JOINT ASSOCIATIONS RESPONSE TO THE PRA AND FCA'S CP13/23 – MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES: AMENDMENTS TO BTS 2016/2251

18 October 2023

Joint Associations Response to the PRA and FCA's CP13/23 – Margin Requirements For Non-Centrally Cleared Derivatives: Amendments to BTS 2016/2251

The International Swaps and Derivatives Association (ISDA), the Investment Association (the IA), the Alternative Investment Management Association (AIMA), and the American Council of Life Insurers (ACLI) – hereby the "Joint Associations" - welcome the opportunity to respond to the PRA and FCA's consultation on its proposed amendments to BTS 2016/2251, which:

- extends the temporary exemption for single-stock equity options and index options from the UK bilateral margining requirements from 4 January 2024 until 4 January 2026, and
- sets out the PRA and FCA's proposed approach to pre-approving bilateral initial margin models.

We respond in turn to these two items below.

Extending the temporary exemption for single-stock equity options and index options

The Joint Associations welcome the PRA and the FCA's proposal to extend the temporary exemption from the UK bilateral margining requirement in BTS 2016/2251 for single-stock equity and index options (''equity options'') from 4 January 2024 until 4 January 2026, allowing the PRA and the FCA to gather the evidence necessary to create a permanent regime.

Given that the process for firms to implement arrangements for bilateral margin requirements can be significant, we welcome this communication on the intention to temporarily extend.

Regarding the longer-term regime, we strongly believe that a permanent exemption of equity options from the Margin RTS is warranted. We note the authorities' intention to gather information on current market practices and risks posed by these types of products to inform their permanent approach and would be happy to discuss how to support that process.

As noted in CP13/23, the original temporary exemption was introduced to avoid market fragmentation, to ensure a level playing field across jurisdictions, and to avoid scope for regulatory arbitrage. This rationale remains valid, and since the exemption was introduced, there has not been a material change to the international position. The PRA refers to this rationale in justifying why it considers its proposal to temporarily extend the derogation to be compatible with supporting its new secondary competitiveness and growth objective, introduced by the Financial Services and Markets (FSM) Act 2023. Making the exemption permanent would also be in line with this new secondary objective and would provide more stability and predictability for firms operating under the UK regime.

The US is the largest market for equity options[1], so alignment with the US in this regard is particularly important to avoid disruption of cross-border business. In the US, equity options are not in scope for the SEC non-cleared margin rules, nor for the CFTC or US prudential margin regimes. They fall outside of Title VII of the Dodd Frank Act as they are not defined as "swaps" or "security-based swaps". Rather, equity options are treated as securities in the US. There is a very limited use case where regulatory margin requirements apply in the US to equity options as 'securities' – though the requirements are vastly different from EMIR and CFTC requirements. This use case does not negate the broader level playing field issues set out in this response document.[2]

There is therefore no prospect of these contracts being subject to the US margin rules, in fact it would require a change of law (i.e. Act of Congress) to make such options subject to Dodd Frank requirements.

In the EU, the co-legislators (European Parliament and Council) have, in the current on-going EMIR 3 negotiations, proposed a similar solution to maintain the current temporary exemption for equity options, subject to regular review if 'international developments have led to more convergence in the treatment of equity options'.3 The likelihood of such exemption being included in the final EMIR 3 Regulation (political agreement between co-legislators is expected in H1 2024) seems very high. Such exemption would be subject to review if 'international developments have led to more convergence in the treatment of equity options'.

Equity options play a significant part in the real economy and are used for multiple purposes aside from transactions between dealers, including hedging exposure to the purchase price in the context of an M&A transaction, and use in share buy-backs by companies. Equity options may also be used to allow UK investors access to equity markets that are closed to direct investment from UK investors (e.g., certain emerging markets), and allowing UK pension funds to diversify their portfolios. Equity options also play a key role in supporting convertible bond issuance by UK corporates, but their usage in this context would no longer be viable if margin requirements were to be applied to them. Finally, certain equity option strategies allow shareholders to hedge the market risk on the shares they own and increased margin requirement could make investing in shares economically unattractive.

The equity options market is very small compared with the overall OTC derivatives market and most of these contracts have a short maturity. The impact on financial stability of

[1] BIS Statistics Explorer: Table D5.1

[2] Margin requirements under FINRA 4210 may apply to OTC options (including equity options) which could be subject to EMIR margin requirements if transacted by EU/UK counterparties.

[3] The Council latest draft EMIR compromise text (Sept 2023) includes a permanent exemption for equity options. The latest EP draft compromise text (Sept 2023) also includes such permanent exemption.

exempting these contracts from the Margin RTS[4] is therefore marginal. According to BIS data[5], equity options represented 0.55% of notional amount outstanding of all OTC derivatives in H1 2022. BIS data also shows that in H1 2022, 64.60% (in notional amount outstanding) of equity linked contracts (which include forward/swaps and options) had a maturity of up to 1 year. Only 5.11% (in notional amount outstanding) of equity linked contracts had a maturity over 5 years in H1 2022, compared to 22.36% of notional amounts outstanding in OTC derivative interest rate contracts.

Without a permanent exemption from the UK margin rules (1) UK clients could face a competitive disadvantage when trading with US dealers compared to US clients knowing US dealers will have to reflect funding costs in their pricing and (2) UK dealers could also face a clear competitive disadvantage compared to US dealers when dealing with most non-UK clients (including US insurers and hedge funds). These non-UK clients are likely to cease trading with UK dealers upon expiry of the exemption.

By way of example, UK firms offering products such as call spreads, for which counterparties commonly seek "equity accounting" treatment, will be negatively impacted. Pursuant to the accounting guidance, one of the conditions to obtaining equity accounting treatment is that such transactions are not collateralized. A call spread is a pair of call options that are often used by convertible bond issuers to hedge the option embedded in a convertible bond. These can be transacted with UK (or EU) firms in reliance on the current options relief. If the option relief expires, pricing such products from a UK entity will be uncompetitive relative to US dealers. There is an expectation that the business would simply be lost to non-UK dealers or otherwise migrated to non-UK legal entities where firms have the capabilities to do this, though this is not economic for all firms to pursue.

Imposing margin requirements in relation to equity options will also have a disproportionate impact for smaller counterparties, potentially leading UK entities that currently use equity options for hedging and risk mitigation purposes to cease trading these products due to the funding cost increase, and – in the case of non-UK clients – discouraging them from entering into equity options transactions with UK dealers.

For relatively small counterparties, which nevertheless exceed the initial margin threshold of aggregate average notional amount of non-centrally cleared derivatives of €8 billion and using equity options for risk mitigation purposes, a significant burden would arise from the requirement to prepare for and to post regulatory initial margin on a daily basis. This collateral must be held in bankruptcy-remote, segregated accounts with no right of re-use. As a result, this would increase funding costs for these relatively small counterparties and would also create opportunity costs (as the assets could not be put to other productive use, such as financing real economy activities). Establishment of segregated initial margin accounts, regulatory initial margin credit support documentation and an initial margin calculation method and governance are legally and operationally complex tasks.

Apart from the increased collateral demands and costly operational uplift associated with expiry of the derogation, global market fragmentation and erosion of hedging liquidity would further inhibit cross-border derivatives business, to the significant disadvantage of UK market

[4] CL2016R2251EN0040010.0001.3bi_cp 1..1 (europa.eu)
[5] BIS Statistics Explorer: Table D5.1

participants (including pension and insurance institutions and other funds, as well as banks and dealers).

The PRA and FCA's proposed approach to pre-approving bilateral initial margin models

The Joint Associations welcome the proposal in CP13/23 to sustain reliance on existing supervisory powers and the current supervisory framework for assessing initial margin models and risk management rather than introduce a formal pre-approval requirement. As the final phase-in period for regulatory initial margin transpired on September 1, 2022, the bulk of market participants which intend to use a quantitative IM model like the ISDA SIMM® (SIMM) are already doing so and such use is subject to oversight under the supervisory framework. Major market participants have been using ISDA SIMM to calculate regulatory initial margin since September 1, 2016. The introduction of a pre-approval requirement at this stage could prove disruptive, casting uncertainty on the permission of UK entities and their counterparties to continue to exchange IM based on SIMM.

The Joint Associations consider that the scope of regulatory technical standards on initial margin models, as it is imposed by the UK EMIR, is too broad. The regulation currently applies related requirements around model performance monitoring to all counterparties and there is no differentiation based on size, systemic importance, or sophistication of firm. We argue that it is disproportionate and unnecessary to require smaller institutions to obtain initial margin model approval, or to undertake model performance monitoring. This could ultimately discourage them from use of industry models, without enhancing the overall safety and soundness of the system, because their dealer counterparties will already be model testing vs. SIMM. In line with the approach applied in the US (and in contrast to the prescriptive proposals of the EBA in the EU) we would encourage the PRA/FCA to consider revising the BTS so that the model monitoring requirements apply only to the largest firms, who would typically already be subject to comparable model rules, with clients able to place reliance on the testing of their dealer counterparties. We welcome a discussion with the PRA/FCA to on how an outcome could be delivered.

ISDA and the users of SIMM value the productive engagement with the PRA, FCA and global regulators to discuss and address maintenance and enhancements to SIMM to ensure it meets global regulatory requirements and remains accessible to market participants.

We would welcome further discussion on either of these matters.

The Joint Associations are aware that the UK authorities are considering reform of UK EMIR as part of their Smarter Regulatory Framework Programme and look forward to engaging with the FCA and the PRA on its list of priority areas for reform.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 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.

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About the Alternative Investment Management Association (AIMA)

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

About the Investment Association (IA)

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

About the American Council of Life Insurers (ACLI)

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. Ninety million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 95 percent of industry assets in the United States. Life insurers are significant end-users of derivatives for prudential asset-liability management. Derivatives allow life insurers to prudently manage the credit and market risk of their portfolios and to fulfill their long-dated obligations to policy and contract owners. As long-term hedgers, life insurers have a strong interest in a stable and robust global financial system, and we strongly encourage coordinated domestic and international approaches to derivatives regulation that will achieve desired stability of the global financial system.