ISDA® Safe, Efficient Markets

FAO Svein Andresen,
Secretary General, Financial Stability Board

By email to fsb@bis.org

29 November 2012

ISDA Response to the Fourth Financial Stability Board Progress Report on Implementation of OTC Derivatives Market Reforms

Dear Svein,

I am writing in response to the Financial Stability Board's 'Fourth Progress report on implementation of OTC derivatives market reforms' ("the Progress Report"), as published on 31 October 2012. This letter sets out the views of the International Swaps and Derivatives Association (ISDA) on the FSB's conclusions.

Firstly, ISDA believes the FSB is right to acknowledge the readiness of market infrastructure across the FSB's member countries to provide clearing services, collect and disseminate trade data and provide organised trading platforms.

ISDA and its members are focusing on industry readiness for forthcoming regulatory changes, which will be unprecedented in scale and scope. In order to help our members navigate the implementation of the new regulatory framework, and in a manner that avoids market disruption, ISDA has established a series of Regulatory Implementation Committees, each covering a key aspect of the new regulatory framework, as follows:

- Risk and Margin
- Business Conduct
- Organized Trade Execution
- Data & Reporting

The creation of the new Regulatory Implementation Committees will support a shift in focus from what the rules should say to how we implement them. They also provide a new forum through which industry can engage with the regulatory community on questions of interpretation and compliance. These committees have been established within our ISDA Industry Governance Committee, which has been a focal point of interaction with global regulators for several years.

Secondly, we agree with the Financial Stability Board's assessment that regulatory uncertainty remains the most significant impediment to further progress and to comprehensive use of market infrastructure.

A major source of regulatory uncertainty is the extraterritorial application of individual jurisdictions' rules, something that it is particularly apparent in the context of the CFTC's cross-border guidance.

In the extreme, extraterritoriality could lead us to what amounts to a regulatory "trade war", with jurisdictions introducing regulations not to make the system safer or more resilient, but because they must respond in some way to assertions of jurisdiction from elsewhere.

We believe that the only solution to this challenge lies in greater international regulatory coordination on implementation of OTC regulations, including true transpositions of international standards locally. For example, significant effort has been expended by BCBS-IOSCO and our members over 2 years to ensure there are no capital disincentives to banks being clearing members of CCPs; and yet we discover some material divergences from these Basel international standards in associated local implementation measures. Regulation of the global OTC derivatives market cannot be effectively addressed other than through a coordinated effort among regulators from all the major jurisdictions. We believe the established international regulatory co-ordination bodies have an important role to play here.

Thirdly, we would encourage the FSB to look further at the overall impact of regulatory reform, as we remain of the view that too little has been done to understand properly the implications of the various rules that will be finalized in the near future. These rules and regulations include: Dodd Frank Act rulemakings, EMIR, Basel 3, the establishment of liquidity buffers, and margin requirements for non-centrally-cleared derivatives, to name but a few.

Of particular concern in this regard are the proposals set out by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") in the Consultative Document "Margin requirements for non-centrally-cleared derivatives" (the "Study") of July 2012.

ISDA strongly opposes the requirement for a universal two-way exchange of Initial Margin (IM) between financial firms and systemically important non-financial firms ("Covered Entities") in the way that is proposed in the Study. The margin rules as proposed are likely to impose significant operational difficulties on market participants and, most importantly, lead to a significant liquidity drain on the OTC derivatives market and potentially the whole economy. The proposed IM requirements are particularly worrisome, as they are highly pro-cyclical, and could potentially destabilize the financial system during periods of extreme market stress. ISDA estimates that the proposed IM rules are likely to require trillions of dollars of additional collateral[1] which, in periods of market stress, could further increase by a factor of 3 or more.

Such demands on liquidity could cause enormous pressure on market liquidity with the potential for significant dislocation in the financial sector and thus the general economy, which makes the imposition of mandatory IM inconsistent with the letter and the spirit of the G20 leaders' recommendation.

In light of this, and the fact that central clearing will in any case deliver significant risk mitigation benefits, ISDA believes that the optimal way forward would be a regime that included a transitional variation margin model, supported by an observation period to determine whether further measures (including increased reliance on initial margin) would in fact be appropriate. In full (including this transitional variation margin model), the key features of the regime would be as follows:

- Robust variation margin framework
- Mandatory clearing for liquid, standardized products
- Appropriate capital standards

We encourage the FSB to engage with BCBS-IOSCO on their joint work, to ensure that this approach is explored in full.

[1] http://www2.isda.org/attachment/NDgyNw==/ISDA_Response_to_BCBS-IOSCO_Study_on_Margin.pdf

Likewise, we believe there has been inadequate analysis of the impact of rules that will move trading activity in OTC derivatives markets to exchanges or electronic trading platforms. In particular, we stress the need to consider fully the link between pre- and post-trade transparency requirements and the continuing liquidity of a given instrument; inappropriately designed transparency requirements could ultimately harm liquidity, adversely impact pricing, and undermine the ability of firms – whether financial or otherwise – to access suitable hedging instruments.

To conclude, I would like to reiterate ISDA's endorsement of the FSB's focus on industry readiness for regulatory change; much now depends on resolving issues relating to extraterritoriality and finalising rules in a way that considers their likely impact, whilst taking account of all of the relevant elements of the global package of regulatory reform. These are significant challenges, and they must be adequately and promptly addressed.

Yours sincerely,

Robert Pickel
Chief Executive Officer
International Swaps and Derivatives Association