ISDA Safe, Efficient Markets

October 19, 2012

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429.

By email: regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; comments@FDIC.gov

Re: Notice of Proposed Rulemaking: Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC RIN 1557-AD46; OCC Docket ID OCC-2012-0009; FRB RIN 7100 AD 87; FRB Docket No. R-1442; FDIC RIN 3064-AD96)

The International Swaps and Derivatives Association, Inc. ("ISDA") appreciates the opportunity to provide the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Board"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") with comments and recommendations regarding the proposed rulemaking described above.

This response is targeted to the specific risk-based capital requirements for derivative and repo-style transactions that are cleared on central counterparties ("CCP Rules"). The Agencies have proposed the CCP Rules following an international framework designed by the Basel Committee on Banking Supervision ("BCBS") to incentivize the use of CCPs, help reduce counterparty credit risk, and promote strong risk management of CCPs to mitigate

their potential for systemic risk. ISDA[1] is a long-time proponent of swap clearing, conducted in a manner that promotes safety and market integrity. Since 2009, we have been active contributors to the design of Basel's capitalisation of bank exposures to CCPs framework, which we recognise as a key new part of Basel 3.

This letter makes three overarching points before answering the Agencies' particular questions on the CCP Rules.

First, we note that the CCP Rules have 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 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 Agencies to reflect those changes in the proposed rulemaking, and note footnote 42 of the proposed rulemaking which recognises that at the time the proposed rulemaking was published the BCBS 227 interim framework had not been finalised and "the agencies expect to take into account the BCBS revisions and incorporate them into the agencies' capital rules through the regular rulemaking process, as appropriate".

Second, there is one aspect of particular concern in the proposed rulemaking. This is the specific identification of the following category of cleared transaction for which banks are required to take regulatory capital[2]:

> A transaction between a clearing member client banking organization and a clearing member where the clearing member acts as a financial intermediary on behalf of the clearing member client and enters into an offsetting transaction with a CCP provided that certain conditions are met.

BCBS 227 clarifies that a clearing member bank is not required to take regulatory capital for client trades unless the bank guarantees the CCP's performance to the client. We understand that the Agencies will take into account the BCBS revisions but we are concerned that, on this point, the rulemaking appears to move in the opposite direction to BCBS 227 (and earlier BCBS consultative documents, which were somewhat ambiguous). Close alignment to the BCBS framework is essential to establish effective international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. In the absence of an explicit guarantee of the CCP's performance by the clearing member, the risk of non-performance by the CCP on client trades is borne by the clients.

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[1] ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

[2] OCC, Board, FDIC Joint notice of proposed rulemaking. *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*, page 46.

Consequently, capital should not be required of clearing members for the clients' exposure to the CCP.

Third, as noted in our most recent letter to the Basel Risk Management Group and CPSS-IOSCO (attached as an annex), we appreciate that BCBS 227 presents an interim framework, which Basel and CPSS-ISOCO will revisit over coming months. Indeed, we are aware that Basel and CPSS-IOSCO have formed a working group to this end. We applaud this work as we consider that key aspects of BCBS 227 merit revision, including the following areas:

(a) the method employed to calculate the capital for default fund contributions to a CCP. Working in collaboration with leading CCPs, we are in the process of developing an alternative to the "hypothetical capital" construct and an analysis of its capital impact;

(b) the prescribed market period of risk ("MPOR") for the clearing member-to-client leg for client clearing. We recommend the rule be revised to reflect the fact that CCPs and Clearing Members ("CMs") are able to demonstrate that close-out for portfolios of exchange-traded derivatives can be achieved in a far shorter period;

(c) the application of the framework to affiliate clearing;

(d) a review of the Internal Models Method ("IMM") short-cut method to acknowledge that, while it is suitable for exposures covered by only Variation Margin, the method is sub-optimal when Initial Margin is used widely, be it with cleared or un-cleared transactions; and

(e) the interaction between the framework and the capital treatment of large exposures and bank leverage. Banks' concentrated exposures to CCPs (which often result from various legal and regulatory initiatives) should be permanently exempt from the large exposure limit, so long as the applicable CCP is a Qualifying CCP. Similarly, any leverage that a CM bank accrues as a result of offering a client clearing service ought to be exempt from the leverage ratio.

We plan to send separate letters to Basel and CPSS-IOSCO regarding these subjects over coming months. If it would be helpful, we would welcome the opportunity to meet with you and members of the working group to provide further details on the above issues and would be grateful if you would provide us with some suitable dates for a meeting.

The Agencies questions

Question 12: The agencies request comment on whether the proposal provides an appropriately risk sensitive treatment of (1) a transaction between a banking organization that is clearing member and its client and (2) a clearing member's guarantee of its client's transaction with a CCP by treating these exposures as OTC derivative contracts.

Re (1) and (2) the clearing member will always capitalise its exposure (including potential CVA risk exposure) to clients as bilateral trades, irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the CCP.

However, to recognise the shorter close-out period for cleared transactions, BCB 227 provides that clearing members can capitalise the exposure to their clients applying a margin period of risk of at least 5 days (if they adopt the IMM); or multiplying the EAD by scalar of no less than 0.71 (if they adopt either the CEM or the Standardised Method). We consider that the agencies should adopt this amendment to be consistent with BCBS 227.

Beyond this, as noted above, we consider that the prescribed MPOR for the clearing member-to-client leg for client clearing ought to be revised as part of the review of the BCBS 227 interim framework.

The agencies also request comment on whether the adjustment of the exposure amount would address possible disincentives for banking organizations that are clearing members to facilitate the clearing of their clients' transactions. What other approaches should the agencies consider?

Under the CCP rules, the client-facing trade remains OTC, and still subject to the full bilateral capital charge. However, it ought to be recognised that due to reduced netting arising from trades being taken out of the bilateral ISDA Master and fragmentation of the clearing market, this relationship is likely to have higher EAD, SEAD, and CVA charge. This increases the regulatory capital burden on a clearing member to facilitate the client clearing.

In this context, it is paramount that the regulatory capital that a banking organisation has for the default fund capital charge is appropriately calibrated to incentive clearing members to clear for clients.

In that regard, we have been long-time proponents of an alternative to the hypothetical capital construct and the use of CEM in that model. On the basis that this charge (if calculated on that basis) would discourage the propagation of central clearing counter to the G20's policy objective (and fail to provide incentives for CCPs to invest in the improvement of their risk systems and methodologies, thereby increasing systemic risk.) We applaud the fact that BCBS 227 has moved away from this model and instead, for an interim period, proposed a choice between two approaches whenever a bank is required to capitalise for exposures arising from default fund contributions to a qualifying CCP. We urge the Agencies to adopt this amendment.

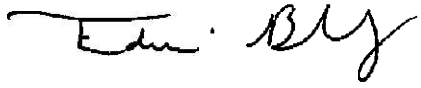
Beyond this, as noted, the method employed to calculate the capital for default fund contributions to a CCP can be improved. Indeed, in collaboration with leading CCPs, we are in the process of developing an alternative to the "hypothetical capital" construct and a quantitative analysis of this proposal.

Question 13: The agencies are seeking comment on the proposed calculation of the risk-based capital for cleared transactions, including the proposed risk-based capital requirements for exposures to a QCCP. Are there specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach? Please provide a detailed description of such transactions or exposures, the mechanics of the alternative risk-based approach, and the supporting rationale.

As above, we believe that the default fund exposures to QCCPs warrant an alternative approach. We are committed to active engagement with the RMG and CPSSS-IOSCO to further develop the framework.

Please contact the undersigned should you require further information.

Yours sincerely,



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

ANNEX

October 10, 2012

Giuseppe Siani
Risk Management Group
Bank for International Settlements

Robert Wasserman
Committee on Payment and Settlement Systems
Bank for International Settlements;
Technical Committee
International Organization of Securities Commissions (collectively "CPSS-IOSCO")

By email: giuseppe.siani@bancaditalia.it; rwasserman@cftc.gov

Clarifications re: ***Capitalisation of bank exposures to central counterparties***

Dear Giuseppe and Robert

We[3] refer to the interim framework for determining capital requirements for bank exposures to central counterparties ("CCPs"), viz. BCBS 227 of July 2012. We are grateful for the time

[3] ISDA: Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

GFMA: The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit http://www.gfma.org.

taken by Basel and CPSS-IOSCO to develop this framework, which is crucial for advancing towards more central clearing.

The purpose of this letter is to seek clarifications on aspects of the interim framework. In the table below, we set out the areas were we are seeking further clarification. We also offer an interpretation or solution for each issue raised. Further clarity on these issues will contribute to timely and efficient local implementation of BCBS 227.

We appreciate that BCBS 227 presents an interim framework, which Basel and CPSS-ISOCO will revisit over coming months. Indeed, we are aware that Basel and CPSS-IOSCO have formed a working group to this end. We applaud this work as we consider that key aspects of BCBS 227 merit revision, including the following areas:

(a) the method employed to calculate the capital for default fund contributions to a CCP. Working in collaboration with leading CCPs, we are in the process of developing an alternative to the "hypothetical capital" construct and an analysis of its capital impact;

(b) the prescribed market period of risk ("MPOR") for the clearing member-to-client leg for client clearing. We recommend the rule be revised to reflect the fact that CCPs and Clearing Members ("CMs") are able to demonstrate that close-out for portfolios of exchange-traded derivatives can be achieved in a far shorter period;

(c) the application of the framework to affiliate clearing[4];

(d) a review of the Internal Models Method ("IMM") short-cut method to acknowledge that, while it is suitable for exposures covered by only Variation Margin, the method is sub-optimal when Initial Margin is used widely, be it with cleared or un-cleared transactions; and

(e) the interaction between the framework and the capital treatment of large exposures and bank leverage. Banks' concentrated exposures to CCPs (which often result from various legal and regulatory initiatives) should be permanently exempt from the large exposure limit, so long as the applicable CCP is a Qualifying CCP. Similarly, any leverage that a CM bank accrues as a result of offering a client clearing service ought to be exempt from the leverage ratio.

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[4] Many clients have one general clearing member ("GCM") who in turn uses local clearing members ("LCM") for certain exchanges or clearing houses. Under BCBS 227 both the GCM and the LCM have to hold capital for their clients and these costs will be passed on. This will result in either additional cost to the users of cleared derivatives or force the clients to use several clearers for different markets. This in turn will cause the breaking of netting sets.

Further, in the US. CFTC Regulation 39.2 requires that where a Futures Commission Merchant ("FCM") is clearing for an affiliate then it had to treat that affiliate's house positions as house positions of the FCM rather than as client positions. As a result. these affiliate positions would not get segregation protection and portability on the FCM's insolvency. Consequently, under BCBS 227, the affiliate would not satisfy the conditions to receive the favourable risk weighting and so face a bilateral exposure to the affiliate FCM. This will be problematic within a US firm as it will mean clients have to use several FCMs for different markets. This in turn will cause the breaking of netting sets and increased costs.

We will send separate letters regarding these subjects over the next weeks and months. Additionally, we would welcome the opportunity to meet with you and members of the working group to provide further details on the above issues and would be grateful if you would provide us with some suitable dates for a potential meeting.

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Clarifications

The table below sets out our questions regarding the interim framework, in order of importance, and our proposed solutions.

Topic in order of importance	BCBS 227 Rule reference	Issue	Our interpretation
1. Interpretation of "highly likely" portability	Paragraph 114 (b) states: Relevant laws, regulation, rules, contractual, or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, should the clearing member default or become insolvent.	• Without further guidance, it is difficult to determine what "highly likely" portability would mean in practice.	We propose the following interpretation: '"highly likely portability" is deemed to exist where it is not specifically prohibited in the client and CCP documentation'. There is clear precedent for transactions being ported upon the failure of a CM, and clear industry intent for this practice to continue.
2. Determination of "Qualifying" CCPs	General Terms and Scope. A qualifying central counterparty [....] is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/ overseer has established, and publicly indicated that it applies to the CCP on an on-going basis, domestic rules and regulations that are consistent with the CPSSIOSCO Principles for Financial Market Infrastructures.	• Who will determine whether a CCP is "Qualifying" ("QCCP") for the purposes of these rules until CPSS IOSCO Principles for FMIs are implemented globally? How will consistency of the consequential determination be ensured? • If the national supervisors will determine whether a CCP is "Qualifying", will a consolidated list be maintained by an international agency?	• In the EU, the power of national supervisors in relation to this issue has been addressed by the relevant implementing legislation (CRD IV) not contemplating Qualifying CCPs which have not been either authorised or recognised by ESMA in accordance with EMIR[5]. • Until CPSS IOSCO Principles for FMIs are implemented globally and national regulators have indicated whether individual CCPs are "Qualifying" or not, banks will determine whether a CCP is a QCCP based on their internal policy that can rely on representations (potentially subject to auditor's confirmation) from CCPs. The policy will state that where a CCP complies with the relevant CPSS-IOSCO Principles for FMIs and calculates or makes available Keep, the bank must treat these as QCCPs • The need for global consistency of approach for qualifying status is vital. In that regard, we re-state the position we put to CPSS-IOSCO in response to the consultation on the proposed Assessment Methodology for the CPSS-IOSCO Principles ("Assessment Methodology") (June 15, 2012): *We believe that, without frequent internal and external compliance reviews, FMIs will be more likely to fail to observe the principles and responsibilities dictated by the FMI Principles. We therefore believe that internal and external assessments should be mandatory, and that national authorities and FMIs should be required to conduct these assessments on at least an annual basis.* *Additionally, while we appreciate the inclusion of timeframes for addressing any identified concerns, we believe that the Assessment Methodology must prescribe a method for ensuring that these concerns are, in fact, addressed. In this regard, the Assessment Methodology should require recommendations to include a date for follow-up testing and should mandate that follow-up testing (by regulators, external assessors or the FMI, depending on who identified the relevant concern) actually occurs.* *Similarly, in order to ensure that any potential problems identified during the assessment process are actually resolved, we urge CPSS-IOSCO to require that any material concerns be reported to the Financial Stability Board (the "FSB"). Additionally, we believe that the FSB should function as a centralized repository for all assessment reports by national authorities, evaluating such reports for consistency and providing external oversight with respect to developing issues. We also suggest that the Assessment Methodology include clear instructions for national authorities, as well as the International Monetary Fund and the World Bank (both of whom will function as external assessors under the Assessment Methodology), as applicable, to bring promptly to the attention of the FSB any issues with respect to an FMI or the oversight of the FMI that warrant the FSB's attention.*
3. Choice between default fund capital requirement methods	Para 121. Whenever a bank is required to capitalise for exposures arising from default fund contributions to a qualifying CCP, clearing member banks may apply one of the following approaches: Method 1: DF x e-factor; Method 2: min(DF x 1250%; Trade exp x 20%)	• Can Method 1 or Method 2 be selected for each CCP separately? • If a bank can use, for example, Method 1 for CCP A and Method 2 for CCP B, does the bank have to use the sum of all trade exposures to CCP A *and* B when calculating the floor for CCP B under Method 2. • Is the decision to use Method 1 or 2 a single, one-time process for each individual CCP, or may it be re-considered if supported by a clear rationale to change from one to the other?	• We consider that banks should be free to re-evaluate the appropriate Method for each (quarterly) calculation period for each individual CCP, and for each separate asset class clearing service at a CCP provided each service is separately risk managed and segmented from the other services. • Method 2 should apply to exposure to an individual CCP, and not to the sum of a bank's exposures to all CCPs.

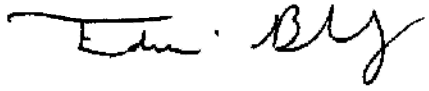
[5] Article 4(73) of CRD IV defines CCP as "…a central counterparty as defined in Article 2(1)(1) of Regulation (EU) ../.. [EMIR] that has been either authorised in accordance with Article 10 of that Regulation or recognised in accordance with Article 23 of that Regulation".

4. Who will be supervising the calculations carried out by the CCPs necessary for Method 1 and to maintain the "Qualifying" status? (These CCP calculations are also necessary for banks to calculate their exposures to CCPs.)?	There is no rule for this in BCBS 227.	• Who will be ensuring that the CCP calculation methodologies are consistent? • In the EU, will ESMA and EBA be involved to supervise the calculations carried out by the CCPs necessary for Method 1 and to maintain the "Qualifying" status? • In the US, the CFTC or Agencies (Fed/OCC/FDIC)? • What happens when the "k" factor is not provided?	• We propose that, for the home jurisdiction of a CCP, the relevant prudential regulator monitors the calculations carried out by the CCPs. To aid global consistency of approach, we recommend Basel perform periodic external assessment to supplement the local monitoring. • We propose pragmatic sanctions are applied to CCPs who do not produce k factors. For example, a certain materiality of breach is reached before a CCP losses its Qualifying status given the consequences to the CCP and affected banks. If all clearing members use method 2 for a given CCP, there is no need to calculate Keep.
5. Default Fund Capital calculation: capital deduction or RWA calculation?	Para 121. Whenever a bank is required to capitalise for exposures arising from default fund contributions to a qualifying CCP, clearing member banks may apply one of the following approaches: Method 1: DF x e-factor Method 2: min(DF x 1250%; Trade exp x 20%)	• In BCBS 227, the Default Fund Capital calculation could arguably be implemented either as a capital deduction, or as a RWA calculation.	• We propose that Method 1 be a capital deduction (which can be converted to RWA by multiplying by 1250%) while Method 2 a RWA calculation.
6. IMM counterparty credit risk stresses	Paragraph 111 states: The exposure amount for such trade exposure is to be calculated in accordance with Annex 4 using the IMM, CEM or Standardised Method, as consistently applied by such bank to such an exposure in the ordinary course of its business, or Part 2, Section II, D3 together with credit risk mitigation techniques set forth in Basel II for collateralised transactions. Footnote 3 states: Changes to IMM introduced in Basel III also apply for these purposes.	• Paragraph 115 of Basel III outlines amendments to paragraph 56, Annex 4 of the Basel II text, regarding the stress testing of counterparty credit risk calculations in the internal model method. Should these amendments be incorporated immediately for the calculation of bank exposures to CCPs, or will they only take effect when Basel III is fully adopted in a given jurisdiction?	• The Basel III stress testing standards for IMM ought not to be applicable until the legal framework underpinning the Basel III rules comes into effect in a given jurisdiction; until such time, the existing Basel II standards for IMM should apply.
7. Use of the 2% risk-weight for loans hedged by cleared CDS	There is no rule for this in BCBS 227.	• It appears to be the case that, if a bank hedges loan exposure with cleared CDS, the bank may use the 2% risk weight for the loan. We seek guidance regarding how substitution and double-default treatments operate for risk-weighting the loan under the interim framework.	• In our view, where a reporting bank is the CM on the CCP, the risk weighting of the exposure should be replaced with that associated with the risk weighting associated with the CCP, in accordance with paragraph 110 or paragraph 126 of BCBS227. Such substitution would be additional to the trade exposures captured in these paragraphs. • Where the reporting bank is a client of the CM on the CCP and meets the conditions set out in paragraph 114 of BCBS227 the risk weighting of the exposure should be replaced with the risk weighting associated with the CCP, in accordance with paragraph 110 or paragraph 126 of BCBS227. Such substitution of risk weighting would be in addition to the trade exposures captured in these paragraphs. Where the conditions in paragraph 114 are not met, but the conditions in paragraph 115 are met, the risk weight should be that set out in paragraph 115. • Where the reporting bank is a client of a CM, and the requirements of paragraphs 114 or 115 are not met, the reporting bank should treat the CM as the CDS counterparty and reflect that in any recognition of credit risk mitigation on a standardised or internal rating basis (as appropriate). • The exposures subject to such credit risk mitigation should also be excluded from the calculation of immateriality for the purpose of IRB coverage purposes (paragraph 256 of Basel 2). • Any recognition of credit risk mitigation associated with cleared CDS should include the usual considerations of asset, maturity and currency mismatch, as required in the existing Basel requirements. • The transfer of risk weighting from that of the original obligor to that of the CCP, with no change in the trade exposures to the CCP, may result in a minor element of double counting of risk. However, the

			impact should be immaterial and we consider it would have the following benefits: - Not applying a risk weighting to the exposure subject to CRM, but rather relying on capitalisation of the counterparty risk associated with trade exposures, is akin to a trading book rather than banking book treatment; and - Excluding such hedging trades from the calculation of counterparty risk on trade exposures to the CCP would be operationally onerous.
8. EMIR Indirect Clearing Please refer to Annex 1 for a summary of Indirect Clearing	There is no rule for this in BCBS 227.	• We consider that more clarity is required in relation to the capital treatment of indirect clearing arrangements for regulatory capital purposes, for CMs, for clients who offer indirect clearing, and for indirect clients.	• An indirect client bank that satisfies the conditions necessary for a direct client to achieve "look through" should also be permitted to "look through" to the CCP and receive favourable capital treatment for trade related exposures. • Unless it has an executed tripartite agreement which contains an obligation on a CM to take on the positions of the indirect client in the event of an indirect clearer's default, the CM should hold no capital in relation to potential exposures to its indirect client. • To the extent indirect clearing involves affiliate clearing as part of the longer term finalisation work, we consider further capital relief is warranted.
9. Existing futures documentation has second-lien on client money held at exchanges, yet this is ineligible as a risk mitigant in the BCBS 227	Paragraph 117 Where assets or collateral of a clearing member or client are posted with a CCP or a clearing member and are not held in a bankruptcy remote manner, the bank posting such assets or collateral must also recognise credit risk based upon the assets or collateral being exposed to risk of loss based on the creditworthiness of the entity holding such assets or collateral.	• Existing futures and OTC clearing documentation have second-lien on client money held at an exchange or CCP. According to BCBS227, this does not meet the hurdle to offset the client leg of the risk, and generates large RWA. In reality, the second-lien does not generate the same concern as it would in a bilateral trade, since the exchange or CCP uses its lien to close out the client position, i.e., to perform the operation that the CM would perform were it to have had first-lien itself. In our experience, renegotiating documentation to achieve first-lien has been unsuccessful because the *quid pro quo* for achieving first-lien involves giving up other credit terms that increase the overall risk required for CMs to achieve capital optimisation.	• Given that there is no real economic difference for a CM having first-lien and having second-lien with the CCP having first-lien, a second lien should be treated as sufficient for a CM to offset the client-leg of the risk.
10. Capitalisation of securities placed as collateral / IM	"117. In all cases, any assets or collateral posted must, from the perspective of the bank posting such collateral, receive the risk weights that otherwise applies to such assets or collateral under the capital adequacy framework, regardless of the fact that such assets have been posted as collateral. Where assets or collateral of a clearing member or client are posted with a CCP or a clearing member and are not held in a bankruptcy remote manner, the bank posting such assets or collateral must also recognise credit risk based upon the assets or collateral being exposed to risk of loss based on the creditworthiness of the entity holding such assets or collateral."	• By using the term "risk weight" the text appears to presuppose that the collateral will always be held in the banking book and subject to the credit risk framework. It is however conceivable that the "securities placed" could be trading book, and subject to market risk treatment • It is unclear what exposure measure is to be used in respect of counterparty risk; specifically, whether a haircut is required.	• Securities placed as collateral should continue to receive the capital treatment for an unencumbered asset (under the credit or market risk framework as appropriate) as well as being subject to a counterparty risk charge where they are not held in a bankruptcy remote manner. • The exposure measure for the counterparty risk charge should be the value of the collateral placed plus an appropriate volatility add-on (e.g., as determined by the supervisory haircut approach or by an approved internal model)

We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,



EDWIN BUDDING
Assistant Director
ISDA

SIMON LEWIS
CEO
GFMA

Annex 1 – Indirect Clearing

Draft versions of the European Market Infrastructure Regulation ("EMIR") envisaged that an entity which was subject to the clearing obligation for OTC derivatives could only satisfy that obligation either by being a direct clearing member of the relevant CCP or being a client of such a direct clearing member. This was considered to be too inflexible in light of the cross-border nature of the business and the scale of clearing services requirements going forward (see below).

Indirect clearing is a label applied to any set of arrangements which allows an entity to access the services of a CCP without being a clearing member or being a direct client of a clearing member of that CCP.

The concept of indirect clearing is key to, at least, a couple of commercial constructs which exist and have been used in particular in cross-border futures business: (1) European entities wishing to use non-EU CCPs - in these cases, for licensing and other reasons, it is common for the European entity to deal with a European broker, who will in turn appoint a local clearing member in the relevant non-EU jurisdiction; (2) an EU-based financial institution which wants to provide a range of clearing services to its own clients (who may in turn be subject to the clearing obligation) but does not have the appetite or resource to become a direct member of all relevant CCPs and would therefore seek to appoint another intermediary to act as its clearing member for some or all CCPs - the first institution would be able to maintain and service its client relationships without itself being a direct member of CCPs.

EMIR now clearly indicates that the establishment of indirect contractual arrangements with a clearing member (i.e. indirect clearing) will satisfy the clearing obligation.

EMIR does establish certain characteristics that an arrangement must meet in order to satisfy this: (i) those arrangements must not increase counterparty risk, and (ii) the assets and positions of the client must benefit from protections equivalent to those set out in EMIR regarding segregation of collateral and portability (Article 39 and 48 of the Regulation, respectively). At the Level 2 stage ESMA has published draft regulatory technical standards describing the types of indirect contractual arrangements that are capable of meeting these conditions. These clearly leave a degree of flexibility to design different contractual constructs through which clearing members are able to deliver EMIR-compliant arrangements. Since there is likely to be an extended chain of relationships in an indirect clearing arrangement (indirect client-indirect clearer-direct clearing member-CCP), there are clearly legal and commercial challenges to delivering EMIR protections which are available in the case of a default of either or both of the indirect clearer and the direct clearing member and further work is on-going to analyse these (by contrast, "normal" EMIR-compliant client clearing arrangements only have to deal with the default of the direct clearing member).