

Response Form to the Consultation Paper on the clearing and derivative trading obligations in view of the 2022 status of the benchmark transition

Q1 Are there any general comments you would like to raise?

ISDA members are overall supportive of ESMA’s consultation on adapting the derivatives clearing obligation (CO) in the context of the on-going interest rate benchmark reform. We also welcome that this consultation allows us to feed into the process again.

ISDA members acknowledge the benefits of central clearing, as demonstrated by the current clearing rates for risk free reference rate (RFR) swaps. We believe that introducing a CO for these products could be a helpful tool for avoiding liquidity fragmentation.

We welcome that ESMA is trying to provide sufficient notice for firms to get prepared for the changes.

Regarding ESMA’s proposed Derivatives Trading Obligation (DTO) mandate adjustments, ISDA members request that ESMA does not introduce swaps referencing any new RFR, including €STR, in the EU DTO until the new DTO suspension mechanism, as proposed by the European Commission (EC) as part of the on-going MiFIR review, is fully enforced, especially knowing that there likely seems to be a political consensus on this specific topic. It would not be appropriate given that the MiFIR review is trying to solve a well-documented and acknowledged existing issue that could only be unnecessarily amplified by adding more swap classes to the DTO without a proper permanent solution in place. We are therefore concerned that adding these swaps prematurely will only amplify an existing issue for which the EC is trying to provide a solution post-Brexit. This could be exacerbated as the structure of the proposed variations of €STR swaps proposed for the DTO is complex and it is not clear whether all combinations (constant notional and 3-months tenor and trade start date Spot (t+0)) proposed in the consultation will be sufficiently liquid under all market conditions.

As demonstrated in our paper “Demystifying Derivatives Trading in the EU”¹, market participants voluntarily trade on venue. The report states that the total interest rate derivatives notional traded on trading venues (TVs) was more than double the notional of IRD transactions subject to the DTO. Therefore, it would not pose a risk to financial stability if €STR contracts were not added to the DTO before the suspension mechanism is in place.

We believe that transactions stemming from Post Trade Risk Reduction (PTRR) exercises should be exempt from the CO, to enable market participants to manage the risk in their uncleared portfolios.

¹ <https://www.isda.org/2022/06/27/demystifying-derivatives-trading-in-the-eu/>

This response should be read in conjunction with our response to the consultation “On the clearing and derivative trading obligations in view of the benchmark transition”² of July 2021.

General Analysis

Q2 Are there any other aspects of the transition that need to be taken into account? Please share any data that would help qualify further the progress with the transition or any other aspects that you think should be considered.

We welcome the thorough analysis provided by ESMA.

We would like to highlight a potential typo in article 37: SOFR features twice, while SONIA is not mentioned, despite being part of figure 11. We believe that the last sentence of this paragraph should read “*In parallel, the share of cleared volumes for SOFR has slightly decreased (less than 80% in May 2022 from roughly 90% in September/October 2021) while it has remained relatively stable for TONA and ~~SOFR~~ SONIA, where in both case the percentage of volume cleared is still around 90% (see Figure 11).*”.

We do not have any other comments.

Clearing Obligation

Q3 Do you agree with the assessment of the EMIR criteria and with the proposed classes? Do you also agree that the maturities for SOFR OIS could be extended, including up to 50 years? If not, please detail how the assessment could differ and please also provide data and information to justify a different assessment.

We welcome the thorough analysis according to Article 5(4) of EMIR and generally do not object with the proposed addition of JPY TONA (7D to 30Y) in the CO and the extension of USD SOFR from 3Y to 50Y, especially knowing these proposed changes are aligning the EU with other major jurisdictions (US and UK).

Q4 Do you agree with the proposed implementation of the changes? if not please provide details that could justify a different implementation.

We do not agree with the proposed implementation timings. Although a large part of inter-dealer swaps referencing TONA or SOFR is currently voluntarily cleared, establishing a framework that enables firms to comply with new CO requires additional market

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https://www.esma.europa.eu/sites/default/files/library/consultation_paper_on_the_co_and_dto_for_swaps_referencing_rfrs.pdf

preparations. We would request a three-month implementation period, commencing on publication of the final rules in the Official Journal, so our members have sufficient time to prepare for this change.

As in our previous response we want to point out that, generally speaking, members require sufficient notice to prepare for implementing a clearing obligation. Many preparations can only be done once the final rules are available and the compliance date is known. Such actions include for example:

- Adapting the control framework to make sure all transactions that fall under the new clearing obligation will be cleared.
- Adapting middleware, which can include liaising with external suppliers that might impose their own notice periods.
- Changes to reporting systems: for instance, EMIR reporting which requires adjustments in term of mandatory clearing instrument eligibility.

All these preparations take time, and our members require a sufficient notice period between publication of final rules and effective date of the clearing obligation.

Trading Obligation

Q5 Do you agree with this assessment and therefore, not to introduce DTO for contracts referencing TONA, SONIA and for the time being SOFR? If not, please explain.

We agree with the analysis, assessment and the proposal not to introduce DTO for contracts referencing TONA, SONIA and SOFR. Generally speaking, ISDA members do not support the introduction of any new RFR in the EU DTO at this stage, as explained in Q1.

Q6 Do you agree with this assessment? Do you consider that also contracts with constant notional and 3 months tenor and trade start date Spot (t+0) should be subject to the DTO? If so, please specify also the other relevant standardised parameters used with those contracts. Do you consider that also contracts with constant notional and 3 years tenor and trade start date second next IMM date shall be subject to the DTO? If so, please specify also the other relevant standardised parameters used with those contracts. Should other tenors be considered for the DTO?

We believe that it is not clear whether there will be sufficient liquidity under all market conditions in all classes with all combinations (constant notional and 3-months tenor and trade start date Spot (t+0)) proposed in the consultation. We note ESMA's analysis of the liquidity of the products proposed to be added to the DTO and whether they are all available to trade on venue. We are unclear whether there is data available to indicate that all products are sufficiently liquid on more than one venue.

As explained in Q1, despite any liquidity assessment, ISDA members request that ESMA does not introduce swaps referencing any new RFR, including €STR, in the EU DTO until the new DTO suspension mechanism, as proposed by the European Commission (EC) as part of the on-going MiFIR review, is fully enforced, especially knowing that there likely seems to be a political consensus on this specific topic. It would not be appropriate given that MiFIR review is trying to solve a well-documented and acknowledged existing issue that could only be unnecessarily amplified by adding more swap classes to the DTO without a proper permanent solution in place. We are therefore concerned that adding these swaps prematurely will only increase an existing issue for which the EC is trying to provide a solution post-Brexit.

We demonstrated in our paper “Demystifying Derivatives Trading in the EU” that market participants already voluntarily trade on venue: The report states that the total interest rate derivatives notional traded on trading venues (TVs) was more than double the notional of IRD transactions subject to the DTO. Therefore, it would not pose a risk to financial stability if €STR contracts were not added to the DTO before the suspension mechanism is in place.

As to the liquidity of certain classes of swaps classes (for instance swaps with constant notional and 3 months tenor and trade start date Spot (t+0) as mentioned in the question), we propose to wait with these determinations until after the DTO suspension mechanism has been implemented. We would like to highlight that the combinations of product scope are more complex and varied than introduced previously by ESMA under the DTO. As such, they will require more complex set up within firms’ systems to deploy.

Q7 Do you agree with this assessment? Do you consider that also the daily floating leg reset frequency is a standardised contract feature that could be considered for the DTO?

As to the liquidity of certain classes of swaps classes (for instance swaps with daily floating leg reset frequency as mentioned in the question), we propose to wait with these determinations until after the DTO suspension mechanism has been fully implemented as explained in Q1 and Q6.

Q8 Do you agree with this proposal? If not, what amendments do you think are necessary?

No, ISDA members disagree as explained in Q1 and Q6.

Q9 Do you agree with proposing to not provide for an implementation period for the entry into force of the amended DTO? If not, please explain.

As explained in Q1 and Q6, ISDA members request that ESMA does not introduce swaps referencing RFR in the EU DTO until the new DTO suspension mechanism, as proposed by the European Commission (EC) as part of the on-going MiFIR review, is fully enforced.

Generally speaking, the industry needs an implementation period of at least 6 months to implement any DTO instrument scope adjustments in order, for example, to: adjust all relevant internal trading and control systems, external trading venues and third-party dependencies, internal front-office training and external client communication / set-up. Please see also under question 4.

Following submission by ESMA of its final report and draft RTS to the Commission, the timing for final adoption and eventual publication in the Official Journal is subject to a degree of unhelpful uncertainty for market participants. As such, RTS which apply immediately upon, or soon after, publication in the Official Journal lead to unnecessarily compressed timeframes for firms to complete implementation preparations. If ESMA decides to progress with introduction of a DTO as proposed, then with the aim of enhancing certainty for market participants, and in light of the necessary implementation period indicated above, we urge ESMA to include in its final draft RTS that the rules would apply from the later of (i) the date [next available Monday] falling 6 months after submission of the final report to the EC or (ii) 3 months after publication in the OJ.

Cost-benefit analysis

Q10 Are there other elements that should be taken into account and that would impact the outcome of the cost-benefit analysis? Please provide quantitative and qualitative details

ISDA members welcome ESMA's cost-benefit analysis but would like to highlight, again, that regarding the proposed introduction of €STR in the DTO, ESMA is failing to capture the detrimental cost / impact for EU banks as explained above, which is surpassing any potential benefits. Therefore, we request that ESMA does not introduce swaps referencing any RFR in the EU DTO until the new DTO suspension mechanism, as proposed by the European Commission (EC) as part of the on-going MiFIR review, is fully enforced.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.