WHITEPAPER
Prudential Boundary Between the Banking and Trading Books in Europe: Treatment of Instruments with Embedded Derivatives
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Executive Summary

Instruments with embedded derivatives are used widely by market participants and banks for a variety of reasons. For example, they can be used by mortgage borrowers to fix or cap payments or terminate loans earlier than the contractual end date. Meanwhile, structured notes allow investors to obtain their chosen level of risk, reward and principal protection, while providing issuers with an important source of funding.

In the European Union, new requirements under the third Capital Requirements Regulation (CRR 3)1 – specifically, those related to the prudential allocation of risks between the banking book and trading book and internal risk transfers (IRT) between them– could cause unintended consequences for the capital treatment of instruments with embedded derivatives. This could occur if a trading-related embedded derivative2 and the corresponding hedge(s) are split across the trading book and the banking book or certain business and booking models are discriminated against. Without clearer and more granular specification of the prudential treatment of these products, the proposed boundary between the banking and trading books could lead to a disproportionately high risk-weighted assets (RWA) calculation, rendering certain activities economically unviable.

As instruments with embedded derivatives may be partially allocated to the banking book, this paper considers whether they should be decomposed into a derivative and a funding component (and how this decomposition should be implemented). The paper does not cover instruments that are allocated in whole to the trading book, which would be allowed under the specific recommendation to amend CRR 3 in this paper.

This paper highlights four key points:

• **Issuance of products with embedded derivatives should be allowed from the trading book or from the banking book**, depending on the different booking models that have been developed by the banks. This will not prevent institutions from maintaining adequate prudential and risk management frameworks following a so-called prudential split3, where the embedded derivative will be allocated to the trading book, while the funding component will be captured as an own liability in the banking book.

• **The prudential split** of a structured note between a derivative that relates to credit or equity risks and a funding component **should be implemented regardless of the accounting treatment** through internal transaction(s), which should fall outside the scope of the IRT requirements. For accounting purposes, these structured notes would, in most instances, fall under the fair value option (FVO), under which structured notes are not bifurcated but are treated as a whole instrument.

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1 The European Commission’s (EC) third Capital Requirements Regulation proposal, https://eur-lex.europa.eu/resource.html?uri=cellar:14dcf18a-37cd-11ec-8daf-01aa75ed71a1.0001.02/DOC_1&format=PDF

2 For example, a trading-related embedded derivatives would include those executed to benefit from actual or expected short-term price differences between buying and selling or those that create a short credit or equity position that is not considered a credit risk mitigant

3 The choice of whether to issue the structured product via the trading book or banking book does not affect the final booking under a split approach that is made for prudential purposes or its prudential treatment
The prudential split concept in the CRR 3 proposal applies to credit and equity risks, but banks issue structured products upon client demand relating to other risks, such as interest rates, FX and commodity risks. It is therefore recommended that the split concept be extended to cover those risks, as well as banking book assets at fair value with trading-related embedded derivatives that relate to interest rates, FX, commodity, credit or equity risks.

The list of instruments subject to a prudential split should be limited to a coherent scope. For example, instruments measured at amortized cost and those with embedded derivatives that only relate to credit or equity risk of the issuer(s)/borrower(s) of the instrument should not be captured.

This paper provides an overview of the different type of instruments with embedded derivatives, as well as the accounting and current prudential treatment of these products. The paper also provides an analysis of the various business and booking models for structured issuances to ensure a correct prudential book allocation.

The industry believes that policymakers should consider the recommendations and amend the European Commission’s (EC) proposed CRR 3 to address the issues described in this paper. The proposed methodology on how to perform the split on instruments with an embedded derivative is included in Annex 1.
Treatment of Instruments with Embedded Derivatives

Products Description

Products with embedded derivatives include structured notes, loans (including mortgages, instalment loans, commercials loans, loans with caps or floors, inflation-indexed loans or loans indexed to equity or credit), deposits (term deposits, savings deposits, etc) with early termination embedded options and convertible bonds. These instruments are used widely by market participants.

The accounting and prudential treatments of these products can differ, depending on the instrument type and the risks embedded in the payoff.

Structured notes are hybrid instruments that combine multiple securities (usually a bond and a derivative) that can result in multiple payoffs. The performance of these instruments could be linked to an interest rate, commodity, currency, equity index or equity security, bond or credit reference. Structured notes allow investors to obtain the level of risk, reward and principal protection that best meets their investment strategy. They are also an important way for issuers to diversify their funding sources and maturity profile.

Liabilities

Accounting Treatment: IFRS

Under International Financial Reporting Standards (IFRS⁴), instruments with embedded derivatives are called hybrid contracts and their treatment is based on their classification as assets and liabilities.

The IFRS rules allow hybrid contracts that are classified as liabilities (with an embedded derivative) but are not held for trading to be accounted in two ways:

• Under accounting bifurcation: The hybrid contract can be split into the funding component, which is measured at amortized cost, and an embedded derivative, which is classified as trading and measured at fair value through profit and loss (FVTPL) (IFRS 9. 4.3.3⁵).

• Under the FVO: Valuation of the whole instrument is measured at FVTPL, but any changes in the credit risk of that liability should be measured at fair value through other comprehensive income (FVOCI) (IFRS 9. 5.7.7⁶).

Most banks apply FVO or FVTPL, and a small subset utilize the accounting bifurcation between a debt instrument and the embedded derivative. Institutions are only allowed to modify the chosen method for new issuance or if a change in the terms of the contract significantly modifies the cashflows (IFRS 9. B4.3.115).

Institutions should apply accounting bifurcation only if the following three conditions are met (IFRS 9.4.3.3):

- The economic characteristics and risks of an embedded derivative are not ‘closely related’ with the economic characteristics and risks of the other component of the contract.

- A separate instrument that has the same terms as the embedded derivative would meet the definition of a derivative.

- When changes in fair value are realized as either profit or loss, then the hybrid contract will not be measured at fair value (ie, a derivative that is embedded in a financial liability at FVTPL is not separated). The option to measure the whole instrument at FVTPL is provided by IFRS 9. 4.35.

The following example illustrates the importance of the ‘closely related’ requirement:

- A call option at par embedded in a vanilla issuance – for example, some Tier 1 or Tier 2 capital instruments – is closely related to the economic characteristics and risks of the debt instrument, so should not be bifurcated.

- Auto-callable structured notes – for example, equity-linked notes – cannot be easily bifurcated due to the dependency between the embedded derivative and the funding component (ie, the derivative can have an impact on the expected maturity of the funding component).

A more granular list of examples of ‘closely related’ or ‘not closely related’ from an IFRS perspective is included in the Annex 2.

Prudential Treatment

Current EU Framework

Firms have developed different organizational and booking models for structured product issuance under the market risk framework in order to manage the embedded market risks across all asset classes.

From a capital perspective, structured products can be issued from the trading book (eg, a trading desk) or the banking book (eg, treasury desk) without any model prohibitions.

The choice of whether to issue the structured product via the trading book or banking book does not affect the final booking under a prudential split approach or its prudential treatment.
In fact, the prudential treatment for the structured issuance will be the same under this prudential split approach, regardless of the issuance allocation (to the trading book or the banking book):

- The funding component will be captured as an own liability in the banking book; and
- The embedded derivative will be included in the trading book.

Requirements on internal hedges under CRR 2 and the proposed CRR 3 requirements that, in principle, would become effective in June 2023 and January 2025, respectively, have triggered discussion on the treatment of structured product issuances.

For structured notes issued from the banking book, banks can transfer the underlying market risk to the trading book via internal transaction(s). From June 2023, external hedges for credit and equity banking book exposure will be required to “perfectly offset the market risk of the internal hedge”. This requirement will not be easy to achieve (if not impossible in some cases) if it is applicable to equity- and credit-linked structured notes, because the bank would have to access the market for each individual transaction to achieve a perfect offset and this will result in unduly high hedging costs, making these activities unviable.

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In addition, external interest rate hedges of banking book interest rate risk exposures would need to be assigned to a dedicated portfolio or desk, where the market risk is calculated on a standalone basis separate from other trading positions. If the requirement applies to interest rate structured notes, this will require banks to book internal hedges via the dedicated IRT desk, which will result in increased hedging costs as these positions will not be permitted to mitigate the risk of other trading positions. The resulting trading interest risk position from the trading-related embedded derivative will be included in the interest rate risk banking book calculation.

The lack of clarity on internal hedges in Article 106 (3) and (4) means firms have been left to interpret whether the rules apply only to specific banking book products by excluding derivatives that are embedded in structured notes. In addition, Article 106 (3) and (4) refer to internal hedges only for credit exposure (including equity) referred to in Article 92(3)(a), which does not capture all credit or equity risk positions.

Based on this interpretation, the following instruments could be included:

- Direct credit or equity exposures in the banking book – for example, including loans, debt instruments, equity and convertible bonds;

- Some derivatives instruments with an equity underlying; and

- Credit default swaps sold (Article 273 (5)).

The credit or equity risks in hybrid instruments classified as liabilities are not referenced as part of banking credit or equity exposures in CRR or CRR 2 (Article 92(3)(a)).

Likewise, structured notes with a trading-related interest rate embedded derivatives (Article 106 (5)) will not be in scope of the banking book. Therefore, their trading hedges will not be in the scope of banking book interest rate hedging activities, as CRR only refers to the hedging of banking book interest rate risk exposures. However, if the interest rate embedded derivative is considered trading related, it does not qualify as a banking book interest rate risk exposure, even though the structured note may be issued out of the banking book.

In fact, these requirements were not designed to apply to hybrid instruments that are composed of a trading-related embedded derivative (trading book) and a funding component (banking book). In contrast, early termination of an embedded option from deposits (term deposits, savings deposits, etc) that do not classify as trading activities will not be subject to a split.

Furthermore, the CRR 2/CRR 3 requirements only address equity- and credit-linked structured notes but do not cover interest rates, FX or commodities. This issue also applies to the current version of the European Central Bank guide to internal models (EGIM), which only refers to bifurcated embedded derivatives that relate to credit and equity.

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For structured notes, the industry believes either of the following points should be clarified:

- If the structured note is issued out of the banking book and the embedded derivative is transferred into the trading book via internal transaction(s), then this internal transaction(s) should not qualify as internal hedge(s) – ie, it should not be in scope of Article 106. Likewise, if the structured note is issued out of the trading book and the funding component is transferred into the banking book via internal transaction(s), then the internal transaction(s) should not be in scope of Article 106.

- A split should only be applied to embedded derivatives that are trading-related (including credit, equity, interest rates, FX and commodities) and embedded in an instrument measured at fair value.

Under the current framework, the prudential split is not based on accounting rules. For example, this is applicable for auto-callable structured notes (eg, equity-linked notes), which contain a funding component that is dependent on an embedded derivative payoff. To manage the embedded market risks across all classes of these issuances, the industry has developed three different methodologies for the prudential split:

- Some banks have chosen to issue the structured product from the banking book and transfer the risk via a funded swap to the trading book.

- Other banks have opted to issue the structured product from the trading book and transfer the funding component to the banking book via a strip of vanilla deposits with variability of expected maturity. The market risk arising from the callability of the note/product is managed by a trading desk.

- A number of banks have chosen to book those structured notes in the banking book. If the option is triggered at par in the banking book, then the structured payoff could be transferred via an auto-callable swap to the trading book.

The prudential split of structured notes performed via internal transaction(s) should not be viewed as internal hedge(s), but rather as an operational decomposition of the hybrid instrument into two components:

- A funding component captured as an own liability in the banking book; and

- The embedded derivative included in the trading book.

There are positions that are assigned to the banking book. For example:

- Credit-linked notes (CLNs) issued by a bank can remain entirely in the banking book. This requirement is for CLNs qualifying as eligible credit risk mitigation for banking book exposures (Art. 204, 218 CRR). Otherwise, the credit default swap embedded in the note qualifying as eligible unfunded protection should be allocated to the trading book, while the loans are allocated to the banking book. Any risk mitigation needs to be transferred back to the banking book. A prudential split in this case creates additional and unnecessary operational complexity for a banking book hedge linked to a banking book exposure.

- Structured issuances with interest rate embedded derivatives that are held to hedge interest rate risk from other positions in the banking book may remain in the banking book.
• An embedded derivative that is hedged on a one-to-one basis by an external derivative that offsets the market risk could be assigned to the banking book. The hedge therefore perfectly matches the market risk exposure created by the embedded derivative.

EC Proposal on CRR 3

The EC proposal on CRR 3 introduces the following articles:

• Article 104 (2) (i) requires “options, or other derivatives, embedded in the own liabilities of the institution or from other instruments in the banking book that relate to credit or equity risk”9 to be assigned in the trading book.

• The last sub-paragraph in article 104 (2) explains how the split should be performed: “For the purposes of point (i), an institution shall split the embedded option from its own liability or from the other instrument in the banking book that relate to credit or equity risk and shall assign, the own liability or the other instrument to the trading or to the banking book, as appropriate, in accordance with this Article.”

• Article 104 (3) (h) requires all own liabilities except those for market-making activities to be assigned to the banking book.

The industry has identified a lack of clarity in the CRR 3 text:

• As per article 104 (3) (h), which is not part of the Basel Committee on Banking Supervision standard (RBC 25.810), it is unclear whether structured note issuances are covered by the exclusion granted for market-making activities. Currently, CRR does not provide a definition of ‘market-making’, which means it is open to interpretation whether liabilities resulting from the issuance of a structured note qualify for the exclusion. This could be clarified to explicitly allow structured note issuances to be covered by the exclusion granted for market-making activities.

• The split clarifications (article 104 (2) last sub-paragraph) also appear to be applicable only to structured issuances recorded in the banking book, without taking other booking models into account. Moreover, it is not clear whether the transaction(s) to facilitate the split qualifies as an internal hedge(s). In addition, the split approach only covers options and there is a lack of clarity on the assignment of the funding component.

• The industry is still considering whether the split can be applied to other types of hybrid contracts. For example, it is unclear whether an institution could or should split structured notes with a trading-related interest rate embedded derivative, or if the internal transaction(s) to facilitate the split will be subject to any requirement similar to interest rate risk hedges in the banking book. The industry believes the CRR text should clarify that the split concept should apply for equity or credit embedded derivatives and could also be applied for other types of hybrid contracts (interest rates, FX or commodities), depending on the nature of the embedded derivative (ie, whether or not it is trading related).

9 A derogation is still available with an approval from a competent authority
Assets

Accounting Treatment: IFRS rules

The IFRS rules (IFRS 9. 4.3.2) do not allow the bifurcation of the embedded derivative from a hybrid contract containing financial assets as a funding component.

Prudential Treatment

Current EU Framework

The trading-related embedded derivatives within structured notes are used for locking in profits and so are captured in the trading book and subject to a market risk calculation. Furthermore, the whole contract will be subject to the usual credit risk calculation based on the fair value.

EC Proposal on CRR 3

The industry welcomes the clarification proposed on the split application of some hybrid contracts. As with the liability side, embedded derivatives in purchased structured notes could be managed by a trading desk and benefit from expected short-term price differences with a hedge.

However, the split approach will be irrelevant for some specific cases:

- The embedded option of an instrument, which references the issuer, should not be required to split. Instead, the instrument as a whole should be treated as an equity exposure of the issuer if it fulfils the definition of article 133, or a debt exposure. As an example, a convertible bond that gives the investor the option to settle in equity shares and is traded like the equity of the issuer rather than its debt should be treated as an equity exposure. There should be no split of the derivative as it would result in double counting of the equity risk.

- An instrument measured at amortized cost or an instrument without trading-related embedded derivatives should not be split.
Conclusion

This paper highlights the industry’s concerns about the treatment of instruments with embedded derivatives within CRR 3. These instruments are widely used by a broad range of market participants and are important for investors with clearly defined risk characteristics. They also provide funding to banks, helping to finance economic activities.

The key issues that would render some activities uneconomic are: i) restrictions on the issuance of products with embedded derivatives from the banking book or the trading book; and ii) the prudential split of structured products between an embedded derivative (that relates to credit, equity, interest rate, FX or commodity risks) and the funding component. To help address these issues, the industry has proposed specific recommendations to amend the EC’s CRR 3 legislative proposal.

This paper proposes allowing the issuance of products with trading-related embedded derivatives equally from the banking and the trading books. It also recommends permitting the prudential split of instruments with trading-related embedded derivatives through internal transaction(s), which should fall outside the scope of the IRT requirements, regardless of the accounting treatment.
Annex 1: Industry Drafting Suggestions

The industry believes the European Commission’s third Capital Requirements Regulation (CRR 3) proposal lacks clarity and would be a step backwards in terms of risk management and business organization.

This paper recommends refining the split definition and extending/refining the perimeter of the split requirement as follows:

“Article 104 Inclusion in the trading book

[…]

2. Institutions shall assign positions in the following instruments to the trading book:

[…]

(i) options, or other equity, credit or trading-related interest rates, foreign exchange or commodity derivatives, embedded in the own liabilities of the institution or from other instruments that do not meet the criteria (d) or (e) of this paragraph and are valued at fair value accounting, in the non-trading book that relate to credit or equity risk with the exception of the instruments with embedded derivative only related to credit or equity risk of the issuer(s)/borrower(s) of the instrument.

[…]

For the purpose of point (i) an institution shall split this instrument with embedded derivative into a derivative assigned to the trading book and a funding component assigned to the non-trading book the embedded option from its own liability or from the other instrument in the non-trading book that relate to credit or equity risk and shall assign, the own liability or the other instrument to the trading or to the non-trading book, as appropriate, in accordance with this Article.

The split is either performed via bifurcation in alignment to the applicable accounting framework or via internal transaction(s) between trading book and non-trading book. Such internal transaction(s) do not qualify as internal hedge(s) of the non-trading book.

[…]

3. Institutions shall not assign positions in the following instruments to the trading book:

[…]

(h) own liabilities of the institution, unless such instruments meet one of the criteria referred to in paragraph 2, points (d), (e) or (i).
4. By way of derogation from paragraph 2, an institution may assign to the non-trading book a position in an instrument referred to in points (d), (e) and (g) to (i) of that paragraph, subject to the approval from its competent authority. The competent authority shall give its approval where the institution has proven to the authority’s satisfaction that the position is not held with trading intent or does not hedge positions held with trading intent or does not hedge positions held with trading intent or used as an eligible credit risk mitigation or where the embedded derivative is hedged by an external derivative that fully offset the market risk.

The institution shall have in place clearly defined policies and procedures for identifying these circumstances and immediately notify its competent authority where such classification has occurred. “
### Annex 2: Examples of Embedded Derivatives that are Closely or Not Closely Related

<table>
<thead>
<tr>
<th>Call put in a host debt contract or host insurance contract (IFRS 9.B4.3.5e)</th>
<th>Not Closely Related</th>
<th>Closely Related</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other cases</td>
<td>If the option’s exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument; or the carrying amount of the host insurance contract</td>
<td></td>
</tr>
<tr>
<td>Indexation of interest and/or capital on the evolution of the price of a share, a stock market index or commodities (IFRS 9.B4.3.5 a, c and d)</td>
<td>X</td>
<td>Other cases</td>
</tr>
<tr>
<td>Prepayment option embedded in a host debt contract or host insurance contract (IFRS 9.B4.3.5e et B4.3.8e)</td>
<td>Other cases</td>
<td>The exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract11</td>
</tr>
<tr>
<td>Option or automatic provision to extend the remaining term to maturity of a debt instrument (IFRS 9.B4.3.5b)</td>
<td>Other cases</td>
<td>Concurrent adjustment to the approximate current market rate of interest at the time of the extension</td>
</tr>
<tr>
<td>Credit derivatives that are embedded in a host debt instrument (IFRS 9.B4.3.5f)</td>
<td>X</td>
<td>Other cases</td>
</tr>
<tr>
<td>Embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract (IFRS 9.B4.3.8a)</td>
<td>If the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognized investment; or the embedded derivative could at least double the holder’s initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract</td>
<td>Other cases</td>
</tr>
<tr>
<td>Embedded floor or cap on the interest rate on a debt contract or insurance contract (IFRS 9.B4.3.8b)</td>
<td>Other cases</td>
<td>The cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued; and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg, a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged</td>
</tr>
<tr>
<td>Embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond) (IFRS 9.B4.3.8c)</td>
<td>-</td>
<td>X</td>
</tr>
<tr>
<td>Embedded derivative is: (ii) an inflation-related index such as an index of lease payments to a consumer price index; (ii) variable lease payments based on related sales; or (iii) variable lease payments based on variable interest rates (IFRS 9.B4.3.8f)</td>
<td>Other cases</td>
<td>The lease is not leveraged; and the index relates to inflation in the entity’s own economic environment</td>
</tr>
</tbody>
</table>

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11 Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.
Annex 3: FRTB Framework Effective from January 2023: RBC 25

The Basel Committee on Banking Supervision’s revised prudential boundary had two objectives that could have unintended consequences on instruments with an embedded derivative:

- To include options in the list of the instruments with a general presumption of trading\(^\text{12}\);
- To impose a perfect ‘pass-through’ approach for IRT of credit and equity risk from banking book exposures to the trading book, and to minimize incentives for capital arbitrage on interest rate risk transfers from the banking book to the trading book\(^\text{13}\).

The industry believes this objective does not apply to market risks of trading-related embedded derivatives in hybrid contracts and is applicable only to banking book exposures (credit and equity).

The latest version of the Basel Committee’s risk-based capital requirements (RBC 25\(^\text{14}\)) allows different interpretations on the treatment of instruments with embedded derivatives, especially structured notes.

The RBC 25.9 specifies there is a general presumption of trading for “options including embedded derivatives from instruments that the institution issued out of its own banking book and that relate to credit or equity risk”.

All naked options, as well as credit or equity options embedded in own liabilities in the banking book, are included in the list of instruments for which there is a general presumption of trading. The third set of frequently asked questions specifies this trading presumption also applies to FX options that hedge FX risk in the banking book. The decision by the Basel Committee to include only credit or equity options embedded in liability instruments in the list for which there is a general presumption of trading is based on the different type of products, risks and situations.

The industry believes the split approach may also apply to embedded derivatives in all other hybrid contracts, including structured notes, which are not subject to a general presumption of trading. The current text is silent on the possibility of splitting other hybrid contracts (other than those mentioned in the RBC25.9 (6)). Footnote 5 in RBC 25.9 (6) only references an example of structured issuances. The second set of frequently asked questions notes that the bifurcation should be conducted by internal decomposition (split) and will not be subject to IRT requirements or reclassification rules between the trading and banking books.

On structured issuances, the first set of frequently asked questions on RBC 25.4 allows structured notes to be designated under the fair value option and allocated to the prudential trading book (without any requirement on the cash transfer).


\(^{14}\) www.bis.org/basel_framework/chapter/RBC/25.htm?inforce=20230101&published=20200327
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