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15 October 2004

Mr. Oliver Page
Director
Financial Services Authority
25 The North Colonnade, Canary Wharf
E14 5HS London, England

Mr. Michael Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549, USA

Dear Messrs. Page and Macchiaroli,

The Bond Market Association (TBMA)¹ and the International Swaps and Derivatives Association (ISDA)² are pleased to respond to the questions posed by the Basel Committee on

¹ The Bond Market Association is the international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities globally. TBMA was founded in 1912, as the Investment Bankers Association of America, later incorporated as The Public Securities Association in 1976, until it changed its name to The Bond Market Association in 1997 to more accurately reflect the Association's broadened constituency and membership. TBMA's member firms engage in a variety of cross-border and domestic securities financing transactions, including repurchase and securities lending transactions under TBMA-sponsored standard agreements. More information is available at <http://www.bondmarkets.com/>

² The International Swaps and Derivatives Association is the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (interest rate, currency, commodity and energy, credit and equity). ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, as well as leading end-users of, privately negotiated derivatives. The membership includes associated service providers and consultants. More information is available at <http://www.isda.org/>

Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) Joint Working Group on the Trading Book in their Survey of the treatment of certain counterparty credit risk issues that may arise in connection with securities lending and financing transactions including prime brokerage and repo-style transactions (hereinafter “securities financing transactions”). The Associations consider these issues to be of vital importance to the securities financing markets, and we have consulted with our members in the preparation of this response. For your convenience, we have reprinted the questions in the text of this letter.

(a) *Describe the range of securities financing transactions (including prime brokerage and repo-style transactions) your member firms engage in. Describe the contracts under which the transactions are conducted – specifically, are they custom contracts or industry standard contracts, and if the latter, do they typically include significant amendments to the industry standard? Who are the counterparties for such transactions? What are the mechanisms for holding credit support for such transactions?*

(i) *Describe the range of securities financing transactions (including prime brokerage and repo-style transactions) your member firms engage in.*

Member firms engage in securities lending, repurchase agreements (repos) and margin loans. In addition, members may engage in a sale of securities in combination with a total return swap on the securities sold. Almost all securities financing transactions contain daily mark-to-market provisions.

(ii) *Describe the contracts under which the transactions are conducted – specifically, are they custom contracts or industry standard contracts, and if the latter, do they typically include significant amendments to the industry standard?*

Member firms conduct securities financing transactions under industry master agreements, their own standard proprietary master agreements and, in some cases, transaction-specific agreements. We understand from our members that the rights contained in the proprietary and custom agreements are comparable to those in the industry masters. Therefore, although our responses focus on the core terms of the most commonly used industry masters, the discussion applies broadly to the other agreements governing securities financing transactions. In the cases where members amend the industry masters, it is generally with supplemental terms, like additional events of default, which do not affect the core performance and close-out provisions discussed here.

Securities Lending

Securities lending transactions are often documented under either of two industry standard agreements: the New York-law Master Securities Loan Agreement (“MSLA”)³ published jointly

³ The industry masters have been updated, and the discussion here concerns the most recent versions. Predecessor versions are still in use by certain counterparties and, in general, do not materially differ from the most recent versions.

in 2000 by TBMA and the Securities Industry Association (SIA),⁴ or the English-law Global Master Securities Lending Agreement of 2000 (“GMSLA”) published by the International Securities Lending Association (ISLA).⁵ Although the MSLA is principally used for loans on U.S. securities involving U.S. counterparties, it is frequently used more broadly. The GMSLA is used broadly for other securities lending transactions, and sometimes by U.S. counterparties.

The MSLA operates as a master agreement for securities lending transactions between two parties; its standard provisions create a single contractual relationship between them. Within this relationship, the parties may enter into any number of individual securities loans, each documented by a confirmation that contains the economic terms particular to it. The standard provisions of the MSLA provide the basic legal protections that market participants require: explicit characterization of securities lending transactions as loans of securities against cash or securities collateral; daily mark-to-market procedures; and clear close-out rights and remedies for events of default, including insolvency. The MSLA permits significant flexibility, as the parties may tailor its standard provisions by amending the existing language and adding additional sections in a negotiated “Schedule.” The Guidance Notes to the MSLA facilitate customization by providing standard language for frequently negotiated supplemental terms, such that the parties may modify their agreement without deviating significantly from industry practice.⁶

The GMSLA has superseded the Overseas Securities Lending Agreement of 1995, also published by ISLA, as the English-law industry master for international securities lending transactions. Like the MSLA, the GMSLA operates as a master agreement for securities lending transactions between two parties; its provisions create a single contractual relationship between them. Within this relationship, the parties may enter into any number of individual securities loans, by oral agreement or by written confirmation that contains the economic terms particular to it. The standard provisions of the GMSLA provide the basic legal protections that market participants require: explicit characterization of securities lending transactions as transfers of

⁴ The Securities Industry Association was established in 1972 through the merger of the Association of Stock Exchange Firms (1913) and the Investment Banker's Association (1912). The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. More information is available at <http://www.sia.com/>

⁵ The International Securities Lending Association is a trade association established in 1989 to represent the common interests of the securities lending industry. ISLA assists in the orderly, efficient and competitive development of the international securities lending market. In this regard, ISLA works closely with regulators and in the UK has representation on the Stock Lending and Repo Committee, a committee of market practitioners chaired by the Bank of England. Today, ISLA has over 50 members comprising insurance companies, pension funds, asset managers, banks and custodians representing more than 4,000 clients. In September 2004, ISLA changed its constitution to allow borrowers to become members for the first time. The geographic spread of ISLA's client base is global in nature, comprising substantial representation from the UK and the other EU member states in addition to other major financial centers such as Switzerland and the United States. More information is available at <http://www.isla.co.uk/>

⁶ Instead of the MSLA, parties could elect to document their securities lending transactions under an ISDA Master Agreement. However, the ISDA Master Agreement is not typically used for securities lending, and ISDA has not published definitions for securities lending.

securities against the transfer of cash or securities margin (transfer-of-title); daily mark-to-market procedures; and clear close-out rights and remedies for events of default, including insolvency. The GMSLA permits significant flexibility, as the parties may tailor its standard provisions by amending the existing language and adding additional sections in negotiated “Addenda” or “Annexures.”

Repurchase Agreements

Repurchase agreements are often documented under either of two agreements: the New York-law Master Repurchase Agreement (“MRA”) published by the TBMA, or the English-law Global Master Repurchase Agreement (“GMRA”) published jointly by the TBMA and the International Securities Market Association (ISMA). Although the MRA is principally used for repos on U.S. securities involving U.S. counterparties, it is frequently used more broadly. The GMRA is used broadly for other repo transactions, and sometimes by U.S. counterparties.

Both the MRA and the GMRA function as master agreements for repurchase transactions between two contracting parties: they establish a single contractual relationship between the two parties, pursuant to which the parties can document individual repurchase transactions by means of negotiated “Confirmations.” The standard provisions provide the basic legal protections that market participants require: explicit characterization of repurchase agreements as purchases and sales; daily mark-to-market procedures; and clear close-out rights and remedies for events of default, including insolvency.

Similar to the MSLA and GMSLA, both the MRA and the GMRA are amenable to amendment. In a negotiated annex the parties may alter the standard MRA or GMRA language and insert additional provisions to tailor the terms of their relationship to best fit their needs. To further facilitate such modifications, the Guidance Notes to the MRA provide standard language that parties may use for frequently negotiated supplemental terms. The Guidance Notes to the GMRA explain key provisions of the GMRA and provide guidance to parties who wish either to enter into the master agreement or to document particular transactions. Additional annexes that provide supplemental terms and conditions to enable the parties to document specific types of transactions, such as equity and buy/sell-back transactions, are available for both the MRA and GMRA.⁷

Margin Loans

Margin loans are documented by house standard agreements, but such agreements are as a rule drafted to reflect the underlying lending relationship: they are drafted in favor of the lender. Such master contracts provide the financial institution the right to call for margin or exercise close-out rights when the financial institution deems it necessary for its own protection. As with other agreements, parties may alter the standard forms to fit a particular relationship, but supplemental terms typically do not derogate from the standard rights accorded the financial institution.

⁷ Although the ISDA Master Agreement can be used to document repo transactions, repos are not typically documented under it, and ISDA has not published definitions for repos.

Sale / Total Return Swaps

Some members enter into sales of securities in combination with a total rate of return swap between the counterparties as a way to essentially finance the securities. The sale of securities is documented by a confirmation, and the total return swap is typically documented under the ISDA Master Agreement and, often, the ISDA Credit Support Annex (“CSA”).

The ISDA Master Agreement is designed to document multiple over-the-counter derivative products. For example, interest rate swaps, currency swaps, forward rate agreements, commodity derivatives, credit derivatives, equity derivatives, foreign exchange transactions and caps, collars and floors can be documented under the ISDA Master Agreement. The Agreement can be tailored to accommodate the particular needs of the trading relationship. Parties typically make elections and address additional provisions in the Schedule to the ISDA Master Agreement, including whether the agreement between them is governed by New York or English law. The standard terms of the ISDA Master Agreement do not describe the nature of the payment or delivery obligations that are owed by the parties in connection with a particular transaction type. Instead, parties may use the defined terms available in product-specific definitions booklets published by ISDA in constructing precise transaction descriptions that are set forth in a confirmation for each trade.

The CSA is one of several Credit Support Documents that ISDA publishes to facilitate providing credit support in a derivatives trading relationship, and it is available in both New York-law and English-law versions. The ISDA Master Agreement and CSA provide the basic legal protections that market participants require: mark-to-market procedures and clear close-out rights and remedies for events of default, including insolvency.

(iii) *Who are the counterparties for such transactions?*

Counterparties to securities lending transactions, repurchase agreements, margin loans and sale and total return swaps include corporations and other unregulated entities, broker-dealers, banks (including agent banks), insurance companies, mutual funds, hedge funds, pension funds (including, in the U.S., both ERISA and non-ERISA pension funds), municipalities, large government-sponsored entities, central banks, supranationals, sovereigns and, particularly in the case of margin loans, individuals.

(iv) *What are the mechanisms for taking or holding credit support for such transactions?*

The securities financing transactions discussed above involve the simultaneous exchange of cash and securities. Strictly speaking, in such transactions both parties take or hold credit support for their positions. Under applicable insolvency law, the mechanism for holding credit support may influence the analysis of a claimant’s rights.

For securities financing transactions, members employ any of three mechanisms for taking or holding credit support. Hold-in-custody arrangements, in which the provider of credit support retains custody or control of the credit support, are least favorable for the support recipient, because the arrangement poses practical hurdles for the recovery of the credit support in the event of the provider’s default, insolvency or bankruptcy. Conversely, hold-in-custody arrangements can be more favorable for the credit support provider in the event of the credit

support receiver's insolvency given the credit support provider's practical control over the credit support. As a result, members rarely agree to hold-in-custody arrangements as recipients of credit support but often agree to hold-in-custody arrangements as credit support providers. Deliver-out arrangements, in which the recipient takes custody or ownership⁸ of the credit support, are most favorable to the recipient in practice because, in a default, insolvency or bankruptcy of the provider, the recipient already controls the credit support and need not take additional action to access it. Finally, a tri-party custody arrangement provides a middle-of-the-road approach that balances the interests of both the provider and recipient of credit support and provides a good deal of operational efficiency. With a tri-party arrangement, a third party takes custody of the credit support in a segregated account on its books, and in the event of the provider's default, insolvency or bankruptcy, the recipient will be able to exercise default remedies, and prior to any default, the provider will have free or relatively unrestricted rights of substitution.

Although the MSLA, GMSLA, MRA, GMRA and CSA permit the parties to select any of these three credit support mechanisms, industry practice largely conforms to certain patterns. When a financial institution receives credit support, it almost always does so on a deliver-out basis, which means that it obtains a first-priority security or ownership interest by taking custody (i.e., control) of the credit support. In contrast, the established practice for when a financial institution provides credit support is less uniform: in the context of repos under the MRA and GMRA, tri-party and hold-in-custody arrangements are quite common, whereas they are not common for securities lent under the MSLA or GMSLA or credit support posted under a CSA. That being said, tri-party arrangements are becoming more common for securities lending. If the parties choose a tri-party custody arrangement, both will also enter into a separate agreement with the third-party custodian. Although each custodian uses its own standard agreement with the parties, these agreements do not vary widely.

But, while the MSLA, GMSLA, MRA, GMRA and CSA do not dictate the choice of a particular credit support mechanism, each agreement imposes particular requirements on the parties. In securities lending transactions under the MSLA, the party providing credit support grants the recipient a first priority security interest in that support. The MSLA also provides that if any securities loan is deemed to be a loan of money by the borrower to the lender, then the borrower shall have, and the lender is deemed to have granted, a security interest in the loaned securities. The GMSLA requires that all right, title and interest in the securities lent or credit support transferred passes from the lender/transferor to the borrower/transferee, whose only obligation is to return "equivalent" securities or credit support, as the case may be. Under the MRA, the seller of securities agrees to transfer all of its interest in those securities to the buyer, and, if the repurchase agreement is recharacterized as a loan, the seller will be deemed to have granted the buyer a security interest in the transferred securities. The GMRA requires the parties to take all necessary steps to ensure that all right, title and interest in any purchased securities passes to the buyer. Under the New York-law CSA each party grants to the other a first priority continuing security interest in the credit support transferred to or received by the other party. Under the English-law CSA each party grants to the other all right, title and interest in the credit support

⁸ While in a hold-in-custody repo the buyer has ownership of the securities, in a deliver-out repo the buyer has the immediate practical ability to exercise its ownership rights with respect to the securities.

transferred to or received by the other party, subject to a contractual obligation to return equivalent securities.

(b) *On what basis do your member firms rely on credit support and netting rights under securities financing transactions in the event of default, insolvency or bankruptcy of the counterparty? Explain generally how this varies depending on the type of counterparty or transaction and credit support holding mechanism given that different counterparties, transactions and credit support holding mechanisms may have different treatment in insolvency proceedings.*

A number of legal considerations inform our member firms' reliance on credit support and netting rights in securities financing transactions documented under the standard agreements described above.

A member firm's willingness to engage in securities financing transactions with a particular counterparty and the terms of such transactions depend in large measure on the firm's risk management systems and protocols. Indeed, legal certainty in insolvency is best addressed in the context of a firm's overall risk management controls. In particular, credit professionals "risk manage" the counterparty relationship by using tools to effectively reduce the risk that firms will have to test the enforceability of netting rights and credit support arrangements upon counterparty default or insolvency. Such tools may include any or all of the following:

- managing the structure and tenor of trades;
- utilizing mark-to-market arrangements;
- contractual rights that reduce exposure at default;
- incorporating early warning triggers that give the non-defaulting party the right to exercise its remedies; and
- robust internal systems and processes for tracking risk and predicting problem situations.

It is no coincidence that financial institutions have historically not incurred material credit losses as a result of a substantial impairment of their netting or collateral rights – notwithstanding the variety of counterparty types and jurisdictions.⁹

In addition, as a component in a broader risk management practice, members evaluate their ability to rely on netting rights and rights to promptly close out (including through liquidation of

⁹ TBMA, SIA and the Risk Management Association recently completed a joint survey of U.S. regulated financial institutions' repo, margin and securities lending activity, in which reporting firms indicated that, despite the estimated size of the combined market (almost \$5.5 trillion outstanding with U.S. counterparties, and almost \$9.2 trillion considering also non-U.S. counterparties), they have had no material losses since 1990 as a result of the substantial impairment of netting or collateral rights.

credit support) upon the counterparty's insolvency, bankruptcy or other default, taking into account various insolvency regimes. For legal comfort on such issues, our members have access to internal information and advice, individually obtained legal opinions from external counsel, or industry standard legal opinions procured by the industry associations that cover the industry standard agreements. Among the last group are industry standard opinions for the GMRA, GMSLA and ISDA Master Agreement and CSA. (The TMBA is in the process of procuring such opinions for the MRA and MSLA as well.)

Reliance on netting and credit support rights can never be all encompassing, however, because counterparty types present varying levels of legal risk depending on the insolvency regime to which they are subject. For example, even among U.S. counterparty types, the rules that govern insolvency are diverse. For some U.S. counterparty types, such as ordinary U.S. Bankruptcy Code debtors, broker-dealers and federally-insured banks, the applicable insolvency regimes clearly protect the non-defaulting party's exercise of rights under many securities financing transactions, including in the event of counterparty insolvency. Enforceability of such rights is less certain with other U.S. counterparty types that are regulated at the state level, like insurance companies. Finally, with the last category of U.S. counterparties – pension funds, municipalities, government-sponsored entities, and multilateral institutions – as well as sovereigns, central banks and non-U.S. multilateral institutions, it is unclear what laws would apply in the event of their insolvency. Nevertheless, our members are comfortable entering into securities financing transactions with this last category of counterparties because the risk that such a counterparty would become insolvent or bankrupt is generally considered negligible, and the risk management tools noted above significantly mitigate the impact of these legal issues. In addition, in many cases, risk of loss is further mitigated because the claims of dealers, as creditors, are superior to those of most other claimants, including pension plan beneficiaries and mutual fund shareholders as well as other subordinate claimholders.

Credit support taking or holding presents the spectrum of risks described above in response (a)(iv). Deliver-out arrangements pose the least risk to the credit support recipient, as they enable it to access the credit support in advance of any counterparty insolvency or bankruptcy, and hold-in-custody arrangements present the most risk to the credit support recipient and the least risk to the credit support provider.

(c) *On what basis do your member firms believe that they will be able to identify and recover assets held for them in the event of default, insolvency or bankruptcy of the custodian?*

Once again, a number of legal considerations provide the basis for members' comfort in their arrangements with custodians. The basis on which member firms believe they will be able to identify and recover assets depends on the nature of the agreement with the custodian, the types of securities involved, and due diligence on the custodian's operations. Generally, standard custodial agreements require that the custodian not commingle the parties' assets with its own. Also, under U.S. federal and state law as under most other laws, segregated custodial property is generally not available to a custodian's general creditors in the event of its insolvency or bankruptcy.

(d) *Do your member firms enter into cross-product netting agreements to mitigate counterparty credit risk for securities financing transactions? If so, describe the types of netting agreements that evidence these arrangements – specifically, are they custom agreements or industry standard agreements, such as The Bond Market Association’s CPMA and ISDA’s 2001 Cross Agreement Bridge, and if the latter, do they typically include significant amendments to the industry standard? On what basis do your members determine whether those arrangements mitigate credit risk?*

Members typically use house standard combination cross-product netting and cross-margining master agreements. Such agreements operate much like the TBMA Cross Product Master Agreement, and similarly provide for cross default and the granting of security interests.

Cross-Product and Cross-Affiliate Netting Arrangements under TBMA’s CPMA

TBMA has published two versions of a Cross Product Master Agreement, “CPMA 1” and “CPMA 2”, to enable cross product netting and margining including among different types of securities financing transactions. The difference between the two versions is that CPMA 2 also provides for cross-affiliate netting. Generally, both CPMA 1 and 2 are “master-master” agreements covering other master agreements, including TBMA-sponsored agreements as well as other master agreements, like the ISDA Master Agreement. The two umbrella agreements provide standard terms to govern parties’ rights to close out the covered agreements and set off their obligations under those agreements. The cross-product agreements provide for cross default among the covered agreements and facilitate the reduction in documentation basis risk.

The CPMA 1 neither replaces nor combines the underlying agreements, but simply places the close-out mechanics of the CPMA 1 between the parties “on top” of the covered agreements. This approach has the advantage of not significantly interfering with the operational procedures or the close-out and valuation provisions of a covered agreement. In addition, the approach minimizes the insolvency, regulatory and tax implications.

Similar to the other master agreements published by TBMA, both versions of the CPMA enable the parties to modify the standard terms by means of a Schedule. However, like the Schedules under the ISDA Master Agreement, the CPMA Schedules require the parties to make certain decisions, such as whether English or New York law governs their agreement and whether certain standardized optional provisions are included, while also allowing them to insert any additional negotiated terms and conditions. Even where parties do not use CPMA 1 or 2, they have found them to be useful resources in drafting their own cross-product netting agreements.

Our members’ determinations as to whether such arrangements mitigate credit risk depend on a number of legal considerations similar to those discussed above: in-house advice, general and counterparty-specific external advice and legal opinions, and industry legal opinions as to the enforceability of CPMA 1 and 2.

Other considerations that inform our members’ reliance on cross product netting arrangements include the availability of cross collateralization and cross-margining that function to mitigate potential exposure at default, the fact that the underlying transactions often require the creation of a first priority ownership or perfected security interest in any credit support, and the

incorporation of credit triggers, which minimize the likelihood that these credit support arrangements will be tested in insolvency proceedings.

Cross-Product Netting Arrangements under ISDA's Bridge

ISDA published the ISDA Cross-Agreement Bridge (the "Bridge") in 2001. The Bridge is designed to permit parties to an ISDA Master Agreement to achieve cross-product netting. The Bridge facilitates this objective by allowing, in certain circumstances, the termination of transactions documented under other industry-standard agreements ("Bridged Agreements") and incorporating the net close-out amounts calculated in respect of those transactions within the close-out provisions of the ISDA Master Agreement.

Parties that wish to use the Bridge are required to incorporate the Bridge in the Schedule to an ISDA Master Agreement. A key element of the bridging mechanism is a cross-default feature under which some or all of the Events of Default under the ISDA Master Agreement constitute Bridging Events (as defined by the parties in the Bridge). If a Bridging Event occurs, an event of default (however such concept is described) under each Bridged Agreement occurs.

The result is that the parties' delivery and payment obligations in respect of the Bridged Agreements are accelerated, terminated or cancelled, as the case may be, in accordance with the provisions of the Bridged Agreements. In addition, all amounts due or which otherwise would become due under Bridged Agreements will be deemed to have been amounts due under Section 2(a)(i) of the ISDA Master Agreement on the Early Termination Date that was designated or that occurred under the ISDA Master Agreement.

The approach taken by the Bridge keeps the agreements between the parties essentially separate from each other and simply places the close-out mechanics of the ISDA Master Agreement between the parties "on top" of the specified Bridged Agreements if a Bridging Event is triggered. This approach has the advantage of not significantly interfering with the operational procedures or the close-out and valuation provisions of a Bridged Agreement. In addition, the approach minimizes the insolvency, regulatory and tax implications.

ISDA has obtained legal advice from its netting counsel stating generally that the use of the Bridge with various master agreements would not affect the conclusions reached by counsel in their annual netting opinion on the ISDA Master Agreement.

The Associations appreciate the opportunity to respond to your questions on the treatment of counterparty credit risk, and look forward to continuing our dialogue. We are happy to provide further information. If you have any questions, please do not hesitate to contact either of the signatories below.

Yours sincerely,



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