ISDA® Safe, Efficient Markets

8 June 2017

Commissioner Valdis Dombrovskis
Vice-President for the Euro and Social Dialogue, Financial Stability, Financial Services and Capital Markets Union
European Commission
Rue de la Loi / Wetstraat 200
1049 Brussels
Belgium

Dear Vice-President Dombrovskis,

We are very pleased to take this opportunity to provide you with the views of the International Swaps and Derivatives Association (ISDA) on the European Commission's (EC's) Communication on *Responding to the challenges for critical financial market infrastructures and further developing the Capital Markets Union.*

Below, please find an Executive Summary of the content of this paper:

- We recognize the EC concerns regarding non-EU critical market infrastructure that plays 'a key systemic role for EU financial markets'. Such CCPs centralize management of large amounts of counterparty risk associated with systemically important EU financial institutions and their clients. Now that these CCPs will no longer be within EU supervisory architecture, we share your belief that it is vital for ***EU and UK regulators to agree appropriate arrangements for oversight and cooperation with respect to UK CCPs.***
- We respectfully draw to your attention that ***a Eurozone location policy would have several unintended consequences***, however. These include higher costs associated with clearing activity as well as financial stability concerns.
- ***Many of the detrimental consequences that we identify in this paper will be felt most keenly by banks' clients.*** For example, while clearing of OTC derivatives has been a cornerstone of G20 reform of derivatives business, the ***successful implementation of central clearing requires certain economies of scale which would be undermined by geographical fragmentation of clearing***. In particular, ***benefits associated with multilateral netting will be lessened, with negative impacts for liquidity and pricing available to clients***. The reduction in these benefits (and higher consequent IM requirements) also indicates more risk in the financial system as a result of location policy.

- In this regard, ISDA has worked with its members to quantify the impacts of a location policy for its members. ***This survey estimates that a requirement that euro-denominated interest rate derivatives be cleared post-Brexit in an EU-based CCP would result in an overall IM increase in the range of 15 to 20%.*** Derivatives users could also face higher execution costs because of creation or ***exacerbation of bases*** (price differences) between Eurozone and non-Eurozone CCPs on the same products**.**
- A location policy is also likely to heighten ***financial stability concerns***, leading to smaller, weaker CCPs in different jurisdictions, and possible concentration of risk in one CCP (for some products) which could be very problematic at a time of market stress (with no alternative CCP within that geography available to clearing members). A location policy could also lead to financial and commercial risks going un-hedged as end users struggle to get connected to a new CCP, impeding EU investment. At a practical level, no regulator in any jurisdiction has to date attempted to implement a location policy involving as vast a migration of risk as would be required were a location policy to be imposed in relation to Euro-denominated contracts currently cleared at LCH, for example.
- An EU CCP location policy would be a departure from the deference- and international comity-based approach the EC has taken to implementing G20 derivatives reforms. ***G20 regulators have been keen to avoid fragmentation, understanding that it is damaging to the global economy.***
- ***For these reasons, ISDA does not believe that a legislative proposal setting out a CCP location policy should be adopted by the EC before a public consultation and thorough impact assessment has been conducted.***

We thank you for taking the time to consider our views on this issue. If you have questions on any of the issues addressed in this letter, we are happy to discuss them with you at your convenience.

Yours sincerely,

Scott O'Malia

Chief Executive Officer

ISDA Response to European Commission Communication 'Responding to the challenges for critical financial market infrastructures and further developing the Capital Markets Union.'

As the global trade association representing leading participants in the swaps and derivatives markets, ISDA[1] welcomes the opportunity to comment on the European Commission's Communication ('the Communication') on *'Responding to the challenges for critical financial market infrastructures and further developing the Capital Markets Union.'*

Clearing of OTC derivatives has been a key pillar of the response to the financial crisis

The 2009 Pittsburgh G20 communique prescribed clearing of standardised OTC derivatives in Central Counterparties (CCPs, or clearing houses) as a cornerstone of reform of OTC derivatives. In Europe, EMIR established an EU-wide CCP authorization system and a mechanism for mandating certain OTC derivatives contracts for clearing. The EU 'clearing obligation' (CO) has been implemented for specific liquid, standardised classes of interest rate and credit derivatives.

Where – pre-crisis - derivatives dealers would mostly have managed counterparty risk bilaterally with each of hundreds of counterparties, CCPs now typically[2] stand between market participants, managing counterparty risk (calling for or paying collateral (Initial and Variation Margin - IM and VM) as a function of changes in trading positions).

This shift is not solely due to regulatory mandate. Dealers have embraced clearing as a means not only to manage counterparty risk, but also because it offers economic and operational efficiencies.

Those benefits are dependent on economies of scale at CCPs. Such economies of scale depend on the ability of global firms to clear contracts on a cross-border basis. The greater the participation in a CCP the greater the multilateral netting benefits (the ability of a clearing member to net all exposures to one CCP resulting from instruments in the same asset class for collateral purposes). Multilateral netting is risk reducing and cost-efficient for clearing members and clients.

The EC's concern regarding oversight of non-EU 'critical' CCPs is understandable

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

[2] Over 70% of gross notional amounts of OTC interest rate swaps in major currency segments are cleared, according to the BIS – see http://www.bis.org/publ/qtrpdf/r_qt1612f.htm

ISDA endorses much of the 'Third Country CCPs' section of the Communication, including the EC commitment to '*integrated financial markets, its international obligations, and the possibility of equivalence for CCPs, and…the need to avoid undue fragmentation of the global system.*'

The paper asserts a need for '*safeguards*' (e.g. supervisory or location requirements for certain non-EU CCPs) supporting the financial and monetary policy responsibilities of EU and Member State institutions, given that, following Brexit, a substantial volume of derivatives denominated in Euros (and other EU currencies) will no longer be subject to EMIR or EU supervisory architecture. The EC's concern herein is valid. Such CCPs centralise management of large amounts of counterparty risk associated with systemically important EU financial institutions and their clients.

The EU and UK authorities (in the case of UK CCPs) must agree methods allowing each to meet their regulatory objectives. Given the regulatory convergence (that will continue after Brexit) and supervisory understanding that has served EU and UK regulators well since the financial crisis, we hope that they can agree appropriate arrangements for oversight and cooperation with respect to UK CCPs. Statements[3] by the Bank of England are encouraging, referring to the need to '*build upon the arrangements…developed for supervisory co-operation and coordination*'[4] and through '*collective oversight and effective cooperation between supervisors and central banks*' to ensure that cross border infrastructures can operate freely, subject to cross-border supervisory oversight.

The EC should conduct comprehensive consultation and impact assessment on any proposal which entails a potential CCP location policy

We believe that it is very important for the EC to carefully consider the arguments for and against a CCP location policy by holding a full public consultation and carrying out an impact assessment, before any legislative proposal should be adopted. While interested stakeholders have had an opportunity to comment on the Communication, this provided little detail. Such consideration is indispensable to ensure avoidance of unintended consequences for the EU economy.

To underscore the need for such an assessment, in the following pages, ISDA will briefly explain some of the negative economic and financial impacts of an EC CCP location policy.

Significant increased costs would be felt by EU and UK investors and corporates

- *Cost of splitting multilateral netting sets*

A location policy would mean that Euro-denominated derivatives would be removed from the large netting set at a non-EU CCP (LCH for example) and instead be cleared at an EU (or quite likely, Eurozone) CCP. The smaller netting sets at both CCPs would lead to greater costs (because

[3] http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech963.pdf

[4]

of reduced netting and collateral efficiencies) for clearing members. A survey conducted by ISDA estimated that a requirement that euro-denominated interest rate swaps be cleared post-Brexit in an EU-based CCP would result in an overall IM increase in the range of 15 to 20%[5]. Some larger clearing members have reported more significant impacts on IM however (up to 54%) or a more significant impact on client accounts than on house accounts. This increased IM also indicates increased risk caused by fragmentation (see below).

It is important to understand that the costs for clearing members associated with this additional IM will ultimately be passed on to clients. Both EU and UK investors and corporates would experience higher costs associated with investment decisions and/or in the costs associated with hedging commercial and treasury risk, all of which would undermine economic growth.

- *A location policy could significantly increase capital costs for EU firms*

It is not clear by which mechanism the EC might effect a location policy. If LCH Ltd was unable to obtain recognition as a third country CCP under EMIR, for example, it would also be unable to obtain QCCP status under the Capital Requirements Regulation, meaning that EU counterparties participating in LCH ltd would face a significant hike in the capital requirements associated with their OTC derivatives exposures at LCH ltd (risk weights rising from 2% to 100%). However 72% of the activity at LCH's Swapclear service is denominated in currencies other than the Euro. If the EC were to pursue this route, EU firms would be heavily penalized for participating in cleared derivatives business at Swapclear that is denominated in dollars, yen and other currencies.

- *A location policy would cause price volatility, also increasing execution costs*

A prospective location policy (i.e. one applying to euro-denominated contracts traded as of a specified date in the future) would artificially exacerbate differences in pricing ('bases') that currently exist between CCPs. These bases often exist in the first place because different CCPs have different sets of participants, with different objectives in their derivatives use (for example, pricing at a CCP whose membership is largely characterised by participation of large derivatives dealing firms (whose books would be largely 'flat') would diverge from pricing at CCPs which may involve more end users with more directional positions in interest rate, credit or other risk classes). As firms build new portfolios at those Eurozone-based CCPs, liquidity in euro derivatives trading could see dramatic fluctuations, exacerbating the risks associated with these bases.

If the location policy were retroactive, firms would have to reprice existing trades that are moved to the Eurozone CCP. However with transactions being novated to the CCP, repricing is not possible. Price difference will crystallise when establishing the new trade at the EU CCP, leading (most likely) to losses, on average. If a significant number of counterparties seek to unwind

[5] These figures are based on our initial analysis of data provided by 11 participating banks. These figures are based on data as at a point in time.

positions at one CCP and reopen them at another at the same time, the pricing basis will be severely exacerbated, causing unwanted volatility and stress in the market.

Again, we stress that the impact of a basis between a non-EU and EU CCP will not only be felt by clearing members. Increased funding costs caused by this basis will ultimately be felt by EU and UK clients, with consequences for financial and corporate investment and hedging decisions.

A CCP location policy would create financial stability risks

- *A location policy would lead to smaller, weaker CCPs*

To the extent that a location policy has been considered in jurisdictions other than the EU, it has only been considered for much smaller CCPs (than London's LCH, for example) in much smaller local swap markets, and has either typically been abandoned as a policy option (in Canada and Australia, for example) or drastically scaled down (Japan).

In the Canadian case, a working group chaired by the Bank of Canada and including representatives of other Canadian regulatory agencies assessed the case for 'onshoring' a clearing requirement for Canadian counterparties from late 2010, but concluded against it in 2012, opining that global CCPs support liquidity and efficiency in a global OTC derivatives market, making them more robust in their resistance to financial shocks. This in turn supports derivatives users' ability to prudently manage risk. The Canadian regulators view adherence to the CPMI-IOSCO Principles for Market Infrastructures by such global CCPs as a sufficient safeguard.

See http://www.bankofcanada.ca/2012/10/statement-by-canadian-authorities/.

The Australian (ASIC) clearing regime stipulates mandatory clearing of certain interest rate derivatives denominated in AUD, USD, EUR, GBP and JPY, but permits counterparties to these trades to clear these trades either at local CCPs or in a number of overseas ('prescribed') CCPs. ASIC cited a wish to minimize disruption to Australian participants in OTC derivatives markets and referred to the adequacy of CPMI-IOSCO standards for foreign CCPs in this regard.

Where an 'onshore' clearing requirement has been mandated in derivatives markets of a material size in other jurisdictions, the requirement has been limited to local market participants trading swaps (with identified local nexus) with each other (e.g. Japan). Even here, volumes are insignificant in comparison to the volume of Euro-denominated derivatives in LCH Limited[6], and the final regime represents a scaling back from the original counterparty scope of the requirement.

[6] For example, looking at daily trading activities, average of cleared volume in Yen-denominated swaps at JSCC over 10 trading days (May 18 -31) was ¥3,888 billion (€31.1 billion) at JSCC, in contrast to €670.8 billion traded in Euro-denominated swaps at LCH on May 31.

If the EC was to impose a requirement for EMIR-regulated firms to use a Eurozone-located CCP to clear Euro-denominated derivatives, it is not clear that global liquidity in Euro-denominated cleared contracts would flow to that CCP. According to LCH, only 25% of their Euro-denominated activity is cleared by EU firms, meaning that the effect of such a move may be to simply create a smaller, balkanised and less liquid CCP in the Eurozone, subject to higher margin and other costs, and with a great burden for its members in terms of underwriting risk at the CCP (at times of market calm, but also in the event that (in market stress) remaining clearing members had to manage default of one or more of the CCP's members) than would be the case in a larger CCP.

- *A location policy can create concentration at one CCP which is problematic in market stress*

The introduction of a euro-clearing location policy would prohibit access to alternative CCPs located outside the EU for clearing mandatory clearable products. In some cases, only one EU CCP may be available to clear certain derivatives. This could create an increased concentration of risk at a systemically important CCP without a viable alternative to clear in, in event of a period of market stress leading to a clearing member default and/or CCP resolution scenario. At such a time, it would be important for market participants to have access to another CCP to fall back on (to 'port' positions) while the affected CCP deals with a default, for example.

- *A location policy would require movement of an operationally and systemically worrisome amount risk from one CCP to another*

No regulator in any jurisdiction has to date attempted to implement a location policy (or a policy based on any consideration) involving movement of such a vast amount of derivatives-related risk from one CCP to another, let alone from a CCP in one political and legal jurisdiction to another ($84 trillion notional volume of Euro-denominated swaps has been cleared at LCH Swapclear so far in 2017, $21 trillion between EU counterparties). The consequences are unpredictable.

- *A location policy may curb access to OTC derivatives business for clients, impeding hedging*

In the event of a location policy being implemented, it will take a long time for many end users of derivatives to be able to access clearing of Euro-denominated OTC derivatives at an EU CCP. Effecting connectivity to CCPs is a time-consuming and labour-intensive process, requiring legal, operational, financial and risk management expertise. DG FISMA officials will be familiar with the present challenges associated with connectivity to CCPs for end users in relation to products subject to EMIR mandatory clearing. A further bottleneck in clearing may prevent access to OTC derivatives hedging business, meaning important financial and commercial risks cannot be adequately managed, itself an obstacle to investment in the wider economy.

An EU location policy is not in keeping with EU adherence to G20 principles

The EU has faithfully implemented the 2009 G20 commitments on derivatives reform, including committing to avoid '*fragmentation of markets, protectionism, and regulatory arbitrage'*.

This approach is reflected in the EU's successful advocacy in favour of the principles of deference and international comity in international forums (e.g. IOSCO and the FSB) charged with monitoring the implementation of the Pittsburgh G20 commitments, principles made explicit in successive FSB progress reports on implementation of OTC derivatives reforms, for example.

An EU CCP location policy would run contrary to the deference principle and would fragment markets. As senior regulators in the US and other G20 authorities understand, fragmentation is harmful to the wider economy and society, and not just a problem for financial markets.

To conclude, ISDA believes that it is appropriate for the UK and EU regulators to agree arrangements ensuring that EU regulators have adequate oversight of risk managed at UK CCPs that is relevant to the EC financial system and wider economy. We believe that a CCP location policy would be damaging to both EU and UK economic interests, and should not be pursued.