ISDA response to the Bank of England consultation
Derivatives clearing obligation – modifications to reflect interest rate benchmark reform: Amendments to BTS 2015/2205

Executive Summary

ISDA members are very supportive of the Bank of England's (BoE) consultation on adapting the UK EMIR derivatives clearing obligation (CO) in the context of interest rate benchmark reform.

ISDA members acknowledge the benefits of central clearing, as demonstrated by the current clearing rates for risk free reference rate (RFR) swaps. We believe that introducing a CO for these products could be a helpful tool for avoiding liquidity fragmentation.

We believe that transactions stemming from Post Trade Risk Reduction (PTRR) exercises should be exempt from the CO, to enable market participants to manage the risk in their uncleared portfolios.

While not strictly in scope of this consultation, we also ask that the impact of a CO for OTC derivatives which reference a RFR on the derivatives trading obligation (DTO) be kept in mind. This impact should be carefully and independently analysed as it could have detrimental impacts on the market. Transactions not subject to the CO (such as IBOR swaps) should also be removed from the scope of the DTO.

Consultation Questions

1. Do you agree with the proposed modifications to the scope of the clearing obligation? If not, please provide your rationale.

ISDA members are very supportive of central clearing

Clearing, one of the key pillars of derivatives regulatory reform in the 2009 Pittsburgh G20 Communique, has several benefits for derivatives business that include: the risk reduction achieved by multilateral netting; tight operational processes; and ultimately reduction of counterparty risk. On top of these benefits, other regulations now provide powerful incentives to clear centrally, such as uncleared margin requirements (UMR)[1].

As such, a very broad clearing mandate may in principle no longer be required, and there may be a case for permitting greater flexibility in its application – for example permitting

[1] UMR continues to be phased in: the final phase of Initial Margin requirements will take effect for the smallest counterparties in-scope of Initial Margin requirements in September 2022.

exemptions from the CO for transactions stemming from post trading risk reduction exercises (see below).

This is evidenced by current clearing rates for new RFR products, which are currently largely outside the scope of CO:

	Full Year 2020		
US$ billions	**Total Notional**	**Cleared Notional**	**Clearing Rate**
SOFR	1,323.0	1,189.4	89.9%
SONIA	16,979.1	16,886.9	99.5%
SARON	32.6	32.5	99.8%
TONA	249.0	241.0	96.8%
€STR	85.3	42.9	50.2%
All IRD Products	230,571.7	208,080.6	90.2%

Source: ISDA analysis based on DTCC SDR data

A clearing obligation could be helpful in avoiding liquidity fragmentation

As noted by the BoE, it is critical that there is sufficient liquidity in all RFRs before supporting a CO, in order to avoid detrimental market impacts. We agree with the BoE's view that the conversion of IBOR swaps by CCPs will provide the required liquidity in RFR swaps.

We welcome the BoE's inclination to limit these changes to benchmarks currently within the scope of the clearing obligation that are being discontinued by January 2022, and that BoE is not proposing a CO for currencies where no clear RFR liquidity has yet developed (e.g. JPY LIBOR) [2] or where the transition will happen at a later stage (e.g. for certain USD LIBOR tenors by 30 June, 2023), in order to avoid market disruption and ease these sensitive transitions.

Despite dealers generally clearing voluntarily, in this particular case, and to support an orderly migration it is important that the market does not split into a cleared and an uncleared market. While we don't believe such a development is likely (as market participants already clear most RFR swaps) a clearing obligation could be helpful to ensure such a split will not happen. Market participants currently not subject to the clearing obligation, whether permanently or temporarily (such as pension scheme arrangements or small financial counterparties (SFCs)) would be able to continue to trade uncleared bilateral transactions, but would have the option to decide to clear voluntarily.

We welcome the BoE's opposition to the frontloading concept, as this would create an unnecessary burden on the derivatives market.

[2] For JPY transactions, CCPs plan to convert transactions to TONA in December 2021. In addition, in the ISDA IBOR fallbacks, LIBOR will be replaced by TONA.

Transactions stemming from PTRR exercises should be exempt from the clearing obligation

We ask the BoE to contemplate an exemption from the clearing mandate applying to RFR swaps in the case of trades resulting from PTRR exercises (such as multilateral risk rebalancing cycles, which reduce uncleared counterparty credit risk and/or shift existing risk from the uncleared space to CCPs). With the extension of the clearing obligations to RFR swaps, such risk management practices, currently undertaken by many large dealer banks, could be impaired, as OIS as a tradeable instrument for both cleared and uncleared interest rate risk would no longer be available.

Reducing risk in uncleared portfolios is very beneficial in volatile markets such as those experienced in March 2020. Large market moves will cause large liquidity requirements for market participants if they are not able to manage the risk in their bilateral portfolios.

We also note (and welcome) that HMT - in the Wholesale Markets Review - has consulted[3] on the question whether there should also be an exemption from the EMIR CO for trades resulting from post-trade risk reduction services, assuming that such trades also become exempted from the DTO.

2. Do you agree with the proposed dates for when these modifications will come into force? If not, please provide your rationale.

We agree with the proposed dates, assuming that all CCPs clearing the affected reference rates will convert transactions at the same time.

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/998165/WMR_condoc_FINAL_OFFICIAL_SENSITIVE_.pdf

3. Do you have any other comments on the proposal set out in this consultation?

The impact of a RFR CO on the derivatives trading obligation (DTO) should be carefully considered by regulators in order to avoid detrimental market impacts

While we are supportive of a clearing obligation for RFR swaps, we welcome the fact that the BoE and the FCA are considering whether the CO and DTO (respectively) should apply to RFR swaps in separate consultations.

In this context, we note that the FCA plans to review the scope of the UK MiFIR DTO and consult on any proposed changes in Q3 this year in light of Brexit and the LIBOR transition. ISDA members look forward to responding to this consultation.

ISDA would welcome early confirmation that LIBOR products that will be discontinued will be removed automatically from the scope of the UK DTO (given that they will no longer be clearable).

Impact on Intragroup transactions

It is important that BoE provide clear guidance to firms that existing approvals for intragroup exemptions (from clearing) remain valid and that no re-application is needed due to the adjustment of the products subject to the CO.

Clearing obligations should be internationally coordinated

While we applaud BoE's leadership in adapting clearing mandates to the changes stemming from the migration from IBOR rates to RFR, we would welcome international regulatory cooperation and coordination regarding clearing mandates to avoid market fragmentation.

We note that on 9th July ESMA issued a consultation on changes to the EU clearing obligation caused by the replacement of reference rates which are broadly comparable to those put forward by the BoE, but at present, it is not clear whether the US CFTC and other jurisdictions are likely to enact similar clearing obligations changes this year.

We appreciate that BoE is in contact with regulators in other jurisdictions and ask for this coordination to continue. Ideally, all jurisdictions, including the UK, should coordinate and implement similar adjustments on their clearing mandates at the same time in order to limit market impacts.

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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 960 member institutions from 76 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.