INTERVIEW
The FCA's Sarah Pritchard on post-Brexit regulation

CLEARING
Roadmap to improve the attractiveness of EU CCPs

RESEARCH
Latest trends in EU derivatives trading

IQ

ISDA® Quarterly

Vol 7, Issue 2: August 2022 | www.isda.org

* STRENGTHENING MARKETS

New guidance sets a path for emerging and developing economies to build safe and efficient derivatives markets

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Notional Outstanding

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Credit Derivatives

Transaction Data

Daily, weekly and quarterly traded notional and trade count by product taxonomy.

Market Risk Activity

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ISDA® Safe, Efficient Markets

Hedging for All

Derivatives play a critical role in supporting vibrant capital markets, enabling market participants to alleviate uncertainty, transfer risk and enhance returns. By allowing companies to lock in the cost of issuing debt or create certainty in the exchange rate at which they can convert future overseas revenues, derivatives enable firms to lend, borrow and invest with confidence.

This ability to hedge risk and manage exposures shouldn't only be an option for firms in the main financial centres – entities in emerging and developing markets should also be able to use these instruments domestically to mitigate risk and facilitate access to capital. But safe, efficient derivatives markets don't emerge by accident: they require deliberate choices on the legal and regulatory framework. ISDA has long worked with policymakers in emerging and developing markets to help navigate these issues, and we published a whitepaper earlier this year that explores some of the choices and implications, based on best practices and work in advanced economies (see pages 12-17).

One of the most fundamental steps is ensuring the enforceability of close-out netting. By allowing counterparties to offset their various obligations into a single net amount owed by one party to the other, netting significantly reduces credit risk and increases the capacity for firms to lend. It also encourages greater participation by foreign and domestic institutions, boosting liquidity and competition.

ISDA has worked with authorities across the globe to help draft legislation on the enforceability of close-out netting and has so far published netting opinions for over 80 jurisdictions, providing certainty for firms trading in those markets. The latest of those opinions was published for China in August, following implementation of the Futures and Derivatives Law (FDL) – an important milestone in the development of a well-functioning derivatives market in China (see page 18-20).

Netting legislation isn't enough on its own, though. Local policymakers need to determine the scope of permitted activity, whether registration requirements are necessary and what disclosure standards should apply. Broader regulatory issues – for example, whether to introduce clearing, margin or reporting mandates – also need to be considered, as well as expectations on risk governance and management.

This issue of **IQ** looks in more detail at what is needed to support the development of effective and robust derivatives markets, as well as analysing the specifics of China's FDL and possible next steps. ISDA will continue to assist however we can in the advancement of local derivatives markets – we strongly believe vibrant capital markets and the ability to manage exposures efficiently and cost effectively should be achievable for everyone.

Nick Sawyer
Global Head of Communications & Strategy
ISDA

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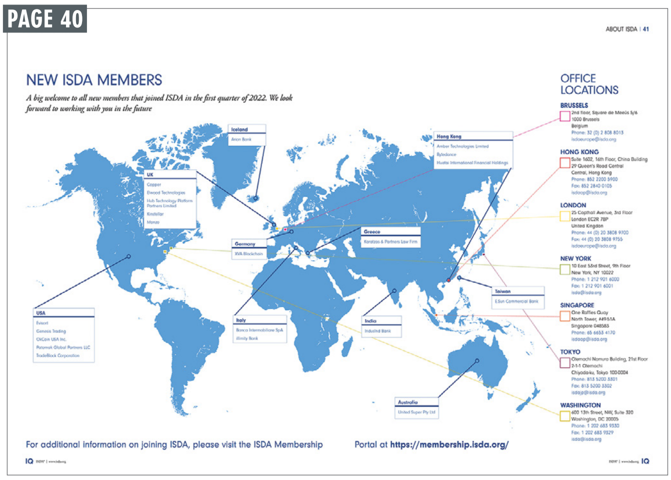

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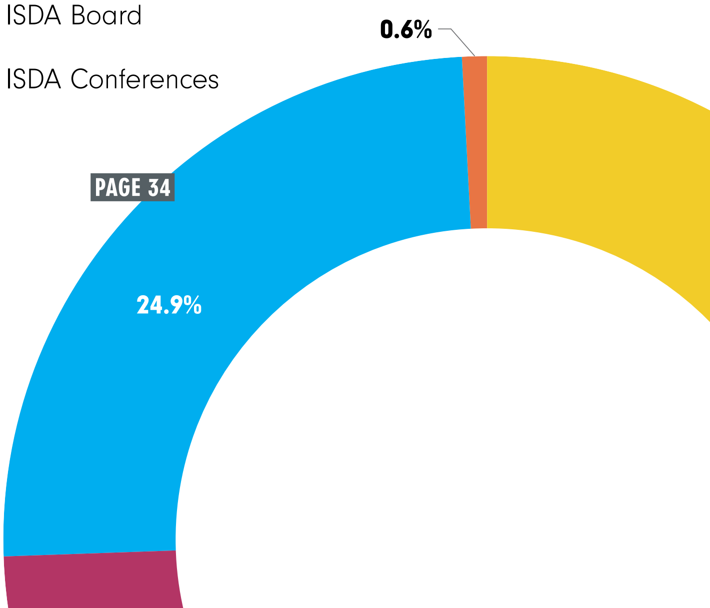

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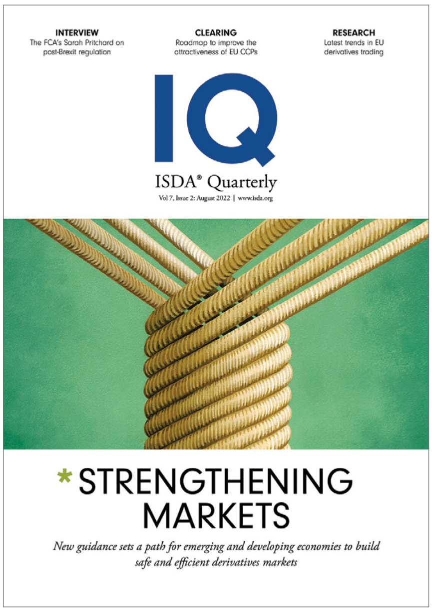
THE COVER PACKAGE

STRENGTHENING MARKETS



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"The passage of the Futures and Derivatives Law marks both the end of a decade-long effort for netting legislation in China, as well as the start of a new era for the Chinese OTC derivatives market"

Terry Yang, Clifford Chance

49.5%

Looking at Treasuries

A new ISDA survey shows there is a divergence of views on the costs and benefits of increased clearing of US Treasuries and repos, writes ***Scott O'Malia***

A string of disruptive events in the US Treasury market has prompted those active in this space to think long and hard about how to strengthen its resilience and ensure it continues to function efficiently during periods of stress. Various potential policy solutions have been batted about, but one that seems to be gaining traction is increased clearing of US Treasury securities and repos.

Such is the importance of the US Treasury market that any significant policy shift could reverberate through other parts of the financial system, including derivatives. It's therefore incumbent on all of us to share our views on the possible implications, costs and benefits. That's why ISDA ran a survey to garner the views of market participants and infrastructure providers, the results of which were published this month.

"Such is the importance of the US Treasury market that any significant policy shift could reverberate through other parts of the financial system"

The first thing that jumps out is the sheer diversity of views. While most respondents were broadly supportive of clearing, there was little consensus on whether additional clearing would materially improve market efficiencies. Indeed, many noted that clearing would not have prevented the dysfunction that occurred in March 2020, when the rapid spread of the coronavirus pandemic sparked extreme volatility in the Treasury market.

Respondents generally agreed more clearing could bring several potential benefits, including increased transparency in risk management practices and greater efficiency. Some highlighted a reduction in counterparty risk due to margin requirements and the netting of exposures, which could reduce the strain on dealer balance sheets – although this was considered less relevant in the cash market than the repo market.

Various potential costs were identified as well, including clearing fees, margin requirements and technology, legal and operational charges. Some also highlighted greater concentration of risk in central counterparties (CCPs). As a result, most participants warned against implementing a clearing mandate, arguing it could lead some entities to reduce activity or withdraw from the market altogether, an opinion that was expressed most strongly for client transactions in both cash Treasuries and repos. However, some participants felt increased clearing was unlikely to occur unless a mandate was in place.

While mandates weren't popular, there was general acceptance that additional clearing could be encouraged through the use of incentives. Suggestions included relief under the supplemental leverage ratio, increased access to indirect clearing for clients, greater access to direct clearing for firms that meet applicable membership requirements, and the ability to post client margin to a CCP. Some respondents identified the Fixed Income Clearing Corporation's (FICC) sponsorship model – which allows members to sponsor non-members to clear via the FICC – as already having contributed to an increase in clearing levels. Others highlighted certain reforms to the sponsorship model that could further encourage clearing, particularly for client repo transactions.

It's too early to know how this will ultimately develop. A recent status update from a Group-of-30 (G-30) Working Group on Treasury Market Liquidity reiterated its recommendation that all Treasury repos should be cleared, as well as all Treasury securities trades executed on electronic interdealer trading platforms. The G-30 also proposed that regulators and market participants should assess whether and how dealer-to-client cash Treasury trades should be cleared. Separately, the US Securities and Exchange Commission is understood to be developing proposals intended to broaden the scope of central clearing for cash Treasury securities and repos.

Beyond clearing, the G-30 working group also recommends US prudential regulators review certain provisions like the leverage ratio to avoid disincentivising market intermediation without weakening the overall resilience of the financial system. Specifically, it suggests the leverage ratio should be adjusted so it serves as a backstop to risk-based capital requirements, rather than acting as a binding constraint. We agree this could be considered – ISDA supports rules that result in risk-appropriate capital, so banks can efficiently allocate capital and support the US Treasury market while remaining resilient.

US Treasuries and repos play a pivotal role across the financial system, so we entirely support the aims of US policymakers to enhance the resilience of this sector – a robust Treasury market will contribute to safe and efficient derivatives markets. We hope our survey serves as a useful data point as policymakers and market participants continue the conversation.

Scott O'Malia
ISDA Chief Executive Officer

Diverse Views on US Treasury Clearing, ISDA Survey Shows

There is a wide variety of views among market participants and infrastructure providers on whether increased clearing would materially improve the resilience and efficiency of cash Treasury securities and repos during times of market stress, according to the results of a survey undertaken by ISDA.

Following discussion among policymakers and market participants about the merits of greater clearing of US Treasuries in light of the market volatility in March 2020, ISDA carried out a survey earlier this year to gather views on the legal, operational, regulatory and policy issues associated with US Treasury clearing.

The results, published on August 10, showed that while most respondents were generally supportive of clearing, there was little backing for broad clearing mandates, with warnings this could result in some participants reducing their activity or withdrawing from the market, potentially reducing liquidity. But this view was not universal – some respondents felt it would not be possible to increase clearing without a mandate.

The survey follows a recent progress report from the Group-of-30 (G-30) Working Group on Treasury Market Liquidity on steps to enhance the resilience and liquidity of the US Treasury markets under stress. The report reiterated earlier recommendations for increased clearing, calling for all Treasury securities trades executed on electronic interdealer trading platforms to be cleared, along with all Treasury repos, including those between dealers and clients (see box).

Separately, the US Securities and Exchange Commission (SEC) is understood to be developing proposals intended to broaden the scope of central clearing for cash Treasury securities and repos. In a speech in London in April, SEC chair Gary Gensler confirmed he had asked staff for recommendations to strengthen clearing in the Treasury market. "This could include better facilitating customer clearing, enhancing risk management of the clearing houses, and broadening the scope of central clearing," said Gensler.

ISDA's survey, which ran from February until April, generated responses from 25 ISDA member and non-member institutions, including primary dealers, principal trading firms, asset managers and central counterparties (CCPs). Respondents identified a number of benefits from increased clearing, including enhanced efficiency, transparency and market stability.

Survey respondents generally agreed increased clearing would have cost implications, including higher fees, margin requirements and increased technology, legal and operational charges. Some also highlighted greater concentration of risk in CCPs and others noted clearing would not have prevented market volatility in March 2020.

"The one indisputable fact from the survey is that the market is very far from a consensus, suggesting further research on the costs and benefits of increased clearing may be necessary. We entirely support the aims of US policymakers to strengthen the resilience of this market, but it's obviously important we get this right," says Scott O'Malia, chief executive of ISDA. IQ

G-30 TREASURY MARKET RECOMMENDATIONS

In July 2021, the Group of 30 (G-30) Working Group on Treasury Market Liquidity published a report, *US Treasury Markets: Steps Toward Increased Resilience*, which explored weaknesses in the US Treasury market that became apparent during the period of market stress in March 2020.

The report made 10 recommendations to increase the resilience and liquidity of the Treasury market during times of stress, including the following relating to clearing:

1. All trades of Treasury securities and Treasury repos executed on electronic interdealer trading platforms that offer anonymous trading by interposing an interdealer broker between buyers and sellers should be centrally cleared;
2. Treasury repos should be centrally cleared;
3. Market participants and regulators should continue to study how dealer-to-client cash trades of Treasuries might best be centrally cleared, including via the sponsored clearing model, and assess the private and public policy cases for central clearing using whatever is the optimal model;
4. The Treasury Department, after consultation with the Federal Reserve, should organise and take responsibility for a joint review of the design and operation of the Fixed Income Clearing Corporation (FICC), with a view toward ensuring the supervision and regulation of the FICC is sufficiently robust;

| Read the recommendations in full in the G-30 report: bit.ly/3JCRXVe

ISDA Publishes China Netting Opinion as FDL Takes Effect

ISDA published a new legal opinion on August 1 that recognizes the enforceability of close-out netting under Chinese law, coinciding with the entry into force of the Futures and Derivatives Law (FDL), which establishes a statutory framework for the trading of futures and derivatives in China.

The FDL, which was first published for consultation in April 2021, enshrines the enforceability of close-out netting in law, paving the way for the growth and development of China's derivatives market. After the law was passed in April 2022, ISDA commissioned King & Wood Mallesons to draft a netting opinion to coincide with the implementation of the FDL.

"We are very pleased these legal reforms in China include the important step of recognising close-out netting. The publication of the netting opinion, which coincides with the FDL coming into effect, marks a historic milestone in the development of a well-functioning derivatives market in China. Having a netting opinion ready from August 1 gives firms the certainty they need to trade derivatives with Chinese counterparties, enabling effective risk management and supporting economic growth," says Scott O'Malia, chief executive of ISDA.

While China is the world's second largest economy, its derivatives market represents only around 1% of global derivatives turnover, according to data from the Bank for International Settlements. As in other jurisdictions where similar legislation has been passed, netting enforceability will lead to greater efficiencies, deepening liquidity and increasing credit capacity. This helps to create vibrant and robust local derivatives markets, enabling effective risk management and supporting economic growth.

"Having a netting opinion available gives firms a high degree of legal certainty that netting is enforceable, giving them comfort to trade with Chinese firms, which in turn should encourage more participants and increase liquidity. Managing credit risk on a net basis leads to significant efficiencies, which will mean more credit is available for firms looking to raise finance or hedge their exposures," says Katherine Tew Darras, ISDA's general counsel.

Wider implications

The China netting opinion noted the ISDA Master Agreement is currently the only international standard master agreement that has been recognised by Chinese financial regulators as a qualifying master netting agreement. With the certainty provided by the netting opinion, and following the publication in February of a new definitional booklet and related provisions to allow firms to document derivatives and securities financing transactions (SFTs) under a single ISDA Master Agreement, firms will now be able to enter into new SFTs and derivatives transactions with the confidence of enforceable close-out netting. It is expected there will be strong rationale for firms to enter into SFT transactions under the ISDA Master Agreement when transacting with Chinese financial institutions.

Meanwhile, with the implementation of the final phase of initial margin requirements for non-cleared derivatives on September 1, the threshold for compliance falls to an average aggregate notional amount of non-cleared derivatives of just €8 billion. According to ISDA's estimates, more than 775 counterparties are caught by phase six.

As it stands, margin rules in the EU, UK and several other countries provide exemptions from posting margin for trades with firms in non-netting jurisdictions. Now that China has a clean netting opinion in place, this exemption is likely to fall away and non-cleared derivatives transactions with in-scope Chinese entities may become subject to the requirements.

This poses significant operational challenges, as firms need to negotiate new documentation, establish custodial relationships and put in place systems and processes for calculating and exchanging initial margin. This could be particularly challenging given the lack of infrastructure for exchanging margin in China. In response, ISDA has written to regulators asking for a transition period to give firms the time they need to put the necessary arrangements in place.

The UK Prudential Regulation Authority and Financial Conduct Authority issued proposals on July 12 to allow a six-month transition period for firms that come into scope of the margin rules for the first time, where the rules would otherwise apply immediately. In cases where a netting exemption falls away, this transition period would begin once a firm has concluded its own legal review to confirm netting is enforceable.

"It's important that firms have sufficient time to prepare for implementation of initial margin requirements in situations when compliance by a certain class of counterparty or across a particular jurisdiction is suddenly required. We welcome the intent behind the proposed transition, and are reflecting on whether the practical application of this period will be long enough where infrastructure in a jurisdiction is not well developed," says Tara Kruse, global head of infrastructure, data and non-cleared margin at ISDA. IQ

"Having a netting opinion available gives firms a high degree of legal certainty that netting is enforceable, giving them comfort to trade with Chinese firms, which in turn should encourage more participants and increase liquidity"
Katherine Tew Darras, ISDA

For more on the FDL and netting in China, see pages 18-20

ISDA Create to be Available on S&P's Counterparty Manager

ISDA, Linklaters and S&P Global Market Intelligence will soon make the ISDA Create contract negotiation platform available within S&P Global Market Intelligence's Counterparty Manager service, enabling firms to easily access full details of their contractual relationships in digital form from a single location.

Counterparty Manager allows users to exchange information when opening a trading relationship and includes ISDA Amend, an online tool that enables market participants to modify multiple ISDA Master Agreements and share regulatory representations with counterparties. As part of this new initiative, users of ISDA Create and ISDA Amend will be able to view a complete digital record of all relationship and contractual data exchanged or created on either platform.

"The linking of ISDA Create and Counterparty Manager is a logical extension of the ISDA Amend collaboration that started 10 years ago. This initiative will allow firms to gain a comprehensive, umbrella view of any contractual relationship in digital form, which can then feed directly into collateral, risk and other systems. This will help facilitate further automation and efficiency in derivatives markets, while reducing risk and the potential for error," says Katherine Tew Darras, ISDA's general counsel.

"Having all of this information available at the click of a few buttons will save firms huge amounts of time and effort, avoiding the need to scan through multiple systems – or, worse, rummage through reams of paper documents – to get critical information they need about their trading relationships"

Scott O'Malia, ISDA

Users of Counterparty Manager will be able to access the full online negotiation and execution functionality of ISDA Create by adding an annex to their existing S&P Market Intelligence Counterparty Manager user agreement.

"Customers rely on S&P Global Market Intelligence to manage their client onboarding and lifecycle management processes for both simple and complex contract negotiations and amendments. The aim of the planned inclusion of ISDA Create's functionality in Counterparty Manager's Onboarding Accelerator and Request for Amendment modules is to help enable information sharing between counterparties via a single point of entry," says Lansing Gatrell, managing director, Counterparty Manager and regulatory solutions at S&P Global Market Intelligence.

Launched in 2019, ISDA Create enables financial institutions to draft, negotiate and execute derivatives documents online, including the ISDA Master Agreement, ISDA variation margin (VM) documentation and account control agreements for certain custodians. It is powered by Linklaters' proprietary technology platform, CreateiQ.

ISDA Create has seen strong growth in 2022, as buy- and sell-side firms and custodians comply with phase six of the regulatory initial margin (IM) requirements for non-cleared derivatives. The number of documents sent through the platform has increased by 86% since the start of 2022 and nearly 1,400 individual users are now active on the platform, including more than 650 users added in 2022.

"I've had the pleasure of working with ISDA and IHS Markit/S&P Global Market Intelligence to create game-changing technology solutions for our industry, starting with ISDA Amend 10 years ago. This initiative will create an integrated, end-to-end solution for operationalising institutional data, from client onboarding through to trading agreements. It is a natural next step on the path that ISDA has put the derivatives industry on, a testament to its forward-thinking vision of a digital future for financial markets," says Doug Donahue, CreateiQ board member and capital markets partner at Linklaters.

Speaking at ISDA's Annual General Meeting in Madrid on May 12, ISDA chief executive Scott O'Malia said making ISDA Create available on Counterparty Manager will take market participants a step closer to having a single golden source for all contractual information.

"This will make it much easier to organise, search and analyse, making even the most complex counterparty relationships with umbrella agreements covering thousands of accounts simpler to navigate from a data perspective. Having all of this information available at the click of a few buttons will save firms huge amounts of time and effort, avoiding the need to scan through multiple systems – or, worse, rummage through reams of paper documents – to get critical information they need about their trading relationships," said O'Malia.

In a separate development, a new VM module has been added to ISDA Create that embeds the ISDA Clause Library for credit support documentation within the relevant VM documents on the platform. Launched in response to industry demand, the new module allows users to draft and agree VM documents faster and more efficiently, as well as capture the resulting structured legal data for use in downstream operations.

"ISDA Create users have been asking us to extend the benefits of online negotiation to VM documentation since we first launched the platform in 2019 to help firms comply with IM requirements. With this release, we now have all of the most-used ISDA documentation on the platform, as well as the utility of the ISDA Clause Library for credit support documentation. This will help the derivatives market leverage structured data for both the Master Agreement and credit support documentation, while simultaneously allowing users to have more efficiency and transparency in their negotiations," says Tew Darras. IQ

SOFR Adoption Rises as US Dollar LIBOR Transition Enters Final Year

The proportion of trading activity referenced to SOFR reached an all-time high in July 2022 as market participants transition away from US dollar LIBOR ahead of the five remaining settings ceasing publication at the end of June 2023.

The percentage of trading activity in SOFR rose to 51.7% of total cleared US dollar interest rate derivatives DV01 transacted in July, according to the ISDA-Clarus RFR Adoption Indicator. This represents an increase of 82% since January 2022, when the percentage of trading activity in SOFR was 28.4%.

In July 2021, when the US Commodity Futures Trading Commission's (CFTC) Market Risk Advisory Committee launched SOFR First, a phased initiative to switch trading conventions from LIBOR to SOFR, the percentage of DV01 referenced to SOFR was 7.4%. Following the launch of SOFR First, trading referenced to the overnight rate rose steadily each month. A 'no new LIBOR' strategy employed by banking regulators since the start of 2022 has also accelerated industry transition efforts.

"From a derivatives perspective and a CFTC perspective, having this momentum over the past 12 months has been really significant and we're in a much better position. We will do what we need to do to keep the pedal down until we get to June 2023, but I think we've put ourselves in a good position to make this transition. As a market, we should be proud that we have a much more resilient, stronger benchmark than we did before," said CFTC chairman Rostin Behnam, speaking at ISDA's Benchmark Strategies Forum in New York on June 7.

Following the end-2021 deadline when 30 LIBOR settings ceased publication or became non-representative, five US dollar LIBOR settings were given an extra 18 months to allow the large volume of legacy LIBOR exposure to roll off naturally. While the vast majority of OTC trades in the US interdealer market are referenced to SOFR, further transition efforts are required in other market segments and geographies.

In the exchange-traded market, where transition to SOFR has been a little slower, there has been recent progress with the launch of CME Group's SOFR First for Options initiative, which implemented specific measures to boost liquidity and trading in SOFR options. These included a market-wide fee waiver for SOFR options in June, July and August, as well as certain market-making incentives.

"As we enter the final straits of the transition, these proactive transition efforts will be vital in switching the market away from US dollar LIBOR. For market participants, the coming year will be all about prioritising the transition of any remaining US dollar LIBOR exposures," said Scott O'Malia, chief executive of ISDA, speaking at the Benchmark Strategies Forum.

For legacy exposures to US dollar LIBOR in non-cleared derivatives, market participants can proactively negotiate a switch to an alternative reference rate, or they can rely on ISDA's contractual fallbacks, which played an important role in the transition of the bulk of LIBOR settings at the end of 2021. More than 15,300 entities across the globe have now adhered to the ISDA 2020 IBOR Fallbacks Protocol, which implements these fallbacks and remains open for adherence.

"The widespread adoption of the fallbacks meant viable alternatives based on risk-free rates automatically took effect for most non-cleared LIBOR derivatives affected by the end-2021 deadline, helping to ensure a smooth transition. These fallbacks also formed the basis for central counterparty conversions of cleared LIBOR derivatives last year. We expect the ISDA fallbacks to play a similarly important role in the transition from the remaining five US dollar LIBOR settings," said O'Malia.

Meanwhile the UK Financial Conduct Authority (FCA) has compelled the continued publication of six sterling and yen LIBOR settings on a synthetic, non-representative basis since the end of 2021 to give holders of legacy contracts more time to complete their transition efforts. The publication of three synthetic yen settings is due to cease at the end of this year and the FCA launched a consultation on June 30 to seek views on winding down the one-, three- and six-month synthetic sterling LIBOR settings.

> "We will do what we need to do to keep the pedal down until we get to June 2023, but I think we've put ourselves in a good position to make this transition. As a market, we should be proud that we have a much more resilient, stronger benchmark than we did before"
>
> **Rostin Behnam, CFTC**

Speaking at the ISDA Benchmark Strategies Forum in London on June 22, Helen Boyd, head of markets policy at the FCA, cited the regulator's estimate that less than 1% of the £30 trillion of contracts that referenced sterling LIBOR at the start of 2021 now remains. This residual exposure is referenced to synthetic sterling LIBOR, she said.

"We have been very clear that synthetic LIBOR was only a temporary bridge that must, along with the rest of the set, be taken down eventually. If you are part of that 1%, it is imperative you have robust plans to ensure that all remaining sterling LIBOR-referenced exposures are addressed and transitioned appropriately. We have been clear that synthetic rates will not be continued simply for the convenience of those that could take action but don't," said Boyd. IQ

THE COVER PACKAGE

Strengthening Markets

New guidance sets a path for emerging and developing economies to build safe and efficient derivatives markets

Companies, financial institutions and governments of all sizes rely on access to capital markets and derivatives to finance growth and create stability in their business and activities. The benefit of derivatives is consistent the world over, but the maturity of derivatives markets varies from one country to the next. Not all economies have the robust legal and regulatory framework that is so important for safe and efficient markets, or the diversity of market participants and sophistication of risk management.

ISDA recently published a whitepaper that seeks to provide policymakers in emerging and developing markets with the information and guidance they need to develop an appropriate policy framework for robust derivatives markets (see pages 12-17). Among the issues addressed in the whitepaper, the enforceability of close-out netting is the most critical. By allowing parties to reduce their obligations to a single net payment, netting dramatically reduces credit risk in the event of a default. The ability to manage credit risk on a net basis increases liquidity and credit capacity, supporting the development of liquid, well-functioning markets.

ISDA has consistently advocated for netting enforceability and worked closely with authorities around the world to help draft legislation. As a result of this work, ISDA's netting opinions are currently available for more than 80 jurisdictions. The most recent addition to this list is China, for which a netting opinion was published on August 1, coinciding with the Futures and Derivatives Law coming into effect (see pages 18-20).

The recognition of enforceable close-out netting in Chinese law is a landmark development, and attention is now turning to what additional policy measures may be needed to further develop the derivatives market. ISDA has put forward 18 specific recommendations, spanning risk governance, market structure, counterparty and market risk management and regulatory framework (see pages 22-23). IQ

"There are a number of standard issues that need to be solved to develop a well-functioning derivatives market, from netting and collateral enforceability to the appropriate market structure for derivatives, particularly with respect to clearing"

Axel van Nederveen, European Bank for Reconstruction and Development

* Building Stability

The development of safe and efficient derivatives markets in emerging and developing economies depends on multiple factors, from a robust legal and regulatory framework to a diverse market participant base and sophisticated risk management

The structural robustness of a building is achieved through many different steps, from the obvious to the more subtle. Steel beams, for example, are usually critical to withstanding heavy loads, but other factors, such as the solidity of the soil or the materials used to construct the building, may be no less important. All these factors must be considered in the design and construction of new buildings.

In a similar way, the effectiveness of an emerging derivatives market is dependent on a wide range of factors, from the legal and regulatory framework to the diversity of market participants and the sophistication of risk management. Many emerging and developing markets have taken the landmark step of implementing legislation to recognise the enforceability of close-out netting, or are making progress towards that objective, but further measures will be needed to develop strong derivatives markets that can support investment and economic growth (see box, *The Role of Derivatives*).

"Effective risk management is fundamental to rising living standards and should not be available only in developed markets, so we have a duty to promote effective derivatives markets all over the world. As in developed markets, the reduction of risk brings greater certainty on future flows and allows business and investment to take place with greater confidence," says Eric Litvack, chairman of ISDA.

Every jurisdiction in the world has its own unique features, but the need for robust capital markets including derivatives is no less acute in emerging and developing markets than in the developed world. Given the often relatively high volatility in GDP, exchange rates, interest rates and capital flows in emerging markets, derivatives can offer a means of facilitating effective risk management and access to capital.

A well-functioning derivatives market can give companies the confidence and certainty they need to navigate the economic headwinds and invest, hire and expand their businesses. This requires derivatives to be underpinned by strong legal, regulatory and risk management foundations. In May 2022, ISDA published a whitepaper, *Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets*, which seeks to provide policymakers with the information and guidance they need to develop an appropriate policy framework for robust derivatives markets.

"There are a number of standard issues that need to be solved to develop a well-functioning derivatives market, from netting and collateral enforceability to the appropriate market structure for derivatives, particularly with respect to clearing. It is very important we have a clear roadmap on the key elements that are needed," says Axel van Nederveen, managing director and treasurer of the European Bank for Reconstruction and Development, and vice chairman of ISDA.

Netting

While the range of issues that may need to be addressed is wide, the legal framework is the natural place to start, as every derivatives transaction is based on a legal agreement between counterparties. Several important legal issues may need to

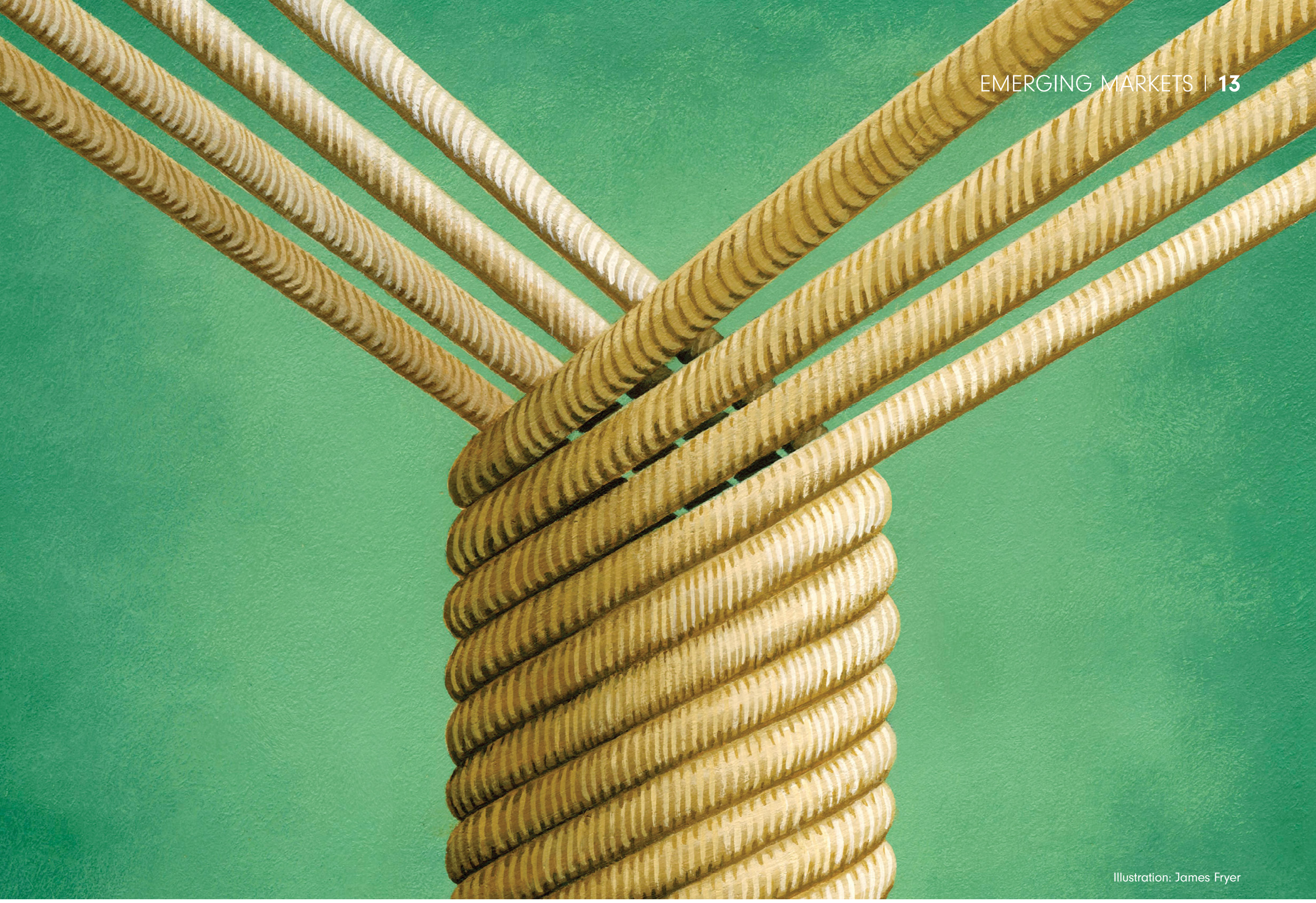


Illustration: James Fryer

be addressed, but the enforceability of close-out netting is the most critical, without which it would be very difficult to develop and grow a well-functioning derivatives market.

By allowing parties to reduce their obligations to a single net payment due from one party to another, netting dramatically reduces credit risk in the event of a default (see box, *What is Close-out Netting?*).

Data from the Bank for International Settlements (BIS) shows that close-out netting reduces the gross market value of outstanding derivatives transactions by nearly 80%. As of the end of 2021, the gross market value of derivatives contracts stood at $12.4 trillion, whereas the gross credit exposure, which adjusts gross market values for legally enforceable bilateral netting agreements, amounted to just $2.5 trillion, according to the BIS.

Managing credit risk on a net rather than a gross basis increases liquidity and credit capacity. Recognition of netting also removes a major barrier to international participation, supporting the development of liquid and efficient capital markets.

80%

Reduction in gross market value due to legally enforceable bilateral netting agreements

"As an intermediated market, the over-the-counter derivatives market offers the benefit of bespoke hedging solutions. For the dealers that act as intermediaries to numerous end users, netting is the critical mechanism that allows them to offset the sum of their risks and provide intermediation at the best price. Once netting is in place, dealers can provide wider access to derivatives-based risk management, which creates greater certainty and will fuel investment and economic growth," says Litvack.

Since its inception in 1985, ISDA has worked with policymakers around the world to make the case for netting and develop the necessary legislation to ensure its enforceability. This can often be a long-running process, and ISDA's 2018 update to the Model Netting Act has provided a helpful template for legislation in many jurisdictions.

Netting legislation has been adopted in many countries, and recent additions to this group include two economic behemoths, India and China, as well as Costa Rica, Croatia, Latvia, Nigeria and Kazakhstan. Depending on member demand, ISDA commissions legal netting →

opinions in those jurisdictions where legislation has been adopted, and clean netting opinions have now been issued for more than 80 jurisdictions.

The achievement of legally enforceable netting in India and China in close succession represents a seminal milestone, which has the potential to facilitate further market growth in both countries. India passed the Bilateral Netting of Qualified Financial Instruments Act in September 2020, while China's Futures and Derivatives Law (FDL) was passed by the National People's Congress of China on April 20, 2022 and came into effect on August 1.

"The FDL brings China's derivatives market into a new era, enabling banks to offer more products to clients to hedge their risks. In the past, there have been concerns over the validity and legitimacy of derivatives initiatives due to the lack of expressive recognitions under the law. The legislation removes that uncertainty and allows the derivatives market to become broader and deeper," says Richard Cao, managing director and Citibank China counsel.

80

Number of jurisdictions in which ISDA has commissioned clean netting opinions

Following the passage of the FDL, ISDA moved quickly to commission a netting opinion for China, which was published on August 1 to coincide with the legislation coming into effect. As in other markets, the legal recognition of netting does not mean that no further reforms or policy measures will be needed, but it does clear a significant barrier for market participants that had previously shied away from non-netting jurisdictions.

"The absence of netting has affected capital charges, costs and pricing of derivatives in the past, so I expect the FDL and the further development of a strong regulatory framework in China will lead to greater interest to invest in the Chinese market and a greater diversity of market participants, including sovereigns, institutional clients and hedge funds," says Cao.

Regulatory framework

The passage of the FDL leaves only one Group-of-20 (G-20) nation without netting legislation in place, and ISDA is working with the regulator of that country to close the gap. But just as the process of safely constructing

THE ROLE OF DERIVATIVES

Derivatives play a vital role in the risk management and financing strategies of companies, financial institutions and governments across the globe. Whether used by corporates to mitigate exchange rate risk on foreign currency earnings, by pension funds to hedge inflation and interest rate risk in long-dated pension liabilities, or by governments to reduce interest rate risk on new bond issuance, derivatives allow users to manage business and financial risks and access capital cost-effectively, creating greater certainty and stability. This stability means users can lend, borrow or invest with greater confidence, contributing to economic growth.

Uses of derivatives include:

Manufacturing: Manufacturers use derivatives to help lock in the cost of issuing debt to finance new investments and factories, which contributes to growth and job creation.

Exporting: Exporters use derivatives to achieve certainty in the rate they can convert future overseas revenue, which creates stability and keeps them competitive.

Energy: Explorers, producers and distributors of energy use derivatives to manage changes in energy prices.

Food production: The agricultural businesses that produce food and the companies that bring it to store use derivatives to manage the risk of fluctuating crop, livestock and fuel prices.

Financial services: Banks use derivatives to manage mismatches between their assets and liabilities, enabling them to expand lending to individuals and businesses.

Mortgage providers: Derivatives allow mortgage providers to hedge the risks posed by offering fixed-rate mortgages.

Transport: Airlines use derivatives to hedge fuel costs, which helps to keep ticket prices more stable.

Pensions: Pension funds use derivatives to manage interest rate and inflation risk to protect the value of pension pots for future retirees.

Insurance: Insurance companies use derivatives to ensure premiums paid by customers are sufficient to meet future insurance claims.

a new building doesn't end when the steel girders are in place, netting should be considered the foundation of a strong derivatives market upon which other important components need to be layered.

Once an appropriate legal framework has been developed, the regulatory framework needs to be addressed. Key issues would include clarifying official sector responsibility for market oversight, setting suitable parameters for market participants and products, and effectively transposing global rule sets in a proportionate manner.

When it comes to global rule sets, the G-20 derivatives reforms that were agreed in Pittsburgh in 2009 are among the most relevant, and jurisdictions must assess whether it is appropriate to implement all, some or none of them (see box, *The G-20 Reforms and Emerging Markets*).

While the G-20 reforms have been widely implemented in developed markets over the past 13 years, not every reform will be appropriate in every jurisdiction. In particular, the implementation of central clearing has played a major role in reducing systemic risk following the financial crisis but may not be a viable policy tool in every location. It will be up to policymakers to determine whether it should be enforced and, if so, in what form.

"In considering the various G-20 obligations, it wouldn't be desirable to create a cliff effect by imposing very challenging requirements as soon as netting has been achieved. Clearing makes sense for large dealers that have counterparty risk in every direction and can benefit from a balance sheet and risk management perspective. But in frontier markets, the trade frequency is typically much lower and there is less economic and risk management rationale for clearing," says Litvack.

Speaking on a panel at the ISDA Annual General Meeting in Madrid on May 12, Brett Gallie, head of the global markets legal team at Standard Bank, shared the experience of South Africa, one of the largest emerging markets and a G-20 nation, noting that the nature of the country's derivatives market means domestic clearing through a local central counterparty (CCP) would not make sense.

"Clearing and margin were brought in post-crisis to de-risk the financial system generally. Our experience, though, is that unfortunately not all of these initiatives cascade so well into developing markets. As a bank, we do a lot of clearing, primarily through London, where the number of members, the mutualisation of losses and the amount of collateral you need to put up makes it much more economically viable. The only local market large enough to sustain clearing is the local currency interest rate swap market. However, the large South African banks primarily trade their interest rate derivatives with offshore banks, and these banks would not use a local CCP. If we were to put local clearing in place, it would only be for local-to-local interest rate derivatives, which would bifurcate the existing market," said Gallie.

International bodies, including the International Organization of Securities Commissions, have recognised that central clearing may not be appropriate in relatively small and non-complex markets and would impose considerable costs. In its policy framework whitepaper, ISDA has set out the conditions that should be met before a clearing mandated could be considered. These →

Asset management: Asset managers use derivatives to hedge unwanted interest rate or foreign exchange risk, to protect portfolios against market volatility, to quickly rebalance asset allocations or to take views on specific markets or sectors, and to enhance returns.

Governments: Governments may decide to issue debt in foreign currency to access a new investor base or tap into cheaper funding rates, then use derivatives to mitigate interest rate and currency risk.

Banks and other market makers are critical to the smooth functioning of this market by providing liquidity and facilitating transactions between end users with different economic needs.

ISDA has published a number of educational videos on the functioning of the derivatives markets:

How do Derivatives Benefit the Global Economy? bit.ly/3PiiB7N

How Big is the Derivatives Market? bit.ly/3cgVb4d

How is Collateral Used in the Derivatives Market? bit.ly/3PfjSwz

How do Derivatives Help Firms Access Global Markets? bit.ly/3INjKlr

What are the Benefits of Close-out Netting? bit.ly/2K1KJf1

Who Uses Derivatives and Why? bit.ly/3PgU0Aq

What Role will Derivatives Play in Tackling Global Climate Change? bit.ly/3yQI8hl

The Resilience of Financial Markets bit.ly/3Pyv4E5

Understanding the ISDA Master Agreement bit.ly/3AYWuiG include ensuring the legal framework supports clearing, developing derivatives markets with a sufficient volume of standardised products, and having a liquid and efficient collateral market without undue restrictions.

"The G-20 Pittsburgh commitments were designed to solve a developed market derivatives crisis, but these rules are only really necessary in very large markets with systemic exposures. A clearing obligation is unlikely to work in most emerging markets. If it's only for a limited number of contracts, the economic case is very weak, and if the legal framework isn't right, it becomes very difficult for the CCP to deploy good risk management practices," says van Nederveen.

In the same way the application of clearing to emerging markets raises certain unique issues, the other G-20 reforms cannot be implemented without first considering several important factors. For example, the exchange of initial margin (IM) requires, among other things, a clean close-out netting regime, a legal framework that supports bilateral IM agreements, and a liquid and efficient collateral market without undue restrictions.

Meanwhile, regulatory reporting may be a helpful exercise to enable risk monitoring, but establishing a trade repository in every market would be costly and potentially duplicative. Rather than creating numerous new trade repositories all over the world, regulators in emerging and developing markets could sign memorandums of understanding with authorities in major trading markets to enable access to relevant derivatives trading information. Alternatively, regulators could require firms to report trades directly to them, thereby avoiding the costs and complexity of setting up a trade repository.

Risk management

Just as no single material or process in isolation renders a building safe and secure, ISDA's work on emerging and developing markets has led to a similar finding. Netting enforceability is fundamental, but it is only part of the solution. An appropriate regulatory framework is important, but it doesn't do the job on its own. Diverse market participation and sophisticated risk governance and risk management are also critical ingredients.

WHAT IS CLOSE-OUT NETTING?

Close-out netting allows firms to terminate outstanding transactions with a counterparty following an event of default, and to offset the various obligations into a single net amount owed by one party to the other. This is an important means of reducing credit risk between two counterparties.

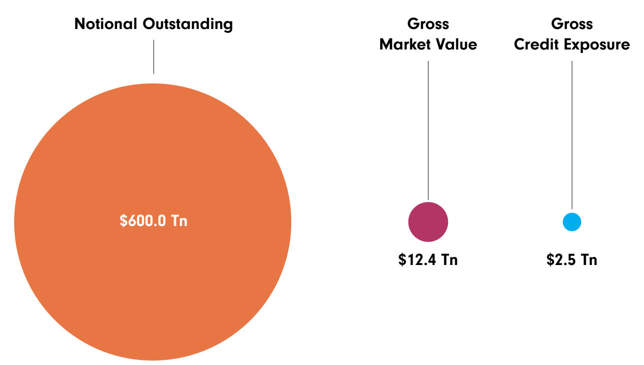
Without close-out netting, firms would need to manage their credit risk on a gross basis. This would result in less credit capacity and reduced liquidity. Managing credit risk on a net basis means more credit is available to firms looking to raise financing or hedge their exposures.

Regulators allow close-out netting to be risk-reducing for the purposes of capital requirements, so long as there is a high degree of legal certainty over the enforceability of close-out netting under the local law in each jurisdiction. Firms can also exchange collateral on the net amount, leading to reduced costs. This encourages more participation in markets where close-out netting is enforceable.

ISDA has worked with authorities across the globe to help draft legislation recognising the enforceability of close-out netting. ISDA's netting opinions are currently available for more than 80 jurisdictions.

ISDA has published the 2018 update to the Model Netting Act, which is designed to provide a template that can be used by jurisdictions considering close-out netting legislation.

Impact of Netting on Global Derivatives Market Value



Source: Bank for International Settlements semi-annual survey, as of December 2021

At the level of individual firms, both the board of directors and senior management are responsible for risk, albeit in different ways. As ISDA's whitepaper sets out, the board should understand, approve and review risk management policies that have been developed by senior management and should define the scope of the firm's derivatives activities, the reasons why it is undertaking those transactions, its permissible market and credit risk exposure, and its risk processes and controls.

"Taken as a whole, this work is all about how you define and design the next stage of a derivatives market once netting has been achieved. Every market has historically had its own way of doing things and there is no single playbook that can be simply applied to every market, but the ISDA policy framework should be a very helpful tool in making sure the most important issues are addressed," says van Nederveen.

Read ISDA's whitepaper, *Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets*: bit.ly/3Pd6Akf

THE G-20 REFORMS AND EMERGING MARKETS

In September 2009, the Group-of-20 (G-20) nations met in Pittsburgh and agreed several major commitments to reform the global over-the-counter (OTC) derivatives market after the financial crisis.

- Clearing of all standardised OTC derivatives through central counterparties;
- Trading of standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate;
- Mandatory reporting of OTC derivatives to trade repositories; and
- Higher capital requirements for non-cleared derivatives.

A further commitment to require margin to be posted on non-cleared derivatives was added in 2011. When transposing these rules to emerging and developing markets, certain conditions need to be satisfied.

For initial margin (IM) requirements:
- Implementing a clean close-out netting regime;
- Ensuring the legal framework supports bilateral IM agreements;
- Developing derivatives markets with a sufficient amount of standardised products;
- Having a liquid and efficient collateral market without undue restrictions;
- Developing the collateral management capabilities of local financial institutions.

For any central clearing mandate:
- Ensuring the legal framework supports clearing;
- Developing derivatives markets with a sufficient amount of standardised products;
- Having a liquid and efficient collateral market without undue restrictions.

Given the small amount of derivatives activity in emerging and developing markets, an electronic trading mandate may not be feasible. Not all G-20 jurisdictions currently have electronic trading platforms, and only six have determinations for specific products to be executed on those platforms.

Regulatory reporting is important in emerging and developing markets to enable appropriate monitoring of risk. However, establishing a trade repository in every market would be costly and duplicative and could have an adverse impact on the development of risk management markets.

One solution would be for regulators in emerging and developing markets to sign memorandums of understanding with authorities in major trading markets to enable access to derivatives trading information, or they could require firms to report directly to them, avoiding the need for a trade repository.

When it comes to higher capital requirements for non-cleared derivatives, Basel III is aimed at larger internationally active banks in advanced economies. Policymakers and other participants have highlighted the need for proportionality in how emerging and developing markets apply capital rules in their jurisdictions. Adoption of the Basel III standards is optional for most emerging and developing markets, and most have not implemented it.

* A New Era

By legally recognising the enforceability of close-out netting for the first time, China's Futures and Derivatives Law represents a major step forward for the Chinese derivatives market, writes ***Terry Yang***

The passage of the Futures and Derivatives Law (FDL) by the National People's Congress (NPC) of China on April 20, 2022 marks a historical milestone for the Chinese derivatives market.

The FDL, which took effect on August 1, 2022, is the first piece of legislation in China to directly address the futures and derivatives market and is the culmination of more than a decade of regulatory engagement with the Chinese legislature, regulators and Supreme Court justices on the critical issue of close-out netting.

Ever since the publication of the first draft of the FDL in April 2021, market participants have been very excited that this legislation may be the holy grail that finally provides sufficient legal comfort for international dealers to treat China as a clean netting jurisdiction. This optimism is, in our view, well justified.

Netting milestone

Although Chinese regulators, including the China Banking and Insurance Regulatory Commission, have helpfully published guidance over the years confirming their view that there is no conflict between close-out netting provisions under ISDA's standard templates and Chinese law, the market has generally believed there was potential uncertainty arising from possible challenges under China's bankruptcy laws, such as an administrator's right to cherry pick between transactions.

The FDL directly addresses these uncertainties by expressly recognising the concept of 'single agreement' and confirming that close-out netting cannot be challenged on the basis of bankruptcy laws. This legislation went through two rounds of public consultation and, on both occasions, ISDA coordinated detailed comments on behalf of the industry. Throughout the process, Chinese authorities and regulators demonstrated their willingness to engage with market participants.

One evolution during the drafting process is worth highlighting. In the initial draft of the FDL, the NPC included a filing requirement for 'master agreements' in order to benefit from the netting protections included in the FDL. ISDA and market participants explained that such a filing requirement for over-the-counter (OTC) derivatives documentation would be almost unique to China and could potentially introduce uncertainties to the netting protection the NPC wanted to provide under the FDL. The industry was subsequently pleased to find that the filing requirement was decoupled from the provisions

"Ever since the publication of the first draft of the FDL in April 2021, market participants have been very excited that this legislation may be the holy grail that finally provides sufficient legal comfort for international dealers to treat China as a clean netting jurisdiction. This optimism is, in our view, well justified"

for netting protections in the final version of the FDL.

As a result of these coordinated industry efforts, the FDL provisions relating to close-out netting cover the key aspects of the most important clause under the ISDA Model Netting Act. This provided a strong basis for clean netting and collateral opinions to be issued with respect of China. Importantly, it should also no longer be necessary for automatic early termination to be applied to Chinese counterparties because of the FDL.

Following the passage of the FDL, ISDA and King & Wood Mallesons, ISDA's legal counsel for China, began drafting the industry netting and collateral opinions for China on the basis of the legislation. The netting opinion was published on August 1, coinciding with the FDL coming into effect, and the collateral opinion is in progress. Market participants welcome ISDA's industry opinion, as it forms an important cornerstone for international banks to adopt clean netting for Chinese counterparties.

Margin implementation

While there should be a significant regulatory capital benefit for many financial institutions in treating exposure to Chinese counterparties as net rather than gross, this will bring the key challenge of implementing regulatory margin requirements. Many international banks incorporated in major financial centres have so far been exempt from exchanging variation margin and initial margin with Chinese counterparties because China was a non-netting jurisdiction. This exemption will no longer be applicable once a financial institution decides to 'switch on' netting for China.

While the regulatory margin requirements in some jurisdictions provide a reasonable period for financial institutions to put in place the relevant margin arrangements with counterparties once the netting treatment has changed, this is not the case for all jurisdictions. ISDA has helpfully coordinated submissions to the regulators of several key jurisdictions, including the EU, UK, Hong Kong, Singapore and Australia, to request or confirm, as applicable, a grace period of 18 months for putting in place regulatory margin arrangements with Chinese counterparties. Given many international dealers and Chinese counterparties will be swamped in the upcoming months with ISDA credit support document negotiations, this grace period will be critical.

In the case of variation margin documentation, our experience is that larger Chinese counterparties have a fair amount of experience with title transfer documents, such as the ISDA credit support annex. However, in the case of initial margin arrangements, we expect many Chinese counterparties will require significant time to obtain all the internal approvals and set up the operational aspects of the tripartite collateral structure before being able to sign off on the relevant agreements. Fortunately, many Chinese

→ counterparties are unlikely to be trading sufficient volumes of OTC derivatives to trigger initial margin requirements. Nonetheless, we anticipate the 18-month grace period will become a very important piece of the puzzle when trading with the largest Chinese banks.

Chinese regulators have signalled their intentions to introduce equivalent regulatory margin requirements for the onshore OTC derivatives market. While there is no guidance on the timing of this development, we anticipate it will come soon given the renewed focus on risk management of derivatives.

"The FDL represents a significant achievement – as a new chapter begins for the Chinese OTC derivatives market, we look forward to working with everyone to deepen cross-border trading opportunities and strengthen the stability and diversity of this key jurisdiction in Asia"

Upcoming developments

The passage of the FDL marks both the end of a decade-long effort for netting legislation in China, as well as the start of a new era for the Chinese OTC derivatives market. From a legal and regulatory perspective, we are already seeing further liberalisation measures being introduced for the Chinese financial markets. Most notably, Chinese regulators have promulgated regulations and documents to support Chinese bond lending transactions, as well as foreign investor participation in additional products on Chinese commodities exchanges.

There is also great anticipation of the launch of carbon futures on the Guangzhou Futures Exchange. In the post-FDL Chinese OTC derivatives market, we look forward to supporting financial institutions in creating new structured transactions following these market developments.

At the same time, it is also worth highlighting further legislative developments that are coming.

For example, the People's Bank of China published the draft Financial Stability Law (FSL) in April 2022. The FSL will lay the foundation for China's resolution regime for financial institutions, in line with the international principles set out by the Financial Stability Board. One of the key issues for international market participants is whether Chinese regulators will limit their termination stay powers to 48 hours, aligning with other major financial centres. Based on ISDA's engagement with the relevant Chinese regulators, this should be enshrined in subsidiary rules in due course.

In addition, the NPC's legislation plan for the second half of 2022 includes an amendment to China's Bankruptcy Law. This is another piece of legislation that has been worked on for many years given the potentially extensive influence it may have on the Chinese economy. One area that should be of particular focus for international investors is whether the Chinese legal system will develop a self-help remedy for the enforcement of security arrangements, and the extent to which the Bankruptcy Law will interfere with such enforcement.

This issue was highlighted in ISDA's joint paper with the China Central Depository and Clearing Co, the depository and clearing institution for Chinese government bonds. Published in March 2021, the paper sets out various short-, medium- and long-term steps needed to facilitate and encourage the use of Chinese bonds as collateral in international financial transactions. It is no secret that, from a policy perspective, Chinese regulators are very keen to promote internationalisation and liberalisation of domestic financial markets. Supporting the use of collateral denominated in renminbi would be a tangible and welcome development for market participants.

In summary, the FDL represents a significant achievement, made possible through the combined efforts of the industry. As a new chapter begins for the Chinese OTC derivatives market, we look forward to working with everyone to deepen cross-border trading opportunities and strengthen the stability and diversity of this key jurisdiction in Asia. IQ

Terry Yang is a partner at Clifford Chance in Hong Kong, specialising in derivatives, structured products and financial regulatory matters

* Next Steps

Following the passage of the Futures and Derivatives Law, attention is turning to what policy measures may be needed to further advance China's derivatives market. ISDA has developed a series of recommendations for what comes next

1.0%

Average daily turnover of OTC derivatives in China, as a percentage of global turnover

China's Futures and Derivatives Law (FDL) marks a watershed moment, removing a significant barrier to the development of safe and efficient derivatives markets by enshrining the enforceability of close-out netting in Chinese law. Now that the FDL has taken effect, policymakers and market participants are considering what further steps may be needed to promote robust derivatives markets in China.

In December 2021, as the National People's Congress was still considering the draft legislation, ISDA published a major whitepaper that sets out how the derivatives market will contribute to China's financial system, capital markets and economic growth, as well as exploring the possible policy measures that will be needed to support further development of China's derivatives market.

"ISDA has always been clear that recognising netting enforceability is the most effective step any country can take to improve the safety and efficiency of its derivatives market, but this is not the end of the journey. Having worked towards the recognition of netting in China for so long, it is important we identify what reforms and policy measures may come next," says Scott O'Malia, chief executive of ISDA.

China's economy has grown at an extraordinary rate over the past decade, with its share of world GDP rising from 12.4% in 2013 to 16.3% in 2019. But while China has been the world's second largest economy for some time, its derivatives market has not grown at the same pace. Average daily turnover of over-the-counter derivatives in China as a percentage of global turnover is only around 1.0%, according to data from the Bank for International Settlements.

The evolution of a well-functioning derivatives market in China will support the development of the country's financial system. When it comes to financing, banks have historically acted as the main intermediaries, providing loans directly to corporates. But as direct financing from capital markets increases, there will be greater demand for derivatives to enable firms to manage their risks effectively. As in other countries, a strong derivatives market underpins effective capital markets, broadening access to financing and supporting economic growth. Certainty over the enforceability of netting will also lead to more international participation, improving liquidity.

"Without netting, China has historically been a no-go for many investors, because the risk is too large. With netting now in place, we need to address the documentation and regulatory framework to make sure they do not implicitly create barriers or exclude any market participants from accessing derivatives. We need diverse market participation to create and maintain a deep pool of liquidity," says Thijs Aaten, chief finance and risk officer at APG Asset Management Asia.

The ISDA whitepaper, which is based on more than 50 interviews with domestic and foreign market participants, explores opportunities and recommendations to further

"With netting now in place, we need to address the documentation and regulatory framework to make sure they do not implicitly create barriers or exclude any market participants from accessing derivatives"

Thijs Aaten, APG Asset Management Asia

develop and strengthen China's derivatives market across four key areas – risk governance, market structure, counterparty and market risk management and the regulatory framework. With netting enforceability now achieved, the next priorities may differ, but the whitepaper provides a valuable blueprint as the market looks to build on the success of the FDL.

The risk governance recommendations centre on promoting the use of derivatives as a risk management tool, making sure market participants understand the role and value of derivatives and helping them develop the necessary expertise to deploy them effectively. Education and training could be critical in increasing the pool of risk management expertise in China and helping realise the potential benefits of derivatives.

As far as market structure is concerned, facilitating access for a diverse range of market participants is an important objective. The whitepaper explores how participation could be broadened and deepened, and recommends several possible measures, including encouraging firms to use interest rate derivatives to hedge interest rate fluctuations and expanding access to government bond futures.

"A larger market participant base with more types of institutions locally and overseas would be helpful to grow a vibrant and liquid market. If we have more commercial banks, insurance companies and asset management companies investing in the Chinese market, this will enhance price discovery, improve liquidity and lower systemic risk," says Andrew Ng, group executive and head of treasury and markets at DBS Bank.

Implementation of the FDL on August 1 constitutes a major step in the mitigation of credit risk, but it will be important to progress further with other measures, such as improving collateral management and developing a strong framework for central clearing. The ISDA paper identifies appropriate supervision of central counterparties and effective management of their risks as a critical development.

With the legal foundations of China's derivatives market strengthened, the regulatory framework will need to evolve further in the future. While the nature of regulations will be determined by Chinese regulators, market participants have welcomed the consultative approach that was taken in the development of the FDL, calling for a similar tactic to be used in future. ISDA's recommendations in this area focus on enhancing the communication, transparency and consultation process for future regulations.

"Our members have welcomed the very collaborative approach to the FDL, including consultations, bilateral meetings and conferences – this is a positive development that could serve as a blueprint for the future. With the FDL now in place, market participants are keen to focus on building a solid legal and regulatory framework, increasing the size and breadth of market participants, and developing expertise in key areas such as settlement, collateral, confirmations and affirmations, so that we don't increase operational risk," says Benoît Gourisse, head of public policy for Asia Pacific at ISDA. IQ

CHINA DERIVATIVES MARKET: RECOMMENDATIONS

A major ISDA whitepaper, published in December 2021, sets out 18 recommendations to further develop the over-the-counter derivatives market in China.

Risk Governance

1. Strengthen the risk governance framework on use of financial instruments;
2. Promote the use of derivatives as a risk management tool;
3. Increase the number of professionals with risk management expertise.

Market Structure

4. Increase the size and breadth of the market participants base;
5. Improve supporting measures to promote credit derivatives use;
6. Implement capital relief qualifications for commercial banks that use credit derivatives;
7. Adopt a registration-based system for new product listings on exchanges;
8. Establish a more comprehensive product portfolio for exchange-traded derivatives;
9. Improve the securities lending business to enhance market liquidity.

Counterparty and Market Risk Management

10. Ensure the finalised Futures and Derivatives Law confirms the enforceability of close-out netting and related financial collateral arrangements;
11. Improve credit mitigation abilities through enhancing collateral management capabilities and processes;
12. Allow trading counterparties to freely choose master agreements based on mutual consent rather than regulatory mandate;
13. Central counterparties (CCPs) should prioritise gaining permanent exemption from derivatives clearing organisation registration from the Commodity Futures Trading Commission, and recognition as a third-country CCP by the European Securities and Markets Authority and the Bank of England;
14. Strengthen the risk management framework at CCPs to maintain systematic stability;
15. Clarify the scope of the Cyber Security Law and explore possible mechanisms to allow for cross-border data transfer.

Regulatory framework

16. Enhance communication of the regulatory rules and framework to market participants;
17. Enhance transparency in future regulatory plans;
18. Foster an open market consultation process to improve communication between regulators and market participants.

Read ISDA's whitepaper, *Developing Safe, Robust, and Efficient Derivatives Markets in China*: bit.ly/3z5q0Rh

A Positive Agenda

As the European Commission seeks to expand derivatives clearing in the EU and improve the attractiveness of EU CCPs, ISDA has developed a roadmap to achieve these policy objectives without jeopardising market stability

From cross-border trade and immigration policies to fisheries and agriculture, the impact of Brexit over the past two years has been far-reaching. As the UK forges a path outside the EU, the location of over-the-counter (OTC) derivatives clearing may be one of the more niche issues both sides have had to confront, but it is one that has systemic implications for derivatives markets. Policymakers and market participants have therefore invested significant time and resources in shaping the future of clearing in Europe.

Following its decision earlier this year to extend equivalence for UK central counterparties (CCPs) until mid-2025, the European Commission (EC) has consulted on ways to expand central clearing in the EU and improve the attractiveness of EU CCPs, and is now preparing to bring forward policy measures. Recognising the EC's objectives, ISDA has built on its response to the consultation to develop a comprehensive roadmap that would drive the expansion of clearing in the EU.

"Clearing is a centripetal business that is more efficient if more volume is cleared in one place, but it is also important to recognise the EU's policy objective to build up onshore financial markets and develop clearing capacity within the EU. Being very dependent on offshore market infrastructures raises EU concerns of risks to financial stability, so while market participants will always want to use the CCP that offers the best service for their business, it is right that we should support the EU's drive to make onshore clearing more attractive," says Eric Litvack, chairman of ISDA.

Building capacity

In September 2020, with just a few months to go until the end of the Brexit transition period, the EC granted temporary equivalence to UK CCPs until June 30, 2022. The decision was taken to avoid any possible risks to financial stability as the UK left the EU, but European market participants were also urged to reduce their exposures to UK CCPs. Last year, the EC established a working group to explore the opportunities and challenges involved in transferring derivatives clearing from UK to EU CCPs. In November, the EC recognised that while a combination of measures would be needed to build clearing capacity in the EU, this could not be achieved by mid-2022.

On February 8, the EC adopted a decision to extend equivalence for UK CCPs until June 30, 2025. While that new

> "Clearing is a centripetal business that is more efficient if more volume is cleared in one place, but it is also important to recognise the EU's policy objective to build up onshore financial markets and develop clearing capacity within the EU"
>
> **Eric Litvack, ISDA**

deadline was more than three years away at the point of the decision being adopted, the EC made clear it does not intend to let the issue drift. To that end, it launched a targeted consultation and call for evidence on ways to expand central clearing in the EU and improve the attractiveness of EU CCPs, in order to reduce the EU's reliance on systemic third-country CCPs.

Mairead McGuiness, the EC's commissioner for financial stability, financial services and capital markets union, committed the EC to bring forward measures later this year to reduce dependence on systemic third-country CCPs and improve the attractiveness of EU CCPs, while also enhancing their supervision. Market participants are anxious to retain the flexibility to use the most appropriate CCPs for their business rather than being forced to clear in a particular location, but they have also welcomed the consultative approach that has been taken over the past two years.

"A location policy for clearing would fragment the derivatives market and reduce choice, and EU-based clearing members and clients would be most affected. But we understand the EC's objective to deepen the EU clearing market. This is best done by making that market more attractive and efficient for users of CCPs' services. We very much welcome the attention that has been paid by the EC and others to consulting with stakeholders from across the market – there has been extensive engagement on this issue and that will continue to be critical in reaching an appropriate outcome," says Howard Miller, director, government affairs at Citi.

ISDA submitted its response to the EC consultation in March, reiterating its position that market participants should be able to choose where to clear their derivatives trades based on their own commercial and risk considerations. The response also welcomed the EC's identification of measures to make clearing in the EU more attractive, and ISDA has subsequently worked with members to develop a comprehensive roadmap of measures to achieve this objective.

"Following Brexit, the EU has a concern about excessive reliance on non-EU financial market infrastructures, and a desire to further develop its own financial infrastructure and capacity. We firmly believe the roadmap for achieving the EU's clearing objectives and responding to its concerns can be found within a positive agenda of building an increasingly competitive EU financial centre. We should make the EU a place where firms want to clear and choose to come to, rather than building barriers," says Roger Cogan, head of European public policy at ISDA.

> "A location policy for clearing would fragment the derivatives market and reduce choice, and EU-based clearing members and clients would be most affected. But we understand the EC's objective to deepen the EU clearing market. This is best done by making that market more attractive and efficient for users of CCPs' services"
>
> **Howard Miller, Citi**

Clearing roadmap

The starting point for developing a roadmap is to recognise the current reality in which UK-based CCPs handle a high percentage of interest rate swaps denominated in global currencies, including the euro. The EU's share of clearing has increased since Brexit, and is more substantial than often thought. Notably, Eurex has a larger market share in euro-denominated OTC interest rate derivatives than CME's share of OTC interest rate derivatives denominated in US dollars.

In a forthcoming paper, ISDA suggests that building on this baseline requires a comprehensive strategy to boost the EU clearing market. This strategy would entail widening the range of market participants clearing in the EU, removing unnecessary barriers and giving the EU a competitive edge without compromising on stability.

While some of the measures associated with these objectives may require legislative change, others could be implemented more quickly through practical measures and adjustments to supervisory approaches. But all of the measures explored in the paper have a role to play in meeting the EU's policy objectives on derivatives clearing.

"It will take time to achieve meaningful change, but there are a number of different tools that can be used to reduce the EU's reliance on offshore CCPs and incentivise →

"We firmly believe the roadmap for achieving the EU's clearing objectives and responding to its concerns can be found within a positive agenda of building an increasingly competitive EU financial centre. We should make the EU a place where firms want to clear and choose to come to, rather than building barriers"

Roger Cogan, ISDA

→ more onshore clearing. Individual steps cannot guarantee an immediate increase in the EU's share of euro clearing, but the roadmap as a whole has the potential to deliver enduring, positive change, and it's important that the EU and UK cooperate closely on CCP supervision," says Litvack.

Boosting liquidity on European CCPs will require a broader range of market participants to clear their business on those CCPs. Entities that could be added to the group of market participants using EU CCPs include pension schemes and public entities.

The main obstacle that currently prevents pension scheme arrangements from clearing is a lack of access to cash to post as variation margin in stressed market conditions. Recognising this constraint, the EC, regulators and industry stakeholders have been considering how pension scheme clearing could best be facilitated. For example, a central bank-backed service could be developed to provide collateral transformation to pension scheme arrangements and other buy-side firms, allowing them to convert high-quality collateral into cash for variation margin.

Meanwhile if the EU were to make recommendations for public entities to clear through European CCPs, this would help to increase liquidity and capacity in the European clearing market. However, mandating clearing by public entities is not recommended and it is suggested they should clear as clients or in sponsored access models to avoid concerns over default fund contributions.

The roadmap also recommends certain targeted changes to European regulations to attract more clearing to the EU. These include recalibrating the Undertakings for the Collective Investment in Transferable Securities Directive so that the counterparty exposure limits distinguish between cleared and non-cleared trades. The Settlement Finality Directive and Financial Collateral Directive could also be amended to expand clearing within the EU.

As the European Market Infrastructure Regulation (EMIR) is reviewed, there is also an opportunity to assess how clearing works across Europe and to give EU CCPs a more competitive edge. Recommended policy actions include improving the operational processes of CCPs, extending the operating hours of Target2 and Target2-Securities, and promoting anti-procyclicality tools for collateral haircuts, thereby boosting confidence in EU CCPs.

EU CCPs are already working to improve operational processes and the roadmap recommends this should continue with the aim of fostering an internationally competitive clearing environment, which will organically attract clearing activity to the EU. It is suggested that CCPs should consult members and end clients to determine where gaps exist in international best practice.

"To increase the competitiveness of EU CCPs, and to build the market's confidence in their ability to handle greater client volumes, any existing processes that are cumbersome or ineffective must be addressed. Areas that may need to be addressed include onboarding new accounts and post-trade compression – improvements in these areas would facilitate greater use of EU CCPs, significantly enhancing the experience of clearing members and clients," says Ulrich Karl, head of clearing services at ISDA.

Removing barriers

As well as widening the range of market participants clearing in Europe and seeking to make EU CCPs more competitive, there is also work to be done to remove any unnecessary barriers that may hinder onshore clearing.

Post-trade risk reduction (PTRR) services such as portfolio compression and portfolio rebalancing are increasingly used to free up balance sheet resources and reduce risk exposure, not least because greater demands are being placed on bank capital and collateral. A conditional exemption from the clearing obligation for trades that arise from PTRR activities would make EU clearing and EU capital markets more attractive, stable and efficient.

The European Securities and Markets Authority has recommended a limited and conditional exemption as a means of promoting greater use of PTRR services. This would not only boost the attractiveness of European CCPs, but it would also mitigate systemic risk by reducing notional exposures, liquidity risk and counterparty credit risk in the non-cleared derivatives market.

Other recommendations include addressing any remaining gaps in Europe's supervision of tier-two CCPs, providing EU CCPs with harmonised access to central bank liquidity and deposit facilities, and aligning accounting rules to make it easier to rebook trades between the UK and EU or deal with changes of clearing members or CCPs.

The roadmap also explores ways to improve supervision of EU CCPs without compromising on stability. Recommended policy steps include pursuing an approach to regulation of EU CCPs that supports innovation, preventing duplicative and conflicting requirements for international firms, supporting bankruptcy remote initial margin in regulation, promoting international openness by amending rules on recognition of third-country CCPs, and protecting intragroup transactions.

"By its very nature, an attractiveness agenda needs to take into account what other jurisdictions are doing. We believe there are changes the EU can make that would help it position itself better in this global context, without sacrificing on regulatory or supervisory rigour. We also call on EU CCPs to adopt best practices in risk management and operational processes," says Karl.

The roadmap recommends that the complex supervisory framework for EU CCPs should be reviewed and streamlined to ensure they can adapt and compete in a rapidly evolving financial system. In the current framework, it can sometimes take EU CCPs more than three years to launch a new product, which makes it difficult for them to compete with other jurisdictions that can move more quickly. Addressing inefficiencies and bottlenecks in the supervisory framework is therefore critical.

Meanwhile intragroup transactions are essential to the centralised management of risk by EU firms and the ability to make investment capital available within the EU. The exemption of these transactions from clearing is key to determining whether there is a level playing field between EU firms whose group is entirely within the bloc, and EU firms that operate internationally.

"We recommend clarifications to ensure the availability of an exemption for cross-border intragroup transactions from clearing, non-cleared margin and the credit valuation adjustment capital charge. At the time of adoption of EMIR and the Capital Requirements Regulation, we believe the co-legislators wanted these exemptions to be available," says Karl.

Path forward

As the EC develops its proposals to reduce the EU's dependence on third-country CCPs and improve the attractiveness of EU-based CCPs, ISDA will publish its proposed roadmap to make EU clearing more attractive, as well as a more technical paper on the implications of requiring EU clearing participants to hold active accounts with EU CCPs. While this step has been discussed as part of the EU's approach to clearing, there are a number of implications that should be considered.

"Requiring active accounts might appear to be a relatively simple policy measure, but if a quantitative measure is used to require a certain level of activity on EU CCPs, then this could become a location policy. Consideration needs to be given to the operational risks associated with additional clearing accounts – this is perhaps more important for small firms," says Citi's Miller.

Developing incentives to help the EU achieve its objectives rather than enforcing a location policy is the foundation of ISDA's forthcoming roadmap. While change will not be achieved immediately with any one measure, there is time over the coming years to take a multi-pronged approach that will boost the attractiveness of clearing in the EU without compromising on market participants' flexibility to make their own choices.

"There is no single measure or seismic step that can transform the EU's share of the euro clearing market. Success will be achieved through taking a set of practical and meaningful steps, and by looking holistically at whether the regulatory environment in the EU reflects its policy objectives. We look forward to working with policymakers to develop and maintain an effective clearing environment in the EU in the years ahead," says ISDA's Cogan. IQ

Live in Madrid

ISDA held its 36th Annual General Meeting (AGM) in Madrid on May 10-12, 2022, attracting more than 650 derivatives professionals and regulators. At this year's AGM – the first to be held in person since 2019 – crypto assets and sustainable finance were high on the agenda, as well as digital regulatory reporting, diversity and benchmark reform.

Keynote speakers included Rostin Behnam, chairman of the US Commodity Futures Trading Commission, Gary Gensler, chairman of the US Securities and Exchange Commission, Pablo Hernández de Cos, governor of the Banco de España and chair of the Basel Committee on Banking Supervision, Klaas Knot, president of De Nederlandsche Bank and chair of the Financial Stability Board, Martin Moloney, secretary general of the International Organization of Securities Commissions, and Verena Ross, chair of the European Securities and Markets Authority.

The AGM also featured keynote interviews with Bill Winters, chief executive of Standard Chartered, and Sam Bankman-Fried, founder and chief executive of FTX.

ISDA would like to thank all our sponsors, exhibitors and delegates for their support, and we look forward to seeing you at ISDA's 37th AGM in Chicago on May 9-11, 2023.

"Today, we are looking ahead to the significant role derivatives will play in the fast-moving crypto assets market and in the transition to a more sustainable economy. We're taking a firm grip on both issues and intend to bring order and efficiency through the development of definitions and robust contractual standards"

Scott O'Malia, ISDA

"As our present and future challenges require us to assess risks borne from newer and more novel sources, our ability to adapt swiftly from theory to practice will be tested over and over again. Our challenge will be doing so in a manner that minimises market disruption, maximises risk-mitigating opportunities and ensures a level of fairness that cannot be undermined by regulatory arbitrage"

Rostin Behnam, US Commodity Futures Trading Commission

"Crypto-asset markets are fast evolving and could soon represent a threat to global financial stability. The rapid evolution and international nature of these markets also raise the potential for regulatory gaps, fragmentation or arbitrage"

Klaas Knot, Financial Stability Board

ISDA AGM STUDIO

At this year's AGM, ISDA launched a TV studio on the exhibition floor to capture the reflections of speakers and sponsors on key topics.

AGM preview, with ISDA's Eric Litvack and Scott O'Malia: bit.ly/3PWVjV2

Scott O'Malia talks to CFTC Commissioner Summer Mersinger: bit.ly/3OKDk38

Scott O'Malia talks to CFTC Commissioner Caroline D. Pham: bit.ly/3PHIs9C

Benchmark reform, with Jack Hattem and Tom Wipf: bit.ly/3OF4AjB

Financial stability, with Rupert Thorne: bit.ly/3PzKTeh

Diversity, equity and inclusion, with Tuvia Borok and Gesa Johannsen: bit.ly/3ozr6Q6

Digital regulatory reporting, with Angus Moir and Valentino Wotton: bit.ly/3b7APuc

Digital documentation, with Shilpa Bhandarkar and Lansing Gatrell: bit.ly/3cOsVWX

Crypto derivatives, with Purvi Maniar and Nicola White: bit.ly/3b9IPea

"Implementing all aspects of the Basel III framework in a full, timely and consistent manner is an imperative for our member jurisdictions. Events over the past two years, including the pandemic and the Ukraine conflict, have once again highlighted the importance of having a prudent and robust regulatory framework in place"

Pablo Hernández de Cos, Basel Committee on Banking Supervision

Catch up on the ISDA AGM with IQ in Brief: bit.ly/3oGgezW

Charting a New Course

*Following its departure from the EU, the UK is reviewing its wholesale markets and regulatory framework, with a focus on innovation, competition and sustainability. **Sarah Pritchard**, executive director for markets at the Financial Conduct Authority, explains the regulator's role in this transition*

IQ: The Financial Conduct Authority (FCA) set out its vision in 2021 to become a "more innovative, assertive and adaptive regulator" that is data-led and partners more effectively with others to protect consumers and promote market integrity. How is that transformation progressing, and what changes can we expect in the FCA's approach to supervision?

Sarah Pritchard (SP): The FCA is already part way through its transformation journey, and this is having an impact on how we work. On April 7, we published a new three-year strategy. For the first time, we've explicitly outlined outcomes that we expect for the markets we regulate and our role in supporting those outcomes.

We have set out three strategic priorities: reducing and preventing serious harm; setting and testing higher standards; and promoting competition and positive change.

We will focus our activity in 13 areas to support those priorities and, for the first time, we have set out measures we will use to monitor progress and hold ourselves accountable for our performance, significantly improving the transparency we provide to the public.

Our new three-year strategy, with annual business plans published each year, will provide more clarity for the markets we regulate and help us to prioritise consistently. We will also use the strategy to inform our supervisory approach. The FCA already has rich data sources available to support our supervision of firms, but as we seek to become more data-led and outcomes-focused, we are working to deploy new technology and analytical capabilities to generate actionable insights.

At the same time, we are continuing to invest in our supervisory capabilities, and are seeking to build as a national regulator too. You will see us recruiting across the UK for our Supervision, Policy and Competition division throughout the course of this year, as well as recruiting an additional 80 roles to focus on removing problem firms from the market.

As we emerge from the COVID pandemic, we are now able to get out more extensively and meet in person. I look forward to doing more of that in the months ahead to build relationships with trade bodies such as ISDA, regulated firms and consumer groups too.

"Brexit is an opportunity to make sure our regulatory framework is right for UK markets. We want UK wholesale markets to support economic growth and embrace innovation. At the same time, we still need high and consistent international standards"

IQ: In wholesale markets, the FCA has said the transformation will include a focus on developing plans to make primary and secondary markets work better, while maintaining high standards following Brexit. What will this mean in practice?

SP: Brexit is an opportunity to make sure our regulatory framework is right for UK markets. We want UK wholesale markets to support economic growth and embrace innovation. At the same time, we still need high and consistent international standards, which the UK has done so much to shape through bodies like the Financial Stability Board and the International Organization of Securities Commissions (IOSCO).

In our new three-year strategy, we have set out that we want to strengthen the UK's position in wholesale markets. To do so, we want to use our role as the securities regulator and listings authority, as well as the supervisor of firms operating in the market. We definitely see opportunities to improve the way UK markets work.

On the primary markets side, we have already undertaken significant work to implement many of the recommendations in the UK Listings Review. We are working closely with government partners on the UK Prospectus Regime, and we published a discussion paper in May to look broadly at the structure of the UK's listing regime. Ultimately, our intention is to support the UK's position as a market of choice for issuers, building on our strengths as a global leader in financial services.

In secondary markets, there has already been some change – for example, with the UK government's announcement of its intention to repeal the double volume cap. In future, we intend to review the FCA's rules that arise from the second Markets in Financial Instruments Directive, including in areas such as block trades, tick sizes and the use of reference prices from overseas trading venues. We're also doing significant work to assess competition in the provision of trading data, benchmarks and credit rating agency data following concerns about escalating costs for market participants.

IQ: The UK Treasury recently consulted on proposals for adapting the regulatory framework for financial services to ensure it remains fit for the future, and to reflect the UK's new position outside the EU. From a markets perspective, what are the most important elements of the Future Regulatory Framework (FRF) Review?

SP: The government has set out that it wants regulation that supports and maintains the UK's status as a leading financial centre, and we welcome this. We especially welcome the proposed transfer of onshored EU legislation to our handbook. It's an opportunity to create a rulebook that strengthens the UK's position in wholesale markets and the specific needs of our market participants.

We share the government's aim to ensure the UK can compete internationally on the basis of high standards, in support of long-term economic growth and prosperity. Regulation has a central role to play in the continued future success and integrity of the UK's financial markets. This includes →

→ our world-leading reputation and leadership in the fields of innovation and environmental, social and governance (ESG) issues. Changes to our approach to consider competitiveness would further develop our focus on advancing long-term growth through well-functioning financial markets.

The proposed new powers rightly come with new obligations and responsibilities that will form part of the future legislative and regulatory framework. We recognise the importance of being accountable – our new strategy and business plan seek to give much greater transparency on our strategic goals and progress against the outcomes we are seeking. We will continue to be guided by our statutory objectives, and, of course, accountable to parliament.

"We share the government's aim to ensure the UK can compete internationally on the basis of high standards, in support of long-term economic growth and prosperity. Regulation has a central role to play in the continued future success and integrity of the UK's financial markets"

IQ: As the UK continues to progress with the FRF Review and the Wholesale Markets Review, with the aim of charting a new course for financial services outside the EU, how is the FCA developing its relations with non-UK regulators? How important are these relationships in maintaining effective cross-border markets?

SP: Cross-border activity is a central feature of modern financial markets. This is often beneficial in supporting market efficiency and risk management, but also makes regulatory cooperation absolutely essential. The FCA attaches huge importance to working with international partners, whether that's in response to market events or in our routine supervision of multinational groups. Dialogue and coordination with international partners have been invaluable in our response to Russia's invasion of Ukraine.

Within the international regulatory community, there is a lot we can learn from one another. The global markets we supervise are constantly changing – from the impact of big tech to the growth of non-bank finance. That makes it imperative for us to share best practice and look at how we can cooperate to secure good outcomes for our respective markets.

Good relationships are at the centre of this cooperation. The FCA is committed to playing a strong role in the membership of international standard-setting bodies, where we can help to forge common solutions to international problems. We also work through forums such as regulatory colleges and international conferences, and bilaterally strengthen relationships on key issues. As one example, our work on LIBOR has involved coordinating with authorities and international bodies across five different currencies to achieve an orderly transition.

IQ: Following the cessation or loss of representativeness of most LIBOR settings at the end of 2021, what more now needs to be done to ensure the effective wind-down of all LIBOR settings?

SP: Quite clearly, an orderly move away from US dollar LIBOR is the major remaining challenge. While this transition is of a larger scale given the global nature of the US dollar, the experience with the other four currencies gives us confidence that the US dollar transition can be successful and smooth too.

There are currently a lot of experts on LIBOR transition within firms. I would encourage institutions to use that acquired knowledge and reflect on their experiences with the other currencies to help ensure an orderly transition to SOFR. This means talking to infrastructure providers, legal and accounting departments and clients well in advance of the mid-2023 deadline.

It has been good to see the progress that has already been made in building liquidity in SOFR. US authorities have been active in supporting markets to move towards SOFR across a range of products. US and UK authorities have been clear that SOFR offers the most robust alternative to US dollar LIBOR, rather than credit-sensitive rates, which have many of the same flaws as LIBOR.

Of course, the ISDA 2020 IBOR Fallbacks Protocol has played a crucial role in supporting transition away from LIBOR. If any firm hasn't yet adhered to the protocol, it remains open for them to do so, helping to provide a robust fallback for LIBOR-linked contracts.

IQ: The FCA published its ESG strategy in November 2021, setting out targets and actions to support the green transition. What are the priorities here, and how will the UK regulatory framework be adapted to support the transition to net-zero emissions?

SP: We are committed to helping the financial sector play its part to support the economy's transition to a more sustainable future, which we reaffirmed in our three-year strategy. To achieve this, listed companies and regulated firms need to have the right incentives, tools and organisational arrangements to set and pursue strategies aligned with the government's net-zero targets.

One of the key themes of our ESG work programme is transition. We will take steps to clarify our own regulatory expectations, promote credible and effective transition plans, address any regulatory barriers and encourage robust market discipline through effective investor stewardship.

We are working to deliver the government's commitment to making publication of transition plans mandatory. We are an active member of the government's Transition Plan Taskforce and look forward to drawing on its outputs to develop our own regulatory expectations on transition plans. It is particularly important that such outputs are well aligned to international standards.

We also want to promote active investor stewardship on climate change, which we see as critical to mobilising the whole economy to transition to net zero. Transition plans need to provide the right information for investors to act as effective stewards and enable a market-led transition by upholding market discipline. We worked with the UK's Financial Reporting Council and other regulators to engage preparers, users and wider stakeholders on how existing stewardship mechanisms in this area can be made more effective, and the potential value of new mechanisms. The findings from this outreach will feed into the work of the Transition Plan Taskforce, including an exercise to pilot a transition plan disclosure framework.

Finally, we are considering how we can meet the government's net-zero goal when discharging all our functions as a regulator across areas including supervision, authorisations and operations. Our recently published climate-related disclosures explored our initial thinking on this. Next year, we will publish a transition plan covering decarbonisation of our own operations.

IQ: The EU is developing a comprehensive regulatory framework for sustainable finance, including a taxonomy for sustainable activities and disclosure requirements. How will the FCA align its work in this area with the EU and other jurisdictions?

SP: We have been working to support the UK government's roadmap to sustainable investing, which outlines plans to introduce sustainability disclosure requirements. It also includes arrangements for reporting under the UK Green Taxonomy, once developed.

We recognise the EU and other jurisdictions are developing their own regimes for sustainability-related reporting. As a supervisor of many firms that operate in global markets, we aim to drive progress towards global solutions as far as possible.

One of the ways we are doing this is through our leadership of international work on sustainability disclosures at IOSCO. In particular, we are collaborating to promote a common global baseline of corporate reporting standards developed by the International Financial Reporting Standards Foundation's International Sustainability Standards Board.

We acknowledge that many UK asset managers and asset owners and their products are subject to the EU's Sustainable Finance Disclosure Regulation (SFDR). We aim to ensure our sustainability disclosure requirements for those firms remain compatible with the SFDR, while reflecting the needs of the UK market. We sought early views on this via a discussion paper last November, and we're now working towards proposals for consultation in the coming months.

We also continue to engage with other regulators – including the US Securities and Exchange Commission, which issued climate-related disclosure proposals for corporates and asset managers earlier this year – to ensure compatibility where possible. IQ

"Cross-border activity is a central feature of modern financial markets. This is often beneficial in supporting market efficiency and risk management, but also makes regulatory cooperation absolutely essential. The FCA attaches huge importance to working with international partners"

Derivatives Trading in the EU

As the EU considers changes to its Markets in Financial Instruments Directive and regulation, new ISDA research shows some interesting trends in how derivatives are being traded in the region

One of the post-crisis commitments of the Group-of-20 nations was for standardised over-the-counter derivatives to be traded on exchanges or electronic trading platforms where appropriate. New analysis shows that aim has largely been achieved in the EU, with market participants opting to execute most interest rate derivatives (IRD) on trading venues (TVs), even when not required to under the revised Markets in Financial Instruments Directive and regulation (MIFID II/MIFIR).

According to ISDA research, about 64.0% of total IRD traded notional reported in the EU in the fourth quarter of 2021 was executed on TVs – that is higher than the 57.4% of IRD traded on swap execution facilities in the US. Significantly, EU participants are choosing to execute on TVs even when they do not have to: just 44.0% of the total $6.3 trillion executed on TVs in the EU was subject to the derivatives trading obligation (DTO).

In comparison, a much smaller proportion – 27.9% of total IRD reported in the EU – was executed by liquidity providers known as systematic internalisers (SIs). These trades are typically highly customised to meet the specific hedging needs of individual counterparties and tend to be larger in size than the more standardised transactions executed on TVs.

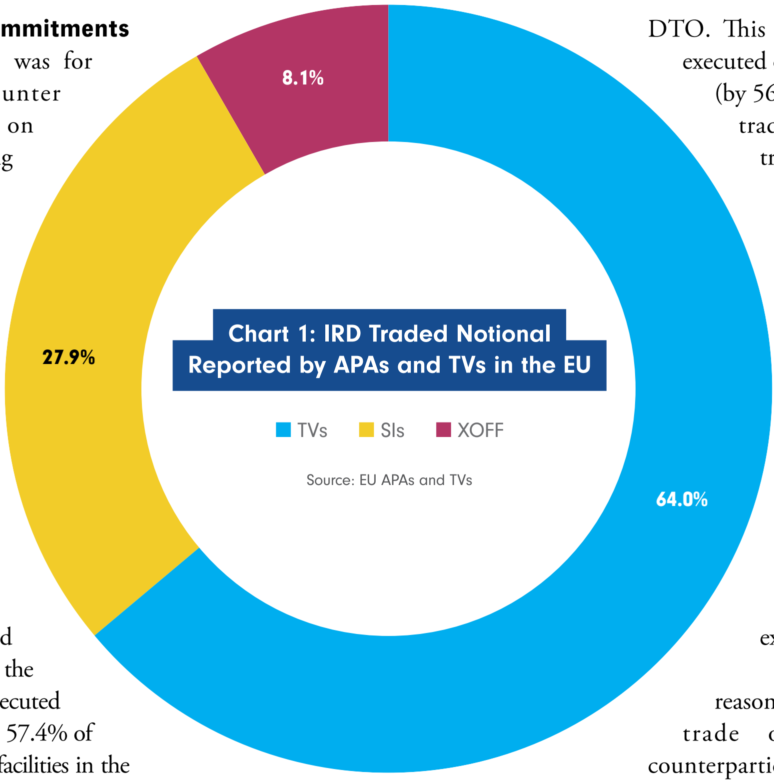


Chart 1: IRD Traded Notional Reported by APAs and TVs in the EU

Trading venues

IRD traded notional reported by approved publication arrangements (APAs) and TVs in the EU in the fourth quarter of 2021 totalled $9.8 trillion. About 64.0% of EU IRD traded notional ($6.3 trillion) was executed on TVs (see Chart 1). This included products covered by the DTO, but most of this volume was not subject to the trading obligation and was voluntarily executed on TVs.

Of the $6.3 trillion IRD traded notional executed on TVs in the fourth quarter of 2021, $2.8 trillion was covered by the DTO. This means IRD traded notional executed on TVs in the EU far exceeded (by 56.0%, or $3.5 trillion) the IRD traded notional subject to the trading obligation.

While fixed-for-floating IRS denominated in euros, US dollars and sterling were subject to the DTO during this period, a substantial share of OIS and forward rate agreements (FRAs) was also executed on TVs.

In the fourth quarter of 2021, 67.6% of fixed-for-floating IRS traded notional, 65.7% of OIS traded notional and 36.7% of FRA traded notional was executed on TVs (see Chart 2).

There are several possible reasons why non-DTO transactions trade on TVs. For example, counterparties may find it more effective to bilaterally negotiate certain contracts off venue and then electronically execute them via TVs. TVs do not play a role in price discovery and negotiation in these transactions but facilitate more efficient trade processing.

Another possible reason is that firms want to put dealers in competition for smaller orders (where information leakage is less of a concern) to achieve better execution. It is more efficient from a workflow perspective to do this via a request for quote on an electronic venue than to call various dealers.

PRE- AND POST-TRADE TRANSPARENCY REQUIREMENTS FOR TRADING VENUES

The revised Markets in Financial Instruments Directive/Markets in Financial Instruments Regulation transparency regime includes pre- and post-trade transparency requirements for non-equities. Pre-trade transparency obligations are designed to provide market participants with near real-time data on firm quotes. Post-trade transparency rules oblige firms to publicly disclose data on executed trades.

Market operators and investment firms operating trading venues (TVs) must make current bid and offer prices and the depth of trading interest at those prices public on a continuous basis during normal trading hours. That also applies to actionable indications of interest (IOIs). Transparency requirements are calibrated for different types of trading systems, including order book, quote driven, hybrid, periodic auction trading and voice trading systems.

Pre-trade transparency requirements can be waived for orders that are:

- Large in scale (LIS) compared with normal market size;
- Orders held in an order management facility;
- Actionable IOIs in request-for-quote and voice trading systems that are above a size specific to the instrument (SSTI);
- Derivatives that are not subject to the derivatives trading obligation and other financial instruments for which there is no liquid market;
- Orders for the purpose of executing an exchange for physical; and
- Certain package orders.

Post-trade transparency rules require market operators and investment firms operating TVs to make the price, volume and time of the transaction public. Transaction details must be disclosed as close to real time as technically possible.

Trade information must be publicly disseminated either by TVs through which a transaction was executed or through approved publication arrangements. The reporting obligation always falls on one party in a trade. If the trade is transacted on a regulated market, multilateral trading facility or organised trading facility, the venue has the reporting obligation. When a trade is executed by a systematic internaliser (SI), the SI has the reporting obligation. When a trade is not executed on a venue, the selling counterparty is required to report.

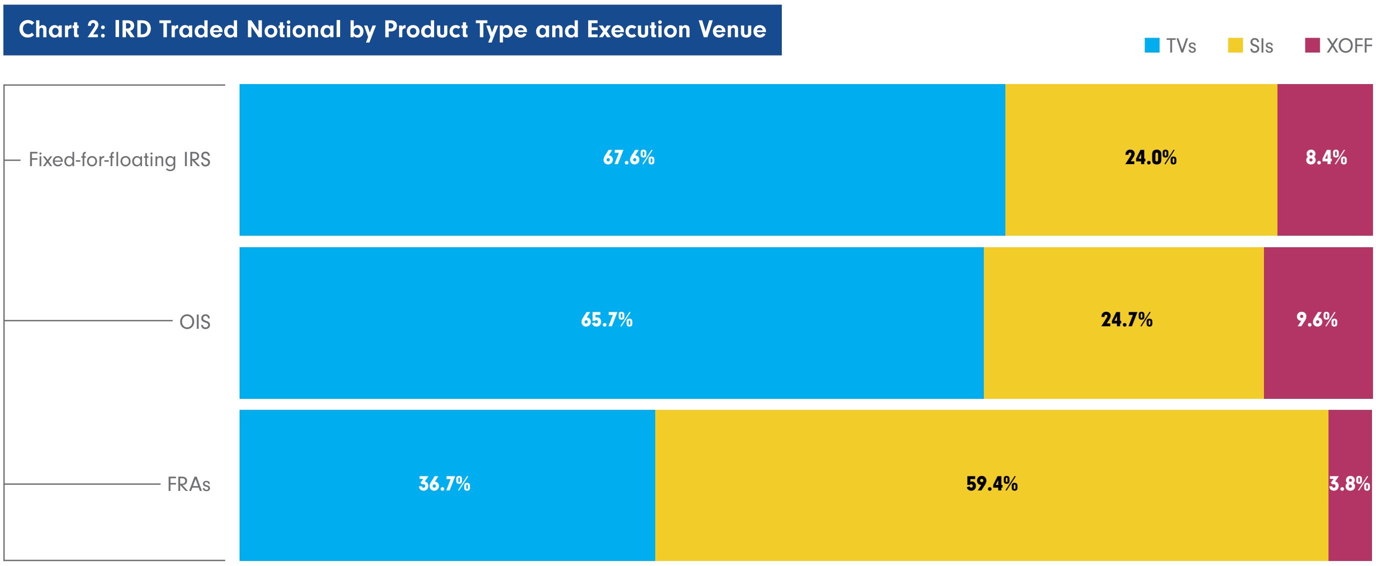
Publication of transaction details can be deferred based on the size and type of the trade. Deferrals are vital to the ability of liquidity providers to offer quotes and trade at the quoted price when transactions are above a certain size or in an illiquid class of derivatives. Deferrals (of price and/or volume information) give liquidity providers the time necessary to hedge the risk they assume from clients when facilitating their hedging activity in these sizeable and/or illiquid trades. If data on these exposures is published close to real time, other market participants would use this information to take positions in markets at the expense of the liquidity providers, which would have to pay a premium to hedge.

Deferrals are allowed for transactions that are LIS compared to normal market size, those that do not have a liquid market, and transactions above the SSTI threshold.

An LIS deferral is given if the trade is larger than the average size of trades within that asset class. An SSTI deferral is granted to transactions that are larger than a minimum size threshold but smaller than the LIS threshold.

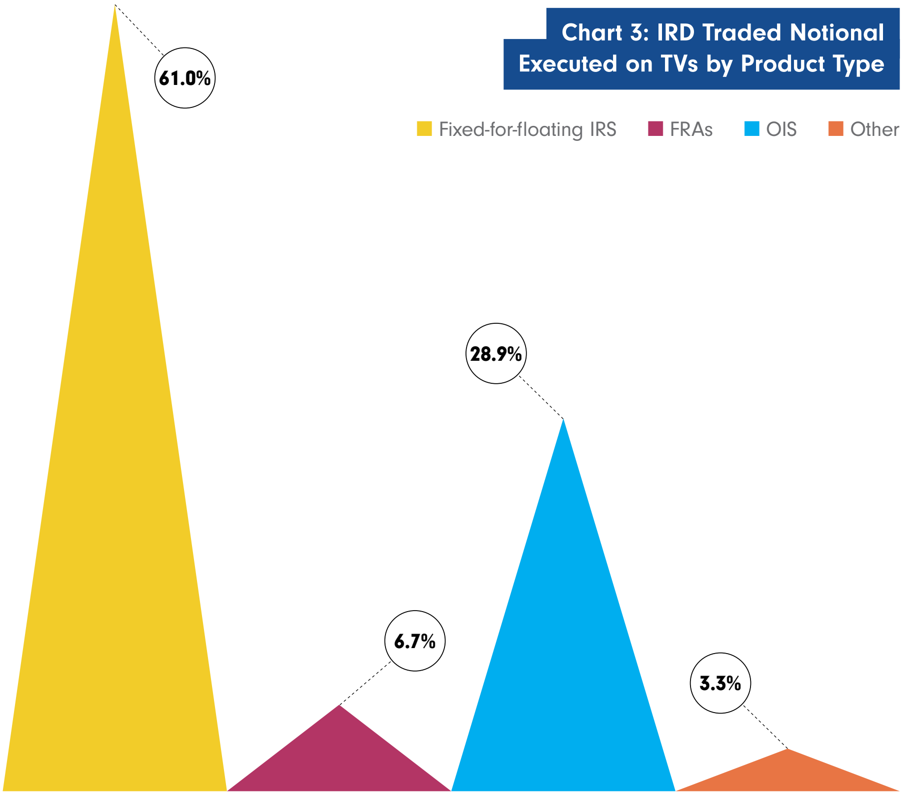
The European Securities and Markets Authority publishes annual transparency calculations for non-equity instruments, including information on the liquidity assessment and LIS and SSTI thresholds above which pre-trade transparency requirements can be waived and the publication of post-trade transparency information can be deferred.

Chart 2: IRD Traded Notional by Product Type and Execution Venue



Source: EU APAs and TVs

Chart 3: IRD Traded Notional Executed on TVs by Product Type



Source: EU APAs and TVs

All in all, fixed-for-floating IRS traded notional accounted for 61.0% of total IRD traded notional executed on TVs in the fourth quarter of 2021. OIS and FRA transactions represented 28.9% and 6.7%, respectively (see Chart 3).

The proportion of IRD executed on TVs in the EU was higher than the percentage traded on swap execution facilities (SEFs) in the US: 57.4% of total IRD traded notional was executed on SEFs in the fourth quarter of 2021 compared to 64.0% of IRD traded notional executed on TVs in the EU.

Overall, 74.4% of fixed-for-floating IRS, 83.7% of FRA, 40.4% of OIS and 37.4% of other IRD traded notional was executed on SEFs in the last three months of 2021. The percentage of IRD traded notional that is subject to the trade execution mandate (known as 'made available to trade') accounted for 3.4% of total IRD traded notional and 5.9% of SEF-traded IRD notional during that period.

Systematic internalisers

SIs executed 27.9% of IRD traded notional reported in the EU in the fourth quarter of 2021. These transactions are generally more customised and less liquid than those subject to the DTO. SIs can also execute transactions in classes of derivatives that are subject to the DTO with counterparties that are exempt from the trading obligation (eg, those categorised as non-financial counterparty 'minus').

SIs in derivatives provide bespoke hedging tools to clients and do not compete with TVs. For example, pension funds use non-standard derivatives to hedge the interest rate and inflation risk inherent in long-dated pension liabilities, while insurance companies use derivatives to manage their assets and liabilities, hedge variable annuity guarantees and enhance investment income. Asset managers might use customised derivatives to hedge unwanted interest rate or foreign exchange risk, protect portfolios against market volatility, enhance returns, quickly rebalance asset allocations or take views on specific markets or sectors.

These derivatives usually need to be tailored to a client's specific needs and do not have equivalents readily available on TVs. Most of these transactions trade episodically and pricing depends on the credit quality of the counterparties and/or relationship factors.

SYSTEMATIC INTERNALISERS

A systematic internaliser (SI) is "an investment firm which, on an organised, frequent systematic and substantial basis deals on own account when executing client orders outside a [regulated market], [multilateral trading facility], or [organised trading facility] without operating a multilateral system".

SIs were introduced under the original Markets in Financial Instruments Directive (MIFID), but were only authorised for equities. Under MIFID II, SIs were authorised to handle equity-like instruments, such as depositary receipts, certificates and exchange-traded funds, as well as non-equity instruments like bonds, emission allowances, structured finance products and derivatives.

The SI regime requires investment firms to assess whether they are SIs in a specific instrument or for a sub-class of instruments on a quarterly basis based on data from the previous six months. An investment firm is required to compare the trading it undertakes on its own account to the total volume and number of transactions executed in the EU.

A significant number of investment firms have decided to voluntarily opt into the SI regime to provide Markets in Financial Instruments Regulation/MIFID reporting services to their clients.

SIs are market participants and are neither trading venues nor market operators. SIs use their own capital to facilitate transactions between end users with different economic needs.

As SIs use their balance sheets to facilitate transactions, they are exposed to risks. In comparison, TVs do not have a similar risk exposure. Most SIs are run by banks and high-frequency trading firms. Many investment firms that provide liquidity to clients as SIs also provide liquidity as members of TVs.

PRE-TRADE AND POST-TRADE TRANSPARENCY REQUIREMENTS FOR SYSTEMATIC INTERNALISERS

Under Markets in Financial Instruments Regulation Article 18, systematic internalisers (SIs) are required to make firm quotes for derivatives traded on a trading venue public when there is a liquid market, they are prompted for a price by a client, and they agree to provide a quote. When there is not a liquid market and SIs agree to provide a quote, they must disclose it to the client on request, but they do not have to make it public.

The pre-trade transparency regime requires SIs to disclose their identity when they publish their quotes. In contrast, when liquidity providers respond to a request for quote for over-the-counter derivatives on multilateral trading facilities or organised trading facilities, the trading venue is not required to publish the identity of the participants submitting a quote.

For pre-trade transparency for quotes provided on SIs, the size-specific-to-an-instrument (SSTI) threshold defines the scope of the transparency requirements. Quotes for transactions below the SSTI level must be disclosed.

As part of the post-trade transparency regime, investment firms are required to make the volume and price of transactions public, as well as the time at which they were concluded. Each transaction must be made public once through a single approved publication arrangement. This applies to transactions executed on an SI's own account and on behalf of clients. Data should be published as close to real-time as technically possible.

There are several post-trade transparency deferrals, including for financial instruments that are not liquid, trades that are large in scale compared to normal market size, and transactions above the SSTI threshold that would expose liquidity providers to undue risk.

Deferrals (of price and/or volume information) provide liquidity providers with the time necessary to hedge the risk they assume from clients when facilitating their hedging activity in these sizeable and/or illiquid trades. If deferrals are too short or unavailable, other market participants would use this information to take positions in markets at the expense of liquidity providers, which would have to pay a premium to hedge these exposures.

Fixed-for-floating IRS traded notional accounted for 49.5% of total IRD traded notional executed by SIs in the fourth quarter of 2021. OIS and FRA transactions represented 24.9% and 25.0%, respectively (see Chart 4).

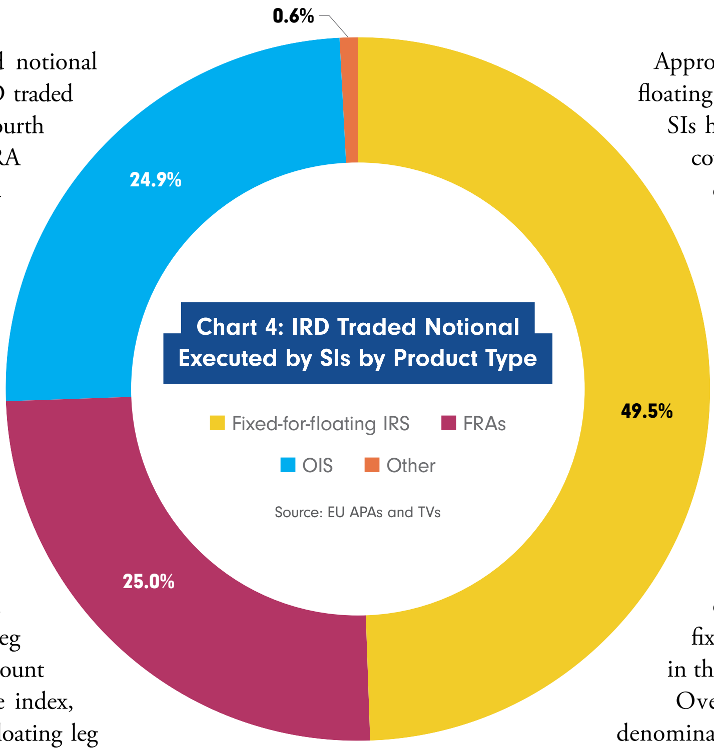
Overall, 24.0% of fixed-for-floating IRS traded notional reported in the EU in the fourth quarter of 2021 was executed by SIs, along with 24.7% of OIS and 59.4% of FRA traded notional (see Chart 2).

A number of fixed-for-floating IRS transactions executed by SIs have non-standard terms, such as settlement currency, trade start type, tenor, fixed leg payment frequency, fixed leg day count convention, floating leg reference index, floating leg reset frequency and floating leg day count convention, which are not covered by the DTO.

Given EU data limitations, ISDA could not identify the transactions that have these non-standard features. However, several attributes of fixed-for-floating IRS transactions that were executed by SIs were analysed, including currency, tenor, floating reference rate and transaction size.

About 13.0% of total fixed-for-floating IRS traded notional executed by SIs was denominated in currencies that were not subject to the DTO. Euro transactions accounted for 58.6% of total fixed-for-floating IRS traded notional executed by SIs in the fourth quarter of 2021, while US dollar- and sterling-denominated IRS traded notional comprised 27.4% and 0.9%, respectively.

Chart 4: IRD Traded Notional Executed by SIs by Product Type



Source: EU APAs and TVs

Approximately 52.6% of total fixed-for-floating IRS traded notional executed by SIs had tenors that fall outside those covered by the DTO for euro-, US dollar- and sterling-denominated fixed-for-floating IRS. Additionally, some transactions were broken dated, meaning they had non-standard tenors with a fraction of a year.

Average transaction size executed by SIs was significantly larger than trades on TVs. For example, average transaction size of fixed-for-floating IRS executed by SIs totalled $97.4 million compared to $73 million for fixed-for-floating IRS traded on TVs in the fourth quarter of 2021.

Over two-thirds of US dollar-denominated fixed-for-floating IRS traded notional ($370.8 billion) was executed by SIs. Of this amount, $232.4 billion (62.7%) was broken dated or had tenors that fell outside those covered by the DTO for US dollar-denominated fixed-for-floating IRS.

This might reflect the fact that EU counterparties requiring US dollar-denominated IRS for hedging purposes find greater liquidity when executing with SIs, particularly when the trades are more →

"There are several possible reasons why non-derivatives trading obligation transactions trade on trading venues. For example, counterparties may find it more effective to bilaterally negotiate certain contracts off venue and then electronically execute them via trading venues"

→ customised. Market participants often execute US-dollar denominated swaps to match the maturity of on-the-run US Treasuries.

Average transaction size of US dollar-denominated fixed-for-floating IRS executed by SIs was more than four times larger than transactions on TVs in the fourth quarter of 2021 – $137.4 million versus $31.8 million.

This data underscores the importance of the waivers and deferrals from pre- and post-trade transparency requirements under MIFID II/MIFIR, particularly for SIs. The size-specific-to-the-instrument (SSTI) threshold and deferrals are crucial to SIs, as they mean pre-trade transparency requirements (which oblige quotes by SIs for potential derivatives client trades to be shared on an attributed basis with the entire market) do not apply for quotes for large trades that entail 'undue risk' to SIs. Post-trade publication of information on the volume of trades conducted above the SSTI level can also be deferred.

Undue risk occurs when liquidity providers are unable to hedge the risks they assume in facilitating client hedges because the market has clear sight of their exposures. If liquidity providers fear they are exposed to undue risk, they will either price in this extra risk or not trade with the client that wants to hedge.

METHODOLOGY

The analysis is based on European data collected by ISDA from 30 European approved publication arrangements (APAs) and trading venues (TVs) in the fourth quarter of 2021. EU interest rate derivatives (IRD) trading activity is measured by IRD traded notional reported by APAs and TVs located in the EU. Of the 30 APAs and TVs included in the ISDA database, 13 are located in the EU.

In the EU, transparency reporting requirements apply to instruments that are admitted to trading on regulated markets, as well as those that are traded on other TVs, including multilateral trading facilities and organised trading facilities. The transparency requirements also apply to investment firms not trading on TVs if the underlying financial instrument is 'traded on a trading venue' or is an index or basket composed of financial instruments that are traded on a TV. Financial instruments that are solely traded outside of TVs are not subject to the requirements and, therefore, are not included in this analysis.

US trading activity is based on data from the Depository Trust & Clearing Corporation swap data repository, which only includes trades that are required to be disclosed under US Commodity Futures Trading Commission regulations.

Conclusion

About 64.0% of IRD traded notional reported in the EU was executed on TVs in the fourth quarter of 2021. This includes trades covered by the DTO, but also a substantial volume of other types of transactions. ISDA's analysis shows IRD traded notional executed on TVs in the EU was more than double the traded notional subject to the DTO.

The percentage of traded notional executed on TVs in the EU (64.0%) also exceeded the proportion of transactions traded on SEFs in the US (57.4%).

In contrast, 27.9% of total IRD traded notional was executed by SIs in the fourth quarter of 2021. SIs play an important role in the EU market by enabling clients to access bespoke hedging tools. Transactions executed by SIs are generally more customised and less liquid than transactions subject to the DTO.

Average transaction size executed by SIs is significantly larger than trades executed on TVs. This underscores the importance of the SSTI threshold for pre- and post-trade transparency for SIs. As SIs are required to make firm quotes below the pre-trade SSTI level public on a name-disclosed basis, this threshold has protected SIs from undue risk. Undue risk occurs when SIs are unable to hedge the risks they assume in facilitating client hedges because the market has clear sight of their exposures. IQ

This is an edited version of an ISDA research note, *Demystifying Derivatives Trading in the EU*. The full paper is available here: bit.ly/3RPRRxq

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ISDA achieves its mission by representing all market participants globally, promoting high standards of commercial conduct that enhance market integrity, and leading industry action on derivatives issues.

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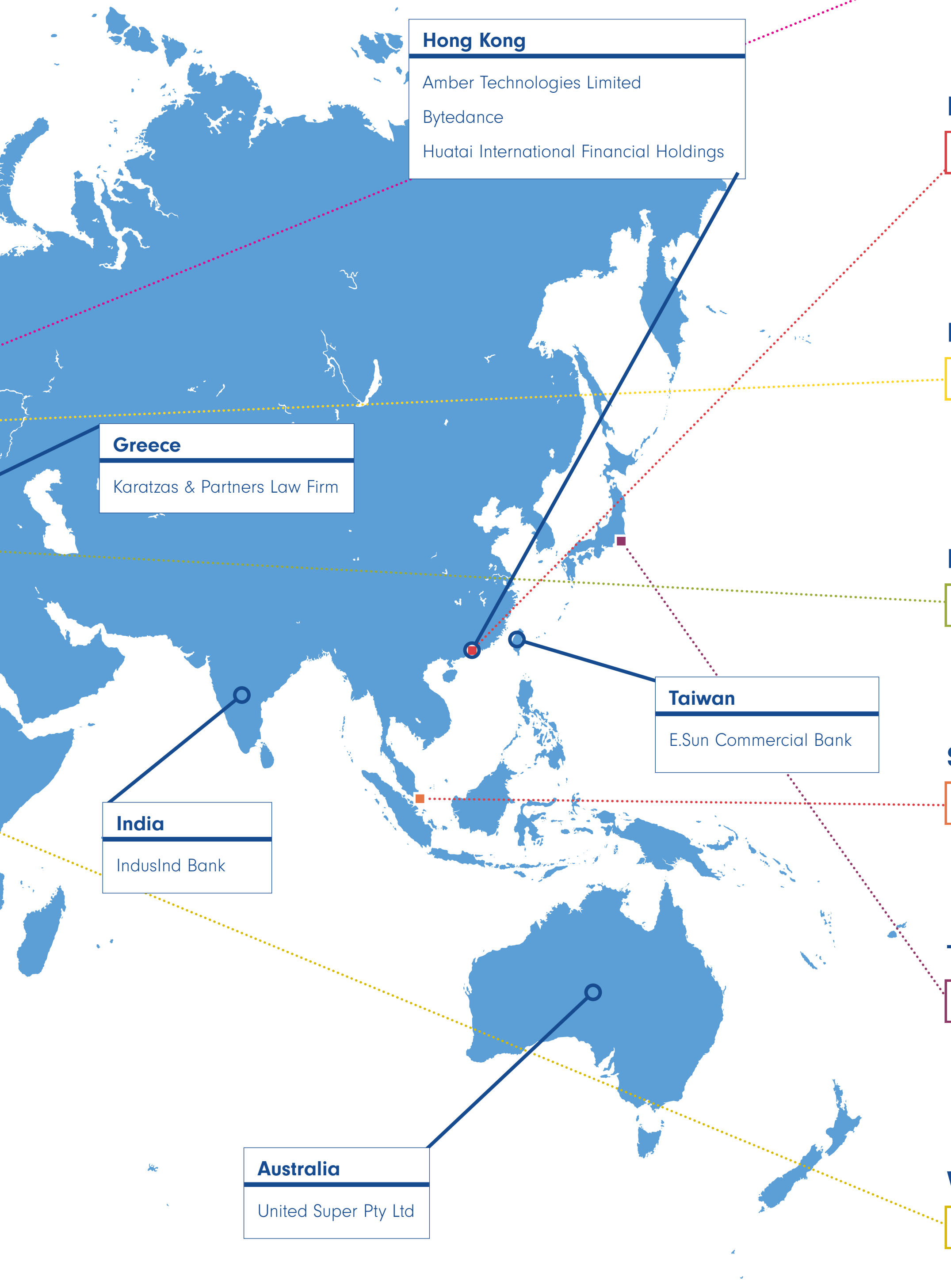
A big welcome to all new members that joined ISDA in the second quarter of 2022. We look forward to working with you in the future

For additional information on joining ISDA, please visit the ISDA Membership



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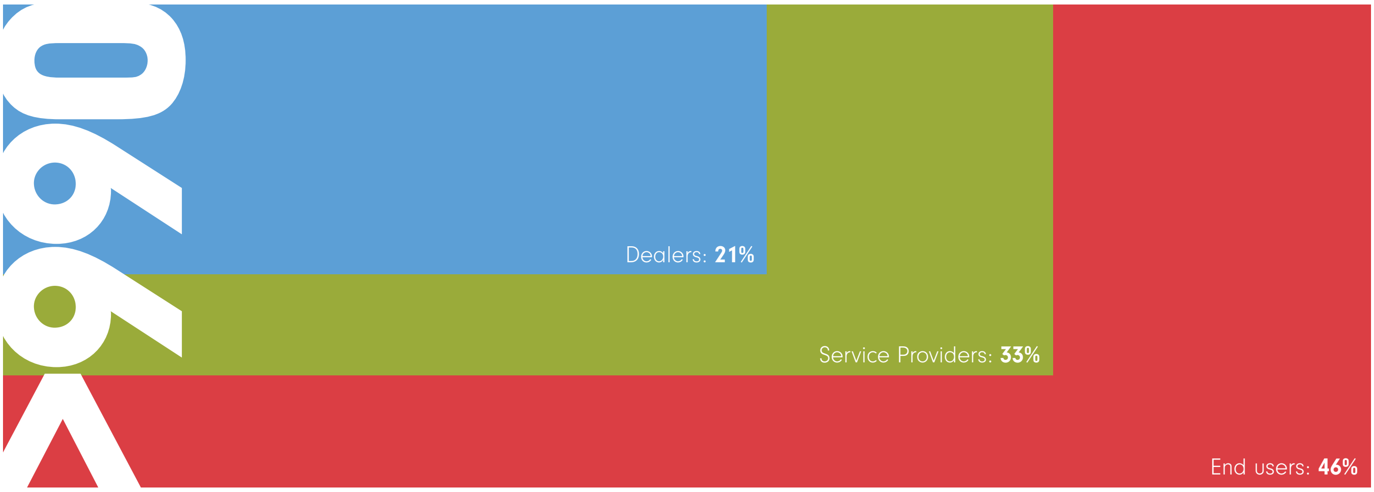
MEMBERSHIP BREAKDOWN



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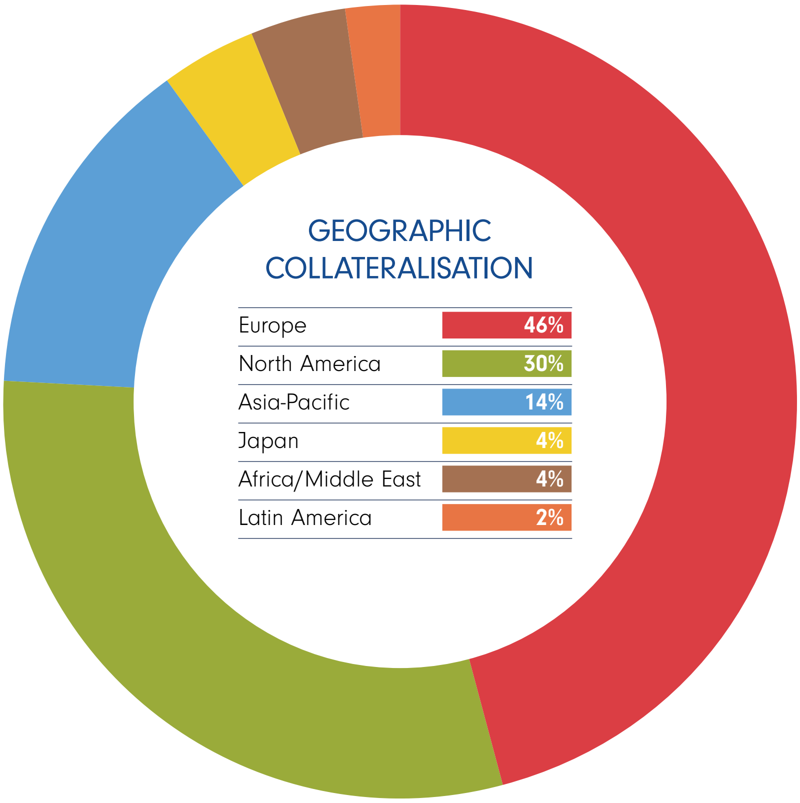

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Europe	46%
North America	30%
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Africa/Middle East	4%
Latin America	2%

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The crypto market has experienced a period of significant volatility, with the value of major cryptocurrencies falling sharply in recent weeks. What impact will this have on the crypto derivatives market? Nicola White of B2C2 and Purvi Maniar of FalconX share their perspectives.

"Recent events highlight the need to apply traditional finance concepts and tried-and-tested procedures around market risk and credit management – a key item is contractual standards, so that when another event like this happens, the market knows how to handle it"

Nicola White, B2C2

Delving into DLT

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Distributed ledger technology (DLT) could potentially revolutionise financial markets by overhauling legacy systems and slashing infrastructure costs. Where are the greatest opportunities in derivatives markets, and what will it take to effect change? Scott O'Malia talks to Digital Asset chief executive Yuval Rooz.

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The US Commodity Futures Trading Commission (CFTC) has a full agenda, with climate change, crypto assets, benchmark reform and swap reporting requirements just a few of the issues on the to-do list. CFTC chairman Rostin Behnam talks with ISDA about the Commission's priorities.

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Episode 20 – April 4, 2022 – Listen in full: **bit.ly/3AcKSal**

Central banks face a wide range of issues in 2022, from the rapid development of sustainable finance to the rise of crypto assets and the potential for central bank digital currencies. Sylvie Goulard, second deputy governor at the Banque de France, joins ISDA's Scott O'Malia to discuss.

Growing China's Derivatives Market

Episode 19 – March 2, 2022 – Listen in full: **bit.ly/3QjLDVd**

China's derivatives market is fairly small relative to the size of its economy, but forthcoming legal and market developments could help to further grow the country's capital markets. Chong Liew from Linklaters and LSEG's Jenny Cosco give their perspective.

Advancing Crypto Derivatives

Episode 18 – February 15, 2022 – Listen in full: **bit.ly/3bKgsDu**

With banks and institutional investors showing increased appetite for crypto assets, what role will derivatives play in this exciting asset class, and what steps need to be taken to build a robust and liquid derivatives market? Mark Wetjen, head of policy and regulatory strategy at FTX US, gives his views.

Pioneering Change in DEI

Episode 17 – December 14, 2021 – Listen in full: **bit.ly/3PlZJnW**

Promoting and maintaining diversity, equity and inclusion in the workplace is fast becoming a risk and compliance priority for financial institutions. Tuvia Borok, global head of policy and documentation at Goldman Sachs, talks to ISDA chief executive Scott O'Malia

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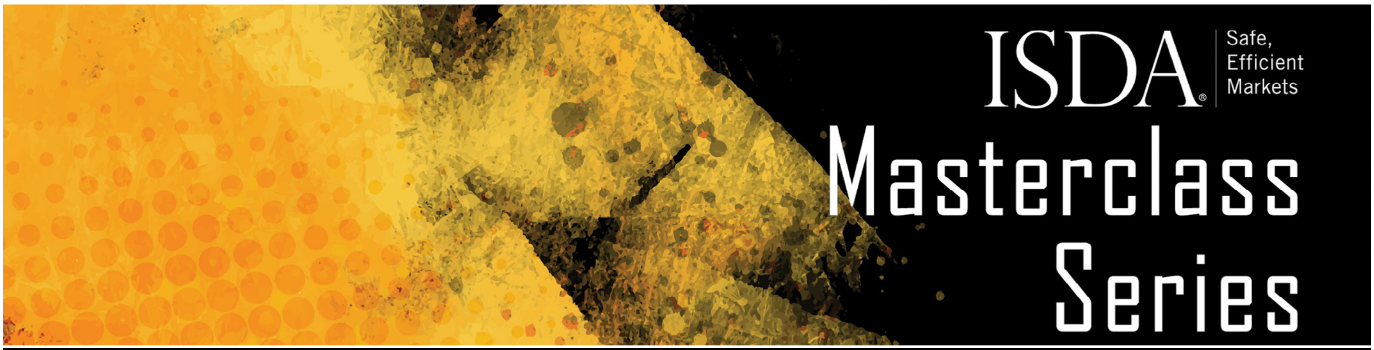

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"For the dealers that act as intermediaries to numerous end users, netting is the critical mechanism that allows them to offset the sum of their risks and provide intermediation at the best price"

Eric Litvack, ISDA