

## ISDA-ANNOTATED AGENDA (rm)

Issues to be discussed by the working group on derivatives – *Meeting of 5<sup>th</sup> Nov 2008*

*See separate list of WG members*

### **Martin Power (MP)**

Welcome / introduction.

Objective: Roadmap by end-07 to move large parts of the CDS market to central clearing. There can be no imposed solution. That's for the market to decide. But, for various supervisory reasons, we need a solution in Europe. Having a trade warehouse is a key part of the equation – a number of issues are already addressed there.

We need to know more about the products, the participants.... We could form a sub-group to deal with technical issues.

Shirvani (ES) – timetable is feasible and we welcome the project. We'll need to discuss the definition of 'European'.

MP – transatlantic co-ordination is a given. 40% of the market is in Europe – how do we manage that? (*response to question from America [GA:]*) We are looking at any European player.

ES – the ICE platform is due to go live early December (with single-names [SNs] to follow in January). At each stage, we could look at whether there are any exclusively European issues that arise.

The biggest issue in having multiple CHs would be the capital we'd have to put up, which might make the market uneconomical. In the US, if more than one solution launches, we'd expect the market to gravitate towards one.

O'Neill ('JO' -- NYSE...) – iTraxx product to go live in December, followed by SNs.

Book (TB – Eurex) – we already have a standardised [contract] product. In the first half we could start clearing, beginning with indices. A lot of the underlying infrastructure is already in place for [anybody] clearing CDS. NB, multiple solutions exist for clearing [cash] equity.

Huertas ('TH' -- CEBS [FSA]) – The roadmap timescale is realistic. We need a CCP to have robust risk management, as it represents a single point of [potential] failure; which means capitalising on the work already done in the US. But a CCP offers a distinct advantage over some bilateral arrangements

MP – we're relying on you, industry, to identify and address EU specificities.

Axilrod (PA) – volumes are 50:50 index vs single-name. It's mainly corporate/sovereign, with a very small proportion being mortgage-related or loan-related.

ES – indices and related SNs account for probably 85% of the market.

Wolff (SW) – backloading is part of the plan with ICE. We've done extensive testing, using DTCC records and building on the technology used in relation to SwapClear. (The exact timing of backloading may vary by dealer.)

GA – Please note – the notional will drop dramatically – the net open interest much less so.

(MP – Please explain this more fully.)

SW – NB: Infrastructure takes time to build [within firms]

ES – We've focused on a) 'operational risk' and b) the risk 'waterfall', ie the robustness of the CH in extreme circumstances.

TH – we'll need to be reassured about the engine, but there has been a lot of [conceptual] work done on these issues.

GA – manual processing will only occur in relation to a small proportion of [tailored] deals that are customer-driven.

Morris (SM) – 2 important issues:

- i) standardising coupons – happening in US; we're not there yet in Europe;
- ii) Restructuring – more problematic. The nature of bankruptcy laws in Europe makes restructuring a more likely event here. Also capital rules make users push for it. With strong support from the Fed, we plan from 20<sup>th</sup> December to move to contracts with no R for US names.

JO – Liffe back- loading planned for after launch.

PA – on interoperability, the DTCC bulk account transfer facility supports the movement of open interest across our books.

Also of relevance: standard settlement process and the process of (net) payments of CLS.

Question: what about standardisation of margin requirements?

SM – Competition is fine. What about 'fungibility' – common approaches to valuation, dispute procedures. It would not be good to have multiple clearers that resulted in weaker capital and, at the same time, no portability.

MP – we need more information on this.

PA – it cost firms \$10s of millions to build their connections to DTCC. It is also a lot of work for CCPs to connect.

Stuart (OS) – we've made a multi-year investment in DTCC and compression also has costs. Also, success increases exponentially as you build up use of existing infrastructure.

ES – we're working – buy-side and sell-side together -- to get the 'auction' mechanism and dispute resolution into the ISDA documentation.

TB – we need that urgently. JO -- ... and with equal access.

ES – certainly, but we have needed to get that buy-side + sell-side consensus in place in order to be able to do that. We have stated publicly at every opportunity that we are committed to that.

SM – this is not just important for clearers, but for our own client-access models and for uniform settlement. Customers have to be bound in to the same mechanism as applies to dealers (and the contracts that they may be centrally clearing).

TH – We're in the loop on this.

JO – it's very important to find a solution for Europe on R.

SM – R presents a lot of problems. Can Commission help to get it removed?

Metcalf – ISDA has done work on the relatively low incidence of R, which we could share with the Commission. The transaction documentation has evolved with the market over its relatively short life. So, just as the definition of bankruptcy has evolved, the market has been moving at least in part away from restructuring, as a focus on 'harder' credit events. The challenge is that the CRD now effectively requires some participants to have restructuring covered (by virtue of the 60% limit on recognition of contracts without it). And that is a significant driver of the inclusion of R in contracts.

Russo ('DR' – ECB) – the CPSS-IOSCO standards for CCPs are not necessarily sufficient, given the specifics of CDS, as work with the Fed has shown. We'd like to work further with CESR on this.

We need to carry out a gap analysis and look at issues such as exposures vs assets and single-name CDS.

The CESR-ECB consultation on standards for CCPs is open.

SM – indices are around 50% of notional / trade count / counterparty exposure. So dealing with indices is a major advance. Rushing into single-name clearing and getting it wrong would create a bigger problem for taking the time to get it right.

MP – re transparency, supervisory is the priority though we are not ruling out public, albeit less granular transparency. We'll get into the details later, in a sub-group.

DR – re supervision issues, we can use the work done with the Fed.

MP – we need to look at whether access to information is good.

Comporti ('CC' – CESR) the issues are:

1. EU-US access to data
2. Within EU, co-ordination between the supervisors of a) a CCP and b) a firm using it [in different jurisdictions]
3. Governance and any home-host issues arising

MP – we'll park the 'Competition' and 'Long term' issues for now.

We've established that we need to understand more:

- i) Not on indices, for which progress is possible,
- ii) On single-name
- iii) 'fungibility'
- iv) Restructuring

We also need to consider the CESR-ECB standards; and supervisory co-ordination.

TH (CEBS) – let's do what we can to get a car on the road by December, if one is ready!

TB – Eurex already has a solution.

JO – That of course is a future – not central clearing of OTC

OS – Operationally, supporting a future is much more challenging and costly than clearing OTC contacts.

## **Short-term issues**

### *Establishment of one or more CCP-clearing solutions for CDS contracts*

The working group should deliver a detailed plan to establish one or more solutions for the central clearing of CDS contracts which should include at least:

- A time schedule;
- Explicit dealers' commitment to shift from bilateral to CCP clearing;
- Type and total notional value of contracts that can be brought onto the CCP(s);
- Eligibility requirements for the contract to be admitted to CCP clearing;
- Rules governing the functioning of the CCP(s) (see below);
- Necessary changes (if any are needed) to the existing contracts in order to bring them onto the CCP.

The developed market solutions would need to respect the following requirements:

- Use of reliable electronic interconnections with affirmation, confirmation, portfolio reconciliation at very early date;
- STP processing (no manual transactions);
- Real time or at least end of day netting;
- Direct same-day settlement;
- Links to cash transfer in one or several currencies;
- Open, non-discriminatory access criteria, including access to the DTCC data warehouse (users in their capacity as owners of the DTCC must guarantee the latter);
- Interoperability in case of multiple CCPs (including at transatlantic level);
- Open and transparent margin requirements and default procedures;
- Compliance with forthcoming ESCB-CESR recommendations and CPSS-IOSCO standards on CCPs;
- Appropriate levels of capitalisation, guarantees, members' backing etc.;
- Public price reporting on CCP-cleared and on other CDS transactions.

### *Supervisory issues*

- The establishment of a CCP for CDSs raises important supervisory/oversight issues due to the systemically important dimension it will reach. For this reason, it must fulfil adequate standards to be drafted in cooperation with the relevant European authorities (ECB and national authorities).
- Since the failure of a CCP may have extremely negative consequences for European institutions and the European financial market in general, and considering the need of supervisors to access the relevant data concerning their supervised entities, the CCP(s) must be established in Europe. Exposures reporting must be established.

- Sufficient level of cooperation among supervisors of OTC CCPs must be ensured. This is particularly important in the transatlantic dimension, also to guarantee that there are no regulatory obstacles for the CCP(s) to access DTCC systems and that the relevant data stored in the data warehouse are available to European regulators.

#### Competition issues

- In establishing the rules governing the CCP(s), it is necessary to determine the owner of the open interest of all the contracts (the single dealers, the CCP or a third party).
- Adequate measure to prevent a commercial use of the information the CCP holds should be put in place.
- The CCP clearer shall separate accounts according to (i) equity vs. derivatives revenue and (ii) on- vs. off-exchange revenues, as applicable.
- If a CCP provides OTC derivatives services and is part of a group also providing trading services for listed derivatives, then the CCP should be physically separated (i.e. a separate legal entity) and any additional measures to avoid conflicts of interest and sharing of commercial knowledge within the group should be considered.

## **Long-term issues**

### Trading venues vs. pure OTC

- An analysis of the benefit of maintaining OTC trading should be carried out and compared with the possibility and necessary incentives to shift the largest possible part of this activity on regulated markets or MTFs.

### Rules for OTC derivatives markets

- The appropriate level of regulation (prudential rules, disclosure rules, risk assessment rules etc.) for improving the safety of OTC derivatives (including the portion of the market that cannot be brought onto a CCP) should be determined. Full collateralisation of exposures must be guaranteed especially in those cases where CCP clearing cannot apply.
- Where the eligibility criteria for CCP clearing are met, a contract irrespectively of its nature (CDSs or other contracts) should be centrally cleared. Investigate whether existing incentives in terms of capital requirements (see Annex III, part 2, point 6 of the Capital Requirements Directive) are sufficient or whether additional incentives should be put in place. When all the criteria are met, commercial reasons cannot prevail in the decision of moving to CCP clearing.
- Explore whether pre- and/or post-trade transparency requirements as well as appropriate transaction and exposure reporting should be established in order to facilitate risk valuation and risk monitoring. Investment firms may report this information on their own or use a third party acting on their behalf (like a trade-matching or reporting system or a data warehouse).
- Identify the appropriate incentives to encourage standardisation wherever applicable (e.g. establishing stricter capital requirements for the use of non-standardised contracts).

### Exchange-traded derivatives

- Explore whether interoperability and unbundling of services as per the Code of Conduct for clearing and settlement are desirable (necessary to improve competition both at trading and post-trading level, impact on innovation) and feasible (ownership of open interest).
- Examine whether measures to improve transparency of fees and services (including discounts and rebates) are needed.
- Explore the need for any further measures to improve risk management transparency.

### Improve efficacy of risk capital management:

- Explore the possibility of establishing margin-offset agreements. Such arrangements exist already (e.g. LCH.Clearnet – CME, CME – OCC).

Netting directive

- Examine the requirements to have effective netting via a netting directive/regulation and provide advice on the specific requirements to be included in the eventual future piece of legislation.