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Margin Requirements on Non-Centrally Cleared Swaps Could Increase Risk, According to ISDA Analysis

Association Issues Margin Analysis and Urges Regulators to Resolve Extraterritoriality Issues

NEW YORK, November 27, 2012 – The International Swaps and Derivatives Association, Inc. (ISDA), today published an analysis of initial margin (IM) requirements for non-centrally cleared OTC derivatives under current regulatory proposals.

International rules governing margin requirements for OTC derivatives and the resolution of issues related to the cross-border application of derivatives rules are two of the most important matters facing global regulators and the industry today.

The IM analysis is based upon data submitted by member firms to the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements (WGMR), as part of the WGMR's Quantitative Impact Study (QIS).[1]

The analysis highlights three significant industry concerns. First, the level of IM required under the BCBS-IOSCO proposal is very significant, ranging from $1.7 trillion to $10.2 trillion depending on whether internal models or standardized schedules are used. Second, the increased amount of IM that would be required in stressed conditions will result in greatly increased demand for new funds at the worst possible time for market participants. This pro-cyclicality, which could increase IM requirements by a factor of three, could have major adverse systemic consequences. Third, the use of thresholds, which are designed to decrease IM requirements, will actually amplify the pro-cyclicality of the IM requirement during market stresses and add to systemic risk concerns.

"The ISDA margin analysis outlines the vital role that non-cleared swaps play in the global economy," said Robert Pickel, ISDA chief executive officer. "Corporates, sovereigns, supranational organizations and investment firms use them in their financing and funding activities, and they are needed for the proper functioning of the housing markets. ISDA believes that current margin proposals for non-cleared swaps could have a harmful impact on those vital markets and on systemic resiliency. The Association supports instead a three-pillar framework for ensuring systemic resiliency that is based upon a robust variation margin framework, mandatory clearing for liquid, standardized products, and appropriate capital standards. The irony here is that the margin rules in current form would increase systemic risk. They could very well harm the financial system they are designed to protect," Mr Pickel said.

With regard to cross-border matters, ISDA has highlighted concerns at all stages of the legislative process. These issues include the creation of uneven playing fields for market participants, overlapping and duplicative rules and uncertainties in jurisdictional authority. In October 2012, the Finance Ministers of France, Japan and the UK together with EU Internal Market Commissioner Barnier, wrote to express similar concerns, stating: "Regulation across the G20 needs to be carefully implemented, in a harmonised way that does not risk fragmenting global markets.[2]" Authorities in Australia, Hong Kong and Singapore have also noted concerns regarding the impact on international business and market liquidity.

ISDA warmly welcomes the international dialogue that is now taking place in the area of cross-border issues, as evidenced earlier this month at the public hearing of the Global Markets Advisory Committee (GMAC) of the US Commodity Futures Trading Commission. The Association hopes that real progress can be made on resolving these questions as regulators continue their discussions. It is essential that market participants have clarity about how and where they are regulated. The current uncertainty is damaging to markets.

"A clean, efficient and fair cross-border framework and an appropriate margin regime, centered around robust variation margin, are essential components of the regulatory reform mosaic," said Stephen O'Connor, ISDA Chairman and Managing Director, Morgan Stanley. "The outcome of policymakers' decisions for these critical issues will have tremendous implications for global markets and for many thousands of OTC derivatives end-users in the real economy around the world."

"ISDA absolutely supports the G20 efforts to reduce systemic risk," said O'Connor at the recent GMAC meeting, noting that market participants are increasingly concerned about cross-border rules which, if poorly implemented "…will stretch regulators, end users and dealers, and will harm market liquidity." ISDA notes that market liquidity is already being affected as certain non-US banks have now ceased trading with US entities in a reaction to the reach of the registration requirements of US regulations.

ISDA's position is that, above all, markets need a level playing field and globally coordinated approach for all rules, with consistency across jurisdictions together with a consistent implementation timeline.

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About ISDA
Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 840 member institutions from 59 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Summary of ISDA Margin Analysis
A presentation outlining the ISDA analysis of margin for non-centrally cleared swaps is available at ISDA's website.

Under the current BIS/IOSCO IM proposal, ISDA estimates that global IM requirements for OTC derivatives that are currently outstanding, but that are not and can not be cleared[3], would range from:

- $10.2 trillion if all firms used the standard IM schedule provided by the regulators.
- $1.7 trillion if all firms used approved internal models.
- $800 billion if all firms used approved internal models and there was a €50 million exposure threshold between counterparties.

ISDA's analysis also indicates that IM requirements could significantly increase – by a factor of 3 to 5 times -- during periods of market stress[4], and could range in such times from:

- $4.1 trillion if all firms used approved internal models and there was a €50 million exposure threshold between counterparties.
- $5.1 trillion if all firms used approved internal models and there was no threshold.

Using the QIS data, ISDA also estimated the IM requirements under current US regulatory proposals from bank supervisors and the Commodity Futures Trading Commission. These proposals differ from the BIS/IOSCO proposal in that they require one-way posting of IM from counterparties to OTC derivatives dealers for non-centrally cleared transactions while the BIS/IOSCO proposal requires universal two-way posting.

Under the current US regulatory proposals[5], IM requirements would range from:

- $7.6 trillion if all firms used the standard IM schedule provided by the regulators.
- $1.2 trillion if all firms used approved internal models.
- $600 billion if all firms used approved internal models and there was a €50 million exposure threshold between counterparties.

The IM requirements under the US regulatory proposals could also significantly increase – by a factor of 3 to 5 times -- during periods of market stress, and could range in such times from:

- $3.0 trillion if all firms used approved internal models and there was a €50 million exposure threshold between counterparties.
- $3.6 trillion if all firms used approved internal models and there was no threshold.

The ISDA analysis also underscores the importance of non-centrally cleared OTC derivatives to the global economy. Estimates today indicate that approximately 80 percent of the current OTC derivatives notional outstanding can be cleared. Large sectors of the OTC derivatives markets – including interest rate options, many single-name credit default swaps (CDS) and currency swaps – are not currently and might never be clearable, but remain important to market participants and end-users.

Adding mandatory initial margin to these transactions could harm the economy and potentially threaten, rather than strengthen, the global financial system. Consequently, ISDA believes that a three-pillar framework is appropriate for ensuring systemic resiliency: a robust variation margin framework, mandatory clearing for liquid, standardized products, and appropriate capital standards.

Footnotes

[1]Members submitted their QIS responses to ISDA for analysis anonymously through an independent third-party. These firms represent 45% to 50% of the global OTC derivatives market.

[2]Letter from October 17: http://www.fsa.go.jp/inter/etc/20121018-2/01.pdf. The letter also says "The derivatives market has allowed financial counterparties across the globe to come together to conduct more effective risk management and, as a result, support economic growth…. At a time of highly fragile economic growth, we believe that it is critical to avoid taking steps that risk a withdrawal from global financial markets, into inevitably less efficient regional or national markets."

[3]The $127tn of unclearable OTC derivatives is an ISDA estimate based on data provided by the QIS respondents as to the current portion of their uncleared OTC derivatives portfolios that can not be cleared.

[4]Source: BIS Working Paper 373, "Collateral requirements for mandatory central clearing of over-the-counter derivatives," page 20. The paper notes that for cleared portfolios, "Across the G14 dealers, initial margin requirements on IRS portfolios total $15 billion in an environment of low market volatility, rising to $29 billion if market volatility increased to medium and $43 billion if it increased to high. For CDS, total initial margin requirements jump from $10 billion in an environment of low market volatility to $51 billion and $107 billion as volatility rises to medium and high." For this analysis, ISDA applied the estimate that IM could rise 3x in stressed conditions across the portfolio of unclearable swaps.

[5]The analyses contained in this presentation were derived from member QIS responses that were developed prior to the issuance of the exemption for FX forwards and swaps by the US Treasury on November 16, 2012. We estimate the Treasury exemption would reduce IM requirements under the US prudential regulators proposals by 15% to 20%. If FX forwards and swaps are excluded globally as per the US Treasury exemption, we estimate that adjustments of a similar magnitude would need to be made to the estimated IM requirements under the BCBS/IOSCO proposal.