David Schraa
Director, Regulatory Affairs

INSTITUTE OF INTERNATIONAL FINANCE

1333 H Street, NW, Suite 800E
Washington, DC 20005-4770
TELEPHONE 202.857.3600
FAX 202.775.1430
WEB iif.com

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William C. Dudley
Chair
Committee on Payment and Settlement Systems (CPSS)

Hans Hoogervoorst
Chair
Technical Committee
International Organization of Securities Commissions (IOSCO)

Re: IIF Response to CPSS-IOSCO Consultative Reports on OTC derivatives

Dear Sirs:

On behalf of the Infrastructure Working Group of the Institute of International Finance (IIF), the global association of financial institutions, we welcome the opportunity to comment on the two consultative reports, "*Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs*" and "*Considerations for trade repositories in OTC derivatives markets*" - henceforth the 'CCP report' and the 'TR report' respectively - prepared by the Working Group of the CPSS and the Technical Committee of IOSCO and issued for comment in May 2010. This letter constitutes our response to both reports.

We are supportive of the broad direction of both reports as part of the wider efforts of the G-20 for enhanced market resilience and increased transparency. As CPSS-IOSCO's media release of February 2, 2010 pointed out, "Robust financial market infrastructures make an essential contribution to financial stability by reducing what could otherwise be a major source of systemic risk." The IIF has emphasised the important role of resilient financial infrastructure and effectively functioning markets in addressing systemic risk and enhancing financial stability.[1] We note that the two reports will contribute to the comprehensive review of the Recommendations for Central Counterparties and other international standards for financial market infrastructures due for public consultation in early 2011.

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[1] See *Restoring Confidence, Creating Resilience: An Industry Perspective on the future of International Financial Regulation and the Search for Stability*, July 2009; and *Systemic Risk and Systemically Important Firms: An Integrated Approach*, May 2010.

We agree with the CCP Report that "a well designed CCP with appropriate risk management arrangements reduces the risks and uncertainties faced by market participants. In doing so, it contributes to maintaining market confidence and liquidity in times of stress, and the goal of financial stability"; and with the TR Report that OTC markets can be improved by a well designed TR that operates with appropriate risk controls, thereby strengthening the scope and quality of information available.

In this response we concentrate mainly on aspects relating to maintaining and enhancing the integration of international markets in financial services, and to increasing financial sector resilience while mitigating systemic risk. We will not reply in detail to many of the issues raised in the document as detailed responses will be offered by other associations with a more specialized focus as well as by individual firms. However, as the Institute's vocation is to provide an international perspective on regulatory developments, we believe it is important to comment on a number of aspects of the matters set out in the document.

Setting high standards for central clearing of OTC derivatives

The significantly increased use of central counterparties in the context of OTC derivative contracts, while likely to be very beneficial in terms of reducing the systemic risk associated with large numbers of bilateral contracts, also gives rise to potentially increased risk associated with the highly interconnected role of such entities. There are, moreover, particular challenges associated with the clearing of such contracts as compared to clearing listed or cash-market products.

Trade repositories will also play an increasingly important role in addressing systemic risk, the reverse side of which is the potential increase of such risk if relied-upon systems fail to work as they should.

We therefore support the view that the governance, management, and operation of such entities needs to be of the highest quality. They should be subject to appropriately stringent standards determined in the context of a well-designed and rigorous regulatory framework and applied by means of high-quality supervision.

International markets require international coordination

We welcome the international coordination represented by the CCP and TR reports. The IIF has been a consistent advocate of such coordination and the need to avoid regulatory fragmentation, not just with a view to avoiding and eliminating regulatory duplication or contradictory legal approaches, but also to ensure that, as the financial crisis has underlined, there be no gaps in global regulation or oversight.

The CCP report recognizes the importance of closer cooperation between relevant authorities due to the increasingly international nature of CCPs in terms of cleared products and markets, participants and operations. This recognition is well founded: the increased financial stability and reduced systemic risk sought could be undermined by a profusion of national approaches, different legal standards and potential contractual conflicts. Such a profusion would lead to at best regulatory arbitrage and at worst legal uncertainty, aggravating any potential future crisis.

OTC derivatives markets are highly international in nature. This international scope brings significant benefits. It is essential that as that market is made more resilient through the increased use of central counterparties and trade repositories, this is done in a manner that retains these benefits. It must be avoided that inward-looking approaches result in the fragmentation of these markets along national or regional lines. The work of CPSS-IOSCO can make a significant contribution in this regard.

The draft CPSS-IOSCO Guidance and Considerations represent an important step in the right direction. However, we believe that if the above objectives are to be successfully met, it will be necessary to go further and to move rapidly to a complete set of fully developed international governing standards in this area for both CCPs and TRs.

We note that in proposals currently being considered, both the United States and the European Union are considering approaches to the recognition of CCPs for OTC derivatives purposes based on equivalence of supervision and regulation.[2] Such approaches carry considerable potential for fragmentation. Accordingly it is essential to have a governing set of high-quality, international standards, adherence to which should be agreed to represent the appropriate standard for mutual recognition amongst jurisdictions.

We would therefore urge CPSS-IOSCO to take forward work on the development of such a comprehensive set of international governing standards. The comprehensive review of the *Recommendations for Central Counterparties* announced on February 2 with a view to publishing proposals for consultation by early 2011 represents a good opportunity to bring this about.

Such standards will also need to be accompanied by effective, consistent implementation across jurisdictions. As part of this review, consideration should also be given to agreed international methods for assessing the implementation of such standards, possibly building on the work of the FSB Standing Committee of Standards Implementation in this general regard. Day to day cooperation between CCPs and jurisdictions will need to be stepped up and the issue of cross-border supervisory cooperation tackled head on.

One critical issue that will need to be addressed in agreeing such standards is the handling of market participants and OTC derivatives contracts in jurisdictions where no CCP is currently established. It is important that such participants should not be penalised through excessive regulatory costs in the name of 'one size fits all' solutions. There should be no geographical limitation to the clearing of derivatives contracts, whether *de jure* or *de facto*. It is important that constraints are not placed on CCPs which would have the effect of limiting or restricting their openness to accepting members which meet the appropriate requirements regardless of their geographical location. Appropriate transition periods and phase-in arrangements will also be necessary to ensure that participants from such markets are not prejudiced.

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[2] See proposed *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Section 725(b) as reported out of conference; and European Commission, *Public Consultation on Derivatives and Market Infrastructures*, June 14, 2010, Part II, 9.

Data availability

An important issue to be addressed for both CCPs and Trade Repositories is that of data sharing and availability. This applies both to the question of what is made publicly available and what is made available to the public authorities in different jurisdictions. We would welcome the publication for consultation of more 'granular' guidance on the former, and a strongly international approach to the latter, making sure that competent authorities from different jurisdictions have full access to relevant data. This is necessary both to effectively address systemic risk and to avoid the erection of new barriers to international markets.

Addressing the risk of failure

We agree with the analysis in the Reports that while the increased use of CCPs and Trade Repositories will, if managed properly, enhance the resilience of the system, such increased use will also create new forms of systemic risk which will need to be effectively addressed.

In addition to ensuring that there is in place an effective set of International Governing Standards to reduce to an appropriate minimum the risks of failure of such entities, it will also be necessary to have in place effective and reliable arrangements for dealing with situations where such entities become weakened and at risk of failure. It will be necessary to ensure that appropriate structures are in place to deal effectively both with liquidity difficulties and solvency crises in such entities.

Close consideration should be given to the role of central banks in the event of liquidity difficulties that may be experienced by such entities. Given that the aim of the proposals in this area generally is to transform the systemic risk potentially arising from transactions between financial institutions into a more limited and manageable form of risk concentrated within central counterparties, it may well also be desirable to countenance the extension of central bank emergency liquidity to such entities in appropriate circumstances. The issues involved in doing so need examination over the coming period.

It might also be considered that recovery and resolution plans (RRPs) be required to to be developed for addressing situations of severe threat to the continuance of the entity and situations where it is required to be wound down. The IIF is supportive of well-designed recovery and resolution plans in the context of financial firms[3] and it considers that they could have a very positive role to play also in this context. It should be noted in this regard of course that the levels of potential risk to which CCPs and TRs are respectively exposed should not be considered equivalent and that this difference should be reflected in any RRP requirement.

Consideration will also need to be given to the implications created by the longevity of OTC contracts and the additional potential complexities to which this may give rise.

[3] See *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, May 2010, Section 2.

Other issues

As discussed above, we have felt it most useful to concentrate on a number of general issues rather than to focus on individual recommendations in the reports where detailed responses will be offered by other associations with a more specialized focus and by individual firms. Nevertheless, there are a few more detailed issues that we would like to flag.

Suitability

In view of the current context of expansion of the use of CCPs in managing the counterparty risk associated with OTC derivatives, which we support, there is a risk that a CCP may feel constrained to increase their scope of activity to take on contracts of a type or category not previously cleared by it and for which it is not well suited. It should be emphasized clearly that such a dynamic would likely lead to an increase in overall systemic risk and not a reduction. For this reason and more generally, stringent type-of-contract acceptance and suitability criteria should be in place, The industry will continue to work with regulators to achieve appropriate outcomes in this area.

Interconnectedness

A key lesson of the recent crisis has been the central role of interconnections between entities in propagating and intensifying systemic risk. Clear and robust standards for the management of interconnectedness risk need to be in place.

CCPs need to share and coordinate information in order to organize the default management timing process, since major players tend to use CCPs "asset class by asset class" or "region by region." As a major player's default will push CCPs to protect themselves as soon as possible, this could cause additional effects to the market and aggravate the systemic issues mentioned above.

Membership

If systemic risk is to be concentrated in CCPs, then those CCPs should be appropriately regulated and required to have strong membership standards. Given that most CCPs proceed on the basis of risk mutualization among the direct participants, we believe that direct participation should be limited to parties meeting strict criteria. These could include operational infrastructure; pricing/trading capability; capitalization; credit quality; and being subject to regulatory oversight. For market participants which are not members of relevant CCPs, they should have the possibility to join the CCP indirectly (i.e. using the access of a member). We therefore believe that appropriate rules on the segregation and portability of assets will be needed to deal with this.

Governance

As indicated in the draft recommendations, the expanded role of CCPs gives rise to a potential increase in the complexity of governance arrangements. This is an aspect which requires further detailed consideration in the compehensive review that is underway. It is important that there be no inappropriate disjuncture between the interests at stake in the operation of a CCP and its governance arrangements.

Transparency

Whilst the CCP report recommends transparency, there is no specific definition on the level of transparency required for the way that CCPs calculate the daily initial and variation margin requirements. Compared to bilateral OTC trading, initial margin will result in an additional layer of cost. Hence it is desirable that there is appropriate transparency on the methodologies and curves applied by CCPs for the initial and variation margin process in order for the participants to be able to check such requirements on a daily basis and if necessary challenge them.

Conclusion

The IIF strongly supports the ongoing work of CPSS-IOSCO in this vital area and the direction of the work contained in these consultation reports. However we believe that given the importance of the issues and the globalization of markets and infrastructures, a more ambitious agenda is now needed. Such an agenda would look to reaching an agreement on binding and detailed international standards and effective implementation and cooperation, resolving geographical and data sharing concerns in a proportionate and targeted manner. It would also look to address issues linked to increased reliance on CCPs and TRs and in particular on how to handle the failure of such institutions.

We recognize that this is an ambitious agenda but believe that it is both feasible if the right level of will and resources are committed, and desirable if we are to achieve the aim of a far more robust financial market infrastructure.

Should you have any questions on the issues raised in this letter, please contact Gerry Cross (gcross@iif.com; +1 202-857-3311) or Crispin Waymouth (cwaymouth@iif.com; +1 202-682-7447).

Very truly yours,