ISDA Safe, Efficient Markets

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Mr Patrick Pearson,
Head of Unit,
Financial Markets Infrastructure (G2)
DG for the Internal Market and Services
The European Commission

Mr Audrius Pranckevicius
Economic Analyst
Banking and Financial Conglomerates Unit
The European Commission

By email: patrick.pearson@ec.europa.eu; audrius.prankevicius@ec.europa.eu

Dear Mr. Pearson and Mr. Pranckevicius

Concerns regarding the timing of application of Own Funds Requirements for Exposures to a Central Counterparty in the Capital Requirements Directive ("CRD IV")

Thank you for meeting with us on 17 July 2012.

As discussed at the meeting, we wish to follow up a number of issues. These include the timing of application of CRD IV and the Regulation on OTC derivatives, central counterparties ("CCPs") and trade repositories ("EMIR"). We understand CRD IV is intended to come into force on 1 January 2013 and that EMIR will come into force on 16 August 2012.

We consider that transitional periods should be allowed, during which CCPs would receive "Qualifying-CCP" treatment for capital purposes. The transitional periods would continue until CCPs have had an opportunity to implement the new Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (collectively "CPSS-IOSCO") Principles for Financial Market Infrastructures and, potentially, EMIR standards, and have attained approval or recognition from ESMA.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P44 (0) 20 3088 3550 F44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
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Our view, which appears consistent with the position taken by the Basel Committee on Banking Supervision ("BCBS"), is that being licensed or authorised by an EU member state should not be a prerequisite for "Qualifying" status during the transitional period.

We also wish to raise a number of concerns regarding capital regulation under CRD IV and client clearing and capital treatment of regulated entities that utilise indirect clearing services.

At the outset, we note that the current draft of the CRD IV/CRR has not been updated to reflect the BCBS's latest position on the capital requirements for bank exposures to CCPs (as set out in the interim rules issued in July 2012). There are various important changes to the proposed framework which were introduced by the BCBS following two public consultations. These changes include, for example, the "highly likely" threshold for the requirement for portability of client trades to a replacement clearing member, the three months' grace period for preferential capital treatment of CCP-cleared exposures to a CCP which has ceased to be Qualifying, the ability of the banking supervisor to designate a CCP as Qualifying in the absence of a national regime for authorisation and licensing of CCPs, and the cap on the risk-weighted exposure amount of all exposures to a Qualifying CCP. We ask the European Commission ("Commission") to reflect those changes in the next revision of the draft CRD IV/CRR.

CRD IV does not contemplate Qualifying CCPs which have not been either authorised or recognised

As you know, Article 4(73) of CRD IV defines CCP as "…a central counterparty as defined in Article 2(1)(1) of Regulation (EU) ../.. [EMIR] that has been either authorised in accordance with Article 10 of that Regulation or recognised in accordance with Article 23 of that Regulation".

Articles 296 to 300 of CRD IV set out the risk weighted exposure amounts for exposures arising from an institution's pre-funded contribution to a CCP's default fund and trade exposures to a Qualifying CCP. Broadly speaking, these capital rules provide capital incentives for banks to use central clearing relative rather than create an uncleared exposure.

CRD IV does not contemplate Qualifying CCPs which have not been either authorised or recognised by ESMA in accordance with EMIR. However, and consistent with our letter of 30 July about the need for transitional arrangements for EMIR, we ask that the favourable capital treatment in Articles 296 to 300 of CRD IV apply to existing CCPs and their clearing members for a transitional period during which the CCP has an opportunity to adapt its rules and procedures to meet the requirements of EMIR and to obtain the approval or recognition by the relevant competent authority (which in some cases may be delayed due to the limited available resources of the relevant competent authority). Otherwise, banks' exposures to CCPs would, in CRD IV, become immediately subject to bilateral capital treatment, instead of the more appropriate treatment set out in Articles 296 to 300.

Accordingly, we ask ESMA or the Commission to confirm that, with respect to a CCP established in the EU and authorised under national law prior to the adoption of the regulatory technical standards referred to in Article 89(3) of EMIR:

(a) the obligations imposed on CCPs in Titles III, IV and V; and

(b) the obligations of clearing members in Title IV

will not apply to that CCP or its clearing members until the CCP is authorised under EMIR and that, during this transitional period, banks may employ the capital treatment in Articles 296 to 300 of CRD IV as if the CCP were authorised or recognised under EMIR. Alternatively, the definition of a CCP could be extended by adding, to Article 4(73) of CRD IV, the words "..... or recognised in accordance with Article 23 of that Regulation or are qualifying as per BCBS 227".

EMIR provides that third country CCPs may only provide clearing services to clearing members or trading venues established in the EU if the CCP is either recognised or approved by ESMA

We urge the Commission to provide transitional arrangements in EMIR in relation to CCPs that do not currently hold a license to operate in the EU. Also, Article 25 of EMIR provides that a CCP established in a third country may only provide clearing services to clearing members or trading venues established in the EU if the CCP is recognised by ESMA. Such recognition may be delayed because of limited available resources on the part of ESMA or relevant supervisory authorities in the jurisdiction where the third party CCP is established. Accordingly, in the absence of transitional arrangements, EU firms would be forced to stop using third country CCPs between the time EMIR comes into force and the time the CCPs are approved or recognised by ESMA.

Further, in the absence of transitional arrangements, even if a EU firm were to access a third country CCP through a local subsidiary, all the exposures to the CCP would be treated as bilateral OTC trades.

The Basel framework for capitalisation of bank exposures to central counterparties (which is the original source of the rules in Section 9 of the draft CRR) provides that where the CCP is in a jurisdiction that does not have a CCP regulator applying the CPSS-IOSCO Principles for Financial Market Infrastructures, then the relevant banking supervisor may determine whether the CCP is Qualifying. The Basel framework also emphasises the importance of banks exercising judgement as to whether a CCP in fact meets the requirements for Qualifying. Accordingly, we believe it is reasonable and fair to allow banks to use the preferential capital treatment in relation to exposures to CCPs which would have been

Qualifying had there been a national regime for authorisation and supervision of CCPs in the jurisdiction where those CCPs are established.

Need for transitional arrangements for key conditions in Section 9 of CRD IV

We refer to the following difficulty obtaining legal opinions in respect of key conditions in Section 9 of CRD IV. In particular:

(a) Article 294(1) 'bankruptcy remote', in relation to client assets, means that effective arrangements exist which ensure that relevant assets will not be available to the creditors of a CCP or clearing member in the event of the insolvency of that CCP or clearing member, and that the assets will not be available to the clearing member to cover losses it incurred following the default of a client or clients other than those that provided the assets;

(b) Article 296 (5)(b) "…relevant laws, regulations, rules and contractual arrangements applicable to or binding that institution or the CCP facilitate transfer of the client's positions relating to those contracts and transactions and of the corresponding collateral to another clearing member within the relevant margin period of risk in the event of default or insolvency of the original clearing member."

Given the novelty of these arrangements and the numerous CCPs and jurisdictions involved, we consider that one year may be necessary to complete the legal work necessary to obtain legal opinions sufficient to meet the requirements of Section 9 of CRD IV.

In particular, some large Clearing Members consider they will require hundreds of legal opinions for each CCP and jurisdiction. In addition, existing CCPs and their clearing members will need time to adapt to the new requirements, in particular as the provisions also apply to CCPs clearing exchange traded derivatives and securities transactions. For example, many of these CCPs do not currently offer individual segregation or portability and will need to put appropriate arrangements in place before they are able to obtain authorisation (and it is possible that in some cases national laws will need to be changed in order to ensure that these arrangements are enforceable). It is not practical for the conditions in Section 9 of CRD IV to apply on 1 January 2013.

Leverage ratio and client clearing

Under the current draft CRD IV there is no exemption from a clearing member's Leverage Ratio for positions cleared on behalf of a client (and the client's clients). Given the G20 imperative to incentivise central clearing and the consequently large volume of trades clearing members will be required to clear for clients, Leverage Ratio calculations that do not take into account the offsetting nature of the matching legs of a cleared trade are inconsistent with the direction of ongoing regulatory reform. The customer-to-clearing member leg of a cleared trade should offset the matching clearing member-to-CCP leg. Otherwise, the balance sheet consumption from OTC derivatives trading for the whole industry would be artificially

inflated and clearing members would be very limited in their ability to offer clearing to third parties.

Capital treatment of indirect clearing

We consider that far more clarity is required in the CRR in relation to the capital treatment of indirect clearing arrangements for regulatory capital purposes, for clearing members, for clients who offer indirect clearing, and for indirect clients themselves.

Treatment of client and indirect client positions in the hypothetical capital calculation

Under BCBS 227, CCPs must be able to calculate the hypothetical capital calculation in order to be a Qualifying CCP. Accordingly, it would be helpful if regulators could provide further guidance how to perform the calculation. In particular, we seek clarity on how CCPs should treat clients' and indirect clients' positions in the hypothetical capital calculation: Given the segregation and portability requirements, which make it highly likely that clients' (and indirect clients') positions will continue to be indirectly transacted after the default of a clearing member or client, a CCP's hypothetical capital calculation should appropriately distinguish between a clearing member's proprietary positions and those of its clients and their indirect clients.

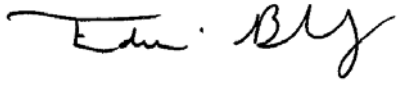
Large Exposure Exemptions – Client-to-Clearing member leg

Art 389(1)(j) exempts "trade exposures to central counterparties and default fund contributions to central counterparties". However, this exemption does not specifically reference the client-to-clearing member leg. BCBS227 treats this leg as exposure to the central counterparty, rather than to the Clearing Member, by allowing either 2% or 4% risk weight, provided certain conditions are met. Accordingly, Art 389(1)(j) exemption should be clarified to allow all clearing related legs that qualify for 2%/4% risk weight to be exempted from the large exposure limits.

This clarification is necessary in order to avoid the situation where clients need to contract with several different Clearing Members to circumvent the 25% cap for Large Exposure purposes.

Please contact the undersigned should you require further information.

Yours sincerely,



Edwin Budding
Assistant Director, Risk and Research
International Swaps and Derivatives Association, Inc.