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Mr David Wright
Secretary General
International Organization of Securities Commissions (IOSCO)
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23rd October 2014

Email info@iosco.org

Dear Secretary Wright:

Re: Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives

The International Banking Federation (IBFed) is the representative body for national and international banking associations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the European Banking Federation, the Japanese Bankers' Association, the China Banking Association, the Indian Banks' Association, the Korean Federation of Banks, the Association of Russian Banks, and the Banking Association of South Africa. This worldwide reach enables the IBFed to function as the key international forum for considering legislative, regulatory, and other issues of interest to the banking industry and to our customers.

The Financial Markets Working Group of the IBFed appreciates the opportunity to provide comments to the IOSCO consultation report (Consultation) regarding risk mitigation standards for non-centrally cleared OTC derivatives. In general, we support IOSCO's efforts to carry out the G20 mandate to improve global financial stability and promote transparency of the global securities markets, of which the risk mitigation standards are an integral part. Specifically, we support the goal of the risk mitigation standards that counterparties agree to fundamental economic and legal terms prior to, or contemporaneously with, the execution of a transaction, and to memorialize those terms. We further support the following intended benefits of the proposed risk mitigation standards: (i) the promotion of legal certainty and facilitation of timely dispute resolution; (ii) the facilitation of the management of counterparty credit and other risks; and (iii) increasing overall financial stability.[1]

[1] *See* IOSCO, Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Consultation Paper, September 2014, ("Consultation Paper") at 2-3.

As IOSCO notes, several jurisdictions have proposed or adopted risk mitigation standards, and others are currently considering introducing similar requirements.[2] We believe IOSCO should look to these ongoing initiatives for guidance about emerging approaches, encourage convergence, and promote global conformity that coalesces around that developing convergence, at a principles-based level. IOSCO should not inadvertently impede these efforts by issuing overly prescriptive risk mitigation standards. It is important for IOSCO to ensure any standards are flexible enough to allow local jurisdictions to tailor risk mitigation standards appropriate for the conditions and circumstances of their markets.

We believe the scope and model for successful risk mitigation techniques will look to current market practices and existing regulatory frameworks and accurately identify where properly established risk mitigation standards currently exist (whether by regulation or current market practice). IOSCO should continue to be mindful of the legal and regulatory differences and approaches of the national jurisdictions, particularly where justified by country-specific objectives. In that vein, we would support the incorporation into the Consultation's "Objectives of Risk Mitigation Techniques" the IOSCO statement that these standards should be "sufficiently compatible across jurisdictions to limit regulatory arbitrage, maintain a level playing field and avoid situations where the same transactions are not subject to conflicting rules."[3]

We believe that successful risk mitigation standards will not attempt to eliminate risk, which would serve only to migrate risks to unregulated sectors, endangering the global economic recovery and sustained economic growth and creating new risks or undermining efforts to address financial stability. New rules, standards, or guidelines enacted to prevent a future financial crisis, in other words, may lead inadvertently to the emergence of new forms of systemic risks or threats. Examples include: (i) increased compliance burden, requirements and costs that may simply transfer activity and risk to the unregulated shadow banking system; (ii) too much concentration of risk in central clearing counterparties (CCPs) that may raise a "too-big-to-fail" concern; (iii) overreliance on collateral as a capital safety mechanism that may stifle global liquidity and lead to collateral shortages for particular securities; (iv) increased economic costs and risk mismatches as standardised instruments are unable to perform the function of risk management needs for end users and the real economy; and (v) complexity (either in the form of legislation applicable to a given jurisdiction or cross border) that will lead to inefficiency, increased costs and a greater likelihood of one-off or systemic problems in the future.

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[2] *See* Consultation Paper at 4 (stating that "[i]n developing the proposals, the working group carried out a survey to gather information about member jurisdictions' existing or proposed approaches to risk mitigation standards. The results of the survey show that several jurisdictions already impose some risk mitigation requirements on non-centrally cleared OTC derivatives. Notably, the authorities in the European Union [(EU)] and the Commodity Futures Trading Commission [(CFTC)] have implemented risk mitigation requirements specifically for non-centrally cleared OTC derivatives. Other authorities impose risk mitigation requirements as part of a broader prudential or risk management regulatory requirement, or as part of the business conduct regulation of brokers and dealers (*e.g.*, the requirement to send a confirmation). The risk management requirements that apply in these situations are typically applied broadly and not limited to non-centrally cleared OTC derivatives. The standards recommended in this report are directed at non-centrally cleared OTC derivatives.").

[3] *See* Consultation Paper at 2. We appreciate the inclusion of "Standard 9: Cross-Border Transactions" in the Consultation, but believe including the suggested phrase in the "Objectives" will highlight the priority on this issue.

We would like to comment on Implementation (Standard 8) in the broader sense. IOSCO's push for implementation of the Standards as soon as practicable is appreciated, particularly when combined with strong encouragement for international convergence. However, given the ongoing era of large-scale regulatory change, we would also note the crucial importance of taking adequate time for consultation with stakeholders and encouraging full and frank communication between the financial industry and the regulatory and supervisory authorities.

We would also like to make specific observations about two of the proposed standards: (1) Dispute Resolution (Standard 7), and (2) Valuation with Counterparties (Standard 4). The proposed dispute resolution standard (Standard 7) requires covered entities to have agreed upon "procedures to be followed in the event of a dispute to ensure that disputes are addressed in a manner agreeable to both parties."[4]

We believe that asking parties to agree to specific procedures for dispute resolution at the execution of a derivative transaction may inadvertently limit the availability of certain courses of action that a party may wish to take in the event of a dispute (*e.g.*, judicial action). Therefore, we recommend that the term "procedures" be deleted and that the standard be that the parties have come to an agreement on how to resolve disputes, whether specific procedures or a more general statement that disputes will be resolved in accordance with applicable law.[5] This may be the dispute resolution arrangements already agreed at Master Agreement level.

Furthermore, given the potential Basel III capital consequences of determining that a discrepancy has become a dispute, we believe that applicable regulation should allow the parties a reasonable degree of flexibility given the particular circumstances pertaining to an incident. For example, we note that that where mark-to-model valuation is used (see the next paragraph for further comment), different proprietary valuation models used by the parties to a transaction may give rise to a discrepancy, but such incidents will rarely become true disputes.

With regard to the valuation standard (Standard 4), in light of the IOSCO/BCBS final policy framework for margin for non-centrally cleared derivatives,[6] the national regulators have formulated proposals to govern margin for non-centrally cleared swaps.[7] The valuation component and documentation of such valuations are integral parts of those rules and we

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[4] *See* Consultation Paper at 17.

[5] In the U.S., the CFTC proposed similar language related to dispute resolutions and received several comments on this issue. The CFTC deleted the term "procedures." *See* "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, Final Rule," 77 Fed. Reg. 55,904, 55,909 (2012).

[6] "Margin Requirements for Non-centrally Cleared Derivatives," published on September 2013, *available at* http://www.bis.org/publ/bcbs261.pdf.

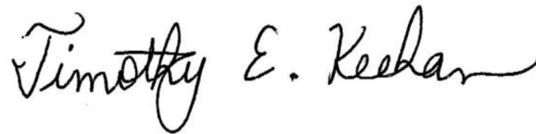
[7] On April 14, 2014, the European Supervisory Authorities published "Draft regulatory technical standards for risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012," *available at* https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf. In September 2014, the U.S. Prudential Regulators and CFTC published proposals to govern margin requirements for non-centrally cleared derivatives. (The prudential rule is *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf and CFTC rule is *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf),

suggest that nothing in the final document should interfere with those ongoing efforts. We would also like it clarified that where Standard 4 states that "Covered entities should agree on and clearly document the process and/or methodology for determining the value…." that there is in fact an understanding that in circumstances where mark-to-model valuation is used, in accordance with footnote 10, the parties would not be expected to agree on or document pertinent information about the models used.

In its application, risk mitigation standards should aim at providing regulatory and supervisory authorities with the necessary tools to perform their tasks in a uniform, clear, and effective manner, without adding unnecessary administrative burden and imposing unjustified costs for market participants or end users. Promoting market-driven and industry-led initiatives should further minimize the cost of additional regulation on market participants and other financial institutions. We also note that the market for non-centrally cleared OTC derivatives will continue to evolve as more products are cleared by CCPs. Sufficient time, therefore, should be allowed for the measured development of clearing before considering further broad and possibly intrusive policy prescriptions and regulatory interventions in the non-centrally cleared OTC derivatives space, as these could have adverse and unintended consequences for overall financial stability, market efficiency, access to finance, and sustained economic growth.

Thank you for your consideration of these views concerning risk mitigation standards for non-centrally cleared OTC derivatives. We look forward to working with IOSCO in this critical area. If you have any questions or wish to discuss, please contact either of the signatories below.

Yours sincerely,



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