitative triggers may overlook changes to the systemic importance of particular entities in the financial system. They may also capture entities that are not in reality systemic thereby subjecting such entities to unnecessary costs. While some components of the financial system should consistently be assessed as systemic, the significance of others may vary depending on a number of factors. An assessment will therefore need to be graduated. This is likely to involve scoring in several dimensions. Drawing any sharp distinction between systemic and non-systemic components will require the exercise of considerable judgment on where to draw the line.

Thirdly, a key issue in the assessment of systemic risk is alignment of interests. If an FMU has significant equity capital, and this capital is at risk, the FMU is more likely to be incentivized to engage in systemically prudent behavior than if this is not the case.

Accordingly, ISDA urges the Council to conduct regular assessments of what constitutes systemic importance, both for entities previously designated as Systemically Important who may no longer meet the requisite criteria, and for previously excluded entities whose systemic importance to the relevant market has increased over time.

2. *Can the considerations listed in section 804(a)(2) be broken down into easily measured factors that the Council should use to determine whether financial market utilities are systemically important? Are there certain levels of quantitative measures (e.g., for value and exposure) or qualitative characteristics (e.g.,*

registered clearing agencies versus exempt clearing agencies) that should trigger a review for systemic importance by the Council?

The considerations listed in section 804(a)(2) can be broken down into easily measured factors that the Council should use to determine whether financial market utilities are systemically important. However, as noted above, we believe that there are risks in making the determination criteria overly mechanical.

In addition to the risk factors noted above, we note that the potentially systemic nature of clearing, payment and settlement systems for a financial system indicates that entities operating in these areas ought to be subject to qualitative and quantitative review for systemic importance. This is recognized in 804(a)(2)(C) of the DFA. In this context, we would also suggest that the Council consider the potential systemic nature of "financial custody systems" meaning securities custodians, third party collateral holders, and the tri-party agents in the tri-party repo market.

3. *Which of the considerations listed in section 804(a)(2) are most important for the Council to consider? Should the application of the considerations differ depending on the type of FMU, and if so how?*

We believe that none of the considerations listed in section 804(a)(2) are more important than any other. In addition, the considerations will differ depending on the type of FMU. For example, the aggregate monetary value of transactions processed by a particular DCO may not be relatively large but nevertheless the effect of its failure could cause significant disruption to critical markets in the relevant product particularly if that DCO is the only central counterparty for a given jurisdiction's market.

5. *How should the Council measure and assess the aggregate exposure of financial market utilities engaged in payment, clearing, or settlement activities to its counterparties?*

   a. *How should the Council identify the extent to which financial market utilities bear and create risk exposures for themselves and their participants?*
   b. *What measures of exposure should be considered (e.g., liquidity exposures, current and potential future counterparty credit exposures, operational risk, the degree of concentration of exposures across participants)?*
   c. *For each type of financial market utility (e.g., central counterparty, funds transfer system), what is the best approach for measuring current credit exposure or, where relevant, potential future exposures? For liquidity (funding), how might the Council assess the potential liquidity risks that a financial market utility may bear or liquidity risks it may impose on the broader financial system should it fail to settle as expected?*

The regulatory community currently possesses a number of risk assessment tools including those used to measure market, credit, counterparty and operational risks in the standardized and advanced approaches under the Basel Capital Accords. Though we recognize that the Basel Accord provides a number of approaches for measuring counterparty credit exposure, Basel-based measures may not be appropriate for use in this context as they have been calibrated for a different purpose and different assumptions (e.g. holding periods).

In addition, we note that another useful starting point is the recommendations and the methodology developed jointly by the CPSS and IOSCO as set out in their report entitled "Recommendations for Central Counterparties" published in November 2004.[4] We would encourage the Council to build on these foundations in an active dialogue with the industry, the Basel Committee, CPSS-IOSCO and other stakeholders.

ISDA would like to particularly emphasize the importance of an assessment of liquidity risk. It is crucial that for each potentially systemic FMU, an understanding is developed of the:

- entity's current role in system wide liquidity dynamics (taker, transformer, processor and/or giver of funds);
- entity's intended role in stressed conditions; and
- consequence of it failing to perform either of those roles.

Finally, ISDA would strongly urge the Council to undertake a comprehensive quantitative impact study of any proposed risk/capital framework before taking action. System-wide stress testing, for example, may have a useful function in assessing the liquidity risk at each potentially systemic FMU. In stressed or dislocated markets a DCO may be incentivized to raise initial margin requirements – but if one or more SIDCOs do this, the resulting liquidity drawdown across the system may introduce other unanticipated risks. A suitable stress test would identify and quantify impacts of this nature. Similarly, reverse stress tests for FMUs may identify issues of macro prudential concern.

> 9. *What other types of information would be effective in helping the Council determine systemic importance? What additional factors does your organization consider when assessing exposure to, or the interconnectedness of, financial market utilities?*

We would consider the following as a non-exhaustive list of further possible risk factors:

- opacity/complexity/disclosure;
- leverage;
- rate of change of activity;
- correlation of exposures;
- existence of competitors to the FMU or time to market of a replacement FMU;
- role in monetary policy;
- role in fiscal policy; and
- risk concentration.

More specifically, "risk concentration" refers to an exposure with the potential to produce losses large enough to threaten an entity's health or ability to maintain its core operations. Risk concentrations can arise in an entity's assets, liabilities or off-balance sheet items, through the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. The potential for loss reflects the size of the position and the extent of loss given a particular adverse circumstance.

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[4] http://www.bis.org/publ/cpss64.pdf

Risk concentrations can take many forms, including exposures to:

- individual counterparties;
- groups of individual counterparties or related entities;
- counterparties in specific geographical locations;
- industry sectors;
- specific products;
- service providers, e.g. CCPs; and
- natural disasters or catastrophes.

For OTC derivatives CCPs specifically, we consider the following as a non-exhaustive list of CCP risk factors:

- risk management practices;
- membership criteria (capital, operations and other resources);
- financial resources requirements and default waterfall;
- frequency and sophistication of margin calculation;
- guarantee fund assessments;
- liquidity of financial resources;
- gross margin;
- regulatory coordination;
- segregation of client margin – cleared trades;
- interaction of CCP corporate governance (Board of Directors) and CCP risk management (Risk Committee);
- CCP ownership;
- business conduct rules; and
- execution requirements.

10. What role should international considerations play in designating financial market utilities?

Having participated in law reform activities at national, regional and international level, ISDA has a clear perspective on the importance of international coordination, harmonization (where possible) and mutual recognition of legal and regulatory frameworks.

ISDA strongly endorses the on-going work of the Financial Stability Board ("**FSB**") to promote common standards in financial markets regulation and related cross-border cooperation and information sharing by authorities to ensure coordinated action and proportionate responses that recognize the international nature of the markets and of financial institution groups.

II. Related Remarks

The designation of an FMU as systemically important should not change the economics of an already agreed financial contract. Please note in this context that the economics of a financial contract include the costs of any associated capital or margin requirements imposed by a FMU on parties to that contract.

As a related matter, we ask the Council to consider the benefits of a gradual approach when applying any additional financial requirement deemed necessary for systemic entities, as a sudden change in, for instance, capital requirements gives rise to both serious concerns about the competitive settings of systemically important FMUs verses non-systemically important FMUs, and the potential disruption caused by the designation itself that the FMU is systemic.

In this regard, we note the package of supervisory proposals advanced in the FSB's paper titled 'Intensity and Effectiveness of SIFI Supervision[5] ("**FSB Paper**") and suggest that supervisory proposals may be a preferable means of addressing the risks posed by systemically important FMUs than the introduction of new or differentiated capital requirements. Of the proposals set out in the FSB Paper, several are particularly important, including:

- Supervisory powers – the industry recognizes that the authorities require a comprehensive toolkit to address financial system stress and to ensure appropriate information sharing (subject to appropriate confidentiality controls) and cooperation between regulators in different countries is facilitated.
- Supervisory colleges, home/host information sharing – the industry welcomes the work being done by authorities to upgrade the guidance in this area and suggests that follow-up work be done to test effectiveness and ensure that supervision is targeted, proportional and consistent.
- Improved techniques – the industry notes that existing regulatory information should be carefully assessed by authorities, given the significant amount of information already provided to authorities.

Finally, we urge the Council to consider the process for a cessation of a systemically important designation in addition to the designation of systemically important for FMUs in recognition of the fact that this is likely to change over time. We would also request that the criteria for both processes be as transparent as possible.

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ISDA appreciates the opportunity to provide comments on the advance notice of proposed rulemaking and looks forward to working with the Council as it continues the rulemaking process. Please feel free to contact me or my staff at your convenience.

Sincerely,

Robert G. Pickel

Robert Pickel
Executive Vice Chairman

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[5] FSB report on Intensity and Effectiveness of SIFI Supervision, 2 November 2010, available at http://www.financialstabilityboard.org/publications/r_101101.pdf

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner