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International Monetary Fund
1900 Pennsylvania Avenue, N.W.
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Dear Sirs,

"Making Over-the-Counter Derivatives Safer: The Role of Central Counterparties" (Chapter 3 of the April 2010 Global Financial Stability Report) clearly and appropriately states the case for the use of clearinghouses. ISDA agrees with much of this report as we too fully recognize the value of clearinghouses as a means of reducing risk. There are, however, some disagreements or misunderstandings in the article that need to be addressed.

One such misunderstanding relates to the section "Getting Dealers to Move," which focuses on the costs of clearing and states: "all of these costs…could reduce or even eliminate any incentives to move contracts to CCPs (clearinghouses)." The entire section focuses on costs, incentives and penalties, rather than the ability of clearinghouses to clear more products with more firms, as the primary factor that drives dealers to clear their trades.

The fact is, the industry has already cleared over $200 trillion of interest rate swaps despite the "costs." Should firms be able to clear forward rate agreements (FRAs), caps, floors and swap options, very sizeable volumes would be cleared very quickly. Similarly, single name default swaps can only be cleared for the most liquid names. The clearinghouses have to develop the means of clearing these products, and clearing them safely, as you point out, before the dealers can use them. Similarly, the clearinghouses typically have very stringent standards about membership because of the potential capital calls if a member defaults and the need for members to bid for the positions of a defaulting member. Members must be able to assist in hedging the clearinghouse as well as bid on positions. Presumably, over time, clearinghouses will not require comprehensive risk management strength for all its members and enable more dealers to become members.

A second issue is more likely a disagreement than a misunderstanding. We believe part of the OTC derivative business is the extension of credit to clients. Dealers are content to

execute derivatives with the highest rated sovereigns and supranationals and for many corporate clients without collateral. The fact that dealers collateralize 78% of transactions (by notional amount) does not appear to be low. The OCC reported that the net derivative exposure of all reporting US banks at year end 2009 was $398 billion. Of that amount, banks held collateral of 67%, leaving net uncollateralized exposure of $131 billion. This is a manageable amount when one considers the aggregate capital and assets of the US banking system. (The difference between 67% and 78% is the use of exposures in one case and notionals in the other and the different samples.) The same would apply to the use of independent amounts. The fact that a user of derivatives has no initial margin with a dealer does not increase the user's exposure to the dealer or reduce its liquidity requirement.

A third point relates to statements that require clarification. The report asserts that clearing the next $100 trillion of interest rate derivatives will cost $20 to $30 trillion in collateral and increments to the default fund when the first $100 trillion cost the same amount. Yet it also (rightly) points out that the more a clearinghouse clears, the greater the economies of scale. The estimate may be correct if it refers to clearing more complex and less liquid products. However, there is ample scope to clear $100 trillion of interest rate derivatives in both currently clearable products and simple, currently non-clearable products, which should be no more expensive to clear than the average interest rate swap. We understand the report used CDS data from June 2009. This may explain why it refers to clearing $24 trillion of CDS, the vast majority of all CDS currently outstanding. The report compares a cost estimate of $100 to $150 billion of margin and guarantee fund contributions to the $221 billion of capital used to support derivatives across 16 major banks. However, one is a potential liability and will require a small capital charge while the other is the capital charge itself. Finally, the report states that if AIG’s derivatives had been cleared, they would not have grown to systemically critical levels. Unfortunately, AIG’s derivatives could not have been cleared, either when they were executed or today, because they cannot be valued and risk managed by a clearing house.

Perhaps another way of examining the risk in OTC derivatives is to consider three separate categories of exposures. The first is the AIG-type of very complex risk. This is not clearable and will not be for the foreseeable future. Entities that produce such risk need to be regulated and their positions reported to regulators. The reporting is starting to happen now. Undoubtedly, legislation will create the regulatory authority.

The second is the interconnectedness of interdealer derivative activities. This is the notion that the default of one dealer could cause a domino effect among others. This risk can best be managed by very extensive use of clearinghouses, something dealers are committed to doing.

Finally, there is the issue of non-financial end-users. It is extremely difficult to imagine a default by an end-user creating systemic risk. It is, however, simple to imagine that end-users could be seriously damaged by a dealer default. Interestingly, a recent analysis of claims against Lehman's derivative subsidiary picked up only five non-financial

corporations with claims of $20 million or more. In the aggregate, these claimed totaled about $250 million while the total amount of claims over $20 million from external counterparties were over $50 billion. Thus, one can see Lehman's default did not do serious damage to corporate end-users. We believe end-users should have the ability to clear trades but should be able to manage their risks as they see best, either through the clearinghouses or in a bilateral manner.

Misunderstandings and disagreements aside, there is much to agree on regarding the value of clearinghouses. The industry is embracing central clearing, is clearing over 90% of new interdealer clearable derivatives and has been for some months.

Sincerely,

Conrad Voldstad
Chief Executive Officer