ISDA Safe, Efficient Markets

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June 3, 2011

Foreign Exchange Policy Division
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By courier and email

Dear Sirs,

On behalf of its members, the International Swaps and Derivatives Association, Inc. (ISDA) presents to the Ministry of Strategy and Finance (MOSF) this letter in relation to the Foreign Exchange Prudential-Stability Levy.

By way of brief introduction, ISDA is the leading global trade association in the privately negotiated derivatives industry with over 800 members from 56 countries on six continents. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

The purpose of this letter is to bring to your attention an issue with the new Foreign Exchange Prudential-Stability Levy (the "Levy") which will come into effect on August 1, 2011. We understand that the Levy will be charged on the period average balance of non-deposit foreign currency liabilities held by domestic and foreign banks in Korea. We note that certain liabilities are exempted from the Levy, however, the exemptions do not extend to foreign currency collateral used in financial derivatives transactions. It is our view that cash collateral used to collateralize the obligations under financial derivatives transactions should be exempted from the Levy.

Collateralization remains among the most widely used methods to mitigate counterparty credit risk in the OTC derivatives market, and market participants have increased their reliance on collateralization over the years. The ISDA Margin Surveys have consistently reported cash collateral as the most commonly used collateral in the OTC derivatives market.[1] According to the ISDA Margin Survey published in April 2011, cash collateral (mainly denominated in USD, Euro, GBP and JPY) accounted for 81% of collateral received and 80% of collateral delivered. There are a number of reasons why market participants have favored cash collateral over securities collateral: for example, cash collateral is operationally easier to administer than securities collateral; transfers of securities collateral might have tax implications which transfers of cash collateral do not have. Imposing the Levy on cash collateral will discourage the use of cash collateral and increase the transactional cost and operational burden for banks. Ultimately, the increased cost might be transferred to Korean corporates which are looking to banks to provide them with cost-effective hedging products. In addition, we do not think cash collateral is relevant enough to the purpose of the Levy. As mentioned in the materials published by the Korean government, the underlying rationale for the introduction of the Levy is to reduce volatility in capital movement and to curb massive capital inflows into Korea. Cash collateral is transferred pursuant to existing collateral agreements which are designed to secure or support net exposure under derivatives transactions between two parties and is not speculative money which the Levy intends to curb. Collateralization is a very important risk mitigation tool and should be encouraged rather than discouraged by regulators. For the above reasons, we urge MOSF to exempt foreign currency cash collateral used in derivatives transactions from the Levy.

ISDA would be happy to clarify any point raised in this letter. If you have questions regarding this letter, please do not hesitate to contact Keith Noyes (knoyes@isda.org, 852 22005909) or Jing Gu (jgu@isda.org, 852 22005908) at ISDA Hong Kong office.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.

Keith Noyes

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[1] See http://www2.isda.org/search?keyword=margin+survey