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Dear Mr Cook,

The Turner Review: A regulatory response to the global banking crisis
Discussion Paper 09/2: A regulatory response to the global banking crisis

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the Turner Review and accompanying Discussion Paper 09/2 outlining a possible regulatory response to the global banking crisis.

ISDA has over 800 member institutions from 56 countries on six continents. These members include most of the world's major 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. As such, we believe that ISDA brings a unique and broad perspective to the prudential regulation of firms in the UK.

In this letter we outline the key concerns of our members in relation to the above referenced review and discussion paper, while recognising that it is not for ISDA to respond on all the issues raised in the publications or indeed attempt to answer all 38 questions in the Discussion Paper (DP). Where possible we have provided references to the questions in the FSA's DP where the themes overlap with the key concerns raised by our members. We have also provided an extensive list of references to relevant documents referred to below, and the majority of these are publicly available on the ISDA website (www.isda.org).

Key Messages

[Section 9: Q25, Q26,Q27,Q28]

ISDA agrees with much of the analysis presented in the Review as to the causes of the financial crisis, and with some of the possible regulatory consequences of the failings identified. However, in many cases we feel the proposals that the DP goes on to explore have not been justified by the analysis in the Review, and furthermore, where supportive analysis has been provided, we feel it could be strengthened by a greater analysis of the aggregate impact of proposed policy measures, a more detailed understanding of the calibration of measures put forward, and a broader understanding of the macro economic implications of the proposals. Above all, we feel the Review and the DP fail to apply sufficient weight to the importance of international accord on many of the proposals discussed and it is crucial that the regulatory consequences for the UK financial sector are considered in the broader context of the fast moving international debate on regional and global financial regulation.

ISDA believes that in order to be truly effective many of the policy options that the Turner Review / DP explore require international agreement (e.g. higher capital requirements, definition and calibration of a leverage ratio, supervisory arrangements etc). A stronger regulatory framework will be just one aspect of the response to the crisis, and in our detailed comments below, ISDA, would like to reflect on the very important work the industry has been doing to address specific issues related to trading activities. These include, the strengthening of trading book capital, improvements to the trading infrastructure, improvements to accounting for financial instruments, and significant developments in collateral management. However, there needs to be recognition from the FSA that wider issues of systemic risk also need to be addressed, such as the global imbalances which led to the rapid build up in excess liquidity, the failures in monetary policy which may have contributed to the creation of asset bubbles, and issues concerning retail mortgage lending in certain key jurisdictions, including in the UK.

Aggregate impact of global regulatory response to the crisis

[Section 3: Q1]

The Turner Review covers many different possible regulatory responses to the crisis, and each of these proposals individually may have some merit (for example we counted at least six or seven separate proposals relating to regulatory capital). However there is no coverage in the Review or the DP as to the aggregate impact of adopting these policies in unison. Furthermore we believe the FSA needs to consider more openly the benefits of having a profitable financial sector, incorporating active trading markets, based in the UK. As it stands, the review fails to adequately cover the costs of more intrusive prudential regulation, and the losses in output that are likely to result from higher capital requirements. We believe it would be worth exploring the specific objectives of each proposal in turn to better understand whether the measures are compatible and their likely aggregate impact on the industry.

Trading and financial innovation

Trading activities and innovation in the financial markets can and do provide essential risk management tools which help to reduce the costs of doing business in the broader economy. The benefits of having deep and liquid trading markets in which financial institutions, corporates, wealth managers, end users, and individuals can manage their risks, are clearly felt throughout the world economy. Additionally, these trading markets are an important source of employment in the UK employing tens of thousands of individuals (most of whom function in middle and back office capacities, handling legal, documentation, collateral and operational issues) and benefiting domestic and foreign companies active in the UK. Within these markets we believe that OTC derivatives offer significant value to the customers who use them, to the dealers who provide them, and to the financial system in general by enabling the transfer of risk between counterparties. OTC derivatives exist to serve the risk management and investment needs of end-users. These end-users form the backbone of any advanced economy. They include over 90% of the Fortune 500, 50 percent of mid-sized companies and thousands of other smaller companies. It is therefore important to understand the wider economic detriment that too harsh a treatment of trading and financial innovation would have on the real economy.

Trading Book Capital

[Section 4: Q1, Q2, Q5, Q6, Section 5, Q9, Q14, Section 7, Q21]

Many of the proposals in the DP focus on capital, however, regulatory capital is not the only driver of confidence in the financial system. Arguably, many of the bank “rescues" that have taken place as a result of the crisis were not triggered by insufficient capital, rather by a sudden and profound lack of market and public confidence. When this occurs, few, if any institution can survive for any length of time. We believe therefore that there are categories of risk for which additional capital is not the most effective mitigant, and in such cases other measures such as improved systems and controls or governance structures maybe more effective measures. Having said that, at ISDA we understand the desire in the current climate to increase the regulatory capital requirements against exposures in firms' trading books.

During 2007-2008, a number of banking organisations suffered write downs on trading book assets in excess of their pre-crisis levels of trading book regulatory capital. Although many firms subsequently revised the calibration of VaR models to better capture risk, the failing of VaR as a risk measure justified a review of the market risk capital framework. We, in principle, support the Basel Committee's current focus on strengthening the trading book capital charge, provided any resulting rise in capital requirements is reasonable and introduced over an appropriate time-frame.

We welcome elements of the proposed changes to the market risk framework being put forward by the Basel Committee working group on trading book capital and we have supported the FSA's work on this group. We agree that these will make a significant difference to firms' trading book capital numbers with a new "stressed" VaR component, incremental capital charges for default and migration risks, and increased charges for securitisations. However, we would like to stress the importance of gaining a thorough understanding of the aggregate impact on firms' capital requirements before finalising the amendments. Although Turner suggests an increase in capital of both "several times" and "more than three times", early results from the Basel Committee's Quantitative Impact Study (QIS) suggest much higher multiples of capital increases. We note that the Basel Committee of Banking Supervision is in the process of reviewing the possible impact on bank capital numbers of the proposed changes, and we strongly support a full evaluation of their impact before the guidelines are finalised. Initial analysis of the results that individual firms have been developing for submission to their regulators seems to show clear trends to disproportionate capital requirements that would result from the rules if implemented as proposed.

We also advise against setting unrealistic and artificial deadlines for completing an international review of trading book capital requirements ("the FSA will propose that it is completed within one year"). ISDA has been an active participant in discussions with the Basel Committee on Basel II standards covering trading activities and these discussions have taken several years and have yet to be concluded. Although in general we are supportive of the majority of the changes being proposed for implementation next year, a more fundamental review should take time to consider a more integrated approach to a capital charge for the trading book considering the recognition of correlation effects between market and credit (including "incremental risks") risks. Such a review should look at how integrated models could be developed, implemented, and validated for regulatory capital purposes. Once finalised, international capital accords remain in place for many years and we would therefore suggest a more suitable timeframe be set that allows for an appropriate level of analysis, review and consultation with the industry.

We understand the concerns about arbitrage between the banking book and the trading book and the existing incentives for holding credit related instruments in the trading book. We can see how this has led both Turner and the Basel Committee to question the appropriateness of a trading book capital charge and whether a banking book treatment could be applied more universally. We agree that the boundary could be better policed by both firms and their supervisors. However, the banking book framework is inappropriate for trading book assets because the framework is only concerned with credit risk and as such only addresses one of the material risks that trading book assets, recorded at fair value, are sensitive to. The banking book rules also fail to address the off setting of long and short positions. Furthermore, because trading book positions attracting a banking book charge would in addition receive general market risk VaR and new "stressed" VaR charges, they could end up consuming considerably more capital than similar exposures in the banking book. This appears hard to justify economically, since risks embedded in trading assets are generally defease over a relatively short time frame, contrary to assets held to maturity in the banking book. Over-capitalising trading assets would create perverse incentives for banks to hold trading book exposures in the banking book.

OTC infrastructure

[Section 10: Q32,Q33, Q34,Q35, Q36]

As you may know, the industry has long been engaged in a dialogue with senior regulators (initiated under Secretary Geithner's stewardship of the New York Fed some four years ago) which has led to substantial and on-going improvements in the key areas of the OTC derivatives infrastructure. These have included the increased standardization of trading terms, improvements in the trade settlement process, greater clarity in the settlement of defaults, significant positive momentum toward central counterparty clearing (which already exists to a significant extent in rate swaps, commodities and equity derivatives, while CLS addresses the major risk in fx derivatives, namely settlement risk), enhanced transparency, and a more open industry governance structure.

In our most recent letter to the New York Fed this month, ISDA and the industry expressed a "firm commitment to strengthen the resilience and robustness of the OTC derivatives markets." As we stated, "We are determined to implement changes to risk management, processing and transparency that will significantly transform the risk profile of these important financial markets, and deliver a risk management and processing infrastructure that includes the additional characteristics and benefits of a traditional clearance model. The OTC Derivative Markets provide important flexibility in terms of products and execution, and will benefit from the strengthening of infrastructure described above."

We reiterate our commitment to reducing systemic risk in the OTC Derivative Markets through the following:

- Implementing data repositories for non-cleared transactions in these markets to ensure appropriate transparency and disclosure, and to assist global supervisors with oversight and surveillance activities.
- Clearing for OTC standardized derivative products in these markets.
- Enabling customer access to clearing through either direct access as a clearing member or via indirect access, including the benefits of initial margin segregation and position portability.
- Delivering robust collateral and margining processes, including portfolio reconciliations, metrics on position and market value breaks, and improved dispute resolution mechanics. (We deal specifically with work on collateral in a separate section below.)
- Updating industry governance to be more inclusive of buy-side participants.
- Continuing to drive improvement in industry infrastructure as well as to engage and partner with supervisors, globally, to expand upon the substantial improvements that have developed since 2005.

Reporting of Trades in Centralized Repositories

To further increase market transparency so that the supervisory community has access to relevant data and the public at large has appropriate access to relevant aggregate data, we commit, for all trades to which we are a party, and that are not cleared through a CCP to: (i) universal recording of CDS trades in a trade repository by July 17, 2009, (ii) universal recording of Interest Rate Derivative (Rates) trades in a trade repository by December 31, 2009, and (iii) universal recording of OTC Equity Derivative (Equities) trades in a trade repository by July 31, 2010. We are committed to enriching the data reported to supervisors as expeditiously as possible to make the metrics more meaningful as a risk management tool. We view the recording of trades in trade repositories as an industry best practice. We strongly encourage all non-signatory market participants to meet these goals within sixty days from compliance by the signatories to this letter.

A major step forward this year has been the 'hardwiring' of auction settlement for credit default swaps. The auction settlement process evolved in 2005-06, to obviate the risk of technical short squeezes upon physical settlement of multiple, economically offsetting CDS on the same reference entity. Through hardwiring, ISDA facilitated formal, ex ante, contractual commitment to this methodology by market participants[1]. We also introduced important related changes, most notably the creation of a Determinations Committee, to provide clarity on the occurrence of credit events and the deliverability of obligations into CDS for those exercising their right to physical settlement. At the time of writing, a further refinement is in progress, addressing the rare but complicated scenario of settlement upon a Restructuring of a reference entity's debt. Finally, 'standard coupons' for CDS are being rolled out in Europe, following their deployment in the US. Each of these changes (hardwiring, Restructuring settlement and standard coupons) brings a significant measure of standardisation to the market and, in addition, increases the efficiency of centralised clearing.

Any consideration of standardization would, in our view, benefit from consideration of two further points. The first is that standardized legal-documentation infrastructure provides the bedrock for the functioning of the market. The ISDA Master Agreement and related transaction templates ensure enforceability of contracts and of close-out netting on the same basis worldwide, with major cross-border systemic benefits as well as operational simplicity and efficiency. Combined with the use of the FpML standard computer language that ISDA has introduced, this supports post-trade automation and therefore position recording and transparency.

The second point is that further levels of standardization may actually be of debatable value. In this area, the public-policy debate in the US is instructive. A number of end-user organizations have indicated quite clearly that, while they support the objective of greater systemic resilience, they oppose artificial limits on the range of contracts available to them. Their needs are only truly served by the ability of financial services firms to tailor contracts to their specific requirements.

The subtle reality is that mature derivative markets consist of a continuum, from highly bespoke to more economically standardized instruments. The more liquid instruments and the more bespoke ones complement each other, without being exact analogues. Over time, liquidity and standardization will naturally develop (as it has in CDS index contracts for example, in a credit-derivative market which originated in completely different instruments and now relatively untraded instruments such as single-name spread options and total return swaps). New markets emerge with demand to hedge particular types of exposure – a current example is longevity – and it is impractical and indeed counterproductive to expect these to spring, fully-formed as standardized instruments.

Hard-wired procyclicality: ratings, triggers, margins and haircuts (pg22)

[Section 4: Q4, Q6, Q7 Section 5: Q12, Q15, Q17]

The Review identifies a number of aspects of the current financial system as "hard-wired procyclicality", without reflecting on one of the key drivers of procyclicality: human nature. We agree with the remarks made by Dr Nout Wellink (Chairman of the Basel Committee on Banking Supervision, before the Committee on Economic and Monetary Affairs of the European Parliament (ECON), Brussels, 30 March 2009) that cyclicality cannot be changed through amendments to prudential regulation or accounting standards.

In the section on the implications for the regulatory reform agenda (pg 28), Turner largely restricts his analysis to the role of collateral posted in OTC derivative contracts, however, a more thorough analysis of the financial markets would uncover a widespread use of contractual provisions, like ratings triggers, that give creditors extra protection when investing in credit sensitive instruments. This can take the form of additional collateral requirements or additional control rights over the borrower's actions [CGFS Papers, No 34 "The role of valuation and leverage in procyclicality" (April 2009)]. The increase in margins and haircuts on a whole range of assets, not just OTC derivatives, contributed to "procyclicality" in the financial system. However, we highlight the fact that the industry correctly identified these effects in the 2008 report from the Counterparty Risk Management Policy Group ("Containing Systemic Risk: The Road to Reform The Report of the CRMPG

[1] Over 2,000 parties adhered to the relevant protocol, by which they formalized the relevant change to the terms of their CDS contracts with the rest of the market collectively.

III", August 6, 2008) and recommended a "paradigm shift in credit terms", urging market participants to establish haircuts and initial margins that are stable over the credit cycle.

Collateral Management

The ISDA margin survey (published in April 2009) confirms that a shift has taken place, with a growth of 86% in collateral used in connection with OTC derivatives transactions (from $2.1 trillion to almost $4.0 trillion during 2008, versus a growth rate of 60% in 2007). Collateral coverage continues to grow, both in terms of trade volume subject to collateral agreements and of credit exposure covered by collateral. This reflects a long-term trend toward increased collateral coverage. For all OTC derivatives, 65 percent of trades are subject to collateral agreements, compared with 63 percent last year and 30 percent in 2003. Further, 66 percent of OTC derivative credit exposure is now covered by collateral compared with 65 percent last year and 29 percent in 2003. It is worth noting that cash remains the predominant form of collateral, with 84% of all collateral received in the form of cash.

[Section 10 : Q34, Q35]

We would also like to comment in more detail on the proposals to regulate collateral margin calls with a view to off setting procyclicality. As we have argued above, cyclicality is not just a feature of market behaviour but of human nature, and we do not believe a regulator can eradicate completely the effects of certain behaviour during the economic cycle. We do not believe regulator's should attempt to set minimum levels of haircut for OTC derivatives as we do not think this would be feasible, practically enforceable or successful in dampening the effects of an economic cycle. Instead we support the goals of the FSA in undertaking a thematic review of collateral processes during 2009 and would be happy to participate in this endeavour.

ISDA would like to take this opportunity to highlight the significant progress the industry has made in improving collateral management practices in response to the crisis. By June 30 2009, dealer signatories to an ISDA letter will perform daily electronic portfolio reconciliation of all collateralized OTC inter-dealer derivative transactions. This will mean that combined with other regular portfolio reconciliations between dealers and others, in the period between October 2008 to June 2009, the OTC derivative market will have progressed from a state where there was no well-defined standard for reconciling portfolios to one where 70% of the outstanding transactions across all derivative asset classes are reconciled frequently. In addition to the daily inter-dealer reconciliations, we will also work to have a market-wide solution for improved resolution of disputed margin calls by September 30, 2009, with an implementation schedule to follow.

The major dealers in the OTC derivatives market have previously set out a comprehensive set of commitments to reform market practice in the collateral management space (industry letters of October 31, 2008 and December, 31 2008). The three pillars of those commitments were:

a) To rapidly put in place robust Portfolio Reconciliation practice to detect significant trade population and valuation differences that could give rise to disputed collateral calls;
b) To follow that up with a new Dispute Resolution process for the industry; and
c) To set out a Roadmap for Collateral Management that will guide the evolution of this segment of the market over the coming years.

The Roadmap for Collateral Management sets out for the industry both near term and longer term goals in the field of collateral management. The inter-disciplinary nature of this field means that some of our objectives are complex and require co-operation across trading desks, legal departments, credit risk managers and collateral practitioners not only within firms but between them too. External agencies such as industry associations, law firms, academics and regulators globally will also have a critical role to play in supporting and reinforcing the implementation of these goals, and we call for a coordinated effort to assist in accomplishing this plan. Lastly, we have been acutely aware of the limited amount of industry resources available across buy- and sell-side firms to support multiple concurrent initiatives. Therefore, the ISDA Collateral Committee has prioritized the available ideas and is committing to attack the highest priority ones first.

Furthermore, given last year's market events, we believe a "Best Practices" document (to be published by June 30th 2010) for collateral management is needed, to be sponsored and adhered to across both buy-side and sell-side participants in the market. In this document we will identify the best-in-class standards that are being used in the market today and work towards having firms adopt these practices over time. The document will distinguish between current best practices and best practices we would ideally adopt when the industry is ready. We intend this document to contain best practices focused specifically on the collateral operations aspects covering the following areas:

- Contents, issuance timing and settlement of margin calls
- Operational procedures for dealing with maintaining data quality
- Valuation and calculation of margin exposure for both independent margin and variation margin
- Handling of special life cycle events such as credit events, settlement risk of unwinds, novations, etc.
- Portfolio Reconciliations, which will be published by December 2009 as a separate document
- Dispute Resolution based on the work to be delivered in May and June as appropriate

Valuations and financial reporting

[Section 5: Q10, Q11, Q12]

The Turner Review/DP raises a number of concerns with regards to the current accounting framework, and in particular highlights concerns around the difficulties in valuing illiquid financial instruments. Furthermore, the FSA appears to conclude that both fair value and cost accounting are procyclical.

On valuations, ISDA has been fully engaged in the work of both the IASB and the FASB in providing additional guidance for valuing instruments in the absence of liquid markets. Examples of this work include, in response to the Financial Stability Forum and the European Commission, the work of the IASB and the Expert Advisory Panel in identifying the practices used for measuring and disclosing financial instruments when markets are no longer active which led to a report that has now become an industry benchmark. This is an example of where we believe some of the main valuation issues raised in the Turner Report have already been tackled. Furthermore, the IASB was already involved in a comprehensive review of accounting and disclosure for financial instruments (the so called IAS 39 replacement project) that will overhaul the present requirements by the end of 2009 and they have also just published an exposure draft on Fair Value Measurement which is intended to be adopted by the end of the year as well. As a result, we believe the FSA should focus its efforts in this area on supporting the IASB and the FASB in their joint response to the crisis, and we would be concerned should FSA initiatives threaten or impede the IASB/FASB programme of convergence towards a single global set of accounting standards by imposing alternative requirements in this area

Furthermore, ISDA agrees on the importance of timely, relevant, reliable and decision-useful disclosures. Many banks have significantly expanded their fair value disclosures to reflect requests from the Financial Stability Board and CEBS, among others, and will be implementing the recently adopted revisions to IFRS 7. The extent of reporting requirements has increased significantly over recent years. Supervisors and firms alike must recognise the trade-off between speed of publication and detail. We particularly question whether externally reported information on valuation practices provides useful information. However, we agree it is important for banks to have robust governance and risk management structures around their valuation processes.

To the extent that prudential filters or other adjustments are applied to numbers produced for financial reporting purposes, we do not believe that these should be included in the income statement as this could undermine investor confidence in the numbers reported. This is particularly important in the area of reported valuations.

We recently highlighted concerns about proposed changes to the Basel II framework for market risk potentially introducing additional liquidity adjustments to fair value measurements for risk management purposes. We strongly encouraged the use of only one definition of 'fair value' for both accounting and prudential regulation. We continue to believe that regulators should work together with standard setters and agree that there cannot be two pricing mechanisms: one for regulatory purposes and another for financial reporting.

On the procyclicality of fair value and cost accounting we would like to make two observations: (i) fair value accounting and the marking of positions to market can provide a useful early warning signal for identifying problem asset classes and (ii) more generally financial reporting is there to reflect the nature of the markets firms operate in, and where markets exhibit elements of procyclicality financial reporting should mirror those effects. We also question whether financial reporting is immediate enough to impact short term trading decisions. Financial reporting follows, rather than precedes trading, and we therefore wonder how much a role in the economic cycle both regulatory capital requirements and the accounting framework can play.

On this note we do not think new regulation should require counter cyclical reserves to be made through the income statement. We do not believe any such reserve would qualify as a provision in the accounting sense of the word and so should not be recognised in the income statement. Instead, we believe the Pillar 2 framework of the Basel II accord would be a more appropriate place for a counter-cyclical reserve. A Pillar 2 approach enables the regulator to tailor any buffer/reserve requirement to the individual firm, and to apply the appropriate level of stress to each business line. This would still leave open the question of when firms would be able to draw down on any such buffer/reserve and whether the market would allow for such an eventuality during a downturn in the cycle.

Open issues (Chapter 3 of the Review) - product regulation

We welcome a discussion on the merits of product regulation, since a methodical approach to this question will permit careful analysis of the nature and characteristics of the product on the one hand and the nature and level of risk in the financial system on the other. Overall, we share the FSA's view that product regulation – or, to be precise, additional product regulation – does not generally add anything to the regulatory construct, (except, we would add, perhaps a layer of cost and complexity).

We have no objection, of course, to product regulation being considered, but believe that it is vital to do three things in conducting any such exercise:

1. Recognise the level of de facto product regulation that already exists
2. identify a clear, proportionate and evidence-based rationale for any additional regulation,
3. work with the grain of existing industry initiatives, notably (at the time of writing) those relating to regulatory transparency.

As regards the first point, the prudential regime exists to capture risk – and, if properly structured and used, can address the systemic dimension thereof – while, the conduct-of-business rules can and do address other issues as relevant, including mis-selling and market abuse (which specifically applies to derivatives linked to publicly traded securities, on which FSA already requires transaction-reporting). The operation of MiFID already brings derivatives into the regulatory remit (for such issues as suitability), while other measures (such as those for anti-money laundering) also apply.

Picking up points made in the review, the incidence of those with no 'insurable interest' can easily be overstated. It would certainly be vital to establish more clearly the profile of participation in the market before concluding that the theoretical possibility of such a situation is somehow characteristic of the market more widely. [2] The non-public work that ISDA has done on the impact of possible changes to the prudential treatment of CDS strongly suggests that a major part of the market consists of portfolio hedging – in other words, the offsetting of existing credit risk, rather than any net short position. This takes one into the debate about the role more generally of short-selling, where we are of the view that it is reactively blamed for falling prices when in fact prices are perfectly capable of falling without short-selling, as evidence from recent bans on short-selling in equity markets has tended to suggest.

[2] Please note that it is the ability of CDS – and indeed other forms of OTC derivative – to bring together those with a position to hedge and other participants that fosters their characteristic market depth, particularly as compared with other forms of risk transfer such as insurance.

In any case, the fact remains that abusive behaviour in CDS linked to publicly traded securities is the subject of existing regulation.

It is also worth stressing in this context that the amount of notional outstandings does not shed much light on this issue. As clearly shown by the large amount of compression achieved to date (over $30 trillion), a very large part of the market consists of economically offsetting contracts, on which firms would have no incentive to attempt to manipulate the price, since by definition they would lose as much on the contracts in which they had sold protection as they gained on those in which they had bought it.

At the same time, the market does remain liquid. Indeed, the (true) size of the market is such that it is hard to reconcile with the notion that prices in it can easily be pushed around.

The ‘feedback’ issue is clearly one that deserves careful consideration, both from a systemic point of view and for the way it is addressed within individual firms’ risk management. (We do, however, wonder how consistent this notion of feedback is with the one relating to possible incentives for abusive behaviour. If credit spreads as expressed via CDS were indeed forced down to what one could objectively determine as the ‘wrong’ level, then it suggests that the ability of market participants to engage in manipulative shorting behaviour were limited.)

The main point on feedback would seem to be the need to monitor systemic risk (leaving aside the highly problematic question of how, even on a national level, to determine the trigger for any supervisory intervention as regards the level of risk taken on by any firm or group of firms). We discuss further below the question of how much systemic risk built up in CDS, but must stress that usage will consist of hedging as well as outright positions. We also reiterate the point that regulatory transparency is being enhanced in CDS.

The key point to bear in mind here, though, would seem to be the following. Given that CDS are a ‘two-way’ instrument, the fact that one party is taking credit risk (by selling protection) is, by definition, balanced out by the existence of the counterparty to the trade taking the equal and opposite view as to the future creditworthiness of the relevant reference entity. So, also by definition, any CDS includes a party seeing value in buying protection at that given level, and not thinking spreads will contract further. To put it more simply, for everyone using a CDS to achieve the same economic effect as buying a bond, there will be someone taking the equal and opposite view. Seen in this light, the feedback characterisation becomes questionable.

On another point, there is a reference in the paper to a) whether participants can be assumed to be sophisticated and b) the possibility of “rent extraction” in financial products. This former point seems to us to be left hanging. Yet a CDS per se is actually a straightforward contract. We would naturally accept that, precisely because the instrument itself is straightforward, it can be applied to a wide variety of exposures (including some structured bonds, although the vast majority of the market did *not* relate to such instruments, but instead to corporate and sovereign *entities*). That to us suggests that the key issue remains the risk exposure that someone is willing to take on and the related issues of whether a party requires protections. To illustrate this point in a more concrete fashion, there would clearly be a big difference on both these counts between a) a credit portfolio manager using a CDS to hedge credit concentration in one particular high-grade borrower and b) my purchase as a retail customer of a credit-linked note tied to an undiversified pool of mezzanine tranches.

We would accordingly caution on the premise that there is a potentially useful distinction between vanilla CDS – as straightforward risk-transfer contracts – and what the Review refers to as “the role of complex synthetic credit derivative instruments”. The complexity in the latter relates to the underlying risk (including the correlation dimension), which could conceivably be generated in other ways, using instruments other than CDS. At the same time, the existence of the CDS as an available means of transferring credit risk ‘x’ does not in itself create extra investment capacity or risk appetite, so we would urge further consideration of their asserted “supporting the growth of complex structured credit”. To some extent, this links to the next issue.

The Review also refers to the possibility of “rent extraction” in innovative financial products (and clearly, one would wish to see evidence that this was a dominant or even significant feature of any market before introducing any measures). We would note that the possibility of it occurring really depends on process failures in other areas – whether in investment judgement or, where a duty of care is owed, in suitability/appropriateness procedures. It is fair to check that the latter are being applied in new products, but it is not clear what additional regulatory measures would be justified or helpful.

The Review further refers to the view held in some quarters that CDS prices do not provide a "useful market-based measure of fundamental credit risk". However, as outlined in our preliminary response (appended to the current submission), it is hard to see how else a market-based instrument could function, other than to reflect the balance of supply and demand at a given point in time for the credit risk of a particular reference entity. Indeed, for them to diverge from the market pricing of debt obligations would arguably be more troubling than for them to conform to it.[3]

The thesis that innovation led to reduced systemic risk is questioned in the Review. We would suggest that, unless and until the profits made on short-credit positions taken on through CDS are factored into the analysis, that question cannot be adequately answered.
On the question of the system-wide build-up of exposures, referred to above, we reproduce here some statistics from the Bank of England Quarterly Review of October 2008 which shed some light as to the nature and source of losses in financial instruments.

Losses in debt securities		Outstanding	Losses	Loss/outstanding
As of Oct 08		*bn of currency*	*bn of currency*	
UK £ bn	prime RMBS	193	17	9%
	other RMBS	39	8	21%
	CMBS	33	4	12%
	IG Corp	450	87	19%
	Hi-yield	15	7	47%
sum		**730**	**123**	**17%**
$ equiv		*608*	*103*	*17%*
US$bn	Residential ABS	757	310	41%
	Res-ABS CDOs	421	277	66%
	CMBS	700	97	14%
	CLO	340	46	14%
	IG Corp	3308	600	18%
	Hi-yield	692	247	36%
sum		**6218**	**1577**	**25%**
euro bn	RMBS	387	39	10%
	CMBS	34	4	12%
	CLOs	103	23	22%
	IG Corp	5324	643	12%
	Hi yield	175	76	43%
sum		**6023**	**785**	**13%**

[3] There is a well understood exception to this, in the form of the 'basis',, in that liquidity in bonds can vary, affecting the spread relative to credit-risk-free instruments, in a way that will not affect the spread on an unfunded instrument such as a CDS.

$ equiv	*6023*	*785*	*13%*
$ equiv (bn)	*12849*	*2465*	*19%*

Source; Bank of England Quarterly Review, October 2008
$ equivalent -- ISDA calculation

This again could be taken to suggest that rather than a focus on any particular type of instrument, the single most important issue is to be addressed is the level and distribution of risk in the system and (going to the issues described above) the degree of informed judgement being applied by market participants. This would appear, particularly pertinent when these loss numbers are set against statistics for counterparty exposures in OTC derivatives. Clearly, counterparty risk in OTC derivatives is a component of the level and distribution of risk. But equally clearly, it is by no means the only or the largest component – BIS Statistics show that gross credit exposure stands at $5 trillion, and is the amount that would be payable if *all* OTC derivatives contacts, on *all* underlyings (ie, not just CDS), between *all* counterparties, were to be closed out simultaneously at current market values. The circumstances in which such a cataclysmic event could occur would, by definition, have wider implications than for OTC derivatives and betoken much deeper issues. (Note also, that the $5 trillion amount is what applies only after a prolonged financial crisis, ie, it is a 'stressed' price).

Nor is counterparty exposure truly hidden, since supervisors have existing and developing tools to monitor it. Current industry work focuses on improved, centralised delivery mechanisms for this, through trade information warehouses.

Another potentially useful comparative statistic is the size of settlements in CDS. This demonstrates the relatively small size of realised payments, reflecting the economic offsets inherent in the books of major market makers. The Senior Supervisors Group has, of course, highlighted the effectiveness of industry's approach to settlement of CDS.

Settlement amounts on selected CDS events / exposures (as of early March 2009)

Events	(Single-name CDS)	*US$bn*		A. Gross turnover	B. Required payment	Ratio (B/A)
	Ecuador			4.0	0.3	7.5%
	FHMLC + FNMA + Tembec*			99.0	0.4	0.4%
	Glitnir + Kaupthing + Landsbanki*			71.0	4.7	6.6%
	Lehman Brothers			72.0	5.2	7.2%
	Tribune			14.8	0.9	6.1%
				260.8	11.5	4.4%
	** Various CDS settled on same day*					
Exposures	CDS Market Top 1000				*Maximum pay-out*	
	10th Feb			14,387	1,416	9.8%
	3rd Feb			14,248		9.9%

					1,411	
	Indices					
	10th Feb			13,750	1,174	8.5%
	3rd Feb			13,247	1,181	8.9%

Source: DTCC/Deriv/SERV

We would suggest that there is no little danger of demonising credit derivatives, which remain a useful risk management tool, and in fact they are relatively simple. They offer a clearly defined, contractually binding payout, reflecting material decline in creditworthiness of a reference entity, provided this occurs as a result of true changes in creditworthiness (rather than, say, a general decline in market prices of debt). This allows the pure pricing of credit. (*On this subject of pricing of credit, again please see our preliminary submission, dated April 2009, which we append for ease of reference*.)

We believe, therefore, that any discussion of product-specific regulation should set out clearly a) the objectives and b) some sense of perspective on the issue, both in terms of the nature and the magnitude of the risks involved.

We would be happy to discuss these general points and any of the points we raise above in more detail and we look forward to continued discussions with the UK FSA on the topics raised as part of the Turner Review in both UK focussed regulatory groups and in more international fora.

Yours sincerely,

Head of Risk and Reporting

Head of Policy

Relevant materials:

Joint Association (ISDA, IIF, LIBA, IBFed) response to “Revisions to the Basel II market risk framework" (BCBS 148) and "Guidelines for computing capital for incremental risk in the trading book" (BCBS 149) - March 13th 2009

Joint Association (IBFED, ISDA, LIBA, ESF) response to Basel Committee on BCBS 150 - Proposed enhancement to the Basel II framework (Covering letter) (Response) - April 22nd, 2009

Joint Association (ISDA, LIBA, BBA) response to the UK FSA's CP 08 22 on "Strengthening Liquidity Standards" - March 5th 2009

ISDA's Comment letter on: “Financial Crisis Advisory Group (FCAG) Written Submissions from Constituents” - April 2, 2009

ISDA Outlines Next Phase in Industry Efforts to Increase Efficiency and Reduce Risks in OTC Derivatives Business - June 2nd, 2009

Joint Association (ISDA, LIBA, EBF, ESF) response to the EU Commission Services Working Document on proposed changes to the Capital Requirements Directive - April 29th, 2009

ISDA Publishes Year-End 2008 Market Survey Results - April 22nd, 2009

ISDA 2009 Margin Survey Results: Collateral Use Increases 86% to $4.0 Trillion (Press Release) (Survey) - April 22nd, 2009

Derivatives Post-Trade Processing Improves: ISDA Operations Benchmarking Survey (Press Release) (Survey) - April 22ns, 2009

ISDA Outlines Next Phase in Industry Efforts to Increase Efficiency and Reduce Risks in OTC Derivatives Business - NEW YORK, Tuesday, June 2, 2009]

By electronic mail: dp09_02@fsa.gov.uk April 20th, 2009
For the attention of David Cook, Financial Services Authority

Dear Mr Cook,

Turner Review – section 1.4 (iv): "The failure of market discipline"

The Turner Review is outstanding in its timely grasp of the big issues. In particular, it clearly and scrupulously identifies the major macro-economic factors, without which the current reduced risk appetite and depressed and unstable price levels for many assets would not exist.

As such, the related Discussion Paper deserves thorough and considered analysis, which is something ISDA intends to use the full consultation period to carry out. This, by contrast, is a preliminary submission, focusing on one very specific point where we feel the issue has been oddly framed[4], to the potential detriment of the policy debate.

Specifically, one of the points on credit derivatives (CDS) seems inconsistent with the overall assessment of dynamics of credit-risk-taking. At a point when CDS have continued to serve market participants better than any other credit-related instrument through the past 18-24 months, this appears perverse.

The inconsistency arises in the use and interpretation of the chart in Section 1.4iv (page 46), which purports to show a "failure of market discipline" in CDS (specifically, bank spreads). The relevant paragraph reads as follows (with our underlining added):

> "Bank CDS prices before the crash of 2007 <u>did not provide forewarning of the scale of problems ahead</u>. They were moderately successful in indicating the *relative* riskiness of different institutions; eg, suggesting that Northern Rock was more risky than other banks. But their overall, sector-wide level suggested that risks were at historically low – not historically high – levels."

The Review also suggests that, rather than "constrain risks", market prices "may have played positively harmful roles".

We find these comments flawed, principally because they fail to take account of the nature of the instrument in question. (In practice, the comments also appear to betray an inconsistent approach to the notion of market efficiency).

Risk transfer instrument

[4] We will comment further in our full response on the major specific proposals, including those regarding leverage and core-funding ratios. At this stage, we merely note that we understand the motivation to pursue these.

By its nature, a credit default swap is a risk-transfer instrument (rather than an asset in the traditional sense of a 'funded' investment). By definition, therefore, for any participant actually entering a transaction to 'sell protection' at what later proves to be a relatively low level, there must irrefutably be a participant benefiting from the purchase of protection in that same scenario, experiencing a mark-to-market profit as a result.

Contrast this with a traditional credit asset. Unless a market participant can and does short such an instrument, they will see no continuing benefit from having sold the asset if it subsequently falls in value; while the purchaser looking to realize some benefit from their position relies on either holding the asset to maturity or having someone else 'follow the trend' and push the price up.

This is not to suggest that CDS are immune from price trends – just that it is misleading to say that any given level for premia is (or ever can be) "harmful", when the market's mechanics do in fact constitute a zero-sum game.

Risk appetite

In point of fact, in our view it is also a fallacy that CDS prices can somehow disconnect from relevant price trends and, more importantly, the risk appetite that those trends reflect. In a pre-2007 world where, fuelled by loose money, investors were 'chasing yield', the truly bizarre situation would have been for CDS spreads to remain high when all other credit risk spreads were tight.

Clearly, it can and does happen that a 'basis' exists between bond spreads and CDS spreads; but, for this situation to exist, there needs to be new and specific information. Absent such specific factors, instruments can clearly only trade at the level where participants wish to transact – not at some theoretical equilibrium level that is somehow disconnected from risk appetite.

By the same token, for spreads to come back in requires market participants to demonstrate risk appetite. That clearly has not been the case across financial markets; and, absent that appetite, the prices may well be 'wrong', relative to where they would average out over the cycle.

We would add that, broadly speaking, the same participants operate in all sectors; while the utility of CDS is simply to isolate the 'pure' credit-spread element that must otherwise remain bundled together with other variables.

(The crucial difference, though, in our view remains the following: at those tight, early-2007 spreads, the CDS allowed participants to go short credit.)

There is a related point in the paper: that feedback effects can be harmful. If the point is that some market participants may have been uncritical in their acceptance of risk, we could not agree more. And we would accept that this is a serious matter, both for the health of those participants individually and for the system as a whole.

But not only is this a problem that is common to financial markets generally; more importantly the CDS market arguably makes it more apparent when the price of credit risk has moved away from historic levels.

This situation will be more apparent for any individual participant (and, by extension, their supervisor) when they can look to CDS prices; whereas previous ways of taking on credit risk – via bonds or asset swaps—left the picture less clear, given that the pricing of such instruments is complicated by other factors, including the complex interaction between interest rates, liquidity and what might be termed the 'pure' credit that is traded in a CDS.

In any case, while individual participants may draw the 'wrong' conclusions about risk, that says more about their assumptions than about the instrument whose message they misconstrue and which allows participants to express that view on risk. And, as the Review itself identifies, attitudes towards risk are influenced significantly by measures such as the cost of borrowing. How supervisors interact with market professionals – individually and collectively – in such circumstances is beyond the scope of the current submission.

CDS-equity link

One final point we would like to make regarding Exhibit 1.27 is as follows (though the Review does not itself address this point). We would note that relative pricing of CDS and equity is a matter of much ill-informed comment. On this point, market data clearly show that CDS spreads for individual names generally only move out sharply once equity price has already reached a critical point. This calls into question the assumption that CDS prices lead those of equity (and that CDS trades can be used to influence equity prices).

(The exception to this price pattern is that a wide range of names may be affected when a major default hits one particular entity, particularly when that wider range of names is in the same industry sector. This is precisely what happened upon the collapse of Lehman Brothers. Again, risk appetite is the key: uncertainty will affect this, leading to temporary price distortions.)

Generally, this pattern of relative price moves – with single-name spreads moving sharply once equity has already reached a critical point – is entirely consistent with credit pricing theory (particularly the 'Merton model'), which essentially states that default occurs once equity is exhausted.

Viewed from this angle, one might say that not only do CDS prices behave exactly as one would wish them to before a crash, but after it too.

Thank you in anticipation for taking these comments into account. Naturally, you should not hesitate to get in touch if you wish to discuss any aspect of this further with ISDA.

Yours sincerely,

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