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ISDA response to CESR-ESCB consultation paper

Draft Recommendations for Central Counterparties 1-2, 4-8, 14 and 15

Revised for CCPs clearing OTC derivatives

Introduction

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 820 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For further information, please visit www.isda.org.

ISDA welcomes the opportunity to respond to the ESCB/CESR Consultation Paper on Central Counterparties and is supportive of the objectives of these Recommendations.

As suggested by CESR and the ESCB, ISDA is structuring its response to address each relevant recommendation in turn.

Prior to addressing each recommendation, however, ISDA would like to make the following comments:

- ISDA supports the adoption of redrafted recommendations for central counterparties, taking into account the specific nature of OTC derivatives. It is vital that central clearing of these products takes place on a sound basis: central clearing without proper and adequate risk management will result in an increase in risk – it is therefore imperative that risk reduction remains the primary focus.
- ISDA and its members have made considerable progress recently on a number of initiatives that will both underpin the transparency and safety of the OTC market and facilitate clearing where appropriate. We refer, for example, to the contractual harmonization of procedures for credit event determination, and the ‘hardwiring’ of the ISDA auction settlement mechanism into contracts.
- We fully support the principle that trade data should be available to regulators globally regardless of the product or settlement approach. We remind regulators that the DTCC has pledged to share data with any international regulator in this context. We note the reference to

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the need for a ‘*cooperative*’ oversight framework at global level for warehouses serving multiple markets, ensuring access to information for regulators.

- Further to the above point, and in relation to paper’s reference to the need for global consistency, we welcome the willingness to ensure consistency with CPSS-IOSCO recommendations. We believe that potential regulatory concerns regarding data warehouses can (and should) also be met through *international* regulatory cooperation, especially with US regulators. Scope for resolving such concerns in this way should be explored before further steps are taken. Any ‘relevant and targeted recommendations for data warehouses’ which CESR/ESCB develops in due course should take account of the global dimension.
- We note the interest expressed in the paper concerning the indirect risk which may be posed by non-clearing participants in clearing houses (acting through clearing members) especially ‘non-regulated’ entities and industry is working to develop appropriate solutions. Naturally, investigation and any further action in such cases by regulators should be undertaken on a clearly defined risk-based basis.
- The CESR-ESCB consultation refers to the ‘further aspects’ that may be considered to help improve the trading, transaction processing and risk management infrastructures supporting OTC markets. In this context, we refer you to the 31 October OMG¹ Industry commitment letter setting out ambitious operational targets for processing of CDS and other OTC derivatives classes: http://www.newyorkfed.org/newsevents/news/markets/2008/regulators_letter.pdf

Comments on Draft Recommendations

Recommendation 1: Legal Risk

CCPs, linked or interoperable CCPs should have a well-founded, transparent and enforceable legal framework for each aspect of their activities in all relevant jurisdictions.

ISDA strongly agrees on the need for a clear legal framework for CCPs clearing OTC derivatives. We would make the observation that while central clearing is a useful tool in containment of counterparty

¹ The OMG (Operations Management Group) comprises senior OTC derivatives operations professionals from the buy-side and sell-side, as well as ISDA, the Managed Funds Association (MFA), and the Asset Management Group of SIFMA.

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and operational risk, it also creates a (potential) single point of failure. As such, safety, transparency and legal certainty are key.

Paragraph 3 – as an organization that has made risk management and legal certainty in industry documentation its core mission, ISDA fully agrees that the legal terms defining and governing OTC derivative contracts must be certain, and has been engaged in a process of standardization of contractual terms to further improve the current structure, governing issues such as ‘hardwiring’ of the auction settlement mechanism into ISDA CDS documentation (which, inter alia, means that all CDS contracts processed in a clearing house have recourse to the same procedure for finding a cash settlement price when a credit event occurs), and determination of credit events. ISDA has also been engaged in an ongoing process towards standardization of how restructuring credit events are dealt with. Standardisation efforts will facilitate central clearing, and will aid transparency.

Paragraph 7 – ISDA welcomes the comments in the paper concerning the need for a sound and transparent legal basis for CCP netting arrangements. ISDA has for many years been calling for the adoption of a single EU instrument harmonizing netting laws across the EU.

Paragraph 9 – ISDA agrees that the circumstances under which a CCP may rehypothecate collateral posted to it should be clearly defined, and that the legal position under the relevant governing law should be understood. Please however refer to our response to paragraph 2 of Recommendation 7.

Paragraph 10 – Any CCP for OTC derivatives established in the EU should comply with the Settlement Finality Directive. CESR and ESCB members may be aware of the commitment by 9 dealer firms in the CDS market to clear their own CDS trades on a European CCP regulated under the Settlement Finality Directive.

Paragraph 12 – With reference to the observation regarding potential risks associated with non-clearing participants, we highlight that there is a high incentive for clearing members providing clearing services to these entities to ensure their financial soundness (given their exposure to them).

Recommendation 2 : Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

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ISDA supports this recommendation.

With reference to paragraph 4, operational requirements by their nature will need to have some subjectivity

Paragraph 3: As this paragraph mentions, CCPs only have direct exposure to clearing members. This exposure should be managed through recourse to margining and strong membership criteria. Any additional admission criteria for clearing members offering clearing services for non-clearing participants, including hedge funds, should be proportionate (particularly if more of the OTC derivative market is to be centrally cleared) and consistent.

Paragraph 4: ISDA agrees that a CCP's participants should have a high level of operational robustness, and whilst it is obviously critical that participants can operationally support the level of risk they bring to the clearing house, all parties who may be subject to risk mutualisation must have the capability to handle the additional risk/complexity that may expose them to. Similarly any peak load capacity measure must also include the potential auction/ risk mutualisation impact.

Recommendation 4 : Margin Requirements

A CCP should to the greatest extent feasible impose margin requirements to limit its credit exposures to participants. These requirements should be sufficient to cover potential exposures that the CCP estimates to occur until the liquidation of the relevant positions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

ISDA strongly supports this Recommendation. As Section 5.10 of the consultation proposes, a CCP should contemplate the possibility to implement dedicated resources e.g. a dedicated clearing pool for CDS.

Recommendation 5: Other Risk Controls

A CCP should maintain sufficient available financial resources to cover potential losses that exceed the losses to be covered by margin requirements. For this purpose, the CCP should develop plausible scenarios and conduct stress tests accordingly. At a minimum, a CCP should be able to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

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ISDA member firms agree strongly with this recommendation.

Robust, comprehensive risk controls are the most important factor for potential clearing members in deciding which clearing house to use, no less than such controls are of importance to regulators. As such we highlight that a liquidity facility in no way replaces a sound and comprehensive risk management process.

ISDA member firms have asked a series of questions to potential clearing houses for CDS, with a view to seeking clarity on the soundness and efficiency of each potential service provider.

These questions focused on e.g.

- Risk calculations.
- Risk/financial protection waterfall.
- Guaranty fund.
- Member default process.
- Margin operations.
- Intra-day margin.
- Scope and details of products they can clear.
- Contract backloading schedule.
- Operational issues, such as detail regarding workflow, calculation and reconciliation of coupon payments, mechanisms for payments when credit events occur.
- Interoperability arrangements.
- Legal and governance arrangements.

Recommendation 6 : Default Procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available and tested regularly.

ISDA agrees with this Recommendation.

Recommendation 7: Custody and Investment Risks

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A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

ISDA agrees with this recommendation.

However, ISDA is extremely concerned with the reference to rehypothecation in paragraph 2 of Part C (Explanatory Memorandum) of Recommendation 7. We believe that this may be simply a result of the drafting, rather than a substantive issue, but we recommend that it be corrected in order to avoid any misunderstanding. The word “rehypothecation” is used in paragraph 2 alongside terms such as “insolvency”, “negligence” and “fraud” in a way that suggests that rehypothecation is analogous to these other events and therefore harmful and undesirable in itself. This is emphatically not the case. Under English law and under the laws of many other jurisdictions, where collateral is posted to a party using the title transfer method, the posted assets become the property of the transferee, with the transferor having a right to the return of equivalent assets (subject to the transferee’s right of set-off). Accordingly, whether or not the transferee rehypothecates the assets does not affect the legal position of the transferor. Clearly, a CCP would need to ensure that this was the case under the relevant governing law, but this is a matter of due diligence rather than a reason to exclude the possibility of rehypothecation altogether.

ISDA agrees that the conditions under which a CCP may rehypothecate posted collateral should be clear and defined, as is recognised in paragraph 9 of Recommendation 1, and that a CCP should ascertain the controls that a custodian has in place in relation to its rehypothecation of posted collateral, which is what we believe paragraph 2 of Recommendation 7 is intended to say. We believe, however, that it is wrong to word this recommendation in such a way as to imply that rehypothecation is in itself undesirable. If there is a debate to be had as to the extent to which a CCP may rehypothecate posted collateral, then that debate should be had, but it must take place on the basis of a clear understanding of what the terms mean and what the legal rights of the parties are.

Recommendation 8: Operational Risk

A CCP should identify sources of operational risk, monitor and regularly assess them. The CCP should minimise these risks through the development of appropriate systems, , and effective controls and procedures. Systems and related functions should be (i) reliable and secure, (ii) based on sound technical solutions, (iii) developed and maintained in accordance with proven procedures and (iv) have

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adequate, scalable capacity. The CCP should have appropriate business continuity and disaster recovery plans that allow for timely recovery of operations and fulfilment of a CCP's obligations. Systems should be subject to frequent and independent audits.

ISDA agrees with this Recommendation.

ISDA understands that, in relation to data warehouses, this Recommendation applies only to the relationship between CCP(s) and warehouse(s). We are aware that CESR is currently conducting a feasibility study regarding establishment of a European data warehouse.

Recommendation 14: Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

ISDA agrees with this recommendation.

Transparency regarding the risk management processes (in particular) and organization of central counterparties is very important to ISDA members. We refer you again to the questions put to potential CCPs for CDS by large dealer firms in this context – the substance of which is summarized in our comments on Recommendation 5.

Much emphasis has been placed on when clearing houses are 'ready to clear', but it is vital that prospective members of clearing houses can know that operations will be sound and fair.

Recommendation 15: Regulation, Supervision and Oversight

A CCP should be subject to transparent, effective and consistent regulation, supervision and oversight. In both a national and a cross borders context, central banks and securities regulators should cooperate with each other and with other relevant authorities regarding the CCP. Such cooperation should also ensure a consistent implementation of the recommendations.

We support this recommendation, but add that the emphasis in this context should be not only on cooperation between EU regulators, but also between EU regulators and regulators in third countries – especially in the United States. We would underline that the EU-US Regulatory Dialogue is most effective

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when deployed as means of preventing conflict, rather than having to resolve conflict caused by precipitative action.

In order to ensure effective and consistent regulation of CCPs, it is very important that supervisors of CCPs should well-resourced, in terms of ensuring sufficient expertise and manpower to make practical use of information gleaned from CCPs. We would recommend that this be reflected in the explanatory memorandum to this Recommendation.