ISDA Safe, Efficient Markets

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ISDA (International Swaps and Derivatives Association) Comments on Belgian Presidency compromise text of 7 December 2010 on EMIR

29 December 2010

We note the broadening of the **subject matter and scope in Article 1**, so that the Regulation applies to all derivatives. The reasoning for this is not entirely clear. We make the following remarks however:

- This change will have an impact on Article 48 (Interoperability arrangements). Though recital 42 still reflects the intention that interoperability arrangements should be restricted to cash securities, a further clarification in the body of the legislation would be appropriate in light of this expanded scope.

- This seems like rather a significant step to take at this stage and it is not clear to us whether there has been a lot of analysis as to the impact of this amendment.

In relation to **scope and definitions (Articles 1 and 2)** we continue to believe that there is a strong case for exempting some types of financial institution from clearing requirements including

- Pension fund managers and insurance companies managing pension funds with liability driven investments (LDIs) for whom the frequent margin calls associated with central clearing may represent an inappropriate liquidity strain and (resultant) disproportionate cost. A previous exemption for IORPs is no longer apparent in the 7 December text;

- Captive finance companies of non-financial corporations. These are excluded under Dodd-Frank. If a similar exclusion is not reflected in EMIR, this could (a) put European companies at a disadvantage vs. US competitors or (b) encourage regulatory arbitrage by compelling European companies to establish captive financing operations in the US which they would use to fund and hedge their activities on a global basis.

Furthermore, we believe that consideration should be given as to whether there is a case for **scoping out intra-group transactions**. In this regard, it should be considered whether the extra operational risk created by requiring clearing of these transactions is justified by the extent to which counterparty risk is reduced by clearing them. ISDA is preparing a briefing on this issue which it will circulate shortly.

We continue to believe that there is a strong case for exempting large parts of the **FX business** from clearing on the basis that (a) large parts of this business represent limited counterparty (short maturities) (b) central settlement is already in place, addressing the key risk in FX business (and effort should be concentrated in getting more counterparties signed up to CLS and (c) it is quite

possible that the US Treasury may exempt large parts of this business for clearing for this reason (a decision is pending).

Also in Article 2, we do not believe that the **definition of trade repository** should include reference to the 'objectives' of trade repositories. We believe that relevant regulators should have access to information from the industry that they need to fulfil mandates such as systemic risk and market integrity monitoring, but some coherent thinking needs to be done as to whether or not its is really appropriate to impose responsibility for responding to all such needs on trade repositories. For example, transaction reports may be a more appropriate market integrity monitoring tool.

Art.3 (Clearing obligation): The text in square brackets indicates that **'backloading'** onto CCPs of contracts that exist before the date of effect of the clearing obligation will no longer be required. Our remarks:

- We suggest that the words 'concluded on' should be deleted and replaced with 'entered into' to clarify that contracts that have been negotiated and signed by counterparties but which have not yet matured should not be cleared. Thus the wording would be *'The clearing obligation shall apply to all derivative contracts which are entered into on and after the date from which the clearing obligation takes effect..'.*

- Apart from this, we strongly support the suggestion that existing contracts should not be backloaded, for a number of reasons:

    - This change would bring Europe into line with the US legislation, which does not require backloading of existing contracts, if they are reported to trade repositories;

    - This change would mean that Europe and European market participants (in particular buyside firms, which are more likely to have more 'one way' risk then dealers, for example) would *not* face a much more extreme 'liquidity crunch' impact than would be experienced in the US (because Dodd-Frank carves out existing contracts);

    - A requirement to clear existing contracts is logistically extremely challenging – it would require dealers to persuade tens of thousands of clients to agree to have their contracts centrally cleared;

    - Apart from the logistical challenges, the clearing requirement would create major legal challenges. Existing bilaterally risk-managed contracts have been negotiated based on price assumptions which are inextricably linked with the credit risk conditions, exposures and risk mitigation tools addressed in those bilateral contracts. Counterparties may feel that a forced clearing requirement could represent a threat to their property rights, unless they are absolutely satisfied with the terms associated with new arrangements.

Recital 12, Art 4.2b, Art 4.4 (Eligibility for the clearing obligation): The text suggests that clearing could be 'phased-in' for example in terms of percentage levels of eligible contracts to be cleared by

certain dates, or different dates of application for different categories of market participants. We support the ‘**phasing-in’** suggestion, as it would

(a) allow regulators and CCPs to focus on the getting the most systemically important market participants onto CCPs first i.e. dealers and larger financial buyside firms such as large hedge fund managers and large investment fund managers;

(b) allow time for other buyside participants – who would probably feel the impact of clearing (in relative terms) most keenly – to ready themselves and their finances for these demands.

Other key points **in Article 4** include

- We note that the eligibility criteria are amended, with one new criterion stating that ‘*the impact on the level of counterparty credit risk in the market, within the relevant class of derivatives and between classes of derivatives, as result of applying an obligation to the relevant class of derivative contracts’* should be considered if a contract is to be deemed eligible. We believe there are some situations where a requirement to clear 100% of all eligible contracts could actually increase risk in the financial system. For example, where two dealers have a balanced position facing each other, comprising a collection of eligible and non-eligible contracts alike, taking the eligible contracts out of this relationship and putting them onto a CCP could create a large bilateral exposure between the dealers in relation to the ineligible contracts (where no exposure had previously existed). If Art 3aa is retained, we would welcome this, in this context.

- The ability of a CCP to handle the volume of relevant contracts should be a pertinent consideration for the purposes of eligibility determination and we therefore oppose the 7 December text’s deletion of this criterion.

- We believe there may be a case for making international convergence a clearing eligibility consideration;

- We believe that the list of criteria for consideration in relation to eligibility should not necessarily be exhaustive. ESMA should be able to consider any factor brought to its attention if this factor is pertinent in systemic risk terms.

- Contrary to recital 12a, the top-down approach, as set out in Article 4 does not refer to the ability of ESMA to restrict trading in contracts that ESMA deems eligible but that CCPs are not prepared to clear (or for which CCPs have not yet received authorisation). While we recognise that such a step may only be deemed necessary after several other intermediate measures (e.g. extensive dialogue with industry, gauging the efficacy of bilateral risk mitigation tools in place for these contracts) have been pursued, we believe that the Articles should not refer to such a power/measure, as it could have unhelpful consequences in terms of basis risk and liquidity.

In **Article 5 (Access to a CCP)**, while we welcome the reference to the need for CCPs to use ‘relevant international communication procedures and standards for messaging and reference data’, we fear that the requirement that venues obtaining access should complying with ‘operational and technical

requirements' set out by the CCP could still be deployed as a means for vertically integrated CCPs to block access.

On **<u>Article 6 (Reporting Obligation),</u>** we are concerned that the intent behind the article could be better addressed by referring to "*Counterparties or CCPs*" (rather than "*counterparties and CCPs*") but are not convinced that even this change will resolve the issue of duplication. Perhaps the text should clarify that the obligation to report applies to one counterparty only (i.e. the obligation is satisfied by one counterparty reporting). We also note that Article 6(2) now does not contemplate reporting of positions to home regulators, but rather to ESMA. This is likely to have practical implication and we would query the basis on which home regulators have been excluded from this process.

Under **<u>Article 7 (Non-financial counterparties)</u>** we

- Welcome the proposal that 'open' contracts entered into by non-financial counterparties would not have to be cleared (no backloading).

- Welcome the fact that "clearing thresholds shall be determined taking into account the systemic relevance of the sum of net positions and exposures by counterparty per class of derivatives over *<u>a specified time period"</u>* – in other words, a non-financial would not be required to clear all contracts by virtue of it *momentarily* exceeding this threshold.

- Welcome the suggestion that a non-financial counterparty would have 6 months to comply with its clearing requirements if exceeding the threshold.

In **<u>Article 8 (Risk mitigation techniques for contracts not cleared by a CCP)</u>**, paragraph 1a no longer specifies that segregation of collateral (in cases where title transfer is not deployed) applies to initial margin – we believe it should.

In **<u>Article 23 (third countries) and 63 (equivalence and recognition)</u>**, ESMA is given up to 180 days to rule on the recognition or otherwise of third country CCPs and trade repositories. Certainly, in the case of trade repositories, this seems an excessive amount of time for such a decision. Furthermore – also in relation to Article 23 and 63 – while we understand the political reasons for the demand for arrangements to be in place onsite inspections of third country CCPs and trade repositories, we believe that such arrangements are best made through dialogue with regulators in other jurisdictions and not in regulation.

We welcome the new **<u>Art. 32a (Communication procedures with clearing members and market infrastructure).</u>**

Under **<u>Art. 35 (Participation requirements),</u>** we welcome the suggestion that CCPs must seek the advice of the Risk Committee in establishing categories of clearing members and admission criteria. We suggest that there should be more clarity as to what is meant by '*necessary additional financial resources*' in paragraph 3, for the purpose of clearing members who wish to clear on behalf of clients and, in particular, what *'additional obligations' ('proportional to the risk brought'* by clearing members) could/should be imposed on clearing members in a default situation. The concern in this

regard is that an undue burden could fall on these clearing members – if holding a high proportion of position in such a situation – thus jeopardising their position and that of the CCP.

Article 37 (Segregation) now stipulates that CCPs should offer full segregation, and we welcome this. We are concerned that the zero weighting charge will not apply unless full segregation is provided, however, and believe that this is inconsistent with Directive 2006/48/EC, Annex III, Part 2, point 6.

Art. 37a (Provision of margins and default fund contributions) allows CCPs to use margins or default fund contributions collected via a security financial collateral arrangement, where agreed with a member. We have reservations on this point – for systemic risk reasons.

In **Article 41 (other available financial resources)** there is no mention of any cap on non-defaulting members' liability towards the CCP. Some general commentary – at least – would be welcome on this point, even if it cannot be addressed in detail at level 1.

We welcome the improvement in **Art. 42 (Default waterfall)** in relation to ensuring that CCPs use their 'own funds' before depleting the default fund ('skin-in-the game') although more detail in this regard would be welcome (rather than just referring to '*a reasonable part'* of their own funds).

Art. 43 (Collateral requirements) continues to indicate that CCPs may be able to accept highly liquid collateral other than cash as collateral, with the EC to draft standards defining what types of collateral can be considered highly liquid. We believe that a distinction should be made herein between initial margin and variation margin, however. We also believe strongly that extensive public consultation should take place as to what constitutes '*highly liquid'*.

In **Art.44 (Investment policy),** we would make the observation that the new language in paragraphs 2 and 2a that appears to be designed to reassure clearing members as to the security of their default fund contributions seems to contradict the aim of the last paragraph of Art. 37a regarding reuse of such contributions by CCPs.

In Article 46 (Review of models, stress testing and back testing), we would suggest that regulators adopt a risk based approach to determine the likelihood that a clearing member will be able to meet its unfunded obligations across all clearing houses.