OTC derivatives: ensuring safe, efficient markets that support economic growth

Stephen O'CONNOR
Chairman
International Swaps and Derivatives Association

In 2009, the G20 committed to strengthening the financial system and improving the over-the-counter derivatives markets by increasing regulatory transparency and reducing credit risk. Three years on, the industry is delivering, with significant progress made in increasing usage of central clearing facilities and in nearly universal centralised trade reporting by dealers.

Today, however, the global financial system and market participants face new challenges and risks. Proposed collateral requirements for non-centrally-cleared derivatives may be pro-cyclical and exacerbate, instead of alleviate financial market stress. Short-selling and other restrictions threaten prudent risk management and investment in the European economy.

Overcoming these challenges is important to ensuring robust, stable financial markets, as well as a strong, growing and productive economy.

In September 2009, at their Pittsburgh Summit, the heads of state of the G20 nations committed to strengthening the financial system and the world economy. One initiative announced in their end-of-summit communiqué was to improve the resiliency of the over-the-counter (OTC) derivatives markets. Proposals included measures such as the reporting of OTC derivative transactions to central trade repositories (TRs) and the mandating of central counterparty clearing.

Now, more than three years on, a great deal of progress has been made towards safer, more resilient markets. For example, TRs have been established covering derivatives in all major asset classes – interest rates, credit, equities, commodities and foreign exchange. Regulators around the world now have tools that give them access to activity in the derivatives market. With this development, the amount and completeness of information that will be available to regulators is unprecedented in global financial markets. For no other financial instrument, in any asset class, has there ever been a way for authorities to access a complete database of the entire global transaction population. Regulators will now be able to readily detect improper behaviour, observe transaction flows and identify trends in liquidity in the OTC markets.

With regard to clearing of derivatives through central counterparties, nearly two-thirds of the interest rate swap market is already centrally cleared, largely due to voluntary initiatives and commitments by banks to global regulators in advance of legal mandates. Clearing will increase significantly in the next twelve to twenty-four months as trades between dealers and their clients become subject to mandatory clearing; this began in the United States in March 2013.

Since the 2009 Summit, and even before that in the case of clearing and in the area of operational risk reduction, policymakers and industry have worked diligently and constructively together on the shared goal of reducing systemic risk and improving the safety of the OTC derivatives markets.

There are many initiatives underway that are designed to improve systemic resiliency in markets and most of these initiatives have clear benefits and they themselves create little or no incremental risk to the system. But in certain cases, a new element of systemic risk may be introduced by a proposed reform. The test, in terms of whether or not to implement a change designed to improve market resiliency, is whether the benefits of the change – in terms of tangible improvements to the system that result from it – outweigh any potential risks to the system created by such change. As an example, TRs introduce very limited incremental risk other than obvious (and solvable) data security concerns that information might get into the wrong hands.

With respect to clearing, the case needs a little more thought. The primary goal of central clearing is the elimination of the risk of peer-to-peer default contagion. Each participant in the cleared markets will face the central clearing house, not other market participants. This is clearly an extremely worthy goal and is largely achieved.[1] However, there are risks associated with mandatory clearing.

As regulations push transactions into clearing houses, the clearing houses will become the contractual counterparty to entire markets or large proportions of markets. As a result, the default of a major clearing house would be a catastrophic event. Simply put, clearing houses are now among the most systemically important institutions, and with that comes the obligation to ensure they are managed prudently and carefully regulated.

Fortunately, the risk of such a default can be, to a very large degree, controlled by adopting policies and procedures that ensure a proper risk profile for the clearing house. These include robust operational systems, conservative risk and margin policies, a high creditworthiness standard for membership eligibility and diligence with respect to product eligibility. Clearing houses must not be allowed to clear products which have insufficient liquidity or price transparency, since in the time of ultimate stress – a member default – they must be able to liquidate positions quickly and aggressively. Clearing of products that are illiquid or difficult to trade or value could severely impact a member closeout, resulting in unhedged losses which would erode the capital and consequently impact the stability of the clearing house. Rigorous product approval processes

1 *In the case of clearing house members clearing for their clients, it is those clearing house members, not the clearing house itself, that are exposed to the default risk of those clients.*

will ensure the right outcome. Overall, in the case of clearing, the benefits to the system will outweigh the risks if clearing house policies and risk frameworks continue to be as robust as they are today.

There are many other initiatives designed to reduce systemic risk underway in the OTC derivatives markets, such as the transition from the exchange of paper contracts to real-time electronic matching. Portfolio compression exercises, where counterparty risk and operational risk is significantly lowered as portfolios of transactions are reduced to smaller portfolios with equal risk characteristics, are another example. Compression has greatly rationalised the OTC markets. As of mid-year 2012, compression had resulted in OTC notional contracts outstanding being reduced by over USD 230 trillion in notional terms. In the credit default swap market, compression has resulted in notional outstandings being reduced by a factor of three. Modernisation of the confirmation process and portfolio compression are examples of initiatives with real systemic benefits and very little risk.

The systemic risk-reward cases for TRs, electronic confirmations, compression and clearing are clear. Now, however, regulators are considering rule proposals where the systemic benefit is not clearly defined or understood. These proposed rules are in the area of margin for non-cleared OTC transactions. Such rules, if badly crafted, could potentially threaten, rather than strengthen, the global financial system.

In 2011, the G20 supplemented their 2009 communiqué with a call for regulators to devise proposals to improve margin arrangements in the non-cleared OTC derivatives market. Market participants also see robust deployment of margin practices as an essential tool for systemic resiliency. With this new regulatory focus and with industry support, why the controversy? Where do the potential problems lie?

The new margin framework proposed by regulators consists of two elements: variation margin and initial margin. Many OTC derivatives transactions currently involve the payment, or "posting", of variation margin. Variation margin is a mechanism which is used to avoid the build-up of unsecured risk exposures between counterparties.

Variation margin is called for as portfolio valuations change and can be thought of as daily settlement of amounts owed and is extensively used as a tool to reduce risk by a wide variety of market participants. The International Swaps and Derivatives Association (ISDA) has promoted the use of variation margin for non-cleared trades for more than twenty years and fully supports the regulatory push for the mandatory exchange of variation margin for the broader OTC derivatives markets as a means to improve systemic resiliency. ISDA research[2] reveals that more than 70% of all OTC derivatives transactions – including 84% of those executed by large dealers – are subject to variation margin arrangements. The major exceptions to the practice of posting collateral are sovereigns, the majority of whom do not pay variation margin to their banks for historical reasons.

The case for initial margin, on the other hand, is much more complex. While variation margin covers amounts owed under derivatives contracts, initial margin represents extra payments made between parties in excess of amounts owed. Payments of initial margin are a safety cushion, designed to cover the replacement costs in the event of a default by the party posting the initial margin. And initial margin really does improve the situation of the non-defaulting party by insulating that party against losses. This reduces the risk of default contagion across the system, which is clearly a very worthwhile goal. However, initial margin comes with some significant potential costs, all relating to the fact that it consumes the financial resources of the posting party, causing a potential liquidity strain – and can therefore introduce risk into the system.

Before discussing the risks of mandatory initial margin in more detail, it is worth understanding which products and markets exist in the non-cleared OTC sector.

1| Who uses non-cleared OTC derivatives... and why?

Why does any of this matter? How important is the non-cleared OTC derivatives market segment? The cleared sector of the OTC derivatives market, which is the majority of the market when expressed in

2 *ISDA Margin Survey 2012 available at* http://www2.isda.org/functional-areas/research/surveys/margin-surveys/.

notional terms, accounts for only a handful of the many types of OTC products. Non-cleared products comprise not just the majority of OTC derivative transaction types, but many of the types that are most beneficial to today's global economy.

The list is extensive, but some examples of important non-cleared OTC derivatives include currency swaps that corporations, sovereigns and supra-nationals use to enable capital raising in foreign markets; interest rate options that facilitate the mortgage markets – in the United States, for instance, mortgage agencies could not properly function without access to interest rate options; single name credit hedges that banks use to hedge lending activities and that investors and underwriters use to hedge corporate bonds and inflation swaps that pension funds use to hedge their long term liability needs. And there are many others, many of which are vital to economic activity and growth. In addition to the many product types that cannot be cleared, there is another segment to the non-cleared market, transactions that utilise products which, in their generic form, could be cleared, but which are modified to meet the needs of the end user. It could be argued that these transactions, tailored to suit the exact risk management needs of the user, are the most socially useful of any derivative transactions, cleared or non-cleared.

2| Inherent conservatism of initial margin

While initial margin has the clear benefit of reducing the risk of default contagion, it is an inherently conservative approach to risk management. The premise of an initial margin arrangement is that the counterparty posting the margin could default at any time, and that in preparation for such possible default, the costs that might be incurred by the non-defaulting party are pre-funded in full from the outset of a transaction.

At a clearing house, this degree of conservatism is appropriate, due to the overwhelming systemic importance of those institutions. However, the introduction of mandatory initial margin into the non-cleared derivatives market introduces an enormous degree of conservatism into that market.

To give an insight into this conservatism it is useful to compare initial margin in the cleared market to initial margin in the non-cleared market. The total initial margin currently held at the major OTC clearing houses is approximately USD 40 billion. This provides very robust support for a population of cleared transactions of approximately USD 300 trillion. In the non-cleared sector, under current proposals,[3] ISDA estimates[4] that total global initial margin requirements will be in the range of USD 0.8 trillion to USD 10 trillion.[5] This much larger amount of margin would support the smaller, non-cleared population of approximately USD 125 trillion. Put another way, using a figure of just USD 2 trillion for the total global initial margin, which is at the lower end of that estimated range, the amount of initial margin required in the non-cleared sector would be over one hundred times more than in the cleared sector for the same notional amount of trades. Even with the lowest estimate of USD 0.8 trillion,[6] it will be around fifty times more expensive to trade in the non-cleared market compared to the (already robustly margined) cleared market.

Again, this is due to the inherent conservatism of the initial margin approach. The numbers are so large because they reflect the implicit premise that any market participant could default at any time, and provides for pre-funding of replacement costs associated with all such potential defaults. In other words, in order to ensure that the market is protected from the next default, whoever that might be, every party in the market must pre-fund any costs that might be associated with its default to any other party in the market that it transacts with. Given this conservatism, the wholesale

3 *Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commission (IOSCO) formed a working group, the Working Group on Margining Requirements (WGMR) to study the margin market and develop proposals for a new margin framework. Proposals were issued in July 2012. WGMR commissioned a Quantitative Impact Study (QIS) asking major market participants to provide estimates as to the quantum of margin needed in the proposed regime. A revised proposal was issued in February 2013.*

4 *ISDA estimates are based on member submissions to the WGMR QIS. A presentation setting out these estimates, "*Initial margin for non-centrally cleared swaps: understanding the systemic implications, November 27, 2012*", is published at* http://www2.isda.org/functional-areas/risk-management/.

5 *The wide range depends upon two key variables: whether parties obtain approval for risk models or use standardized tables; and whether thresholds are adopted – thresholds allow for a certain amount of risk activity to be undertaken with no initial margin requirement.*

6 *A USD 0.8 trillion total market initial margin estimate reflects the assumption that every participant in markets obtains regulatory approval for a margin risk model and policymakers globally grant a threshold of EUR 50 million, the highest threshold contemplated in the WGMR QIS.*

deployment of a mandatory initial margin regime into the non-cleared market carries an enormous cost. Addressing risk through variation margin together with an appropriate capital regime, rather than initial margin, will lead to a much more logical outcome while still retaining systemic resiliency.

3| Impact on depth and liquidity of OTC markets

Mandatory initial margin imposes very significant cost and resource drains on the posting party. This leads to a number of consequences both at the level of the market participant and at the systemic level. From the perspective of the market participant, the posting of initial margin consumes valuable liquidity, and liquidity management is of paramount importance to all financial institutions.

Current initial margin proposals call for margin to be calculated using a value-at-risk (VaR) approach. VaR models, in the context of initial margin, are designed to project short term movements in the market value of portfolios of derivatives with a certain confidence level. VaR results depend upon volatility inputs, since volatility is used to create the dispersion of portfolio values, and as volatility used by the VaR models increases, initial margin will increase. Initial margin is dynamic in this sense – it rises and falls according to changes in volatility inputs of the VaR models. Increases in model volatility, such as might occur in a crisis, could cause significant increases in initial margin requirements. From the perspective of a market participant, initial margin therefore gives rise to both a *current* liquidity requirement, needed to fund current margin obligations, and a *contingent* liquidity requirement, resulting from potential increased margin calls should volatility increase.

Initial margin therefore creates both a liquidity cost and a liquidity risk for market participants. The cost is the funding cost of initial margin sent out to counterparties, which must be added to the costs of transactions. The risk aspect is that even without any new trading activity, the dynamic aspect of the margin calculation could lead to large liquidity calls, which might be particularly stressful in times of crisis.

The funding cost component of initial margin will also cause bid-offer spreads in the non-cleared OTC derivative market to widen. This is because banks need to cover their costs when quoting prices to a customer (or withdraw from the business). A bank could face two amounts of initial margin[7] on each customer trade: it will be required to post initial margin both to its customer and to the institution on the other side of the trade that provides the hedge for the bank. For end-users, wider bid-offer spreads quoted by banks will be additive to direct costs of funding the initial margin that they must post to the banks.[8] Under proposed rules, end-users will therefore face transaction costs that run to multiples of current market bid-offer spreads.

Given all of the extra cost, the application of the proposed measures will come at a very high price in terms of impact on depth and liquidity of non-cleared OTC derivative markets. Even with the envisioned use of thresholds, the proposed measures are likely to lead to a significant deterioration in market liquidity and product availability.

If policymakers are focused on preservation of market liquidity in these important markets, the terms of any mandatory initial margin proposals must be carefully considered. Imposing initial margin requirements as contemplated by current proposals will have damaging consequences, severely impacting liquidity in those important sectors of the economy as noted above.

4| Pro-cyclicality concerns

In addition to the impact on market liquidity and transaction costs caused by initial margin, the potential for levels of initial margin to rise in times of market volatility could be destabilising for the financial system.

In its study on collateral requirements, the Bank for International Settlements (BIS)[9] showed that, for

7 *Current proposals call for banks to post initial margin both to other banks and to their clients.*
8 *A customer could effectively end up paying for the funding impact of three amounts of initial margin on just one trade.*
9 *BIS Working Papers No. 373,* Collateral requirements for mandatory central clearing of over-the-counter derivatives*, March 2012, p. 20; available at* http://www.bis.org/publ/work373.pdf.

OTC interest rate swap portfolios of fourteen major derivatives dealers, initial margin requirements for cleared portfolios under high market volatility would be approximately three times the initial margin requirements in low market volatility (increases were more pronounced for credit products). If the same ratio held true in the non-cleared world, this would create a very significant, potentially unmanageable stress in markets. In terms of quantum, a "peacetime" total global initial margin requirement of USD 1 trillion, for example, could increase to USD 3 trillion in market stress conditions. Many institutions could face individual incremental liquidity needs of USD 10 billion or more. These needs would be in addition to any other funding stresses that might occur at the same time in other parts of their businesses. History shows that liquidity drains of this magnitude can cause the default of institutions.

This dynamic aspect of initial margin is clearly inconsistent with the objective of systemic resiliency. Simply put, in stressed market conditions, it may not be possible for the market to deliver the incremental margin implied by the proposals as currently formulated.

5| Common misperceptions regarding non-cleared OTC derivatives

The concerns expressed above with regard to the impact of proposed rules on market liquidity and pro-cyclicality are very real. These concerns are sometimes countered by incorrect arguments or assertions. At this point it is worth laying some of these out in order to better inform the debate.

5|1 Perception: if it can't be cleared, it's too risky

There are those that believe that if an OTC derivative can't be cleared, then perhaps it is too risky, and it should not exist. For some, the prevailing perception of non-cleared OTC derivatives may be that they are complex and risky; to others, non-cleared OTC derivatives should either be cleared or those markets should be shut down.

The fact is the riskiness of an OTC derivative is not a proxy for its clearing eligibility. As highlighted above, clearing houses must have stringent product eligibility criteria. To meet such criteria, products must pass many tests, but the riskiness of a product is not one of them. Most importantly, products must be easy to value and have sufficient liquidity to be readily tradeable in the event of a member default. With respect to riskiness, there are products deemed "risky" that meet the criteria, and therefore can be cleared, and there are non-risky products that cannot be cleared since they fail, most importantly, liquidity, valuation or other tests.

5|2 Perception: market participants don't want to clear

There is a perception that banks and end-users are predisposed to avoid clearing a derivative. Or that they might alter the economic characteristics of a trade to change it from being clearable to non-clearable. Such views diametrically oppose reality. Banks have been clearing interest rate swaps at LCH.Clearnet SwapClear for more than twelve years – and that development was entirely market driven, not the result of a regulatory push. The fact is that market participants, including both banks and end-users, prefer to clear. Capital is lower, operational risk and operational costs are lower and credit risk is lower. These incentives existed in large part when SwapClear was launched and will become even stronger in the future. In fact, there are few, if any, factors that make the non-cleared space more attractive to market participants than the cleared space, other than the case where the desired economics of a trade are not catered for in the cleared market.

5|3 Perception: participants should use clearable products instead of non-cleared products

Another prevailing perception is that market participants can easily find another alternative to a non-cleared OTC derivative by using a cleared or exchange traded alternative. End-users and dealers alike have a preference to trade cleared swaps, for many reasons as described above. But often,

end-users need to hedge unique and specific risks in order to manage their businesses. If end-users are not able to use the true hedge, but instead have to hedge with a cleared or exchange traded alternative, they would have an imperfect hedge. The resulting financial risk exposures would lead to uncertainty, earnings volatility, and possible unmanaged losses in their financial results with potentially damaging consequences, such as less investment, lower employment and lower contribution to public finances.

Consider the case where an interest rate swap was needed in a certain currency, but instead a swap in a "similar", but clearable, currency was used. Or if an entity in need of an option product had to hedge with a linear, non-option, product – for instance the use of interest rate swaps to hedge risks where an interest rate option was really required. Or consider the case where a bank credit officer when making a loan to a corporation was forced to execute a credit hedge in a "similar" corporation or a broad index. In all of these cases, where parties were forced to use a cleared product when perfectly good but non-cleared alternatives were available, the residual unhedged risks could be harmful or damaging to the individual institutions, with knock-on effects for the wider economy.

The unhedged portion of the risk, the difference between the true hedge and the imperfect hedge, is known as basis risk. Some might say that this basis risk should simply be absorbed by the end-user. But end-users are charged with managing their underlying businesses. Hence their drive for hedges that best match their risks. To meet this need, banks typically provide and make a market in transactions that provide such a solution. It is far better for the end-users and far better for the economy that banks with appropriate expertise manage the net basis risk across the thousands of their clients, rather than inflicting such risks on those clients.

5|4 Perception: if initial margin is set high enough, that will provide an incentive to clear more products

Another misconception is that setting initial margin requirements for non-cleared OTC derivatives at a high enough level will induce and incentivise market participants to clear more.

This position is seriously flawed. The best way to maximise clearing is straightforward. First, and most importantly, ensure that clearing house product eligibility decisions are appropriate – this should be done by diligent scrutiny of products proposed for clearing, such scrutiny being performed by experts at regulators, clearing houses and clearing house member risk committees. Once such decisions are made, laws should then be passed to ensure that such clearable products cannot be traded without being cleared. This approach removes any commercial or subjective considerations entirely and achieves the desired result of clearing the entire universe of products that are suitable for clearing.

So, if a product is clearable, then legal mandates – and not punitive initial margin – should drive clearing. If a product is not clearable, then no amount of initial margin can cause it to be cleared. If a punitive level of initial margin is the tool used to try to incentivise clearing, not only would such a strategy fail, but there would be a number of potential adverse ramifications: market liquidity will be drastically affected in non-cleared OTC markets; end-users may be driven to use imperfect hedges; and market participants and clearinghouses will be strongly biased towards introducing products to the clearinghouse that are not suitable for clearing.

5|5 Perception: there should be a level playing field in margin terms between cleared and non-cleared OTC derivatives

Another misperception regarding non-cleared OTC derivatives is that because initial margin is required for cleared OTC derivatives, it should also be required for those that are not cleared, in order to ensure a level playing field. This argument misses two key points:

First, initial margin is essential at clearing houses because clearing houses typically have very little capital of their own supporting the creditworthiness of the clearing house, often a tiny fraction of the capital of their larger members. Even though they

will be the largest participants in global markets, the clearing houses are not creditworthy in their own right. The members provide the capital to the clearing houses in the form of default fund contributions and initial margin. Quite simply, without initial margin there would be no clearing houses.

In the non-cleared sector, counterparties bring their own creditworthiness – supported by assets and tangible capital. Initial margin is not necessary for the market to function, as it is in the cleared space. Having said that, initial margin is used in the non-cleared market, but based on commercial decisions at the option of the counterparties. Institutions of lower credit standing may choose, or be required by their banks, to post initial margin in order to facilitate credit lines.

Second, in the non-cleared sector, capital charges will be higher than for cleared transactions. In its 2009 Pittsburgh communiqué, the G20 stipulated that non-cleared OTC derivative contracts should be subject to higher capital requirements than cleared transactions. The logic behind this approach is sound. Capital must be aligned with risk and in general, a clearing house is of better credit standing than bilateral counterparties. In the non-cleared market, capital will be sized commensurately for cases where there is initial margin and for cases where there is no initial margin. And for that matter for cases where there is no variation margin.[10] In summary, with appropriate capital rules, initial margin for non-cleared trades is not necessary to ensure systemic resiliency.

5|6 Perception: all standardised products should be cleared

Some use the words "standardised" and "clearable" interchangeably. Others refer to standardised as the key criteria for clearing house eligibility. Clearability is a very different concept to standardisation. Just because a product is standardised does not mean it will meet the clearing house product eligibility criteria; and if a product is not standardised it does not mean that it will automatically fail to meet such criteria. Interestingly, almost any type of interest rate swap, though not standardised, can be cleared. Conversely, most single name credit derivatives, though standardised, cannot be cleared due to lack of liquidity in many reference names.

6| What if there is no mandatory initial margin? – The theory

Having discussed some of the problems with initial margin, let us consider the case where there is no mandatory initial margin requirement. Will the system be safe?

ISDA fully endorses the goal of the G20 to ensure systemic resiliency and supports global policymakers in their efforts to achieve it. With respect to ensuring systemic resiliency around non-cleared OTC derivative markets, ISDA believes that a three pillar framework is appropriate for ensuring systemic resiliency:

- mandatory clearing of OTC derivatives where appropriate;

- a robust variation margin framework for non-cleared OTC derivatives that involves frequent collateral exchanges; and

- an appropriate capital regime to cover any residual counterparty risks in either the cleared or the non-cleared markets.

This approach will ensure systemic resiliency without compromising the liquidity in key OTC markets. Adding mandatory initial margin to this framework could increase rather than decrease systemic risk and harm liquidity in vital markets.

10 *Regulatory proposals currently contemplate granting exceptions to the margin proposals for many types of end-users.*

7| No mandatory initial margin – the empirical evidence

Experience – both good and bad – has demonstrated that the practice of frequently settling the unrealised valuation changes between two parties using variation margin is beneficial in reducing counterparty risk. It avoids the build-up of large unrealised exposures that could become destabilising in periods of market stress.

The American International Group (AIG) and Lehman Brothers situations are cases in point. From inception, AIG did not post full daily variation margin with all counterparties. Faced with huge collateral calls when its ratings declined, this triggered post-facto variation margin calls on a systemic scale. The liquidity drain caused by the sudden collateral requirements led to AIG's collapse, to widespread fears about systemic contagion and, ultimately, to the government bailout.

In contrast, Lehman Brothers posted variation margin daily (and did not post initial margin). It faced no large or sudden increase in collateral requirements. When it collapsed, there were shocks to markets, but there was no contagion in OTC markets and no government bailout. The disruptions arising out of the Lehman Brothers situation had to do with the long process of resolving its positions in markets other than OTC derivatives and not market disorder as such. OTC derivatives positions were closed out immediately under ISDA protocols, and OTC derivatives margin was liquidated immediately (notably, OTC margin was not held up at custodians as in other asset classes). Counterparties did incur losses over and above variation margin held (losses which would have been mitigated by initial margin) but those losses were minor, considering that Lehman Brothers was a major global financial institution, compared to the costs of the proposed remedy of mandated initial margin. As stated above, initial margin has benefits, but comes at a cost. The benefits must be considered in relation to the costs involved. Total losses in OTC portfolios as a result of the bankruptcy of Lehman Brothers were of the order of USD 10 billion globally; the estimated cost of the purported "remedy", mandatory initial margin, as noted above could run to multiple USD trillions.

8| Conclusion

ISDA, the OTC derivatives industry and global policymakers share a common goal: safer, more efficient markets. The significant progress made in key areas of financial regulatory reform – in terms of clearing and transparency – evidence this commitment.

The non-cleared OTC markets play a vital role in key sectors of the global economy, ranging from housing to corporate and sovereign funding to credit origination. The importance of these markets to a stable and efficient global economy cannot be overstated.

Current proposals would significantly impact market depth and liquidity in the OTC derivative markets and in so doing, could harm important sectors of the global economy.

And while current margin proposals are motivated by a desire to establish systemic resiliency by reducing *counterparty* risk, their application is likely to increase *economic* risk (and thus compromise systemic resiliency) by discouraging (or even eliminating) the ability of market participants to hedge risks to their businesses. Finally, the pro-cyclical problems caused by the use of a dynamic approach to margin are a real concern.

ISDA strongly urges policymakers to conduct a new, thorough impact study before imposing margin requirements. The proposed requirements will have serious negative effects on the markets as a whole, in terms of liquidity drain, collateral demand and transaction costs. The toll of such effects may well outweigh any actual benefits realised.

ISDA is committed to working with regulators, policymakers and market participants around the world to overcome the challenges we currently face and secure robust, stable financial markets, as well as a strong, growing and productive global economy.