ISDA Safe, Efficient Markets

For the attention of

Mr Valdis Dombrovkis
Vice President of the Euro and Social Dialogue, also in charge of
Financial Stability, Financial Services and Capital Markets Union
European Commission
Rue de la Loi/Wetstraat 200
1049 Brussels
Belgium

Mr Steven Maijoor
Chair of ESMA
103 rue de Grenelle
75345 Paris
France

August 14th, 2019

Dear Mr Dombrovkis and Mr Maijoor

Re: IBOR Transition and EMIR grandfathering with respect to legacy derivatives transactions

On July 2nd, 2019, Mr Steven van Rijswijk, Chair of the working group on euro risk-free rates (EU RFR WG) wrote to you[1] requesting, among other things, an urgent statement confirming that none of:

(i) the incorporation or the effect of fallback provisions designed to enhance the contractual robustness of existing derivatives and other trades which reference a benchmark; nor

(ii) the amendment of existing transactions which currently reference EONIA so that they instead reference €STR plus the spread published by the European Central Bank or such other form of compensation (if any) that the parties may agree and which is necessary to minimize value transfer

would on their own (whether individually or in combination) have the effect of imposing margin or clearing obligations under the European Market Infrastructure Regulation[2] (EMIR).

[1] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/20190704/2019_07-04_Item_2_Letter_to_European_authorities_on_EMIR_margin_requirements.pdf

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32012R0648&from=EN

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The International Swaps and Derivatives Association (ISDA) represents over 900 participants in the global derivatives market, including corporations, investment managers, government entities, insurance companies, energy and commodities firms, and international and regional banks, many of them domiciled in the EU. On behalf of those members, we write to express our unqualified support for the points the EU RFR WG Chair raises in that letter.

ISDA has identified concerns around existing transactions being brought into scope of clearing and margining obligations as a critical issue on the path to ensuring successful adoption of the fallbacks it is creating for derivatives referencing benchmarks. These include fallbacks for systemically important interbank offered rates such as EURIBOR and LIBOR[3], as well as the generic fallbacks contained in the ISDA Benchmarks Supplement[4]. The ISDA Benchmarks Supplement was published in response to Article 28(2) of the EU Benchmarks Regulation and covers interest rates, equity indices, commodity indices and fx rates. While the EU RFR WG Chair's letter specifically addresses clearing and margining issues in relation to EURIBOR, EONIA and €STR, it is therefore critical that the requested clarification applies more broadly to existing transactions referencing benchmarks of all kinds that have been executed by institutions which are subject to EU legislation. This will remove any impediment market participants may otherwise perceive to ensuring that fallback provisions in their existing transactions (regardless of when they were executed) are consistent with fallback provisions in their new transactions. This will help to reduce basis risk across their portfolio of transactions to the maximum possible extent.

Efficacy of a Clarificatory Statement

The EU RFR WG Chair notes in his letter that the Financial Stability Board recommended national authorities issue guidance or take other steps to clarify or ensure that national rules fully reflect the BCBS and IOSCO requirements that genuine amendments to existing contracts made for the purposes of increasing contract robustness should not, in itself, qualify as a new contract resulting in margin requirements[5].

We do not believe that the EMIR rules require any amendment in respect of either margining[6] or

3 https://www.isda.org/category/legal/benchmarks/

4 https://www.isda.org/book/isda-benchmarks-supplement/

5 https://www.fsb.org/wp-content/uploads/P101017.pdf, P.31

6 Article 11(3) of EMIR simply states that:

> "Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after 16 August 2012."

clearing[7] and that a simple clarificatory statement has a number of advantages:

- it would provide sufficient comfort to ensure EU market participants take action to embed fallbacks or to amend existing transactions so that they stop referencing benchmarks identified by the global regulatory community as vulnerable to contingencies (such as permanent cessation) and instead reference more robust benchmarks without fear of bringing them into scope of the margining or clearing requirements.

- it can be issued more quickly than a Level 1, Level 2 or Level 3 instrument (each a 'legislative approach'). As the EU RFR WG Chair notes in his letter, the timetable set by the European Benchmarks Regulation and global benchmark reform initiatives means that market participants need to start the process of transitioning to risk free rates and embedding robust fallbacks immediately given the volumes of transactions involved.

- there is a very significant danger that using legislative approaches to address issues which are already permitted by existing level 1 text will create an environment in which market participants do not feel comfortable executing day-to-day life-cycle operations (such as non-material amendments to legacy transactions) without the authorities using legislative approaches to provide specific permission. This would lead to inefficiencies in the market that damage rather than enhance its safety and operation.

- we understand regulators may be concerned to ensure that market participants do not abuse any pronouncements on these issues to introduce amendments which go beyond what is necessary to embed fallbacks, to ensure their efficacy in operation or to replace a vulnerable benchmark with a more robust benchmark. A legislative approach would require complex controls to be designed. A statement, on the other hand, would allow regulators flexibility to make clear that its scope is limited to what is required to achieve its stated aims and that any attempt to circumvent the regulation will be dealt with through enforcement proceedings. Given the long-term nature of the transactions at risk of losing their exemption from clearing and margining obligations, it may be that insurance companies and pension funds are most likely to benefit from the clarification sought. Their highly governanced and regulated nature may also help reduce concerns around this issue.

Global efforts to transition to more robust benchmarks

The precise mechanisms by which market participants transition from IBORs to risk-free rates are in the early stages of discussion and may vary from IBOR to IBOR. It may be that their success will similarly require action on the part of regulators with respect to margin and clearing obligations (including guidance and/or legislative approaches). ISDA would encourage the

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7 Article 4(1)(b) of EMIR says that the clearing obligation will apply to transactions that are entered into or novated either:

(i) on or after the date from which the clearing obligation takes effect; or

(ii) on or after notification as referred to in Article 5(1) but before the date from which the clearing obligation takes effect if the contracts have a remaining maturity higher than the minimum remaining maturity determined by the Commission in accordance with Article 5(2)(c).

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regulatory authorities to consult with market participants on the most efficient means of addressing these issues at the appropriate time and to ensure that messaging around the deployment of any legislative approach makes clear it is designed to cover actions which are not otherwise permitted under existing level 1 text.

We would be happy to discuss these issues with you further.

Sincerely,

Scott O'Malia
Chief Executive Officer
International Swaps and Derivatives Association, Inc.