**ISDA Response to the Consultation Document
On the Review of the Central Clearing Framework in the EU**

Executive Summary

ISDA welcomes the opportunity to thank the European Commission (the Commission) for the dialogue-based approach it has taken so far on the topic of the central clearing framework in the EU and also the Commission's open-mindedness and willingness to listen to and consider industry concerns in their decision making. ISDA encourages the Commission to continue along this path and stands ready to discuss these issues with the Commission.

ISDA members do not agree with the Commission's assessment that the use of Tier 2 CCPs, including those located in the UK, is a source of unmitigated financial stability risk for the EU, given that EMIR and EMIR2.2 are sufficiently robust to ensure safe clearing. In this light, we believe that any measures that force clearing participants (clearing members and their clients) to use certain CCPs will be damaging to the overall derivatives market including the Capital Markets Union (CMU), clearing participants and end-users, especially those in the EU.

Clearing participants should be free to choose where to clear, based on commercial and risk considerations. EU markets will be the most attractive to investors and market participants where they are open, innovative, dynamic and responsive. It is important that EU derivatives regulation acknowledges the global nature of the derivatives market and seeks to foster open markets with international jurisdictions based on the key principles of deference, as well as supervisory and regulatory cooperation.

We welcome that the Commission has identified positive measures in its consultation paper, that would make clearing in the EU truly more attractive. We ask the Commission to focus on these measures.

We propose that the Commission should consider a wider review how financial regulation in the EU could be aligned and streamlined, for instance in the areas of MiFID, UCITS and the link between recognition and the qualifying status in the Capital Requirements Regulation (CRR).

Introduction

In ISDA's view, EMIR 2.2 provides robust tools for ESMA to supervise Tier 2 CCPs appropriately, with potential enhancements to supervisory cooperation in crisis times. As a result, we do not agree with the general premise that the use of Tier 2 CCPs, including those located in the UK, is a source of unmitigated financial stability risk for the EU. We note that upwards of 90% USD interest rate swaps (IRS) are cleared at SwapClear, without concerns on the part of US regulators.

We welcome that the Commission identified measures that are intended to make clearing in the EU more attractive, like:

- Encourage EU CCPs to offer all EU denominated currencies and increase their product offerings to reflect those offered by third country CCPs, including focusing on increasing liquidity in global cleared currencies.
- EU CCPs to build out operational resiliency to be able to risk manage larger pools of derivatives.
- EU CCPs developing their post-trade compression services by working with vendors as well as market participants.

We welcome the focus of the Commission, as set out in its Newsroom article on the CMU[1] that "*measures to make Europe an attractive, competitive and cost-efficient clearing hub should help drive an expansion of central clearing activities in the EU.*"

However, we note that most of the measures outlined in the consultation would negatively affect EU firms and the attractiveness of EU markets to some degree. These disadvantages for EU firms compared to third-country firms would be to the detriment of the EU's goal of fostering more dynamic financial markets in the EU and could increase reliance on third-country firms, which would be contrary to the Commission's overall objective to develop a stronger EU capital market.

Contrary to supporting the CMU, such measures would hinder progress towards realisation of the CMU by fragmenting the EU derivatives market. The EU should instead incentivize as many firms as possible to support the goals of the CMU and be active in the EU capital markets, wherever they are located and wherever they decide to clear. Progressing work on the CMU and fostering vibrant markets in the EU would potentially also contribute to enticing firms to clear in the EU.

In our view, EU markets will be the most attractive to investors and market participants where they are open, dynamic and responsive. In this way, it is important that EU derivatives regulation acknowledges the global nature of the derivatives market and seeks to foster open markets with international jurisdictions based on the key principles of deference, as well as supervisory and regulatory cooperation.

[1] https://ec.europa.eu/newsroom/fisma/items/738334/en

If the Commission chooses to enact measures that would reduce the choice of clearing locations available to EU market participants, it would risk reducing competition in the EU clearing market. This would need to be mitigated by strong protections to ensure users are subject to fair, reasonable and equitable terms by the CCPs involved.

We are concerned that any decision to place restrictions or additional regulation in certain areas or for certain products could have wide repercussions. Many clearing participants decide on the clearing location based on their overall product and currency mix. Should the Commission decide to implement measures that affect euro-denominated products, the impact of such measures would potentially extend to the whole cleared portfolio of such firms, the result of which, may be that that such firms would lose cross-currency netting benefits across the entire portfolio. In other words, the practical impact of any measures would not remain limited to euro-denominated derivatives, even if that it is the Commission's intended focus area.

We would also highlight that increasing the attractiveness of EU capital markets in general should act as an incentive for globally active participants to choose to do business in the EU. In this light we draw the attention of the Commission to other areas of EU financial regulation which have the potential to increase the attractiveness of the EU as a capital markets hub through streamlining rules, including MiFID, and UCITS, as well as the link between recognition and CCP qualifying status under CRR.

As another example, European clearing members are concerned that several third country CCPs which they access via subsidiaries will have to be treated as non-qualifying CCPs because of unintended consequences in regulation that go far beyond euro-denominated products.

In addition, while the consultation identifies Tier 2 CCPs or clearing services as systemically important for the EU or an EU member state, for many of the proposed measures it is unclear what the scope in terms of products or currencies would be.

As to the proposals to review European CCP regulation, while it is always commendable to seek improvements, EMIR and EMIR 2.2 already provide a solid foundation for CCP regulation and are not considered a disincentive for clearing in the EU (quite the contrary).

We did not respond to each question in the questionnaire, because many questions are better addressed by individual firms and because of the short time available for responding to this consultation.

Responses to questions

Due to the short time for providing the response, we have decided to focus on assessing each of the proposed tools (along question 1.1 on page 8).

EFFECTIVENESS OF PROPOSED TOOLS

Below, we provide rankings which of the proposed measures are the most effective in ISDA members' view in contributing to the objectives of:

- enhancing the attractiveness of clearing at EU CCPs.
- have a positive impact on the market in general and supports the CMU.
- does not affect the competitive position of European firms and adds cost for European end users.

We organise the proposed measures in the following groups:

- Measures that are market led and promote EU CCP capacity.
- Measures that incentivise clearing on a EU CCP.
- Measures that add costs to EU firms when clearing on a Tier 2 CCP.
- Measures that force clearing to an EU CCP and are market disruptive.

Please note that these rankings cannot fully reflect the complexities of these measures and their impact on the derivatives market, the CMU and on market actors inside and outside the EU. We have added comments on the selected rating if required. For more context we refer to the detailed assessment of each measure further below.

<u>Measures that are market led and promote EU CCP capacity</u>

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
Measures to expand the services by EU CCPs		2				
Enhancing funding and liquidity management conditions	1					A central bank liquidity backstop, especially for PSAs would be very supportive for EU clearing markets.

Measures that incentivise clearing on a EU CCP

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
Broadening the scope of clearing participants (public authorities)	1					Due to the liquidity provided and the signaling effect.
Hedge accounting rules		2				
Use of post-trade risk reduction services		2				
Payment and settlement arrangements for central clearing	1					
Segregated default funds				4		
Interopera-bility				4		

Measures that add costs to EU firms when clearing on a Tier 2 CCP

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
Broadening the scope of clearing				4		Participation of EU clients needs to be voluntary, as they would otherwise be

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
participants (clients)						disadvantaged compared to their global peers. EMIR Refit already reduced the scope of the clearing obligation for smaller firms as not deemed proportionate. Expanding the clearing obligation scope would add costs and complexity for smaller firms and could act as disincentive to hedge.
Higher capital requirements in CRR for exposures to Tier 2 CCPs				4		
Macroprudential tools						Unclear what exact tools are proposed.

Measures that force clearing to an EU CCP and are market disruptive

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
Exposure reduction targets toward specific Tier 2 CCPs				4		Rating depends on what sanctions are planned if targets are missed.

	1 (very effective)	2 (rather effective)	3 (neutral)	4 (rather not effective)	5 (not effective)	Comment
Active account with an EU CCP				4		
Obligation to clear in the EU					5	
Fair, reasonable, non-discriminatory and transparent (FRANDT) commercial terms for clearing services					5	Might reduce client clearing capacity in the EU.
Broadening the scope of clearing participants (PSA)				4		this rating reflects the importance of a solution to the PSAs' liquidity issue (detailed below) that is required before a clearing obligation should be put in place.

SCOPE OF CLEARING PARTICIPANTS AND PRODUCTS CLEARED

<u>Broadening the scope of clearing participants</u>

We agree that it is a worthwhile objective to encourage more entities to clear in the EU, as long as this decision is voluntary and driven by the business needs of these entities. We will break down this assessment by the three constituents proposed further down in the consultation.

Section 1a: Clearing obligation for Pension Scheme Arrangements (PSAs)

As identified in Section 1a of the consultation, after the expiration of the PSA exemption from the clearing obligation in June 2023[2], PSAs will be required to clear derivatives subject to the clearing obligation under EMIR. ISDA believes that the expiration of this exemption may naturally lead to an increase in clearing activity at EU CCPs. In addition to the expiration of the clearing obligation for PSAs, the next phases of uncleared margin requirements may also naturally create an additional incentive for many PSAs to clear.

PSAs are less likely to hold multi-currency portfolios than other types of market participants and might therefore be less negatively affected by the absence of cross-currency netting if they decided to clear their euro-denominated portfolios at EU CCPs. However, we wish to point out that this will not be the case for all PSAs and in addition not all PSAs will be required to clear, as many PSAs will be small financial counterparties (SFCs) with a derivative portfolio below the clearing threshold. We also believe that PSAs, like all end-investors, should have the choice to clear at a CCP that works best for their individual investment strategy.

We recommend that the Commission analyses which PSAs will fall under the clearing mandate and review which CCPs are used by PSAs that currently clear on a voluntary basis to confirm this assumption.

PSAs often have very large and directional portfolios, which could be challenging to port and to close out during a default of the PSA's clearing member. They will therefore require significant capacity of client clearing service providers, in a situation where the number of such providers is already fairly small.[3]. In 2018, Pensions Europe and ISDA published the study 'Potential demand for clearing by EU Pension Funds'[4], which stated that "*In particular, we broadly estimate that once European pension funds start to clear, the initial margin held by central counterparties could increase to c.EUR85bn over a number of years (or a full range of c.EUR58 to c.EUR111bn depending on varying assumptions). This is a significant increase: globally, CCPs currently hold c.EUR130bn of IM for interest rate swaps, of which only c.EUR77bn correspond to client-cleared trades.*"

We also believe that the issues with the prompt availability of cash for variation margin (VM) calls that led to the exemption from clearing for PSAs have not been solved yet. The key challenge for PSAs is the lack of robust long-term solutions to address the cash VM issue: pension funds must ensure they hold enough cash, or are able to generate enough cash, to meet VM calls. In stressed situations, this leads to an increase in volatility even for high-quality liquid assets (HQLA) as pension funds seek to convert these into cash.

[2] Assuming the PSA exemption is extended for a further year until 18 June 2023.

[3] One large client clearing service provider has recently decided to leave the client clearing market.

[4] https://www.pensionseurope.eu/system/files/Joint%20Paper%20ISDA%20and%20PensionsEurope%20paper%20on%20pension%20fund%20clearing%20demand_0.pdf

We are not convinced that, should a similar crisis to the COVID market crisis of March 2020 happen when all PSAs have to clear, these PSAs will have sufficient access to cash to pay for increased VM. This could become the source of wider market instability. We propose that the Commission should explore ways to solve this issue, for instance through a central bank backstop. In the FIA/ISDA response[5] to ESMA's consultation on clearing solutions for pension scheme arrangements under EMIR[6], FIA and ISDA conclude that "*ISDA and the FIA believe that only a central bank-backed collateral transformation facility would be a credible solution for the cash VM problem as described in ESMA's report to provide additional security.*" There should be an in-depth analysis of how central bank access could be intermediated to allow a last resort solution for PSAs. We are cognizant there is no simple answer to this and how it would work in practice requires more consultation.

We believe, however, that such a facility would be a strong incentive to clear at EU CCPs.

Based on PSA managers' experiences, the pressure for cash VM may be exacerbated by requests for PSAs to post cash for non-cleared derivatives. It is therefore important to ensure there is an appropriate calibration between non-cleared and cleared requirements. For example, PSAs are not going to be able to clear if they do not have a range of options available for generating cash for VM calls.

Sponsored access models in clearing for repos might be helpful here to some extent, although they remain at a nascent stage and still require repo counterparties to be readily available. As noted by CPMI/IOSCO (in a wider context) in their "Discussion paper on client clearing: access and portability"[7], these models are also mostly suitable for PSAs that are sufficiently large to satisfy rulebook criteria for direct access to the CCP. PSA managers also ask for these models to be made simpler to use.

We note that even a large PSA would not be able to become a sponsored member without another intermediary such as an asset manager or agency broker, due to a PSA not having the operational infrastructure to manage post-trade processes.

Direct access clearing models do not address the cash VM issue directly, which is still the primary obstacle preventing pension funds voluntarily clearing in large volumes. Sponsored access models will help only indirectly - for instance repo clearing might remove some obstacles for PSAs to transform their collateral.

While we support development of sponsored repo clearing models, at present PSAs cannot rely on this model alone to provide cash in a stressed environment: the model is still reliant on an agent sponsoring the repo trades, there are very few clearing members that are also

[5] https://www.isda.org/2020/06/16/fia-and-isda-respond-to-esma-consultation-clearing-solutions-for-pension-scheme-arrangements/
[6] https://www.esma.europa.eu/press-news/esma-news/esma-consults-clearing-solutions-pension-scheme-arrangements-under-emir
[7] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD691.pdf

sponsored agents and, as mentioned above, it is mostly suitable for large PSAs. In addition, the sponsored model has not been really tested by buyside entities.

ESMA concluded in its letter to the Commission[8] that PSAs are, to a large extent, operationally ready to clear their OTC derivatives". However, as mentioned above, the key issue is not operational, but the access to collateral transformation services (see above).

Section 1b: More clearing by private entities that do not access CCPs directly

It is worthwhile to explore how private entity clients could be incentivised to clear at EU CCPs. This information can be used to identify any initiatives to make EU CCPs more attractive or to remove any obstacles to clearing at such CCPs currently.

We believe that all market participants, including clients, should be able to choose where to clear, driven by their own business requirements and risk preferences.

While sponsored clearing access models could be helpful for certain client types, the model is still relatively new and usually employed by larger and more sophisticated clients. One of the reasons for this is that CCPs must not weaken their membership criteria, which will restrict the number and types of clients who would be able to use such models. Smaller firms could also struggle with the increased operational requirements. We also refer to ISDA's response[9] to CPMI/IOSCO's "A discussion paper on client clearing: access and portability"[10].

A true and positive incentive to clear in Europe for clients and even clearing members would be if there were a central bank backed collateral transformation service that would allow firms to convert high quality collateral into cash for VM calls, at least as a backstop in emergency situations. (Please see above under the response to section 1a: Clearing obligation for Pension Scheme Arrangements)

Section 1c: Encourage clearing by public entities

The consultation considers the potential role for public entities in increasing the liquidity pool available at EU CCPs. This measure has previously been proposed by industry. ISDA continues to believe that increased clearing by public entities would help encourage domestic capacity and incentivise an expansion of central clearing activities in the EU.

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[8] https://www.esma.europa.eu/press-news/esma-news/esma-recommends-clearing-obligation-pension-funds-start-in-june-2023#:~:text=ESMA%2C%20following%20its%20assessment%2C%20concludes,PSAs%20from%2019%20June%202023.

[9] https://www.isda.org/2022/02/08/isda-responds-to-cpmi-iosco-on-client-clearing/

[10] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD691.pdf

Clearing by European public entities would also send a clear message of confidence in European CCPs.

Following the 2008 global financial crisis, policymakers and market participants alike have recognized the benefits of central clearing in terms of risk, efficiency and operational ease. These benefits apply to public entities as well as those private sector market participants.

We understand that in some cases public entities are unable to assume liability for default fund contributions. However, public entities are willing to take counterparty risk in the bilateral markets, and – all things considered – default fund risk is merely a different structuring of counterparty risk. Overall risk is reduced, also for public entities. Public entities could also clear as clients or in new direct or sponsored access models.

We note that public entities may be disincentivised to clear because, under EMIR, they are currently exempted not just from clearing but also from regulatory margining of uncleared OTC derivatives. Having to post initial margin could introduce a notable cost for the derivative activities of public entities and this should be weighed against the aforementioned benefits. We therefore propose for public entities to clear voluntarily, not under a clearing obligation.

Section 1d and Section 2a: Broaden the product scope of the clearing obligation

The consultation states that "*In order for EU CCPs to remain competitive internationally, the range of clearing services they provide should be as broad as possible.*" In our view, it is not just the scope of the product offering which is important, but also the liquidity in those products which could contribute to a more competitive position of EU CCPs.

International rules on clearing obligations as implemented under EMIR have so far delivered a fairly uniform range of clearing mandates globally. These rules are linked to objective criteria, like liquidity, standardisation and availability of pricing. Adding business development of EU CCPs to these criteria would run counter to international consensus and might introduce clearing mandates in products where other conditions are not met, which itself would increase financial stability risks.

To question 1, we believe that the range of products currently subject to the clearing obligation is appropriate[11]. The EU is currently broadly in line with other jurisdictions in terms of the clearing obligation scope. We do not believe that there is a sufficient justification for changing the scope of the clearing obligation for the primary purpose of increasing clearing in the EU. We believe decisions about determining the scope of products subject to the CO should still be based on whether a product satisfies the underlying criteria

[11] See also FIA's and ISDA's response to the ESMA discussion paper on clearing thresholds under EMIR that supports the current scope of the clearing obligation: https://www.fia.org/resources/fia-and-isda-submit-response-esma-discussion-paper-clearing-thresholds-under-emir

for determining which products should be in/out of scope (e.g. liquidity, standardisation etc).

Voluntary clearing should be encouraged where it provides benefits to EU market participants, but the clearing obligation should not be expanded if the criteria outlined above have not been met. For example, we note that there are products which are correctly not covered by the clearing obligation, for instance due to liquidity issues with deliverable FX products and the complexities of integrating CLS (especially for client clearing), the lack of standardisation of equity derivatives and unclear default management processes for less liquid rates products like swaptions.

Regarding intragroup transactions, ISDA does not believe that intragroup transactions should count towards the clearing threshold for Non Financial Counterparties (NFCs) under any circumstances. At the moment, intragroup transactions may only be excluded from the calculation if they qualify as hedging transactions under Article 10 of Commission Delegated Regulation No 149/2013.

While Singapore aligned with the EU in including intragroup transactions within the clearing threshold calculation, other major derivatives (such as the US and Australia) jurisdictions do not include intragroup transactions within this calculation.

Intragroup transactions are internal transactions that imply little external counterparty risk.

For further information, we refer to the European Federation of Energy Traders response to the recent ESMA consultation on the review of the clearing thresholds under EMIR[12].

As the Commission is aware, ISDA does not believe that the clearing obligation should apply to intragroup transactions to which EU firms are counterparties. No other jurisdiction applies a clearing mandate to intragroup transactions. ISDA believes that the current time-limited derogation from the clearing obligation (expiring 30 June 2022) for cross-border intragroup transactions should be extended pending revision of EMIR Level 1. Please see our recent letter to the EC in this regard[13].

SECTION 2: MEASURES TOWARDS MARKET PARTICIPANTS

Section 2b: Changing capital rules

ISDA disagrees with the use of capital requirements to incentivize clearing in the EU.

The impact of such measures would only apply to some market participants. For example, many non-banks and corporates would not be subject to them. The effect would also be

[12] https://www.esma.europa.eu/file/122476/download?token=eyE74hd4
[13] https://www.isda.org/a/k0ngE/Industry-Urges-EU-to-Extend-Relief-for-Cross-Border-Intragroup-Transactions.pdf

disparate based on jurisdiction. For example, non-EU firms may not be impacted in the same way as EU participants.

Such capital requirements would also not be in line with Basel rules as Basel does not envisage a regime which implements different capital treatments for Tier 1 vs Tier 2 CCPs, outside of the Qualifying CCP (QCCP) framework.

Instead, it would be better to focus on mechanisms which would provide capital incentives for market participants to clear within the EU. One such approach would be to review and address regulatory or CCP-rule related challenges that prevent CCPs from accepting margin in a bankruptcy remote way. This would create financial incentives for market participants as they would not be required to hold capital against bankruptcy remote initial margin posted on cleared transactions.

As to the design of any such measures, we do not think that operational risk framework scenarios include limitation of access/non-recognition of a third country CCP, or activation of the EMIR 2.2 process under Article 25.2c of EMIR, as we find it very unlikely that banks should reserve capital for financial stability risk created by a regulator in their home jurisdiction.

In terms of measures intended to directly limit “excessive” clearing members’ exposures to a CCP – the term “excessive” is undefined in the consultation. However, we believe that any measures of this nature, such as limits or reduction targets, are unnecessary and could negatively impact market participants. EMIR 2.2 already contains the necessary tools to enhance supervision of third country CCPs, should they be considered a financial stability concern, without resorting to measures which would restrict individual firms’ risk management or business decisions.

Macroprudential tools

We are unclear how macroprudential tools could be applied to incentivise firms to clear in the EU but assume that the comments we made for changes in capital rules will also apply to macroprudential tools.

Section 2c): Set exposure reduction targets

As mentioned elsewhere in this response, we believe that EMIR 2.2 already gives EU regulators the necessary tools to oversee third country CCPs that are considered to be systemic to the EU. As a result, we do not believe that incremental measures related to reduction or limitation of “excessive” exposures is necessary.

We do not think that exposure to non-EU CCPs should be capped or restricted in any other way. As an industry association, we cannot make any statement or "*foster cooperation*" on how such a cap should be sized or work. Any caps or limitations would create significant concerns in terms of limiting market participants' risk management and business decisions and would add costs to EU clients. Additionally, this measure could restrict EU market makers and clearing firms, making them less competitive compared with non-EU firms who do not have the same restrictions.

Any caps could only work on end user/account level and would need to be separately applied in house accounts and client accounts, because client clearing service providers do not decide where a client clears.

Section 2d): Level playing field

As mentioned above, the majority of proposed measures would be disproportionately harmful to EU firms: the consultation states "*non-EU market participants would continue to have access to third-country CCPs for all of their transactions, e.g. for the clearing of euro-denominated OTC derivatives while EU market participants would be restricted to using EU CCPs.*" We predict that this would lead to two different pools of liquidity, with the more liquid pool being outside the EU and higher costs inside the EU.

The most straightforward solution to this issue would be not to enact rules that would disadvantage EU firms by restricting their choices where to clear.

We think the best path forward is to continue to focus on making the EU an attractive place to clear, rather than by requiring firms to clear there through regulation. Any measures that involve regulatory pressure to non-EU firms would have to be considerably extraterritorial in scope and might lead to backlash or even retributive moves from other jurisdictions to re-patriate clearing activity in their national currency, which would further fragment derivatives markets. Another potential outcome of this might be the emergence of significant non-deliverable markets for euro denominated instruments.

Section 2e): Facilitate transfer of contracts from outside the EU

We welcome the creativity in finding measures that would incentivize more clearing in the EU and would welcome proposals that avoid disadvantaging firms that take business or risk decisions to clear activity at non-EU CCPs.

The consultation already acknowledges that the measure might not incentivize clearing per se.

Without changing laws retrospectively, we also do not see how these transactions could be made subject to a clearing obligation, let alone to a clearing obligation at an EU CCP. Should the Commission consider changing the rules retrospectively, it should also consider potential reactions by other jurisdictions. There are also other issues, like for instance non standardised collateral terms which make clearing costly for many trades.

We also believe compression exercises are already required by EMIR for uncleared transactions.

Section 2f): Obligation to clearing in the EU

We do not agree that adding more risk to Tier 2 CCPs should be avoided. These are merely large CCPs, as the thresholds to become a Tier 2 CCP are purely size thresholds.

We strongly object to the proposal that "*a requirement should be imposed on EU participants to fulfil the clearing obligation only at EU CCPs and/or Tier 1 third-country CCPs.*" The consultation already acknowledges that such a move might restrict market choice. We also highlight that such a move would effectively implement requirements akin to a CCP being deemed to be of substantial systemic importance that it should be denied recognition, as it would not allow EU participants to clear the most liquid and high-volume contracts at the Tier 2 CCP. Such a measure, ESMA has concluded would be too costly and too risky for the EU: "*Based on a comprehensive analysis of costs, benefits, and consequences, the assessment concluded that at this point in time the costs of derecognising these clearing services would outweigh the benefits*"[14].

As this would only affect new transactions, in our white paper "The Case for CCP Supervisory Cooperation" [15], we highlight that this would give rise to the concern that while EU firms could keep their legacy portfolios at UK Tier-2 CCPs, they would not be allowed to continue to risk manage these portfolios. From the whitepaper:

- *In this situation, EU participants will not be able to continue to manage portfolios at the legacy CCP due to the restrictions on where they can clear new trades. This could result in increased margin requirements and liquidity strain between the legacy CCP where the legacy portfolio is held and the CCP where new hedges would have to be booked.*
- *The legacy CCP would need clarity over whether it has access to a sufficient breadth of liquidity providers in a given product if certain participants maintain their positions there but are not able to participate in the default management procedure (DMP).*

[14] ESMA's public statement "ESMA concludes Tier 2 CCP assessment under Article 25(2c) of EMIR": https://www.esma.europa.eu/sites/default/files/library/esma91-372-1913_statement_uk_ccp_article25_2c_assessment_2021.pdf

[15] https://www.isda.org/a/8hmEE/The-Case-for-CCP-Supervisory-Cooperation.pdf

- *If EU participants are allowed to add risk-reducing transactions to run down their portfolios at the legacy CCP, their risk management costs would increase. The participants would be unable to make markets and would have to 'cross the spread' each time they add a risk-reducing transaction.*
- *The legacy CCP could be forced to terminate clearing members and their clients that are not allowed to risk manage their portfolios and cannot participate in the DMP. Should the denial of recognition make an exception and allow participation in the DMP, these clearing members would have no incentive to bid as they cannot risk manage the won portfolio at the legacy CCP. The integrity of the legacy CCP would be called into question should some clearing members not be suitably incentivized to bid aggressively in the DMP, because of the difficulty in trading out of the positions.*

Imposing a requirement, which would only allow EU market participants to fulfil the clearing obligation at EU CCPs and/or Tier 1 non-EU CCPs would also not address EU policymakers' objectives as it could lead to the result that clearing activity may simply shift to Tier 1 non-EU CCPs, which will potentially increase their systemic importance, and thus they will also eventually become Tier 2 CCPs.

Section 2g): Active account

Many large ISDA members which are clearing members already keep active accounts at EU CCPs, both for business reasons because they offer access to EU CCPs as a service to clients, and as a risk management measure. Where economically feasible, having access to more than one CCP for a given product increases financial stability by providing redundancy. This is however only feasible for larger entities, as adding a clearing relationship is costly and non-trivial. A requirement for active accounts would therefore not be proportional and affect smaller firms more than larger firms. Also, in addition to losing margin netting benefits by having to split positions across CCPs, there is also the operational burden of maintaining collateral payments on more than one CCPs.

A second issue would arise if the level of activity would be prescribed. This would have to be done at account level as opposed to the clearing member level, as the clearing member has no influence over where its clients clear.

Any requirement for the demonstration of activity on an account should fall upon the account owner, rather than the clearing member. There should also be an exemption for EU market makers.

It would be possible in theory to have a requirement for subsidiaries of international banks to have an active account, as these are firms established in the EU. These measures would disincentivise firms from establishing such subsidiaries, which in turn might have broader, unintended consequences such as reducing competition, limiting market choice and frustrating the achievement of objectives like the CMU that such entities might otherwise help facilitate.

We are also concerned that creating active account requirements does not, in all likelihood, prompt generation of liquidity as such. The cost of maintaining accounts on different CCP could pose too challenging for smaller firms and it may neutralize the benefits gained from trading derivatives.

Section 2h): Hedge accounting

As mentioned above, we welcome all measures that provide real incentives, as opposed to applying regulatory force, to clear in the EU.

Changes to hedge accounting might certainly be helpful at least in some cases, as any type of trade event such as a change of clearing member (CM) or CCP affects the accounting treatment of the trades in question which would be a real concern for clients.

We also believe that alignment of accounting rules and other legal or regulatory frameworks will be helpful for the EU in general, including the CMU.

Section 2i): Transactions reducing from Post Trading Risk Reduction (PTRR)

We do not think that there is an issue with compression within CCPs, regardless of whether they are Tier 2 CCPs or other CCPs. Quite the opposite, the larger a CCP is, the more effective a compression exercise will be.

Multilateral compression in the uncleared space (this includes not only legacy transactions, but also transactions not under the clearing obligation, for instance swaptions) is mostly helpful for counterparty risk reduction in the uncleared space. There could be a requirement for an equal and opposite transaction (on a net basis) to the technical risk reducing transaction that is booked in a CCP. We are very supportive of PTRR and of excluding technical risk reducing transactions from the clearing obligation. While PTRR does work using transactions like swaptions to reduce risk in the uncleared portfolio, it would be easier and more accessible for smaller firms to be able to also use more vanilla transactions like interest rate swaps. These transactions however cannot be used at present as they fall under the clearing obligation.

Inclusion of CCPs in a PTRR exercise enables balancing of offsetting risks between cleared and bilateral portfolios. The outcome can result in a reduction in the absolute amount of risk in the CCP, commensurate with a reduction in the absolute amount of risk in bilateral portfolios. ISDA has worked extensively on the PTRR topic in the past and has proposed a framework of controls to prevent avoidance of the clearing obligation[16].

The Commission could link the exemption of PTRR trades from the clearing obligation to firms moving the resulting risk into EU CCPs but needs to be cognisant that the OTC market is global, compression exercises are subjective to a network effect and therefore might not be effective if only a subset of the market is incentivised to use such services.

We also note that HM Treasury in their summary of consultation responses to the Wholesale Market Review[17] have already announced that they will propose to exempt transactions stemming from PTRR from the clearing obligation.

Section 2j): Fair, reasonable, non-discriminatory and transparent (FRANDT) commercial terms for clearing services

ISDA supports fair and competitive markets, including in the market of client clearing service provision.

Large client clearing service providers (CCSPs) will offer clearing at many CCPs, including EU CCPs and are already motivated to provide a competitive offering to clients by offering access to the CCPs where there is sufficient drive from clients to be able to clear at that CCP. Smaller CCSPs might not be able to offer a full set of CCPs and may specialise on a sub-set of CCPs that they offer. A requirement to provide clearing at EU CCPs might force these CCSPs out of the market. Depending on other measures in this consultation, some CCSPs might find clearing in the EU too expensive or cumbersome. Further, as we have advocated previously in respect of FRANDT requirements, CCSPs are concerned that setting out requirements that are too detailed and prescriptive may render the provision of clearing services unprofitable. The Commission should not take any steps that would further reduce client clearing capacity in the EU, particularly in light of the already limited number of CCSPs in Europe.

The choice of where to clear should remain with the end client based on their needs and CCSPs should not be required or incentivised to influence that choice. Adding such incentives would go far beyond the original intention of the FRANDT requirements, which was to give clients who cannot access clearing greater access.

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[16] https://www.isda.org/2020/06/16/ebf-and-isda-respond-to-esma-consultation-on-post-trade-risk-reduction-services-with-regards-to-the-clearing-obligation/

[17] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1057897/Wholesale_Markets_Review_Consultation_Response.pdf

SECTION 3: MEASURES TOWARDS CCPS

Section 3a): Measures to expand the offer by CCPs

We are supportive of making supervision in the EU more efficient, without compromising financial stability and risk in CCPs. A “regulatory race to the bottom” should be avoided at all costs.

It would be helpful if EU CCPs had the same level of access to liquid non-Euro products to achieve cross currency netting or to provide other netting benefits (cross-product netting) to get clearing members and clients to shift to the EU. If there are regulatory tools to support this, that will be welcome.

It would certainly be a worthwhile approach to rethink the process and how national competent authorities and ESMA work together in the review of changes to models and parameters (Article 49 EMIR) as well as approval of extension of activities (Article 15 EMIR).

Our members do not support an ex-post approach to supervision, where CCPs apply change and their supervisor reviews these changes when they are already live but propose early inclusion of supervisors in the development of planned changes.

We do not see how it would make a difference whether the criteria for extension of authority or significant changes were in level 1 or in level 2 of EMIR. If at all, implementing these criteria in level 1 would make processes less nimble as level 1 regulation cannot be changed easily.

Section 3b): Payment/settlement arrangements for central clearing

Extending operating hours in Target2 and T2Sis a proposal made by industry and would be very welcome.

This measure is another example of measures that would make the EU clearing market better and easier to operate in. The Commission should focus on such measures before considering other measures that would disadvantage EU firms.

Section 3c): Require segregated default funds

Our members have in the past indeed advocated for segregated default funds.

While segregated default funds have the advantage to separate the layers of mutualisation according to the risk taken, it depends on the markets, the products that a CCP clears as well as on the structure of market participants or on the ratio of default funds versus initial margins where the right balance is between a sensible mutualisation of risks amongst clearing members and fragmentation of responsibilities. We believe this is very hard to legislate or regulate as such in a general way. However, we believe that the clearing members should have a say in this, as they are the ones to pay the respective default fund, and find an agreement with the CCP, which has to provide the respective skin(s)-in-the-game for each default fund.

Section 3d): Enhancing funding and liquidity management conditions

Generally, we think the current options for funding, liquidity, collateral safekeeping/management, investment are sufficient to support the growth of EU-based clearing. We made proposals in the response[18] to the ESMA report on highly liquid financial instruments with regards to the investment policy of central counterparties[19] to allow certain high quality Money Market Funds.

We would also propose for EU central banks of issue to offer central bank accounts to CCPs at minimum for depositing cash margin, ideally also as a liquidity resource to all EU CCPs.

Please see our proposal of a central bank backed collateral transformation service above under the section "More clearing by private entities that do not access CCPs directly".

Section 3e): Interoperability

While interoperability for derivatives between EU CCPs might have a marginal positive effect on market liquidity (at least market liquidity in swaps denominated in EU currencies would not be fragmented as they are today in EU), there are concerns.

Derivatives are products with longer maturity than cash equities or repos and can be riskier. For this reason, interoperability arrangements for derivatives would be considerably more complex than the same arrangements for cash products or repos. Issues to be considered will be:

- Different legal frameworks.
- Coordination of intraday calls.
- Sufficient margining of the transactions between the involved CCPs.
- Ringfencing of the involved collateral to protect the CCP links.
- How to deal with bases between the involved CCPs.
- Agreements between CCPs.
- Coordination among Supervisors.
- Proper monitoring of inter-CCP risks and integrated stress tests.

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[18] https://www.isda.org/2022/01/25/isda-responds-to-esma-on-eligible-ccp-investments/

[19] https://www.esma.europa.eu/sites/default/files/library/esma91-372-1593_consultation_report_on_highly_liquid_financial_instruments_with_regards_to_the_investment_policy_of_central_counterparties_emir_article_853ae.pdf

- Sound procedures for recovery and resolution in case of an interoperable CCP defaulting.

It would also not be clear if all involved CCPs would have an interest in joining such arrangements.

As of now, calls for interoperability of derivatives CCPs have not materialised to a significant extent, in part because of the issues mentioned above. As described by the ESRB, "*There are five interoperability arrangements in Europe: three authorised CCPs located in the EU (EuroCCP in the Netherlands, CC&G in Italy and LCH SA in France) and two recognised third-country CCPs (LCH Ltd in the UK and Swiss SIX x-clear in Switzerland, including its Norwegian branch SIX x-clear NO).*" The links, which have been approved since the implementation of EMIR, mostly cover the clearing of cash equities and government bonds, with one link covering the clearing of ETD[20]. There are no such arrangements in place between CCPs for OTC derivatives.

We do not think pure cross-margining arrangements would be sufficient. Such arrangements will only be used if the overall margin requirements are reduced for participants and can lead to each individual CCP being under-margined.

Section 3f): Other measures

We propose that EU CCPs should review their operational processes to make them as seamless as possible and aim towards best-in-class processes. It might be helpful if CCPs consulted their members to establish where there are gaps in international best practice.

Some examples we collected from our members:

- Improvements in operational workflows would build market confidence in the CCPs' ability to handle client volumes.
- We understand that onboarding new accounts at EU CCPs is slower compared to Tier 1 and Tier 2 CCPs. Time to market is much slower, ultimately reducing competitiveness of the EU CCPs.
- Whether EU CCPs can handle high volumes of operational setups has not been tested.
- It also seems that EU CCPs are tied by stricter or less flexible regulation, which does not put them in a strong position to adapt their platform and workflows to meet the needs of the market, particularly buy-side firms.
- Connectivity to EU CCPs is broadly slower compared to UK and US competitors due to lack of flexibility.

[20] Please see the ESRB paper on CCP interoperability arrangements on page 14: https://www.esrb.europa.eu/pub/pdf/reports/esrb.report190131_CCP_interoperability_arrangements~99908a78e7.en.pdf

- Overly complex regulation and variety of models will only slow down EU CCPs' ability to act quickly and competitively.

We also propose other potential improvements, although these should only be implemented to the extent that they do not create more risk to EU CCPs:

- Encourage EU CCPs to disapply or at least reduce concentration limits on EU securities collateral posting, and consider the possibility of lightening the current securities haircut: this would be a clear advantage for a number of clients.
- Margin add-ons: EU CCPs could be encouraged to lift certain add-on thresholds, considering that concentrating euro exposure could immediately drive add-on margin requests from EU CCPs, as clearing participants cannot benefit from currency margin netting benefits.

SECTION 4: MONITORING PROGRESS TOWARDS REDUCED RELIANCE OF EU PARTICIPANTS ON TIER-2 CCPS

As mentioned elsewhere, we do not agree that reliance on UK CCPs is a source of financial stability risk. Other jurisdictions rely on UK CCPs without concerns. We therefore do not believe that exposure to UK CCPs needs to be reduced or that monitoring of exposure reductions is required.

Should the Commission believe that risk to UK CCPs should be monitored, it should ask ESMA to provide the required numbers. EMIR 2.2 should have given ESMA the required powers to request the required data from Tier 2 CCPs.

If such data collection is considered, the data needs to be collected for clearing members and clients separately, as clearing members have no influence over their clients' decision as to where to clear.

SECTION 5: SUPERVISION OF CCPS

We do not think that there are issues with the quality of supervision of EU CCPs at present. However, the extensive list of authorities that are involved in EU CCP supervision (i.e. national competent authorities, ESMA including the CCP Supervisory Committee, the European Central Bank and other central banks of issue) might indicate that supervision is not as efficient as it could perhaps be.

Section 5a): Identifying costs related to current supervisory framework and benefits with a stronger role for EU-level supervision

We leave the response to this question to European CCPs but note that a considerable part of the structure of supervision of EU CCPs is driven by EMIR.

We also want to make clear that any efficiency gain cannot come at the cost of increased risk.

While we agree in principle that a stronger role for EU-level supervision could be more efficient and more in line with how (for instance) U.S. CCPs are regulated, there would be a misalignment between responsibility for supervision on one hand and liability on the other if a CCP needs to be resolved. This misalignment should not be solved by implementation of measures that would make clearing in the EU more expensive and therefore less attractive, especially for EU firms (e.g. new resolution funds).

Section 5b): How should EU-level supervision be given a stronger role?

As mentioned above, a single regulator/supervisor could be more efficient (this does not need to be the same for every CCP) but would pose the risk that supervisory decisions would not be taken in the jurisdiction that ultimately underwrites the CCP if resolution be necessary. As mentioned above, this misalignment should not be solved by implementation of measures that would make clearing in the EU more expensive and therefore less attractive (e.g. new resolution funds), especially for EU firms.

A first step could be to review the processes of supervision between national competent authorities, ESMA and other involved authorities to identify inefficiencies and change working practices or regulation to streamline these processes.

As which authorities should be more closely involved in supervision, this should be a matter between national competent authority and ESMA. Adding too many other players will make regulation complicated, potentially slow and costly.

Regardless of whether there is a single regulator or multiple regulators, the key will be to ensure that there is sufficient technical expertise and funding for the regulator to carry out its functions effectively.

Section 5c): Areas for a stronger role of EU-level supervision

We refer to our previous responses: the most important action herein should be to analyse processes and cooperation between national competent authorities and other European authorities. Decisions as to which authority should have a stronger role will flow from this analysis. The result can be different depending on the areas in EMIR identified in the consultation.

Section 5d): ESMA's role in fostering a coherent application of EMIR

As mentioned elsewhere, having only one authority supervising EU CCPs would potentially be most efficient, but challenges, such as the misalignment between responsibility and liability. We also agree that supervision of EU CCPs could converge more.

A stronger role for ESMA in fostering convergence might create duplication and more elaborate processes, making EU supervision more cumbersome, however.

SECTION 6: EMIR AND OTHER REGULATIONS/DIRECTIVES

One example of unnecessary links between regulations is the link of the qualifying status in CRR to recognition under EMIR. Requiring a CCP to have EMIR recognition status in order to be considered a QCCP under CRR requires smaller CCPs with no EU domiciled clearing members to gain recognition at considerable expense solely for the CCP to be deemed to be qualifying. This creates situations where CCPs can potentially lose their qualifying status if an equivalence decision has not yet been taken under EMIR.

There are many areas in MiFID that should be streamlined to make EU markets more attractive.

There needs to be more thought given on the interaction between UCITS and EMIR in terms of cleared OTC derivative exposure. For example, at the moment the UCITS guidelines are more aligned with bilateral OTC derivatives, which can result in odd outcomes in measuring counterparty exposure and may disincentivize clearing (Articles 50(1)(g) (iii) and 52 and of Directive 2009/65/EC). Consideration should be given to updating this guidance to take into account how clearing operates through segregated accounts. We in particular refer to the ESMA opinion issued in May 2015 "Impact of Regulation 648/2012 on Articles 50(1)(g) (iii) and 52 and of Directive 2009/65/EC for over-the-counter financial derivative transactions that are centrally cleared"[21] that proposes that the UCITS Directive be amended so that the counterparty limits in Article 52(1)(b) with respect to the counterparty to an OTC derivatives transaction should no longer apply with respect to cleared OTC derivatives, which should instead be treated in the same way as exchange-traded derivatives.

[21] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-880_esma_opinion_on_impact_of_emir_on_ucits.pdf

SECTION 7: EMIR AND OTHER REGULATIONS/DIRECTIVES

Section 7a): Blockchain and Distributed Ledger Technology (DLT)

It is clearly helpful for EU markets if EU CCPs and other firms have the freedom to utilise new technologies. ISDA and its members would be very happy to contribute to work exploring this option further.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 970 member institutions from 77 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses 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 website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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