Overview of ISDA Standard Credit Support Annex (SCSA)

November 3, 2011

Background

1. CSA is the Credit Support Annex to the ISDA Master Agreement. It covers terms of the collateral arrangement between two counterparties.

2. CSA specifies type of collateral permitted: cash, currency options, government bonds, haircuts, thresholds, etc.

3. Tremendous amount of optionality exists in CSAs. There could literally be millions of combinations of terms. Knowledgeable counterparties should deliver the cheapest form of collateral.

Simple Example

1. Deliver Euro cash or USD cash collateral

2. Euro/USD basis swap:

1 year	65 basis points
3 year	45 basis points
5 year	35 basis points
10 year	20 basis points

3. Dollar funding gets converted to Euro with a 65 basis point savings in year 1. How does one know how much collateral is needed throughout the derivative relationship and what the basis swap market will be in the future?

4. CSAs contain a set of complex options where the option values and the option sizes can only be estimated probabilistically.

5. Valuation, collateral and novation issues arise.

ISDA Board Action

- In July 2010 the ISDA Board agreed to investigate the feasibility of a Standard Credit Support Annex (“SCSA”).

- In May 2011 the Collateral Steering Committee delivered the feasibility study (“The Standard Credit Support Annex”, ISDA, 2011).

- Subsequently the Board charged the Committee to develop an Implementation Plan for the SCSA, addressing the practical and logistical aspects of expeditiously bringing the SCSA to the market.

- Plan has been agreed in principle.

Why Standardize the CSA?

- A CSA is a complex derivative on a portfolio of underlying derivatives, with contingent daily flows of collateral and embedded exotic options
- Many ISDA members have only partially captured the full detail and complexity of their bespoke CSAs in risk and accounting processes: Eligible Collateral, Eligible Credit Support, Eligible Currency, Threshold, Interest Rate, and Ratings-Based Initial Margin terms vary widely
- The embedded CSA terms have economic consequences that are, in many cases, held at fair value through the income statement
- Disparate approaches to booking and modeling of CSA terms lead to collateral disputes, as well as to inconsistent and non-transparent valuations when assigning or re-couponing trades
- SwapClear is discounting using overnight index swap (OIS) rate curves rather than LIBOR for some currencies. An OIS-based standard CSA substantially consistent with the LCH would facilitate the novation of OTC derivatives to CCPs.
- It may also influence emerging CCPs in a convergent direction.
- Regulators and legislators are actively encouraging dealers and trade associations to standardize their frameworks and processes, where appropriate.

Strategic Rationale

There is a clear economic imperative for the SCSA

Regulators and legislators are actively encouraging the market to standardize their frameworks and processes

- We have discussed the SCSA with the NY Fed, the CFTC, the UK FSA, the Bank of England and the ODSG.
- There is recognition that the SCSA is structurally important to the market and support for this ISDA initiative.
- It is important that proposed industry practice change such as the SCSA and regulatory change are consistent.

However there are significant logistical challenges that must be overcome to implement the SCSA

- The simplest mode of implementation relies upon a payment-versus-payment (PVP) mechanism to eliminate Herstatt risk - such a mechanism does not exist currently and to construct one will take considerable time.
- An alternative method of Herstatt risk elimination based on netting of cashflows does exist (the Implied Swap Adjustment or ISA method), but requires non-trivial standardization of data and computation to be used across the market.
- Regardless of approach, firms will need to undertake considerable internal technology and process re-engineering work to implement the SCSA.

Our proposed implementation plan attempts to balance these factors in a pragmatic way

Primary Objectives of the SCSA

Align the mechanics and economics of collateralization between the bilateral and cleared OTC derivative markets

- More standardization between the two market hemispheres
- Promote liquid transfer of risk between bilateral and cleared derivatives
- Reduces the risk and cost of hedging bilateral risk with cleared derivative products because margin terms are synchronized.

Standardize market practice regarding embedded Collateral Switch Options in CSAs

- Eliminate switch options, thereby eliminating the inconsistent recognition of switch-option economics by different firms
- Reduce margin disputes attributable to such valuation differences
- Simplify and standardize market processes

Support the adoption of OIS discounting for derivatives

- Align interest accruals on cash collateral with discount rates for underlying derivative trades
- Eliminate non-cash collateral, which does not align to OIS discounting
- Promote convergence towards OIS discounting across CCPs and bilateral market participants

How the SCSA Works : Market Context

Portfolio of executed transactions between two counterparties

PARTY X

PARTY Y

Transactions clearable when executed

Clearing House 1

Clearing House 2

Clearing House 3

Clearing House 4

Clearing House 5

Clearing House …n…

Each clearing house has its own unique margin rules

Transactions not clearable when executed

CSA (Legacy Trades)

One net collateral requirement each day, delivered in eligible collateral of choice

SCSA (New trades)

One collateral requirement per currency each day, delivered in each currency or converted to a single currency with an interest adjustment overlay.

See over for detailed mechanics

Netting Set maintained across full Master Agreement scope and all collateral.

Trades may be moved from the CSA to the SCSA (but not vice versa).

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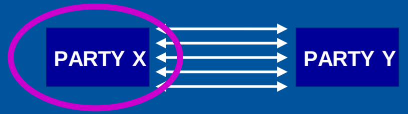
How the SCSA Works: Detailed Mechanics



PARTY X PERSPECTIVE:

Designated Collateral Currency (DCC) Silos

	USD	EUR	GBP	CHF	JPY	Pro Forma Current CSA for Comparison
INCLUDED TRANSACTIONS	USD Transactions Cross-Currency Transactions Other Transactions	EUR Transactions	GBP Transactions	CHF Transactions	JPY Transactions	All Transactions
EXPOSURE	$\sum MTM_{USD}$	$\sum MTM_{EUR}$	$\sum MTM_{GBP}$	$\sum MTM_{CHF}$	$\sum MTM_{JPY}$	$\sum MTM_{ALL}$
COLLATERAL	$\sum CASH_{USD}$	$\sum CASH_{EUR}$	$\sum CASH_{GBP}$	$\sum CASH_{CHF}$	$\sum CASH_{JPY}$	$\sum CASH_{ALL} + \sum SECURITIES_{ALL}$
REQUIRED SETTLEMENT Threshold = 0 MTA = 0	$\sum CASH_{USD} - \sum MTM_{USD}$	$\sum CASH_{EUR} - \sum MTM_{EUR}$	$\sum CASH_{GBP} - \sum MTM_{GBP}$	$\sum CASH_{CHF} - \sum MTM_{CHF}$	$\sum CASH_{JPY} - \sum MTM_{JPY}$	$\sum CASH_{ALL} + \sum SECURITIES_{ALL} - \sum MTM_{ALL} -$ THRESHOLD

OR OR OR OR OR

Herstatt Risk Elimination

SAFE SETTLEMENT (PVP OR ESCROW) PLATFORM
OR COMMON ARBITRAGE-FREE IMPLIED SWAP ADJUSTMENT MODEL

OR OR OR OR OR

MIRROR IMAGE PARTY Y PERSPECTIVE

OR

PARTY Y

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Implementing the SCSA

Important Principles

1. **A flexible implementation approach that allows firms to move at the pace they deem appropriate.**
2. **The SCSA is a market-driven initiative.**

Implement in Phases

- Phase 1 - Pathfinder Implementation for Volunteer Firms
  - Permit volunteer firms use the SCSA and to bilaterally accept Herstatt risk if they so choose…but…
  - Require use of the ISA method upon demand of either party.
  - Therefore all Phase 1 participants must be fully mobilized to use the ISA. No impact on firms not participating in Phase 1.
  - ISDA to provide central infrastructure to support the ISA method
  - Development in Q4 2011 and Q1 2012. Market testing in Q2 2012.

- Phase 2 - Wider Market Adoption:
  - When a payment-versus-payment (PVP) mechanism is operative.
  - No restriction on SCSA use - open to all.
  - No mandate on SCSA use - economics should be the driver.
  - Both PVP and ISA methods of Herstatt risk mitigation to accommodate needs of different market participants.

The SCSA draft documentation Will Be Used

- Initial feedback from New York and UK counsel indicate that collateral enforceability under the SCSA will be similar to that under the CSA; ISDA will ask counsel in all jurisdictions to confirm the SCSA would be covered in their opinion once the SCSA is completed.
- SCSA documentation will be finalized upon resolution of outstanding points and updated as new features are developed.

SCSA to be based on ISDA-Managed Market Infrastructure

- The SCSA cannot be implemented as a purely bilateral manner like the CSA was.
- Therefore ISDA will play a central role in managing the market infrastructure needed for the SCSA with execution of services sourced under contract from others.

Implementing the SCSA

Required Market Infrastructure

- Successful rollout of the SCSA will require adoption of common market infrastructure elements:
  - Common rate set (FX spot fixes at 10am and close by region, tom/next FX swap rates, OIS rates)
  - Common ISA calculation specification and open source code base (C++ or similar)
  - Interoperable electronic communication methods for margin calls and other data between parties

- The operating model will be designed and owned by ISDA

Cross-Leveraging Other Initiatives

- We will take the opportunity for the SCSA project to leverage and support other key market initiatives, specifically:
  - All SCSAs should be created electronically, stored in digital form and electronically executed.
  - All margin calls and data transfers under an SCSA should be made electronically
  - The SCSA and Dispute Resolution procedures should be fully conformed and compatible
  - LEI support should be designed in (to be used when LEIs are available)

The SCSA is not a mandatory initiative

- The SCSA was conceived out of the recognition of certain economic risks and a desire to mitigate those risks. There should be no compulsion to use the SCSA - it should be adopted, or not, according to its economic merits and the particular needs of each market participant.

Regulatory Coordination is a critical success factor

- The industry and supervisors in the US and internationally should coordinate parallel SCSA development and rule-making efforts to ensure compatibility and consistency globally.

Questions?

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