A Competitive, Resilient, Sustainable Europe:

How derivatives can serve the EU’s strategic agenda

ISDA
Safe,
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Markets

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International Swaps and Derivatives Association (ISDA) paper

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Introduction

Since 1985, ISDA's mission has been to build and promote robust, stable financial markets and a strong financial regulatory framework.

Safe and efficient derivatives markets play a vital role in managing risk and facilitating sound, liquid capital markets, in turn supporting economic growth.

In the years since the 2008 Great Financial Crisis, a wave of EU legislation was adopted, with the goal of addressing counterparty risk, creating greater transparency, and mitigating systemic risk. This framework has proved beneficial to the EU financial system.

It is important that further progress is made in the coming years, to make the EU a place where derivatives business can thrive and support the investment and competitiveness the European Union will need to meet the challenges it faces.

The next mandate of the European Commission (EC) will be crucial from many standpoints:

- Great geopolitical uncertainty and the potential impact of this uncertainty on trade, investment and supply chains makes it ever more important that Europe does all it can to promote the leadership of European firms and markets. This is critical both for Europe's competitiveness and for its future economic security – two goals that need to be pursued in a mutually-complementary way. Mobilizing private-sector capital and placing the financial system at the service of the economy, is central to this – especially after recent years in which public finances have been placed under intense strain, and monetary policy has undergone a dramatic tightening.

- Europe is approaching a demographic tipping point: in the euro area, a continuous decline in the working age population looks set to begin as early as 2025. The EU financial regulatory framework should ensure that EU citizens can benefit from deep and liquid financial markets in which they can save for retirement. It should also ensure that the financial system can generate investment to support the economy through changing times.

- The EU still needs to make decisive progress towards a climate-neutral and sustainable economy by 2050; to this end, the EC has advocated an ambitious target of a 90% reduction in net emissions compared to 1990 levels by 2040. Sustainable finance will play a key role in delivering this goal, by helping to close the investment gap.

Derivatives are a crucial tool for helping Europe to meet these challenges, serving the overarching – and interconnected – goals of an EU that:

- **Improves its competitiveness**: achieving an economic renewal that delivers jobs, growth, and prosperity, including through improving the financing possibilities for European companies, and the investment opportunities for Europeans – two goals which are synergistic. Derivatives serve competitiveness by helping companies mitigate risk, by increasing market risk transparency and by lowering financing costs to support growth.

- **Reinforces its resilience in an uncertain world**: with a focus on further developing and improving the functioning of critical European markets and market infrastructure – a goal linked to ensuring Europe's status as a standard for sound, stable regulation that underpins financial stability. Derivatives are key to much of this, including the good functioning of energy markets that are critical to Europe's economic security.

- **Achieves its sustainability objectives**: greening and futureproofing the European economy, with derivatives serving as a fundamental risk management tool; one that supports innovative financing solutions for green technologies and the global economy's transition from carbon.

With the right policy choices, these three strategic EU objectives can be pursued in a way that is complementary and mutually-reinforcing.

The following paper, organized according to these three themes, sets out a roadmap for ensuring that derivatives can fully play their role in this positive strategic agenda.

Boosting Europe's competitiveness: the role of derivatives in a capital markets agenda for growth and investment

The increased political impetus behind growing Europe's capital markets is a sign of the importance of private-sector capital to Europe's competitiveness. The EU is engaged in a global race for clean-tech and deep-tech leadership and is seeking more broadly to energise its economy in the wake of recent pressures. This all places an emphasis on the ability of the financial system to support the economy, and particularly on the role of markets in channeling savings towards productive investment.

Derivatives have a crucial role to play here – supporting the good functioning of markets, by serving as means for price discovery and risk transfer, by promoting the efficient allocation of resources to their most high value uses over time, by enhancing opportunities for investors to access alternative asset classes, and by mitigating "underinvestment problems[1]".

We recognize that within the policy discussion on competitiveness, there is a risk of having two parallel conversations that talk past each other: one about the competitiveness of the real economy, and the role of the financial system in serving that aim; and one about the competitiveness of the financial system itself.

But we see the two as inherently linked: a vibrant EU financial system is what we need to move the real economy forward.

In this spirit, ISDA has already been encouraged by calls by EU leaders at the March 2024 Euro Summit, at the April 2024 European Council, and at the May Eurogroup meeting for a reinforced Capital Markets Union (CMU) agenda. While the scope of that overall agenda is necessarily broad – taking in everything from questions of supervision to insolvency law and covering policy steps at both EU and national level – there are several important opportunities for politically-feasible EU action around derivatives that would serve the EU's overarching aim of stimulating productive institutional and retail investment flows.

Key elements of this include:

1) Encouraging continued innovations and improvements in risk management, by ensuring that the treatment of financial markets and derivatives activity is aligned with and proportionate to their underlying risks.

2) Improving the attractiveness of Europe's market infrastructure, including by fostering a competitive European clearing landscape through further reduction in administrative

[1] See "The social functions of derivatives", Pr. C. L. Culp in "Financial derivatives – pricing and risk management", Kolb series in Finance, Oct. 2009.

burden, increasing access to a wider participant base, and a holistic review of the regulatory framework to remove barriers to execution.

3) Calibrating a transparency and reporting framework which supports the development of the EU as a global trading hub – lowering barriers to access and attracting investment.

4) Supporting an EU market ecosystem which is competitive in the wider international context. This means upholding an international level-playing field in relation to key regulatory requirements; as well as promoting equal access opportunities for EU players, such as EU banks and asset managers, to global liquidity pools and key international reference rates.

5) Enhancing EU competitiveness by enabling the European Supervisory Authorities (ESAs) to react to unforeseen circumstances and streamline implementation of regulations by creating more effective forbearance powers.

Encouraging continued innovations and improvements in risk management

Robust capital markets require financial intermediaries to allocate capital efficiently and effectively to lines of business that provide appropriate returns. Toward this end, banks routinely invest significantly in their risk management and technology systems and resources to support their decision-making and enhance their competitiveness. It is important that this process of continuous improvement be supported and facilitated such that the treatment of financial markets and derivatives activity is aligned with and proportionate to their underlying risks.

We therefore encourage the EC to maintain a proportionate approach to regulation, aligned with better regulation principles, and which encourages, and certainly does not hinder, advances in risk management knowledge and practice.

Improving the attractiveness of Europe's market infrastructure

We support the EC's aim of expanding central clearing activities in the EU.

The EU should pursue a positive agenda to achieve this – one that creates a framework that fosters a competitive EU financial centre, equips the EU with an open-market structure commensurate with its status as home of the world's second reserve currency, and enables market participants to choose between different services that meet their needs.

In doing so, the EU should build on the positive steps already taken to improve the attractiveness of EU post-trade infrastructure.

Notably, the recently agreed European Market Infrastructure Regulation[2] (EMIR 3) legislation on over-the-counter derivatives marks a major step to promote EU clearing, as new measures will allow for a quicker adoption of margin-model changes at Central Counterparties (CCPs), and for the launching of new products and services. This will allow EU CCPs to be quicker to market with innovative proposals, which is critical to the competitiveness of the EU clearing ecosystem.

The agreed legislation also provides greater incentivization for EU mutual funds[3] to clear. Clearing represents an efficient way of managing counterparty credit risk, enhancing financial stability and transparency. Furthermore, and in the interest of financial stability, it facilitates buy-side entities' access to deep and stable pools of liquidity, on a voluntary basis, further enhancing the resilience of those firms, most notably in stressed market conditions.

Going beyond this, more can be done to make Europe's clearing business more attractive and dynamic.

Key measures for the next mandate include:

- EU authorities pushing for a wider adoption of clearing by European public or semi-public entities, so enhancing the clearing eco-system in liquidity terms. This would make it more likely, in particular, that EU buyside firms, in particular hedge funds, would clear in an EU CCP.

- Systemically reviewing the prudential rules applicable to clearing members to ensure that they do not disincentivize central clearing of over the counter (OTC) derivatives. The number of clearing members – usually financial firms – offering services to buy-side companies has diminished significantly since the 2008 Financial Crisis, making it increasingly difficult to deliver on the G20 leaders' commitment to promote clearing of derivatives.

- Exploring how constrained clearing capacity and operational limitations makes it harder for client positions to be ported to an alternative clearing member in the event of default[4].

- Studying the interplay between bank resolution and the porting regime. Porting of positions can never be guaranteed, including for clients that maintain multiple clearing relationships. As such, there appears to be a critical role for resolution authorities to play in ensuring continuity of access to clearing following the default of a clearing member.

[2] Revision of the European Market Infrastructure Regulation proposed by the EC in December 2022; EMIR regulates the over-the-counter derivatives market

[3] Undertaking for collective investment in transferable securities (UCITS)

[4] ISDA's October 2023 whitepaper on porting identifies capital constraints as an important factor to the likelihood of porting.

Calibrating a transparency framework which supports the EU's development as a global trading hub

In the competitiveness race, Europe needs a framework for derivatives markets that supports our goal of maximizing investment flows into the EU to help meet financing needs.

That entails supporting optimal pricing conditions in derivatives markets, alongside reducing barriers to EU market access for global players.

Both the European Securities and Markets Authority (ESMA) and the EC will be working through 2024 and 2025 on detailed facets of the Market in Financial Instruments (MIFIR)[5] framework which – if calibrated effectively – would help achieve these goals.

Getting the balance right when calibrating reporting deferrals

ESMA will begin to work later this year on calibration of reporting deferrals for OTC derivatives covered by MIFIR post-trade transparency requirements. Getting this balance right will support optimal pricing conditions in derivatives business and, ultimately, European capital market investments.

Deferrals will be determined based on assessment of the size of trades in in-scope derivatives, and of the liquidity of the market in those derivatives. In doing so, it will balance the need for market participants to understand market-pricing levels with the need for liquidity providers to hedge the risks they assume in fulfilling that function.

Making sure market participants benefit from published information

Derivatives markets' transparency and usability is undermined if market participants do not understand published information.

Europe has a problem in this area at present because of its reliance on the system of International Securities Identification Numbers (ISINs) for reporting of OTC derivatives trades. Fixing this would be of clear benefit to market participants.

In particular, the practical use of the OTC ISIN system is compromised by the so-called "rolling date" issue, meaning that identical instruments traded on consecutive days are allocated different ISINs for certain OTC derivatives asset classes (including interest rate derivatives comprising around 80% of all notional volume of OTC derivatives business). This causes practical problems when it comes to derivatives covered by MIFIR trade transparency requirements, for example interest-rate derivatives, hampering the ability of market participants to compare prices of the same instrument across a given time series.

[5] Markets in Financial Instruments Regulation which sets rules for financial trading in Europe

We welcome the recognition by the EU co-legislators and by ESMA that this is a concern that should be remedied.

The EC was mandated under the recently revised MIFIR legislation to publish a Delegated Act to address this issue, designating an appropriate identifier for OTC derivatives for MIFIR transparency. Importantly, this would also apply to a potential future Consolidated Tape (CT) for trade reporting on derivatives.

ISDA believes that the Unique Product Identifier (ISO standard 4914, developed under the aegis of the Committee on Payments and Market Infrastructures – International Organisation of Securities Commissions (CPMI-IOSCO), should be designated as a 'globally agreed' identifier for OTC derivatives in MIFIR, as it overcomes the shortcomings described above.

We believe that incorporating the UPI in the MIFIR context will eventually reduce costs for market participants (including potential new entrants to EU markets), and more fully align OTC derivatives identification in EU markets with international norms. Following the consensus reached under CPMI-IOSCO on the UPI, the US Commodity Futures Trading Commission (CFTC) has been requiring identification of OTC derivatives for reporting to the market as well as to regulators (for market efficiency and systemic risk purposes) since January 2024. The UK Financial Conduct Authority (FCA) has, in recent months, been reviewing how to most appropriately identify OTC derivatives for transparency purposes[6] and is expected to do so for transaction reporting next year.

The UPI should be integrated into the MIFIR reporting ecosystem in the following ways:

- The UPI should be included in "core market data" for the purpose of the Consolidated Tape, as designating an identifier for the purpose of the CT is part of the subject matter of the Delegated Act. Core market data should also include several additional fields to ensure appropriate granularity.

- The UPI, plus the additional fields, should be included in the appropriate Level 2 legislative measure to operationalize the new MIFIR legislation, i.e. MIFIR Regulatory Technical Standards (RTS) 2.

- The UPI should be included in the Financial Instruments Reference Data System (FIRDS) maintained by ESMA, to facilitate an eventual transition to use of the UPI, plus the additional fields, in MIFIR transaction reporting.

We recognize the operational and financial burden a rapid switch to use of the UPI alone would imply – for regulators, including ESMA, and industry alike. As such, we are open to the temporary retention of the 'modified ISIN' concept alongside UPI.

[6] FCA CP 23/32 on 'Improving transparency for bond and derivatives markets'

Under this concept, the expiry date would be removed from the ISIN. This modified ISIN would be maintained in 'core market data,' MIFIR RTS 2, and FIRDS, at least for several years.

This would also provide ESMA and the EC with the time necessary for a thorough cost-benefit assessment for a full transition to the UPI-plus-additional-fields model across all MIFIR reporting requirements.

Facilitating machine-readable and executable reporting

Machine readable and executable reporting offers real benefits to market participants in terms of burden reduction, and so boosts attractiveness.

The EC, as part of its strategy on supervisory data in EU financial services, should continue to explore the potential here.

ISDA has developed Digital Regulatory Reporting (DRR)[7] for EMIR based on the open-source Common Domain Model.

DRR will improve reporting quality and reduce costs for supervisors and reporting entities. We invite the EC to consider how they and the ESAs could leverage this industry initiative to improve the reporting environment.

Supporting an EU market ecosystem which is competitive in the wider international context

It will be important over the coming years to consider the impact EU rules have on European actors' ability to compete in what is, and will remain, a global financial system.

For example, growing the EU as a hub for central clearing – an important and positive aim – should not conflict with the need of EU financial firms also having access to services they need beyond the EU's borders.

Both factors are part of a true competitiveness agenda – as unhelpful barriers to accessing services hamper key activities in the EU financial system, such as risk management, in turn hindering the system's support to the real economy.

Key elements to consider here will include the topics in the following sub-sections.

[7] ISDA Digital Regulatory Reporting, InfoHub

Enabling access to non-EU CCPs

Under current rules, a non-EU CCP must obtain EMIR recognition status for EU-domiciled banks (and their subsidiaries globally) to benefit from preferential capital treatment for their direct exposures as clearing member to that non-EU CCP.

Seeking EMIR recognition by ESMA is a considerable expense. For small non-EU CCPs with no EU-domiciled bank as clearing member, it is a disproportionate requirement that is not justified on financial stability grounds.

The practical and efficient solution here is to de-link bank capital requirements, established under the EU's Capital Requirements Regulation (CRR) legislation, from the EMIR recognition, a step that can be achieved by amending the CRR.

Equally, to allow EU banks to remain competitive and to have a global footprint, they need to retain access to UK CCPs. Loss of this access would cut EU banks out of the global liquidity pool for Interest Rate Swaps and Short-Term Interest Rate contracts. It is also important to allow EU firms to fairly access both domestic and third country CCPs, a situation that will lead to a geographical diversification of CCPs' membership, increasing financial stability in the system.

The overarching goal should be to make the EU a place where market participants want to clear and choose to come to, rather than to build counterproductive barriers to accessing non-EU services.

EMIR 3.0 introduces the requirement to clear representative transactions in active accounts at EU CCPs but allows the remaining business to be cleared at tier-2 CCPs. For these transactions, both in euro and other currencies, to be cleared at tier-2 CCPs, an extension of the equivalence determination of UK CCPs is required and would be in the spirit of the new regulation.

We recommend that the EC announces its decision to grant non-time limited equivalence on UK CCPs well in advance of the 30 June 2025 deadline to avoid unnecessary market uncertainty.

Ensuring access to reference rates

EU market participants rely on certain non-EU administered interest-rate, FX, commodity, and other types of benchmarks for hedging risks, and with this practice safeguarding their competitiveness at the global level.

Access to these benchmarks is a crucial consideration and is central to the ongoing EU efforts to reform the EU Benchmark Regulation (BMR).

The EC has carefully considered the concerns of EU market participants acting in global markets and has adopted an ambitious proposal. This would lead to a major leap forward for the BMR and provide a workable framework for all types of market participants and all types of benchmarks.

The plans offer the opportunity for a long-term improvement to the current BMR regime, protecting end-users from the cessation and manipulation of significant benchmarks whilst ensuring that EU firms remain competitive in global markets.

Specifically, the EU should address long-standing concerns regarding non-compliance and de-facto prohibition of several relevant third-country benchmarks which are key for EU firms' risk management.

ISDA encourages the EC to pursue the direction of travel taken in its proposal.

Importantly, we support additional discretionary power for the EC to exempt benchmarks from the regulation, if such in-scoping would lead to prohibitions of vital benchmarks administered outside of the EU.

The EC should have the necessary mechanism to react to unforeseen circumstances, and to changes in the market structure, and should lead the charge with respect to required industry consultations.

Ensuring a level playing field in market-risk capital requirements

Banks' wholesale and trading operations are profoundly global. This is because investors from different regions are looking for the best investment opportunities within their mandates, and securities issuers want to have access to finance from all corners of the world.

Equally, frictionless intermediation by broker-dealer banks is at the core of liquidity formation in most markets.

This means that coordinated international implementation of bank capital requirements for trading activities is essential, with the risk (otherwise) of market fragmentation that hampers the investment environment.

This means that the Fundamental Review of the Trading Book (FRTB), agreed at international level by the Basel Committee, needs to be implemented in a consistent way across jurisdictions.

In Europe, that implementation is set to happen as part of the revised CRR 3.

Evidence is starting to emerge of potential divergences in regional implementation, which warrants a careful review of the FRTB standards in the major jurisdictions, including on timing.

The practical ramifications of divergence include that later implementation may offer a temporary competitive advantage over banks that had to adopt the new requirements earlier.

The EU start date of the FRTB framework is set for 1st January 2025, while the US and the UK have already set a different timing expectation of 1st July 2025.

The international picture is more uncertain than this headline timing misalignment would suggest: the "Basel Endgame" framework proposed by the US regulators, which contains the FRTB changes, is unlikely to be finalised this year; while UK regulators have built in mechanisms to delay implementation should the need arise.

Such divergence problems were foreseen by the EU co-legislators – who gave the EC the responsibility, through a Level 2 measure[8], of ensuring a level playing field for EU financial firms by, if necessary, delaying or recalibrating the FRTB changes.

Given the uncertainty, notably about how the U.S. will implement the standards, the EC should set out its intentions regarding the process and content of this Delegated Act (DA) on market risk as soon as possible.

An early indication regarding the EC's intentions is of critical importance to all firms operating in the European capital markets, who need a signal that the EU will try to align with other major counterparts.

In the longer term, it will be important for the EU to examine and assess in detail the differences in implementation vis-à-vis third countries, and particularly the rules as implemented in other leading financial centers.

The European Banking Authority (EBA) will be tasked to report on the differences between the EU and other jurisdictions' frameworks. It is important that this process takes place as soon as there is clarity in the final rulemaking, allowing significant deviations to be assessed.

Creating effective forbearance powers for European Supervisory Authorities (ESAs)

Following the most recent ESAs review, ESMA and the EBA have power to publish 'no-action' letters in relation to the application of requirements under EU regulation.

No-action letter powers enable authorities to react to unforeseen events, such as the outbreak of a global pandemic, or streamline implementation of EU regulations, such as sustainability-related disclosures for benchmarks or the EMIR Margin RTS.

However, Article 9a of the ESMA Regulation and Article 9c of the EBA Regulation maintain obstacles to the deployment of 'no-action' letters. As such, the use of these 'no-action' statements has been limited. ESMA has typically continued to issue 'deprioritisation of enforcement' statements instead.

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[8] Article 461a Market Risk Delegated Act, CRR3 agreement

The existing 'no-action' letter power does not allow the ESAs to disapply the application of EU law, meaning that full legal clarity is not achieved.

Furthermore, requirements associated with issuance of 'no-action' letters hamper the ESAs' ability to react swiftly where necessary. ESMA must send a detailed account in writing to the competent authorities and the EC, issue a formal opinion, and provide recommendations for an EU legislative proposal, addressing the issue in question.

We believe that the EC should address this weakness in the governance of EU capital markets and allow ESMA and other ESAs to react more nimbly to 'events' (*as ESMA's peers can, for example like the CFTC in the US*).

Reinforcing Europe's resilience: the role of derivatives in underpinning the EU's economic strength and security

While the European Union remains one of the world's most open economies, the climate of geopolitical uncertainty has placed a focus on the continent's ability to operate with strategic independence and to weather crises. Financial markets in general, and derivatives specifically, have a key role to play in meeting the EU's economic security goals.

In part, this links to the competitiveness agenda described above, notably when it comes to growing Europe's market infrastructure to a level appropriate for one of the world's economic superpowers.

Crucially, it is an agenda that also encompasses financial stability – as the financial system must be a secure, sound, foundation for the real economy, even in testing times.

Fostering European energy markets and building EU commodity markets

The geopolitical shock of Russia's invasion of Ukraine in 2022 immediately brought the question of energy security to the top of the EU agenda, and with it concern about how to cope with spikes in prices, as constraints on supply weighed on businesses and households across Europe.

As we enter the next institutional cycle, the EC will be at the forefront of implementing crisis-targeted reforms and incentivizing the building of EU commodity markets, including for non-energy products serving as essential input factors for the European economy.

Going forward, measures targeting possible shortcomings in the spot market should not negatively impact requirements in relation to commodity derivatives. The commodity derivatives market played its role correctly during the energy crisis, providing important price signals to market participants.

When it comes to this incentivization, positive steps have already been taken. The 2021 Markets in Financial Instruments Directive (MiFID) Quick Fix legislation[9] removed position limits for nascent contracts, recognizing that these restrictions had proved to be unfavorable for the development of new commodity markets. Any measures targeting energy price volatility should not be to the detriment to other types of commodities.

Additionally, reforms introduced under EMIR 3 with respect to clearing rules for non-financial corporates are positive in terms of facilitating participation and enhancing transparency

Supervisory competences should also remain well defined.

The Agency for the Cooperation of Energy Regulators (ACER) and national regulatory authorities should focus on spot market supervision while ESMA takes the lead with respect to commodity markets.

These delineated roles should not prevent these bodies from collaborating closely, as outlined in the Memorandum of Understanding between ACER and ESMA on wholesale energy markets.

In terms of the operationalizing recent regulatory changes, it will be important that the EC carry out evidence-based impact assessments with respect to upcoming Level 2 requirements.

This should be the case for key upcoming EC assessments under the EU's revised MIFIR/D legislation for financial trading: notably those for the ancillary activity exemption, which introduces proportionate authorisation requirements for firms needing access to commodity markets, depending on the principal nature of their business[10].

This approach should also apply for the calibration of the new clearing thresholds for non-financial corporates.[11]

Fortifying financial stability: improving liquidity management in the non-bank sector

In the wake of recent stress episodes, international regulators are focusing on measures to mitigate the build-up of systemic risk in the wide field of Non-Bank Financial Intermediaries, a term encompassing buy-side actors such as investment funds, insurance companies, and pension funds.

[9] MiFiD QuickFix, February 2021
[10] DIRECTIVE (EU) 2024/790 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 28 February 2024 amending Directive 2014/65/EU on markets in financial instruments
[11] See political agreement on the review of the European Market Infrastructure Regulation ("EMIR 3.0")

The functioning of collateral / margining requirements for market participants in a stress environment has been a key part of this work, drawing on recent experience.

Under the auspices of the Financial Stability Board (FSB), international standard-setting bodies are preparing recommendations aimed at increasing transparency and liquidity preparedness of market participants, and at improving the responsiveness of the cleared and uncleared margin models on which markets rely.

These recommendations will enhance transparency and resilience of derivatives markets and are a crucial step forward.

At EU level, the recently agreed EMIR 3 legislation gives the EC a mandate to implement some of the international recommendations on the transparency of cleared initial margins – this should be addressed in a timely manner.

There are also other lessons to learn from recent crisis events.

The elevated volatility in commodities markets and the Liability Driven Investment market turmoil have demonstrated the need to increase automation in collateral management processes; this is something that would improve efficiency, and reduce operational and liquidity risks.

The industry has a key role in addressing this, and ISDA has developed "Suggested Operational Practices for the OTC Derivatives Collateral" to support collateral management processes[12].

To facilitate trading across the transaction cycle of financial products (derivatives and others), the industry[13] has also developed a standardised, machine-readable and machine-executable data and process model[14].

Collateral availability

Reducing barriers to using Money Market Funds (MMFs) as collateral for regulatory uncleared Initial Margin would also help market participants, especially the buy-side, source sufficient collateral, particularly in market stresses.

MMFs that meet strict criteria provide a secure and easier-to-segregate alternative to cash. We urge policy makers to review the concentration limits applicable to MMFs under the regulatory technical standards.

[12] Latest revision, updated November 2022
[13] Joint initiative by the International Capital Markets Association, the International Securities Lending Association, and the International Swaps and Derivatives Association)
[14] Common Domain Model

Similarly, allowing CCPs to accept a wider range of collateral would help meet the needs of the market, particularly buy-side firms, without reducing the resilience of CCPs.

The application of prudent haircuts and concentration limits would ensure that widening the pool of eligible collateral does not reduce CCPs' robustness. In that regard, the EU's MMFs Regulation should be reviewed to facilitate the use of MMFs as collateral.

ISDA also believes that a specific sub-set of MMFs which are of the same credit quality and as liquid as other instruments eligible for CCP investments, in particular Public Debt Constant Net Asset Value MMFs, should be eligible instruments for investment by CCPs. These funds experienced high inflows and represented a haven in times of market turmoil.

ISDA also believes that central banks have a role to play in providing collateral transformation (the exchange of less-liquid forms of collateral for more liquid ones) to the buy-side, and we would urge the EC to explore this avenue with the European Central Bank (ECB) and other EU central banks.

Along with improving supply of collateral – the other key avenue of work is to take measures that reduce the scale of collateral demands in the first place.

This can be achieved through Post Trade Risk Reduction (PTRR) exercises that rationalize the web of collateral obligations among an interconnected group of market participants, reducing overall volumes of margin requirements in a risk-neutral way.

The implementation of the recently agreed[15] derogation from central-clearing requirements for transactions that result from Post Trade Risk Reduction (PTRR) exercises will encourage more market players to participate in PTRR. This could result in a material reduction of liquidity needs and of risk in uncleared portfolios.

Fortifying financial stability: improving the effectiveness of the EU framework for CCP recovery and resolution[16]

The forthcoming review of the EU's recovery and resolution framework for CCPs, set for 2025, will provide a welcome opportunity to enhance the effectiveness of the EU framework by reflecting recent international work on the CCP resolution toolbox and CCP equity and revisiting the existing No Creditor Worse Off (NCWO) safeguard.

A more efficient EU framework would enhance financial stability but also make clearing in the EU more attractive.

[15] As part of EMIR 3 negotiations

[16] This section covers the positions of our members on the buy-side and sell-side. It does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views.

The outcome of the international work carried out under the auspices of the Financial Stability Board (FSB) includes reflections on the role that a resolution toolbox[17], consisting of tools such as bail-in bonds, resolution funds and third-party contractual support (for example in the form of parental support), could play in a resolution scenario to maintain the continuity of critical functions and financial stability. The FSB publications[18] also address the treatment and quantum of CCP equity to further strengthen the resilience and resolvability of CCPs in default and non-default loss scenarios. The FSB resolution toolbox and equity considerations should be reflected in the revised EU CCP recovery and resolution framework.

In addition to reflecting the international work, we urge the EC to revisit the existing No Creditor Worse Off (NCWO) safeguard, intended to ensure that a resolution process of a failed CCP does not cause more financial harm to shareholders, clearing members and other creditors than a traditional insolvency.

The EU needs an appropriate and fair NCWO safeguard to uphold credibility and certainty in the EU CCP resolution regime, which affects the attractiveness of clearing on EU CCPs and the EU's aim of making the EU a global centre for derivatives clearing.

The current safeguard, which requires resolution authorities to seek an independent assessment as soon as possible after the resolution action has taken place, includes too much flexibility in estimating the losses that clearing members would have incurred if the CCP had been allowed to fail under insolvency proceedings[19].

This makes the non-resolution counterfactual scenario artificially costly for clearing members, and so makes the NCWO safeguard less effective than it should be by reducing the potential compensation amount – which is problematic given the safeguard is key to the integrity of the EU legal framework for resolution.

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[17] FSB report titled "Financial Resources and Tools for Central Counterparty Resolution" (April 2024)

[18] FSB report titled "Financial Resources and Tools for Central Counterparty Resolution" (April 2024) and FSB report titled "Central Counterparty Financial Resources for Recovery and Resolution"

[19] Specifically, there is a requirement in the current legislation that the assessment of the alternative scenario – the one that would have played out in the absence of a managed resolution procedure – should take into account a "*commercially reasonable estimate of the direct replacement costs, including any additional margin requirements, incurred by the clearing members to reopen within an appropriate period their comparable net positions in the market",* and in doing so to consider "*effective market conditions, including market depth and ability of the market to transact the relevant volume of such net positions within that period*".

Achieving Europe's sustainability objectives: the role of derivatives in accelerating the transition

The green transition is not an agenda of choice for the European Union, nor for the world. For Europe, it is one driven by concern for future generations. But it is also driven by the pressing priority of diversifying our energy mix on economic security grounds, as described above, and with ensuring that Europe is home to green industries and green jobs that will be a bedrock of our economy in the future. As the EC has consistently noted, economic recovery and the green transition are intrinsically linked.

Recent estimates suggest that some €400bn per year of additional green investment will be needed for the EU to achieve its sustainability goals[20].

The current fiscal environment, and the volumes of funding involved, naturally place an onus on the role of the financial system in channeling productive investment.

In this context, financial instruments' contribution to sustainability can be looked at through different lenses: for example, the role of the primary market in provision of cash through lending or direct financing; and the role of the secondary market and derivatives when it comes to stewardship, engagement, de-risking, and the cost of capital.

Specifically, derivatives allow investors to manage the project risk, interest-rate risk and currency risk associated with sustainable investments, as well as other risks related to environmental, social and governance (ESG) factors.

To give one example – derivatives are typically a component of capital-protected investment products provided to retail investors wishing to allocate their savings towards sustainable initiatives.

As an industry, we have undertaken a wide range of projects to provide standardized documentation, with the aim of making trading in sustainable finance more efficient. We have also engaged with both global and national regulators on ESG issues and educated market participants on the role of derivatives within sustainable finance.

The organisation of sustainable finance boils down to two questions:

1) How do we offer a simple, clear, reliable framework for investors looking to invest sustainably – one which is usable, and in which they can have confidence that they are not falling victim to greenwashing?

2) When it comes to the markets that directly address carbon emissions, be it through buying compliance allowances (in the cap-and-trade schemes) or verified credits (in the

[20] Institute for Climate Economics, February 2024

voluntary markets), how do we ensure a robust, credible system that is as internationally connected as possible? This is important because markets are global, the investment environment is global, and the challenge is global.

The following section offers recommendations for how derivatives can fully play their positive role in meeting these two challenges.

Maximising usability of our sustainable finance framework

The EU has taken huge strides in recent years to develop this framework. Now, we need to make it as usable as possible, so that we maximise the volume of capital getting to where it is needed.

Improving transparency and disclosure

At the heart of this is the EU's taxonomy for defining sustainable investments, and ISDA supports the continued work of the EC and of the EU's Platform on Sustainable Finance (PSF) to achieve this.

A critical concern is to prevent 'green-washing' and 'green-hushing' – and the way that financial instruments are treated in the taxonomy framework is critical to this.

This means that we need suitable disclosure rules for derivatives to ensure product transparency. To this end, the EC and PSF's future work should include a refinement of the treatment of derivatives across the following metrics: Taxonomy, Principle Adverse Impacts (PAIs) and Sustainable Investments.

Under recent findings from the Platform, only equity and credit derivatives are considered fit for inclusion in the numerator for calculating green asset ratios under the taxonomy, and for the disclosure of Key Performance Indicators (KPIs) under the EU's Sustainable Financial Disclosure Regulation (SFDR).

However, to ensure future-proofing of the recommendations, there should not be blanket exclusion of any asset classes. Also, as new objectives and methodologies develop, these asset classes may be assessed and further considered.

Importantly, a consistent approach and methodology regarding derivatives in sustainable finance should be applied to all relevant ESG metrics.

This will require continuous collaboration between the PSF, the EC, the ESAs and relevant industry stakeholders. This is especially so in light of upcoming reviews of the SFDR as well as of the "Article 8" Taxonomy Delegated Act, which sets out disclosure rules for investors on the environmental performance of assets and economic activities of undertakings.

Preventing unhelpful market distortions through benchmark labels

Alongside the disclosure framework, and the taxonomy, the other key pillar of the EU's quest for a clear, transparent sustainable finance framework has been the rollout of rules around labels and benchmark indices that act as signposts for green investment.

As in other areas, the principle of "better regulation" – of keeping the rulebook as simple and non-duplicative as possible – is key.

To this end, it will be important to avoid duplication of requirements that already exist under the SFDR regarding financial product providers; any SFDR-related issues should be dealt with through the upcoming review of that legislation rather than via the creation of additional ESG benchmark labels.

There is also a strong need for independence of research, information, and approaches to ESG matters – in the broad sense of the term – to allow the market to be able to deal with transition risks, without creating severe disruptions that could affect investors and issuers, notably EU corporates.

As an example, an EU ESG benchmark label excluding all energy companies would scope out the companies that invest most heavily in clean technologies.

Such a benchmark label could also have negative consequences for EU energy independence, for the "social/just" aspects of the transition, and for competitiveness, by depriving EU investors of independent information.

As such, ISDA encourages the EC to adopt a holistic approach when assessing the need to regulate benchmarks with ESG factors, exploring the issue in a way that takes into account other sustainable finance initiatives such as the SFDR and the Corporate Sustainability Reporting Directive (CSRD), developments with respect to company ESG reporting, and the availability of ESG quality data.

Notably, a recent PWC report[21] has recognised that the market is not ready for a mandatory ESG benchmark label. It instead recommended a voluntary label, also due to the lack of good quality data.

Even if voluntary, there needs to be a recognition of the independence of methodologies for benchmark administrators.

Market integrity will be key to the success of the sustainable finance framework. As such, interference by public authorities in the weighting methodologies and asset selection policies

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[21] PWC report: "Study on the feasibility, minimum standards and transparency requirements of an EU ESG Benchmark label", December 2022

for such a potentially broad scope of indices would be counterproductive – amounting to a serious breach of independence of the administrators.

Taking all this into account – if an EU ESG benchmark label is proposed by the EC under its new mandate, a benchmark administrator should not be required to "endeavour to provide" it, as is the case for Climate Transition Benchmarks (CTB) under current EU law[22].

This would set an undesirable precedent in EU financial services regulation by forcing a benchmark administrator to undertake an activity it may not wish to undertake. It also presents several other risks, notably:

- Inconsistency with the objectives of the BMR "to ensure the accuracy and integrity of indices used as benchmarks." Moreover, it is unclear what the provision requires of a benchmark administrator in practice and what the consequences are of not "endeavoring to provide" one or more CTBs.
- The provision could also be read as requiring a benchmark administrator to continue to produce a benchmark following potential changes to the relevant Delegated Acts, even if the administrator is not able or competent to undertake this.
- Interference in the independence of benchmark methodologies.
- Requiring benchmark administrators that may not have the necessary expertise to try to provide benchmarks which may not be fit-for-purpose potentially introduces market risk. This could expose benchmark administrators and, in turn, regulatory authorities, to litigation risk.

Reinforcing confidence in carbon markets

The EU has led the world in putting a price on carbon emissions – and the further development of carbon markets will be integral to meeting the stated target of a 90% reduction in net greenhouse gas emissions by 2040 compared with 1990 levels.

This will require both scaling up voluntary carbon markets, where companies can buy verified carbon credits to reduce/avoid their net emissions, and maximising the reach and impact of the EU's Emissions Trading System (ETS), where companies pay a price to pollute.

[22] Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks, EurLex

Scaling up Voluntary Carbon Markets (VCMs)

As is the case with other financial markets, the success of markets for Voluntary Carbon Credits (VCCs) will depend on a flourishing secondary market.

The development of standardised products in the secondary market helps to increase liquidity, transparency, and price discovery. All of these are key ingredients for the development of a healthy market, and which in turn help to increase the size and value of the primary market.

Greater standardisation in the derivative markets is helping to scale VCMs and to develop safe, efficient carbon derivative markets.

Market participants have worked together to provide elements of this standardization.

In 2022, ISDA published the Verified Carbon Credit Transactions Definitions (VCC Definitions), as part of an effort to deliver robust legal and risk management standards for markets related to ESG activities.

The VCC Definitions are a booklet of defined terms and standardized contractual provisions that can be used in documenting VCC spot, forward, and option transactions.

We will continue to update our Definitions as the voluntary carbon market develops and new market conventions or standards progress[23], as the ultimate goal of the VCC Definitions it to make it more efficient for market participants to trade in carbon credit transactions.

Beyond this, in order to support scaling through legal certainty, regulatory authorities need to confirm the categorisation of VCCs.

While it may not be possible to identify a harmonised approach to categorisation at an international level, regulators should be encouraged to provide clarity in their jurisdictions.

Maximising the impact of the Emissions Trading System (ETS),

The EU's ETS is a crowning achievement in the fight against global warming. While it has been further developed in recent years, there are further opportunities to maximise its impact.

Notably, linking the EU and UK ETS would enhance the integrity and confidence in both regions' carbon markets and lower the cost of decarbonising both economies as they pursue net-zero policies.

Crucially, the move could spur other countries to adopt similar carbon pricing mechanisms.

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[23] E.g., Earlier this year, ISDA updated the Definitions to include defined terms that enable counterparties to reference the standards put forward by the Integrity Council for Voluntary Carbon Markets (ICVCM).

The commitment in the EU-UK Trade and Cooperation Agreement (TCA) for both jurisdictions to "seriously consider linking their respective carbon pricing systems" is highly positive, and negotiations should be initiated on this[24].

This would require that all allowances are treated equally and remain fungible across installations and borders.

Linkage would enhance liquidity and price discovery and establish a level-playing field in carbon pricing, incentivising investment sectors and ensuring that no new trade barriers on carbon leakage are created between the UK and the EU.

The EU and UK ETS are similar, for example when it comes to total cap on allowances adjusted for comparable Net Zero targets, and to the sectors identified for expanding the schemes.

Any technical differences between the two schemes – such as dates or thresholds – could easily be bridged and addressed during the process of linking.

Time is of the essence, however: should the schemes continue to evolve in isolation, finding a linkage arrangement will inevitably become more challenging.

So, it is important for the EU and for the UK to engage constructively on this issue as soon as possible.

[24] EU-UK Trade and Cooperation Agreement, 30 April 2021

Conclusion

The above proposals offer a roadmap for derivatives to fully play their positive role in supporting key EU strategic priorities.

It is an agenda rooted in the idea that competitiveness of the financial sector and of the real economy are mutually complementary.

It is also rooted in the idea that the financial system in general, and derivatives specifically, can help the EU thread the needle of simultaneously pursuing competitiveness, economic security, and a successful green transition.

Above all, it is an agenda that recognizes that financial stability, and the soundness of financial markets, are an essential bedrock to all that we are trying to achieve.

The coming years are a crucial opportunity for the European Union to craft a place for financial regulation within the heart of the EU's broader strategic objectives – objectives that are vital for our continent's continued prosperity in testing times. It is an opportunity that we must not miss.

About ISDA

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

ISDA has over 1000 member institutions from 77 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.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

Website: www.isda.org.