ISDA® Safe, Efficient Markets

Priya Kotadia/John Wu
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

25 August 2021

Sent via email and by FCA response form: cp21-22@fca.org.uk

Dear Priya and John,

Response to FCA CP21/22[1] on LIBOR transition and the derivative trading obligation

The International Swaps and Derivatives Association, Inc. (**ISDA**)[2] welcomes the opportunity to respond to the FCA's CP21/22.

Overview and summary

We welcome the opportunity to respond to this consultation and note that we strongly support the FCA's position on the following points that are key to support a smooth transition away from LIBOR linked products and are also key in light of the global nature of derivatives markets:

- We agree that taking no action with respect to derivatives referencing legacy benchmarks that will be discontinued or may continue on an unrepresentative basis would undermine the G20 commitment and policy objective of the DTO;
- We also support the FCA's comments that as there is currently no clearing mandate or platform trading mandate for SOFR products in the US, there should not be a clearing mandate or platform trading mandate for these products in the UK - while the US regulatory framework for the platform trading mandate differs from that under MiFIR, the objectives are the same.

However, we would ask the FCA to consider phasing in any new products to be included within the scope of the DTO. As discussed below, we do not consider that a phase-in of any new obligation would result in material risk to UK markets, and it would help to alleviate the pressures on firms currently working hard to effect LIBOR transition by the end of 2021.

[1] https://www.fca.org.uk/publication/consultation/cp21-22.pdf

[2] **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 78 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.

.

Q1: Do you agree with the approach and assumptions specified above? If not, please explain why.

Yes, we agree with the FCA's approach and in particular its comments that:

- Taking no action with respect to derivatives referencing legacy benchmarks that will be discontinued or may continue on an unrepresentative basis would undermine the G20 commitment and policy objective of the DTO;
- Where possible implementation dates for removal of products from the DTO should be aligned with changes to the DCO and relevant dates that CCPs have announced as part of broader transition efforts;
- The FCA has not considered inclusion of contract types referencing LIBOR in currencies such as JPY and CHF, as these are not proposed to be included in the DCO.

We acknowledge that it has been challenging for the FCA to conduct an assessment of average frequency of trades as the LIBOR transition is not yet complete and because of other market challenges (including Brexit and the current pandemic), but we welcome the FCA's proposal to carry out ongoing monitoring of liquidity in €STR and SOFR linked derivatives rather than include these within the DTO at this stage.

Q2: Do you agree with the FCA that there do not appear to be any classes of derivatives or individual derivative contracts that should be subject to the DTO but for which no CCP has yet received authorisation under EMIR or which are not admitted to trading or traded on a trading venue? If not, please explain why.

Yes, we agree with the FCA that there do not appear to be any classes of derivatives or individual derivative contracts that should be subject to the DTO but for which no CCP has yet received authorisation under EMIR or which are not admitted to trading or traded on a trading venue.

Q3: Do you agree with the FCA's view on impact in paragraphs 3.26 and 3.27 above? If not, please explain why.

While we acknowledge the evidence that inclusion of new classes of derivatives within the DTO can result in improved liquidity in those derivatives, we note that market participants are undertaking a significant amount of work to prepare for LIBOR cessation and that capacity (both within firms and within their clients and counterparties) to undertake additional work to implement a new trading obligation is likely to be more restricted between now and the end of 2021.

While inclusion of new classes of derivatives within the DTO may not <u>on its own</u> slow, hinder or disrupt the LIBOR transition process, it is also necessary to take into account not only the other work that market participants are currently undertaking with respect to LIBOR transition in the UK, but also the work that needs to be undertaken in other jurisdictions to facilitate LIBOR transition (including potential implementation of new clearing and trading obligations in other jurisdictions), as well as the timing for introduction of new classes of derivatives to the DTO. If new obligations are introduced towards the end of 2021 just as market participants are managing the impact of LIBOR actually ceasing to be published, this will involve an additional regulatory burden and may potentially result in disruption to the LIBOR transition process.

As a result, as discussed further in our response to question 5 below, we would ask the FCA to consider phasing in any new trading obligation, so that the new obligation would take effect no earlier than Q3 2022, to avoid over-burdening already stretched resources of market participants.

Q4: Do you agree with the liquidity analysis set out above? If not, please provide explanations and data to support your response.

N/A.

Q5: Do you agree that LIBOR transition plans have provided market participants with sufficient time to prepare within the proposed timelines for the changes described above? If not, please explain what transition period is needed and why?

While market participants are working hard to prepare for LIBOR cessation at the end of 2021, this work has so far focussed on preparing for lack of availability of LIBOR and lack of liquidity in LIBOR-referenced products, rather than on preparing to develop the systems and documentation necessary to support mandatory clearing or trading in additional products.

As a result, while we agree with the timelines proposed by the FCA for removal of derivatives referencing GBP LIBOR from the current DTO, we are concerned by the proposal to introduce derivatives referencing SONIA to the DTO from the same date. While we do not disagree with the FCA's proposal to include derivatives referencing SONIA in the DTO, implementation of this obligation will take additional work and time. If counterparties need to prepare for implementation of a new trading obligation at the end of 2021 this will be an additional regulatory burden on market participants at a time when there is already potential for market disruption, despite the huge amount of work already undertaken by market participants in connection with LIBOR cessation.

We would ask the FCA to consider an additional phase-in period of 6 months, with the effect that market participants are only required to comply with any new DTO for transactions concluded from the end of the phase-in period. This additional phase-in period would allow firms to undertake the practical steps necessary to prepare for implementation, including client communications, internal system updates and amendments, co-ordination with relevant CCPs and trading venues and internal compliance steps (including staff training and updating relevant policies and procedures). We note that there are significant commercial incentives to clear RFR linked products and trade them on-venue, and that liquidity is building in these products on CCPs and on-venue. We do not consider that a delay in phase-in of the DTO would have a negative impact on this. However, a phase-in period will help provide a breathing space to smaller market participants who may find that their resources are already stretched, especially given the proposed introduction of new tenors and new start types.

We would also ask the FCA to confirm the proposed changes to the DTO at the earliest possible opportunity, in order to help market participants prepare for implementation.

While we appreciate that the FCA has carried out an analysis of the liquidity of the derivatives referencing SONIA that it proposes to include in the DTO, and that the FCA is only proposing to include instruments that it considers to meet the liquidity criteria, we would reinforce the point that only highly liquid instruments should be made subject to mandatory trading, given the risk of damage to the liquidity of less liquid instruments if a DTO is imposed too early. We would also note that it is not necessary for transactions to be made subject to a DTO in order for them to benefit from robust post-trade infrastructure – interest swaps executed bilaterally will typically be processed through the same post-trade infrastructure as swaps executed on-venue (at least where the bilateral swaps are cleared on a CCP).

We also consider that transactions stemming from Post Trade Risk Reduction (PTRR) exercises should be exempt from the CO and DTO, to enable market participants to manage the risk in their uncleared portfolios. We appreciate that HM Treasury is currently considering whether to implement any formal 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). However, we would ask the FCA to bear in mind, when introducing new products to the DTO, that PTRR exercises are a key tool in managing LIBOR transition. With the extension of the clearing and trading 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.

Q6: Do you agree with our proposal with respect to €STR products? If not, please explain why and please provide supporting data where possible.

We agree with the FCA's proposal with respect to €STR products. While it is clearly necessary to ensure that contracts do not become subject to the DTO unless they are already subject to the DCO, contracts should not become subject to the DTO unless there is sufficient liquidity to support this. As a result, we welcome the FCA's proposal to monitor market developments and liquidity in €STR OIS over the coming months and consider including these contracts in the DTO only when the FCA is satisfied that the class of derivatives is sufficiently liquid.

Q7: When might be the right time to remove USD LIBOR products from the scope of the DTO? Please provide supporting data where possible.

We consider it likely that the transition regarding USD LIBOR will have made sufficient progress by this Autumn to support a decision to remove IRS referencing USD LIBOR from the DTO. While we understand that the current intention is for the majority of tenors of USD LIBOR to continue to be published until June 2023, 1-week and 2-month USD LIBOR will cease to be published at the end of 2021. In addition, the strong recommendation from relevant regulators, including regulators in the US as well as the FCA and Bank of England has been that firms should cease to reference any tenor of USD LIBOR in new derivative contracts by the end of 2021. As a result, we consider that the efforts that have been and continue to be taken to transition away from these rates should be supported with a change in the scope of the DTO.

In the event that USD LIBOR is kept within the scope of the DTO, we would ask the FCA to monitor this closely as we would expect liquidity to decrease significantly in the near future. Several CCPs have already announced that they will cease clearing swaps referencing LIBOR from specified "big bang" dates (with the first of these falling on 18 October 2021, in relation to EONIA). If USD LIBOR derivatives are kept within the scope of the DTO at this stage, and if it is not possible to remove USD LIBOR from the DTO on short notice at a later date then it may be necessary for the FCA to provide for regulatory forbearance or other relief if market participants become unable to clear in-scope USD LIBOR products or trade them on-venue.

Q8: Do you agree with our proposal with respect to SOFR products? If not, please explain why and please provide supporting data where possible.

We agree with the FCA's proposal with respect to SOFR products. We do not consider that there is yet sufficient liquidity to introduce SOFR OIS to the DTO (and, as mentioned above, in any event we consider that contracts should not be made subject to the DTO where they are not already subject to the DCO, and the BoE has not proposed to make these contracts subject to the DCO).

In addition, as the FCA mentions in the CP, there is currently no clearing mandate or platform trading mandate for SOFR products in the US, and while the US regulatory framework for the platform trading mandate differs from that under MiFIR, the objectives are the same.

Contacts:

Fiona Taylor, Director of UK Public Policy, ftaylor@isda.org
Roger Cogan, Head of European Public Policy, rcogan@isda.org
Ulrich Karl, Head of Clearing Services, ukarl@isda.org