ISDA® Safe, Efficient Markets

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European Securities and Markets Authority
CS 60747
103 Rue de Grenelle
75345 Paris Cedex 07
France

Sent by email to: www.esma.europe.eu

Response to 'Consultation Paper: Guidelines for establishing consistent, efficient and effective assessments of interoperability arrangements'

This letter contains the response of the International Swaps and Derivatives Association, Inc.[1] ("ISDA") to the European Securities and Markets Authority ("ESMA") Consultation Paper on Guidelines for establishing consistent, efficient and effective assessments of interoperability arrangements (the "CP").

At the outset, we refer to recital 73 of the European Market Infrastructure Regulation ("EMIR"):

> Interoperability arrangements are important for greater integration of the post-trading market within the Union and regulation should be provided for. However, as interoperability arrangements may expose CCPs to additional risks, CCPs should have been, for three years, authorised to clear or recognised in accordance with this Regulation, or authorised under a pre-existing national authorisation regime, before competent authorities grant approval of such interoperability arrangements. In addition, *given the additional complexities involved in an interoperability arrangement between CCPs clearing OTC derivative contracts, it is appropriate at this stage to restrict the scope of interoperability arrangements to transferable securities and money-market instruments. However, by 30 September 2014, ESMA should submit a report to the Commission on whether an extension of that scope to other financial instruments would be appropriate*. [Emphasis added]

As the scope of interoperability under EMIR is currently limited to money market instruments and transferable securities (and not derivatives) and that ESMA is required to report by September 2014 on whether the scope should be expanded to cover other

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 **F** 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

instruments[2], we expect that ISDA will have an opportunity to provide further comment if and when the scope of interoperability is expanded to cover derivatives.

We support the extension of interoperability for central clearing of derivatives, though wish to emphasise the need for further consultation. In that regard, please note that ISDA's Risk and Margin Regulatory Implementation Committee is an industry forum with which ESMA can engage with industry on this subject. Indeed, we would welcome the opportunity to meet with ESMA to provide further comments and would be grateful if you would provide us with some suitable dates for a potential meeting.

Central counterparty ("CCP") interoperability is desirable in theory as it achieves the optimal combination of a virtual single CCP from each user's perspective while retaining the benefits of competition. Under full interoperability, users can choose to work with a single CCP selected from possible choices within a competitive environment. Interoperability could also work against the establishment of CCP monopolies, which would result in costs passing back to the wider economy.

Clearing Members ("CMs") do not underestimate the challenges or the risks involved in creating interoperable structures for derivatives clearing. Certainly, the guidelines for interoperability for OTC derivatives CCPs, in particular, will be more complicated than for cash instruments. The difficulties include the potential for systemic risk caused by the CCP which is the weakest link in the chain. Further, the interoperability arrangements for cash equities that currently exist in Europe require additional collateral being posted by CMs to the interoperating CCPs. However, given that the risk profile (including, notably, that OTC derivatives are far less liquid than cash instruments) and settlement periods of OTC derivatives are substantially different to the risk profile and settlement periods for cash instruments[3], the required additional collateral appears to be much higher. There are also potential operational complexities for clients that choose the individual segregation model that is required to be offered under EMIR. Individual segregation will add complexities, operational risk and legal considerations within the collateral process between CCPs. For instance, an interoperating CCP would have to potentially maintain accounts for clients of CMs of the other CCP(s).

Despite these and other challenges, the ability of CMs to transfer positions from one CCP to another via CCP interoperability will result in lower liquidity demands and lower individual CCP credit exposures than where interoperability is not in place. Indeed, in the absence of interoperability, active management of swap books on a CCP by CCP basis will be necessary in order to control the amount of collateral the CM will have to provide to each CCP, and their consequent exposure to each CCP. For example, given that the US is characterised by fixed rate mortgages and Europe by pension plan asset-liability management, it is possible that swap dealer participants will be receiving fixed in rates at a US CCP, and paying fixed at an EU CCP. In this case, a balanced rate book for the CM becomes very directional at each

[2] In addition, we note that annex II, paragraph 2 of the CP states that the European Commission, when presenting its proposal for EMIR, only did a cost benefit analysis that looked at interoperability for cash instruments and the ESMA proposals are driven by EMIR.

[3] While listed derivatives have a fairly short duration, the average life of an OTC derivative is around 8 years and max duration is 50 years.

CCP, motivating collateral and exposure management, and the provision of higher rate markets for US cleared swaps relative to EU cleared swaps, thus fragmenting the liquidity of the market as it is today.

While again acknowledging the considerable obstacles, the ability for CMs to transfer positions from one CCP to another also appears to be a route to resolve a CCP that is no longer viable and, in so doing, help to mitigate the systemic risk associated with CCP failure.

In light of the above, ESMA standards should be consistent with interoperability while recognising the substantial challenges in realising it. Accordingly, the development of risk management standards necessary will requires at least the following settings:

- *Full respect for/adherence to CCP recovery and resolution rules*. Derivative CCPs are extremely important to the industry and their smooth operation is essential to the proper functioning of these markets. The arrangements which a CCP makes in respect of recovery are a matter of contract between the CCP and its members. CMs require certainty and transparency in their dealings with CCPs. Accordingly, it is of the utmost importance that these rules are respected by regulators up to the point of non-viability[4]. If resolution is unavoidable, it is imperative that *ex ante* resolution arrangements are also transparent and predictable.

- *Limited liability for CMs to prevent systemic risk*. Provision of mutualised resources by guarantors is a risk that cannot be actively controlled, so default fund contributions, assessments, etc, must be a limited and known amount. Should losses ever exceed these defined and known resources, residual amounts must then be shared by all participants, direct and indirect alike, whether through recapitalisation, the closure of segments of a CCP or unpaid variation margin gain haircutting. These measures must be executed in a way which does not contradict the principle of limited liability for CM guarantors, and features such as forced partial tear-ups and uncapped default fund liability should be avoided altogether.

- *Protection of, and support for, favorable netting enforceability and collateral arrangements.* Interoperability should in no way interfere with CM closeout netting rights or full segregation and bankruptcy remoteness of CM initial margin. In order to report counterparty exposure on a net rather than gross basis, accounting rules require institutions to obtain an unqualified legal opinion that there is a legally enforceable right to net transactions against that counterparty. Put simply, the breaking of netting sets can expose CMs to uncertain risks. Interoperability must be implemented in a way which does not expose CMs to any level of uncertainty with respect to sanctity of CMs' initial margin or individual CCP netting sets. Further, we urge regulators to cooperate internationally to bring about a robust regime which protects the sanctity of initial margin.

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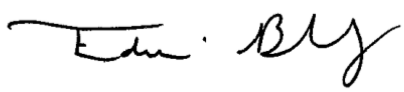
[4] In the event that the CCP (and/or its CMs) fails to perform to its default management plan, a service termination or a resolution event would be warranted depending on whether the service is limited recourse or not. This encourages members to turn up and bid responsibly in any auction. Also refer to ISDA's response to the European Commission Consultation on a possible recovery and resolution framework for financial institutions other than banks, December 27 2012 at http://www2.isda.org/functional-areas/risk-management/.

- *Mitigation for the risk resulting from different CM requirements*. Interoperability for derivatives must address the issue of different CM requirements of CCPs. These differences could result in a weaker, from a risk point of view, CCP causing a cross default in a stronger CCP. There is brief mention in the CP that membership requirement should be monitored (Section 3(2)(d)(i)), but otherwise there is limited consideration given to the issue.

- *Flexibility in relation to any interoperability mandate.* Sections of the CP suggest that there will be a mandate to accede to interoperability requests and that the only grounds on which a CCP could decline to interoperate is on risk ground (section 2(1)). Given the complexities introduced in this letter, greater flexibility would be needed for derivatives interoperability.

We welcome the opportunity to share these comments and would be pleased to have further discussions with ESMA in implementing an appropriate framework with sufficient prudential safeguards to deliver effective interoperability arrangements for derivatives CCPs. We consider this work would enhance market liquidity, reduce risk and foster financial stability. If you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,



Edwin Budding
Director, Risk and Capital
ISDA