Maria-Teresa Fabregas,
Head of Unit
Financial Markets Infrastructure (C2)
DG FISMA
European Commission

28 April 2016

Re: Final Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP ("Final Draft RTS")

REQUEST FOR AMENDMENT OF FINAL DRAFT RTS ON MARGIN REQUIREMENTS FOR UNCLEARED SWAPS

Dear Mrs. Fabregas,

The members of the International Swaps and Derivatives Association1 ("ISDA") are in the process of implementing the margin rules for uncleared swaps. In light of this implementation, ISDA requests amendment of the Final Draft RTS as described below.

ISDA will be writing to the European Commission separately regarding the issue of settlement timing for Variation Margin for firms that are outside the scope of mandatory Initial Margin requirements, an issue on which market participants have significant concerns.

1) Non-EU Custodians – Article 23(d)(i)

Proposal:

Article 23(d)(i) should be changed so that cash accounts for initial margin ("IM") may be maintained at custodians that are non-EU banks. We propose the following amendments (altered text is in bold and underlined):

(d) that cash accounts for initial margin are maintained at central banks or credit institutions which fulfil both of the following conditions:

---

1 Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s web site: www.isda.org.
(i) they are authorized in accordance with Directive 2013/36/EU or they are undertakings, including their branches, which, were they established in the Union, would fulfil the definition of the term "credit institution" and have been authorized in a third country that applies prudential and supervisory requirements at least equivalent to those applied in the Union:

(ii) they are neither the posting nor the collecting counterparties.

Discussion:

As currently drafted, the requirement under Article 23(d)(i) provides that cash accounts for IM may only be maintained at central banks or credit institutions that are authorized in accordance with Regulation (EU) No 575/2013 (the Capital Requirements Regulation, or "CRR").

The CRR only sets out rules concerning prudential requirements for institutions supervised under Directive 2013/36/EU ("CRD IV"), i.e. EU incorporated and authorized credit institutions (and investment firms). The CRR does not require authorization of credit institutions. However, even if the reference to CRR was read as a reference to CRD IV, the reference to credit institutions "authorized in accordance with [CRD IV]" would only cover EU incorporated credit institutions. This reference appears to prohibit counterparties that collect collateral in compliance with the Final Draft RTS from maintaining cash accounts for IM with non-EU banks, including EU branches of non-EU banks.

Due to the global reach of Regulation (EU) No 648/2012 ("EMIR") and the Final Draft RTS, such a narrow restriction is not practical and would be disruptive to global markets. The Final Draft RTS can apply to transactions between an EU counterparty and a third country counterparty and there is no reason to prevent the use of a custodian in the jurisdiction of the third country counterparty. Moreover, there is no reason to prohibit EU branches of non-EU banks from providing cash IM accounts.

We propose amending Article 23(d)(i) so that cash accounts for IM may be maintained with EU or non-EU credit institutions (including EU branches of non-EU credit institutions) where the non-EU credit institution is authorized in its home jurisdiction and subject to regulation equivalent to that which applies to EU credit institutions. Under our proposal, the determination of whether the non-EU credit institution meets the necessary requirements would be made by the parties. This proposal is consistent with the risk mitigation goals of EMIR and the Final Draft RTS as a whole. On p. 7, the Executive Summary of the Final Draft RTS states that the Final Draft RTS allow for alternative arrangements such as posting collateral to international custodians as acceptable in certain circumstances. Further, other margin requirements such as the use of a model for assessment of credit quality accept the use of a third country counterparty's approved internal model "where the third country counterparty is subject to laws applying prudential supervisory and regulatory requirements equivalent to those applied in the Union …" (Article 24(1)(b)).

Finally, the proposal above is consistent with the approach taken to third country credit institutions elsewhere in CRR. For example, CRR allows EU banks to treat exposures to a third country credit institution in the same manner as exposures to an EU credit institution (e.g. for the purposes of risk weighting the exposure under the standardized approach) if the relevant third country "applies
prudential supervisory and regulatory requirements to that entity that are at least equivalent to those applied in the Union" (CRR Article 107(3)). The proposed language is similar to the language used in Article 391 of the CRR.

2) Non-Netting Jurisdictions

Proposal:

Article 11(2)(b) should be deleted.

Discussion:

Under Article 11(2), counterparties entering into OTC derivative contracts with third country counterparties located in certain jurisdictions need not collect or post IM if certain conditions are met. The first condition, in Article 11(2)(a), is that the third country counterparty is domiciled in a jurisdiction which meets the legal review condition in Paragraph 4 (the "Paragraph 4 Condition"). This condition is that a legal review either: (a) does not confirm that bilateral netting arrangements in the jurisdiction can be enforced with certainty at all times or (b) confirms that the segregation arrangements with a third country counterparty could not meet the requirements under the Final Draft RTS. Article 11(2)(b) adds a second condition that these Paragraph 4 legal reviews must conclude that collecting collateral in accordance with the Final Draft RTS is not possible.

It is not clear what is intended by Article 11(2)(b) nor what it adds to Article 11(2)(a). The Paragraph 4 legal reviews are about netting and segregation, not whether collecting collateral is possible. Moreover, it is not clear what additional requirements are intended to be addressed by "collecting collateral in accordance with this Regulation". Therefore, Article 11(2)(b) does not seem to be a necessary additional requirement, is in any case very unclear and should be deleted.

3) 2.5% Threshold Regarding Trading with Counterparties in Non-Netting Jurisdictions

Proposal:

Increase the Article 11(3) ratio from 2.5% to 5%.

Discussion:

Under Article 11(2), counterparties entering into OTC derivative contracts with third country counterparties located in certain jurisdictions need not collect or post IM if certain conditions are met. The third condition, in Article 11(2)(c), is that the ratio calculated in accordance with Article 11(3) should be lower than 2.5%. The Article 11(3) ratio is: (a) the notional outstanding amounts of the OTC derivative contracts of the group to which the EU counterparty belongs, for which no margin is collected for all the counterparties in jurisdictions meeting the Paragraph 4 Condition, divided by (b) the notional outstanding amount for all the OTC derivative contracts of the group to which it belongs, excluding intragroup transactions.

We propose that the ratio should be increased to 5%. This proposal reflects the need for a proportionate yet workable approach that echoes the level and type of exposures of EU entities to
counterparties in non-netting jurisdictions, while also ensuring EU financial institutions can continue to access these key growth markets.

The threshold of 5% would be set at a high enough level to accommodate the difference in the relative size of banks’ balance sheets, while also being low enough not to lead to an imprudent level of risk taking by EU institutions. In the case of prudentially regulated firms such as banks, this risk is already subject to capital requirements, with exposures calculated on a gross basis.

Furthermore, many of the derivative contracts with counterparties in non-netting jurisdictions are likely to be short-dated and liquid foreign exchange ("FX") derivatives. This reflects the greater relevance of exchange rate risk and the real need for FX risk management for many emerging market economies, including non-netting jurisdictions such as China or the Middle East. As noted in the BIS Quarterly Review from December 2013, 2 FX derivatives account for over half of total daily turnover in emerging markets economies. Restricting the ability of these counterparties to trade FX derivatives may unintentionally lead to more risk in the system as counterparties stop hedging their FX exposures. This is precisely the opposite of the desired outcome.

4) Intragroup Exemption – Timing of Application/Notification – Article 35(11)

Proposal:

Article 35(11) should not require that all applications or notifications for intragroup exemptions must be submitted before a specified deadline.

Discussion:

Article 35(11) states that the applications and notifications for intragroup exemptions must be submitted on the latest of: (a) the date of entry into force of the Final Draft RTS; or (b) six months before the date of application of the VM requirements for the relevant counterparty, as referred to in Article 39(5).

As drafted, Article 35(11) potentially prohibits any application or notification after the dates specified. This deadline could occur as soon as 1 September 2016 for certain counterparties. Nothing in Article 11(6)-(10) of EMIR, which set out the process for intragroup exemptions, suggests that parties will only be permitted to make applications before a specified date. The intention of these articles of EMIR appears to be that the applications and notifications may be submitted when the parties are seeking an exemption.

Such a deadline for all applications would be very harmful to the market. It will not be possible for a counterparty to determine, as of the deadline, all intragroup entities that it may transact with in the future. If no application or notification can be submitted after the deadline, no exemption will be available for transactions with new affiliates or affiliates that did not previously enter into swaps.

---

We therefore suggest that the timeline in Article 35(11) should be an opening date for the submission of applications and notifications, rather than a single, final deadline.

5) Intragroup Deferral – Requirements of Articles 35-38 – Article 39(8) and (9)

Proposal:

No application should be required in order for a party to qualify for the deferral of the intragroup margin requirements under Article 39(8) and (9).

Discussion:

Article 39(8) and (9) provide for a deferral of certain intragroup margin requirements if, among other conditions, the requirements of Articles 35, 36, 37 and 38 are met.

Article 35 sets out procedural requirements for the submission of an application or notification requesting an intragroup exemption. The requirements of Article 35 only apply if such an application or notification is submitted. In addition, requiring an application will pose timing issues because, as discussed above, such an application would have to be submitted as early as 1 September 2016.

As a result, we believe that the Article 39(9) reference to meeting "the requirements of Article 35" should not be interpreted to mean that an application/notification is required. Instead, it should be interpreted to mean that if an application or notification is submitted, the parties must comply with the Article 35 procedural requirements.

6) Foreign Exchange Forwards and Swaps – Exemption from VM Requirements

Proposal: Physically settled FX swaps and forwards should be exempt from VM requirements.

Discussion: Physically settled FX swaps and forwards, as defined in the Final Draft RTS, are exempt from IM but not from VM, although the VM requirements for physically settled FX forwards apply at a different time than other VM requirements (Articles 7, 39(6)).

Physically settled FX swaps and forwards should be entirely exempt from the VM requirements in order to ensure consistency with the rules in other jurisdictions and because the applicable risks are addressed by supervisory guidance. Physically-settled FX swaps and forwards are exempt from the margin rules in all other jurisdictions that have adopted final rules under the BCBS-IOSCO framework: the US, Japan, Switzerland and Canada. Treating physically settled FX swaps and forwards differently under the EU rules would result in significant operational

---

3 Treasury Determination 77 FR 69694.
4 Financial Instruments and Exchange Act Article 2.22.
5 Financial Markets Infrastructure Ordinance Articles 2, 84, 100; Financial Markets Infrastructure Act Articles 107, 110.
difficulties for market participants who must comply with multiple sets of rules. It would also place EU institutions at a comparative disadvantage.

We recognize that the BCBS has issued supervisory guidance stating that banks should exchange VM for FX swaps and forwards with certain counterparties.\(^7\) However, compliance with supervisory guidance is not identical to compliance with margin rules: supervisory guidance does not have the same level of detail, it may apply only to banks, and may be interpreted in different ways for different countries. As a result, there is a significant difference for ISDA members between implementing margin rules and implementing supervisory guidance. Other jurisdictions, by excluding physically settled FX swaps and forwards from the margin rules, have implicitly recognized that the relevant risks are sufficiently addressed by supervisory guidance.

In particular:

- for parties other than banks, there is extremely limited risk associated with using physically settled FX swaps and forwards for hedging purposes ("FX Hedging") due to the short dated nature of the hedging; and

- imposing VM requirements restricts FX Hedging for many low-risk entities.

If, notwithstanding the discussion above, the EU elects to retain the physically settled FX forwards and swaps requirements in the margin rule, we suggest that the margin rule be modified in one of two ways:

- by only requiring VM on physically settled FX swaps and forwards between counterparties who are in-scope for IM; or

- by providing a carve-out for counterparties who only use physically settled FX swaps and forwards for hedging purposes.

7) Foreign Exchange Forwards and Swaps – Transition Period – Article 39(6)

Proposal:

The application of VM requirements for physically settled FX forwards should apply on the earlier of the following dates:

a) the date of application of Regulation 600/2014 on markets in financial instruments; and

b) 31 December 2018.

This deferral should also apply to physically settled FX swaps.

Discussion:

\(^7\) BCBS, "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" (Feb. 2013), Guideline 3: Replacement cost risk.
Article 39(6) provides that VM requirements for physically settled FX forwards will not apply until the earlier of (1) 31 December 2018 or (2) the entry into force of the Commission Delegated Act referred to in Article 4(2) of Directive 2014/65/EU ("MiFID II") related to the definition of financial instruments with regard to physically settled FX forwards.

The Commission has adopted a delegated act on this subject under MiFID II. This Commission Delegated Act states that it will enter into force on the 20th day following publication in the Official Journal. It is likely that this will be before 1 September 2016.

Providing that the VM requirement becomes effective upon entry into force of the Commission Delegated Act would give market participants little time to respond to the new definition and implement the resulting margin requirements. In order to ensure that market participants have sufficient time to understand the new definition (and that the Commission and ESMA have sufficient time to address any questions regarding the new definition, to ensure that it is implemented consistently across the EU) we propose that the VM requirement for physically settled FX forwards should be delayed for a longer period.

Since the Commission Delegated Act setting out the harmonized definition is intended to interpret terms used in MiFID II and Regulation 600/2014 ("MiFIR"), we suggest that it would be appropriate for the VM requirement for physically settled FX forwards to apply from the date on which MiFIR and national law implementing MiFID II apply.

If Article 39(6) is not amended as requested above, and if the Commission Delegated Act enters into force before 1 September 2016, we interpret the Final Draft RTS such that it does not impose VM requirements before 1 September 2016. In the "Background and rationale" section of the Final Draft RTS, the ESAs describe Article 39(6) as a "delayed application" and as a "postponement" of the VM requirements. As a result, we believe that Article 39(6) will not accelerate the VM requirements to a date earlier than 1 September 2016.

Finally, we also propose that the Article 39(6) deferral as modified should apply to physically settled FX swaps as well as to physically settled FX forwards. An FX swap is economically equivalent to an FX spot combined with an FX forward and during the deferral period neither the FX spot (which is not considered a derivative contract) nor the physically settled FX forward will be subject to VM requirements. There is therefore no reason for a physically settled FX swap to be subject to these requirements during such period.

* * *

Please feel free to contact me at your convenience.

Yours sincerely,

Scott O’Malia
CEO