IQ In brief

On December 2, ISDA held a European public policy virtual conference exploring the implications of the forthcoming end of the Brexit transition period, central counterparty equivalence and the review of the European Union Benchmarks Regulation

European Regulators Resist Calls For Trading Venue Equivalence

European regulators recognise that a lack of equivalence between EU and UK trading venues will result in a fragmentation of liquidity after the end of the Brexit transition period, but have no plans to take action, maintaining the issue does not pose a risk to financial stability.

In keynote remarks at ISDA's European public policy event, Fabrizio Planta, head of markets and data reporting department at the European Securities and Markets Authority (ESMA), repeated the position set out in an ESMA statement on November 25 that the EU derivatives trading obligation (DTO) will continue to apply unchanged after the end of the transition period on December 31, 2020.

"Brexit will impact the functioning of markets and will inevitably result in some fragmentation of liquidity. While this is unfortunate, I believe it is an unavoidable consequence of the decision of the UK to leave the EU," he said. "We have assessed the situation over the last month and carried out a detailed analysis based on the data provided by major dealers. In our view, continuing to apply the EU DTO after the end of the transition period does not represent a financial stability risk."

> "Brexit will impact the functioning of markets and will inevitably result in some fragmentation of liquidity"
>
> **Fabrizio Planta, ESMA**

Without action, an EU and UK firm would find it challenging to trade a derivative that is subject to both the EU and UK trading obligations, because the EU DTO would require the transaction to be executed on an EU-recognised trading venue, and the UK DTO would require execution to take place on a UK-recognised venue. EU entities trading derivatives through their UK branches with a UK counterparty would be equally affected by this conflict. The only way for EU and UK counterparties to avoid this conflict would be to trade in-scope derivatives on US swap execution facilities (SEFs), which are recognised by both jurisdictions. However, this comes with several operational and practical challenges that might make this impossible for some.

"There are going to be negative impacts for end clients because of the absence of equivalence or any mitigating action. What this means is that they are going to face potentially poorer pricing and an inability to access the deepest liquidity pools. Also, from a practical perspective, not all clients are going to be ready from January 1, 2021, despite best efforts. It does take time to onboard onto SEFs, and I think many people have held onto that glimmer of hope that something would be done in the 11th hour," said Emma Tan, vice president of regulatory affairs at JP Morgan, speaking during a panel at the event.

There are some possible workarounds that could partially alleviate the duplication. These include reducing the territorial application to mitigate the impact on business conducted through overseas branches and narrowing the scope of instruments covered by the DTO – approaches proposed by Robert Ophèle, chairman of France's Autorité des Marchés Financiers (*see European DTO Must Be "Rapidly Adjusted", Says AMF's Ophèle, P2)*. However, industry participants maintain that equivalence is the best and most complete way to deal with the conflict for both EU and UK counterparties.

"Equivalence remains by far the most effective option to avoid fragmentation of liquidity and increased operational costs, particularly as the trading venue rules in the EU and UK are virtually identical. Both sides should work towards trading venue equivalence as a priority," said Scott O'Malia, ISDA's chief executive, in his opening remarks.

Also speaking at the event, Gilles Hervé, policy officer at the European Commission, said European authorities had listened to the challenges industry participants would face and would monitor the situation. However, he reiterated the view that changes were unlikely.

"We always knew that Brexit would have consequences on financial markets and on market participants. The idea is to reduce the consequences to the best extent, but we are living in a complicated world where the things that could be seen as pragmatic are mixed with political decisions," said Hervé. IQ

IQ In brief

European DTO Must be "Rapidly Adjusted", Says AMF's Ophèle

A failure to review the scope of the European derivatives trading obligation (DTO) before the end of the Brexit transition period will have severe consequences for liquidity and pricing, Robert Ophèle, chairman of France's Autorité des Marchés Financiers (AMF), has warned.

Delivering a keynote address at the conclusion of ISDA's European public policy virtual conference, Ophèle expressed his hope that the EU DTO "can still be rapidly adjusted both to the right scope of instruments and with a territorial approach".

The bulk of trading liquidity in instruments covered by the European DTO is concentrated in the UK, he observed. But while some platforms that support execution of those instruments have relocated to the EU ahead of the end of the transition period, that does not mean liquidity in all instruments will concentrate in Europe. Sterling- and US dollar-denominated interest rate swaps, as well as index credit default swaps, could be adversely affected, he said.

"For these instruments, there is therefore a huge probability that European firms' ability to tap deep liquidity pools for derivatives pricing will be impaired, despite the relocation to the US of part of their trades and, consequently, also of their clearing," said Ophèle.

"Around 70% of the volume of operations executed by branches of EU banks in the UK is at risk; it will either be lost or carried out on US SEFs"

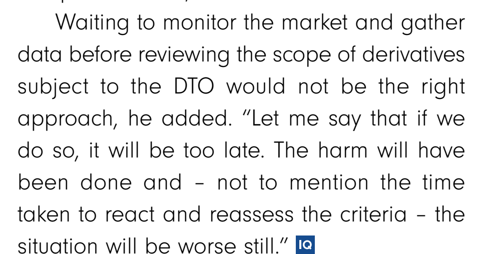
Robert Ophèle, AMF

Ophèle addressed the conflict that will arise from the overlap between the EU and UK DTOs, which are very similar, and the impact on UK branches of EU firms. As the rules currently stand, these branches are covered by the EU DTO and would not be able to deal with UK counterparties primarily subject to the UK DTO unless the transactions take place on third-country platforms recognised by both the EU and the UK, such as US swap execution facilities (SEFs).

"Here we have a perfect example of an overlap of two sets of conflicting rules. Based on French banks data, we could estimate that around 70% of the volume of operations executed by branches of EU banks in the UK is at risk; it will either be lost or carried out on US SEFs," said Ophèle.

Ophèle rebuked several defences of the planned application of the EU DTO after the Brexit transition period, including the argument that it will strengthen the capital markets union (CMU). The idea of the CMU, he said, is to build a mature market for EU counterparts trading on EU platforms, but firms should not be forced to hedge positions in markets that are less liquid than the local markets of each currency.

"The creation of a strong EU market in euro-denominated derivatives from scratch is to be supported where possible, but trying to build up a sterling and US dollar derivatives market in Europe with no critical mass of strong market players in these fields would be detrimental to European market players, without bringing any added value to the European market," he said.



Waiting to monitor the market and gather data before reviewing the scope of derivatives subject to the DTO would not be the right approach, he added. "Let me say that if we do so, it will be too late. The harm will have been done and – not to mention the time taken to react and reassess the criteria – the situation will be worse still." IQ

Join ISDA Online For More Virtual Events

Understanding the New IBOR Fallbacks (Japan)
Thursday December 10, 8:45am JST, https://bit.ly/2VwKK0L

Collateral Management Transformation Showcase
Wednesday January 20 to Thursday January 21, 9am EST, https://bit.ly/2VtQc4F

Digitizing Legal Documentation and Smart Contracts
Thursday January 28, 9am EST, https://bit.ly/2I7bMsD

EU Urged to Rethink BMR Third-country Regime

A political agreement to extend the transition period for the third-country benchmark regime under the EU Benchmarks Regulation (BMR) has been welcomed, but market participants believe further work is needed to avoid a cliff-edge effect for third-country benchmarks when the transition period ends.

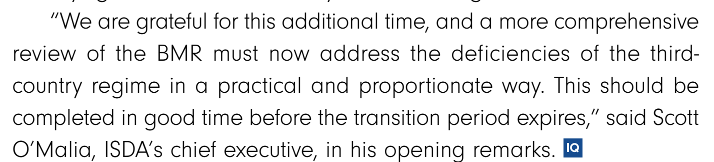
"As an industry, I still don't think we know how many third-country benchmarks we use, and we can't really understand what the impact is going to be until those transitional provisions expire. Without any real change to the scope of the regime, we need to anticipate that there will still be this cliff edge for a significant number of third-country benchmarks," said Anna Grainger, executive director, legal and compliance at Morgan Stanley.

Speaking during a panel discussion at ISDA's European public policy event, Grainger welcomed a recent agreement between EU institutions to extend the transition period for third-country benchmarks from the end of 2021 to the end of 2023. This follows a paper published on November 20 by ISDA and 13 other trade associations to make the case for an extension until the end of 2025 as part of the current review of the BMR.

The key challenge is that all three routes for qualifying third-country benchmarks for use in the EU have turned out to be problematic. Equivalence covers only a handful of benchmarks because very few jurisdictions outside the EU have similar regulations in place, while the other two routes – endorsement and recognition – are difficult, costly and unattractive even for large benchmark administrators.

David Henry Doyle, head of government affairs and public policy for Europe, the Middle East and Africa at S&P Global, explained that the endorsement option for qualification of third-country benchmarks had also proven to be challenging, mainly because of the steps required to link to the European Securities and Markets Authority's register.

"The process for endorsing benchmarks by EU authorised entities is extremely laborious. We were very surprised by the limitations of the register, by the complexity involved and by the very manual process it entails. This is now a major hurdle for large benchmark providers," said Doyle.



There is concern that in spite of the agreed extension of the transition period, problems will only recur at the end of the transition period if the underlying flaws in the third-country benchmark regime are not addressed.

"We are grateful for this additional time, and a more comprehensive review of the BMR must now address the deficiencies of the third-country regime in a practical and proportionate way. This should be completed in good time before the transition period expires," said Scott O'Malia, ISDA's chief executive, in his opening remarks.

EC Calls on Industry to Reduce UK Clearing

The 18-month temporary equivalence granted to UK central counterparties (CCPs) by the EU will not be extended, and EU market participants should work now to tackle any problems preventing them from reducing their exposure to UK clearing houses, according to a European Commission (EC) official speaking at ISDA's European public policy virtual event.

"We expect the industry to list the technical problems and find solutions to these problems, not use technical problems as an excuse, as a wall of technical problems that could be unsurmountable and that would make the commission in the position to be forced to renew an equivalence decision, because yes, this is the last one. This is the last 18 months that we are providing the industry," said Gilles Hervé, policy officer at the EC.

In September, the EC adopted a time-limited equivalence decision for UK CCPs, explicitly stating that market participants should use the time to reduce their reliance on these infrastructures.

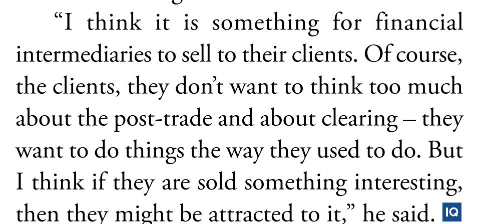
Speaking on the same panel, Emma Tan, vice president of regulatory affairs at JP Morgan, said the industry had "got the message" that there would be no extension of the temporary equivalence, but noted there are a variety of factors that influence a client's decision on where to clear.

"Clients and firms will always want to clear at places that provide them with the best prices, the deepest liquidity and the greatest netting efficiencies, and that is going to drive a lot of decisions," she said.

Any initiative by the industry to collectively move clearing from the UK to the EU could fall foul of antitrust authorities, she added. In addition, there are potential systemic risks associated with moving cleared legacy portfolios from the UK to the EU.

"That would obviously require the close-out of positions on UK CCPs and reopening them on EU CCPs, and that in itself would bring pricing and volatility concerns if the whole industry was trying to do that at the same time," she said.

In response, Hervé said regulators would work with market participants to find solutions to the issues, but noted EU CCPs already provide good liquidity and pricing for euro-denominated interest rate swaps – something clearing members should be making clear to their clients.



"I think it is something for financial intermediaries to sell to their clients. Of course, the clients, they don't want to think too much about the post-trade and about clearing – they want to do things the way they used to do. But I think if they are sold something interesting, then they might be attracted to it," he said.