ISDA Safe, Efficient Markets

20 December 2018

ISDA response to the PRA's Consultation Paper CP26/18 – UK withdrawal from the EU: Changes to PRA Rulebook and onshored Binding Technical Standards

The International Swaps and Derivatives Association ("**ISDA**") welcomes the opportunity to respond to the PRA's Consultation Paper CP26/18 – UK withdrawal from the EU: Changes to PRA Rulebook and onshored Binding Technical Standards.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 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.

1. General comments

PRA's proposal to "divide" the BTS into a PRA version and FCA version

We note the PRA's proposal to divide the BTS so that there is a PRA version and an FCA version of each BTS (with the exception of the BTS on bilateral margining). While we appreciate that this is consistent with the separate statutory objectives of the two regulators and with the approach of each regulator maintaining its own rulebook, we are concerned that this division could lead to divergent obligations arising under the PRA and FCA versions of a particular BTS.

We would ask the PRA (and FCA) to consider maintaining a single version of each BTS but adjusting it as necessary to reflect any different requirements that they consider appropriate for PRA or FCA regulated entities. This will have the advantage of keeping the relevant legislation in a single place and also of ensuring that unintended differences do not start to emerge between the two separate versions.

EU Guidelines and Recommendations

We would welcome confirmation from the PRA that it will publish a definitive list of the guidelines and recommendations that firms can no longer rely on or are no longer expected to comply with, and that firms can assume that they can continue to rely on all of the other guidelines and recommendations published by the European Supervisory Authorities (including guidance issued via Q&As).

2. Chapter 2: Interpreting PRA approach documents, PRA Supervisory Statements, and PRA Statements of Policy

ISDA welcomes the PRA's confirmation that it will not be making detailed amendments to its approach documents, Supervisory Statements or Statements of Policy in advance of exit day, and that firms should continue to apply these to the extent that they remain relevant in light of the UK's withdrawal from the EU.

However, while in some cases it will be obvious where PRA non-binding materials should be interpreted in the light of the changes being made to the relevant legislation (e.g., in the case of references to EU authorities which should be interpreted as references to the relevant UK regulator post Brexit), there may be cases where it is less obvious and where no other guidance on interpretation is available it may be difficult for firms to be certain how to interpret pre-existing PRA non-binding materials. We would welcome confirmation from the PRA that it intends to review its non-binding materials and update these in due course, or that it will produce guidance on interpretation along the lines set out in Appendix 2 in relation to reporting and disclosure requirements.

3. Chapter 3: Approach to reporting and disclosure requirements

ISDA welcomes the PRA's statement that it is considering exercising its temporary transitional power to delay the application of onshoring changes including those in relation to reporting and disclosure requirements and would welcome confirmation that the PRA does intend to exercise the temporary transitional power in this way at the earliest opportunity.

The PRA states that changes in reporting requirements may occur as a result of changes in the underlying regulatory requirements arising from the UK's withdrawal from the EU, rather than as a result of changes in the relevant rules or BTS being made by the PRA, and it identifies changes in capital treatment of exposures to the EU or its Member States as an example. We would welcome confirmation that the PRA intends to exercise its temporary transitional power to give relief from all changes to firms' obligations that arise from Brexit (except where transitional provision is already made in the relevant onshoring SI or in the cases where the PRA has already stated that it does not intend to exercise its temporary transitional power), not just those which arise from specific changes made by the PRA to its rules or BTS.

4. Chapter 4: Proposals relating to PRA-regulated banks, building societies and designated investment firms

Contractual recognition of bail-in

ISDA welcomes the PRA's proposal to amend Rule 2.1 of the Contractual Recognition of Bail-in Part so that the requirement does not apply in respect of EEA law governed liabilities that were created before exit day. We agree that the resultant risk to the resolvability of firms is low, and that in the event that the Bank of England does identify existing EEA law governed liabilities which might constitute a substantive impediment to the resolution of a particular firm, it may use its power of direction to address this issue.

We also welcome the PRA's proposal to use its temporary transitional power to delay the obligation to include a contractual recognition of bail-in term in EEA law governed phase two liabilities that are created or materially amended after exit day.

Contractual recognition of stay in resolution

As for contractual recognition of bail-in, ISDA welcomes the PRA's proposal to require firms to comply with the contractual recognition of stay rules in respect of EEA law governed financial arrangements created or materially amended after exit day, and not otherwise to require firms to update their EEA law governed financial arrangements that are in existence at exit day. Again, we agree that the resultant risk to resolvability is low and that if the Bank of England does identify concerns in relation to a particular firm it can use its power of direction to address those concerns.

However, in contrast to the approach under the contractual recognition of bail-in rules, we note that the PRA does not intend to use the temporary transitional power to delay the obligation to include a contractual recognition of stay term in EEA law governed financial arrangements created or materially amended after exit day.

We are concerned that this may create a discrepancy for liabilities arising under derivative contracts (which are most likely to be phase two liabilities benefiting from transitional relief from the contractual recognition of bail-in rules). This could have the effect of undermining the application of the temporary transitional relief to the contractual recognition of bail-in term requirement, as firms are likely to include that contractual term to the extent Stay in Resolution wording is being added to the agreement governing the liability. It would be helpful if the treatment of the two requirements could be aligned, with the temporary transitional power being extended to the Stay in Resolution rules.

We note that a significant number of UK firms (and their counterparties) have already incorporated contractual recognition of stay in resolution language into their non-EEA law governed financial arrangements (e.g., New York law governed contracts) on the basis of the 2015 version of the PRA rules which introduced this requirement. We note that it would be unduly onerous for market participants to amend such arrangements to reflect this new version of the stay in resolution rules (to the extent that this were required).

BTS on bilateral margining

We understand that the amended BTS will not be "divided" between the PRA and the FCA, so that these BTS will remain the same regardless of whether they apply to a solo regulated or a dual regulated firm. ISDA welcomes this approach as there would be a significant risk of confusion and disruption if the margin rules applicable to PRA and FCA regulated firms started to diverge.

We also have the following comments on the PRA's proposed approach:

- **Eligible collateral**: We understand that EU Member State government debt securities would cease to be eligible as eligible collateral under Article 4(1)(c) of the BTS, which would now only cover UK government debt. They may be eligible as third country debt securities under Article 4(1)(j), but this would depend on whether or not they meet the criteria for the credit quality assessment under Article 6. We understand that the majority of members would rely on a credit quality assessment issued by a recognised External Credit Assessment Institution (ECAI). However, if the relevant ECAIs are not recognised in the UK at exit day then firms will need to obtain an alternative rating or develop an internal rating.

  This is likely to result in a requirement for firms at least to review and potentially also to amend significant number of collateral schedules to reflect these changes, and we would welcome confirmation that the PRA intends to exercise its temporary transitional powers to delay the application of these changes.

  We would also welcome confirmation from the PRA that EU UCITS will continue to qualify as eligible collateral on the same basis as UK UCITS.

- **Credit institutions where cash IM can be maintained**: The PRA proposes that only PRA authorised credit institutions or institutions authorised in an equivalent third country will be eligible. "Equivalent" third countries are determined by reference to Article 142(2) of Regulation (EU) No 575/2013. Unlike with other references to EU legislation, the BTS do not refer to equivalence decisions adopted under CRR prior to exit day, and adopted under onshored CRR post exit day, so it appears that a third country will be equivalent for these purposes if the European Commission adopts an equivalence decision under CRR (even after exit day).

  If this interpretation is correct, UK firms may not be able to hold IM with EU credit institutions, as the European Commission will not adopt an equivalence decision in relation to the EU, so EU credit institutions will not be institutions authorised in an equivalent third country.

We would ask the PRA to correct the reference to "Article 142(2) of Regulation (EU) No 575/2013" so that it refers to "Article 142(2) of the Capital Requirements Regulation". We would also welcome confirmation that the PRA intends to exercise its temporary transitional powers to delay the application of these changes until the necessary equivalence decisions have been adopted. In particular, we note that an inability to hold cash collected as IM with EU credit institutions (even for a short period) would create significant issues for UK firms, as a large proportion of the market currently utilises such credit institutions (e.g., Euroclear and Clearstream) for collateral management purposes.

- **Intragroup exemption**: The PRA proposes to delete the derogation for cross-border intragroup transactions where no equivalence decision is available, as the EMIR onshoring SI already provides for a period of up to 3 years from exit day during which intragroup transactions that are currently exempt from clearing and margin requirements will continue to be exempt.

  Given the difficulties experienced to date in obtaining equivalence decisions under EMIR, unless the PRA and HMT are confident that all necessary equivalence decisions will be in place by the end of the 3 year transitional period we would ask the PRA to consider retaining the existing derogation and aligning the period of the derogation with the period in the EMIR onshoring SI so that if additional time is required this derogation period can be extended.

  While we realise that this is outside the scope of the CP, we would draw the PRA's attention again to the difficulties in interpreting the equivalence requirement under the intragroup exemption, and the uncertainties that arise in the event that a third country jurisdiction implements margin rules that only cover part of the population of OTC derivatives subject to margin under EMIR. We would welcome further guidance on this from the PRA and would be happy to discuss this further.

- **Application of VM rules to physically settled FX**: The ESAs have issued draft regulatory technical standards (JC/2017/79, dated 18/12/2017) proposing that Delegated Regulation (EU) 2016/2251 be amended to provide that counterparties may agree that variation margin should not be required to be posted or collected for physically settled foreign exchange forward contracts where one of the counterparties is an entity other than an "institution" (or is a non-EU entity that would not be an "institution" if it was established in the EU) in the sense of point (3) of Article 4(1) of Regulation (EU) No. 575/2013. The PRA's CP does not discuss this at all and we would welcome confirmation that the margin BTS will be amended to reflect this proposal and that appropriate transitional relief will be available in the interim.

- **Phase-in provisions**: We note that while the bilateral margin RTS contain phase-in provisions for a number of requirements (including initial margin under Article 36 and the application of the requirements to single-stock equity options under Article 38) these provisions are not onshored under the Withdrawal Act and will not form part of the onshored domestic legislation. If the PRA intends to introduce these requirements we would welcome confirmation at the earliest possible stage of the intended application date and any phase-in provisions.

ISDA understand that the PRA intends to exercise its temporary transitional power in relation to the changes in the margin rules, and we would welcome confirmation that the PRA will provide firms with two years of transitional relief given the scale and size of the repapering exercise involved and to avoid imposing additional burdens on firms that are already in the process of implementing the EMIR margin requirements over the same period.

Member firms have indicated that implementing the proposed changes to the margin BTS will require firms to undertake a significant repapering exercise, including negotiating amendments to between 140 and 180 collateral schedules with counterparties in up to 25 different jurisdictions, involving an estimated cost in the region of EUR 1.5 million.

Based on their experiences with margin repapering exercises to date, member firms consider that they will need at least a 2 year transitional period (and potentially up to three years) in order to effect these changes and to avoid adverse impacts on firms' existing projects to prepare for Phase 4 and 5 Initial Margin as well as to implement other Brexit-related changes, including Brexit-related group restructuring and adjustment to the other changes to UK regulation as a result of Brexit.

The comments above focus on renegotiation of collateral schedules, but it is likely that this would form part of a broader renegotiation exercise that would be necessary in order to reflect the wider changes brought about by the split between EU EMIR and UK onshored EMIR. In particular, references to EU EMIR in relevant documentation would need to be replaced with references to UK onshored EMIR, which would greatly expand the scope of documentation which needs to be amended.

However, until it becomes clear that a no-deal scenario is likely, firms do not currently have significant resources focussed on implementation of these proposed changes, so it is difficult for firms to give a detailed assessment of likely implementation timeframes at this stage and it is possible that a longer transitional period may be required.

5. Chapter 5: Proposals relating to PRA-regulated insurers

ISDA does not offer comments on this Chapter.

6. Chapter 6: Proposals relating to credit unions

ISDA does not offer comments on this Chapter.

7. Chapter 7: Proposals relating to firms in the temporary permission regime (TPR)

ISDA welcomes the PRA's proposal to grant temporary transitional relief in relation to certain aspects of the third country branch requirements for EEA firms that enter into the TPR. We agree that these firms are likely to find it challenging to comply immediately after exit day with all of the PRA rules that will apply to them for the first time.

However, we note that the PRA intends to apply the SM&CR for UK branches of third country firms to firms in the TPR, including both UK branches of EEA firms and cross-border service providers without a UK branch. This is not consistent with the approach proposed by the FCA, which currently proposes to continue to apply the regime for EEA branches to firms in the TPR. We would ask the PRA to consider aligning its proposals with those of the FCA to ensure that firms relying on the TPR are not required to implement a new set of requirements during the TPR and then to make further changes once they exit the TPR. The PRA's approach also risks imposing disproportionate burdens on EEA firms currently providing cross-border services without a UK branch that may rely on the TPR to manage their withdrawal from the UK and may not intend to establish a UK branch and apply for Part 4A permission.

8. Chapter 8: Proposals relating to FSCS protection

ISDA does not offer comments on this Chapter.

9. Chapter 9: The PRA's obligations under the Regulations

ISDA does not offer comments on this Chapter.

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