ISDA Safe, Efficient Markets

5th December, 2014

Mr. Jonas Niemeyer, Chair, OTC Derivatives Coordination Group
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Sent by email to: ; baselcommittee@bis.org
fsb@bis.org

Re: Regulatory reform of over-the-counter derivatives: an assessment of incentives to clear centrally (othp21 October 2014)

Dear Mr. Niemeyer,

This letter provides brief initial comments from the Association[1] on the assessment of incentives to clear report (the Report) published in October by the OTC Derivatives Assessment Team, established by the OTC Derivatives Coordination group (the Group). The aim is to bring certain issues, which we believe to be critical to the incentives to clear debate, to the immediate attention of the Group. The Association intends to follow this letter up with detailed and technical support for the issues raised in due course.

ISDA fully supports the clearing of certain OTC derivative contracts through CCPs and therefore shares the view expressed in the Report that misaligned incentives in this area could undermine the regulatory reforms. Whilst it is understood that the framework for examining the costs of central clearing was established prior to the publication of the final Basel III Leverage Ratio Framework, ISDA believes that the conclusions reached may be misleading without taking account of the impact of the Leverage Ratio on the economics of clearing.

The BCBS Leverage Ratio paper from January 2014 has unintended consequences for Clearing since certain aspects potentially render clearing prohibitively expensive for certain types of clients, and furthermore creates disincentives for banks to act as clearing members and facilitate client clearing. There are 3 issues in particular that we would like to bring to your attention at this stage:

1. Total notionals and the Leverage Ratio Denominator (LRD) can be several times higher for equivalent cleared vs. bilateral trades

Compared to a bilateral trade, total trade notionals are tripled when a trade is routed from a client through a clearing member (CM) and CCP. Although the final BCBS Leverage Ratio Framework issued in January 2014 partially addressed this issue by eliminating the CCP-facing leg for client cleared trades, this reduced the impact from 3x to 2x.

[1] The International Swaps and Derivatives Association, Inc. ("ISDA")

Furthermore, once the effect of initial margin (see 3 below) and the default fund contribution are taken into account, the impact on the LRD can be up to 8x higher for cleared trades relative to bilateral trades.

It is recognised that looking at a single trade example is not necessarily representative of the portfolio effect once a large set of transactions is considered. On the market-maker side of the transaction, where a bank is a direct clearing member of the clearing house, considerable benefits of portfolio margining and trade netting could be expected. However, for the bank acting as a clearing member for clients, the portfolios are cumulative and there is no margin or netting benefit between client portfolios, hence the LRD 'explosion' problem persists as client portfolios are added.

2. The derivatives add-on is disproportionately large and appears designed for bilateral, rather than cleared trades:

The derivatives add-on is based on the old CEM methodology which is recognised as being relatively inaccurate at identifying the risks in a portfolio and is being replaced by the BCBS revised framework (SA-CCR). Cleared portfolios enjoy multilateral netting, but it is precisely the multilateral netting that CEM does not recognise, thus defeating those intended netting benefits of clearing.

The new SA-CCR framework incorporates key improvements, including with respect to margined activity, and may be helpful if used in the Leverage Ratio calculations to scale the clearing member add-ons in a more appropriate fashion. Whilst the Report assumes in its findings that SA-CCR replaces CEM, for the purposes of measuring capital against bank exposures to CCPs, it is unclear at this time whether there is regulatory intent to replace CEM with SA-CCR within the LRD context.

3. Segregated Client Margin which can not be re-hypothecated, should not be included in the LRD and should offset potential future exposure.

Currently the exposure calculation for the LRD does not recognise the exposure reducing effect of segregated initial margin for cleared trades. The majority of segregated client margin, however, can not be re-hypothecated, for example, either in the UK on client omnibus accounts or in the US under CFTC rules and can not, therefore, be used by the clearing member to increase leverage.

ISDA recommends that all margin which achieves a required standard of segregation should be regarded as exposure-reducing to offset potential future exposure and should be excluded from LRD calculations.

ISDA urges the Group to urgently consider the impact of the Leverage Ratio in the assessment of the incentives to clear, and consider addressing the above issues which currently render client clearing uneconomic in many cases.

The industry would welcome a further workshop with the OTC DAT and we remain available as a resource to engage in further analysis or discussion at your convenience.

Your sincerely

Mark Gheerbrant
Head of Risk and Capital
ISDA

c.c. Basel Committee on Banking Supervision Secretariat
Secretariat of the Financial Stability Board