ISDA Safe, Efficient Markets

ISDA RESPONSE TO HM TREASURY'S SHORT SELLING REGULATION CONSULTATION – SOVEREIGN DEBT AND CREDIT DEFAULT SWAPS

7 August 2023

Response to HM Treasury Consultation on the Short Selling Regulation – sovereign debt and credit default swaps

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to HM Treasury's short selling consultation on sovereign debt and credit default swaps (CDS). Our response will focus on the CDS market.

1. Do you agree with the analysis of the current SSR requirements set out in paragraphs 2.5-2.10 (including our view on the impact on liquidity and settlement)?

ISDA agrees with HMT's summary in paragraphs 2.5-2.7 which sets out the UK government position, that the UK has historically been opposed to introducing such restrictions on sovereign debt and sovereign CDS, as they previously argued that such restrictions would have a detrimental impact on the liquidity of sovereign debt markets. ISDA also agrees with the need to align with international standards.

The views expressed in paragraph 2.8 on liquidity and settlement state that, in summary, the sheer size and liquidity of the sovereign debt market makes it hard to see that there would ever be a case of settlement failure. Given that the purpose of covering requirements is to prevent settlement failure, the paper concludes that such arrangements are not necessary in CDS markets. Since 2009, auction settlement is the main settlement mechanism for CDS and is 'hardwired' into CDS contracts – under auction settlement a market wide settlement price is set and physical settlement is not necessary. This auction settlement mechanism has been used successfully many times when credit events occur.

2. Do you agree with the proposal set out in paragraphs 2.13-2.15? Please provide details to support your view, including any views on benefits and risks associated with the proposal.

Yes, ISDA strongly agrees with the proposal. We set out our views on this in answer to question 25 of HMT's Call for Evidence (see ISDA/AFME Joint response to HMT's Call for Evidence, March 2023[1]) where some of our members considered that the restrictions around sovereign CDS could be removed.

[1] ISDA-and-AFME-Response-to-HMT-on-Short-Selling-Regulation.pdf

In terms of the **benefits** of removing restrictions around CDS:

- **Removing the restrictions on sovereign CDS may result in more investment in the UK** as the risks can be better managed. In markets without the restrictions, sovereign CDS are used as a proxy hedge – i.e., to hedge various risks in the country that are correlated with the creditworthiness of the sovereign (such as investments in banks and utilities), rather than to hedge sovereign debt. The current restrictions on sovereign CDS have led to inefficiencies in the market. Removing the restrictions means that market participants could use sovereign CDS as an effective hedge to cover various risks they are exposed to in the UK.

- As the consultation points out, in other international jurisdictions, investors can buy protection through sovereign CDS in countries without any short selling restrictions. **Removing the restrictions will therefore help the UK to align with international standards**. If the sovereign CDS spreads widen, such investors are able to sell the CDS which would offset losses it may have incurred on its investments in that country.[2] In the UK (as with other European sovereign CDS covered by EU SSR) it is not possible for market participants to buy uncovered UK sovereign CDS, other than in a market making capacity. Therefore, if the UK economy deteriorates and UK sovereign CDS spreads widen, there will be less market participants to dampen volatility by realizing their hedges and selling protection to those who require it, and therefore swings in UK sovereign CDS prices will be exacerbated. A good example of this was seen during Autumn 2022 – UK sovereign CDS moved from 15bp to 55bp in a little over a week and there was an absence of market participants selling CDS protection to dampen the swing, as there were few owners of CDS protection positions. By way of context, UK sovereign CDS usually trades in a 10-20bp range. **Removing the restrictions around sovereign CDS would therefore help calm the market in volatile times.**

- **Removing the restrictions on sovereign CDS may incentivise more client demand for UK sovereign CDS and therefore more liquidity provision from banks.** This could result in a tighter distribution of spreads and have a positive impact on bank capital through Prudent Valuation Additional Valuation Adjustment (AVA) calculations.

- **Removing the restrictions around sovereign CDS is likely to reduce the extent to which market participants hedge UK country risk by shorting UK banks** (as the nearest equivalent to sovereign CDS).

- **Removing the restrictions altogether is preferable to making further amendments to the existing UK regime,** which is unlikely to deliver benefits that would outweigh the costs and complexity of additional implementation.

In terms of the regulator managing risk, we agree that the emergency intervention powers relating to short selling in exceptional circumstances should continue to extend to sovereign

[2] Note that a credit event on the sovereign does not need to occur for an investor to realize a gain from its CDS hedge – the CDS position can be sold at a higher price.

CDS. We support AFME's response in asking for additional clarity on the intervention powers in exceptional circumstances, such as the information that the FCA can request and the timelines within which firms will be expected to respond.

3. **Do you have any further views on the matters set out in the consultation?**

Members had no further views.

Thank you for the opportunity to respond to this consultation. We remain at your disposal for any other questions.

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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 1,000 member institutions from 79 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.