

December 9, 2019

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**Re: Margin and Capital Requirements for Covered Swap Entities**

Ladies and Gentlemen,

The International Swaps and Derivatives Association, Inc.<sup>1</sup> ("**ISDA**") appreciates the opportunity to comment on the U.S. prudential regulators'<sup>2</sup> (collectively the "**Agencies**") Notice of Proposed Rulemaking and Request for Comments regarding Margin and Capital Requirements for Covered Swap Entities (the "**Proposal**").<sup>3</sup> As discussed in further detail below, ISDA strongly supports the proposal and encourages the Agencies to finalize it expeditiously.

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<sup>1</sup> Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 71 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](http://www.isda.org).

<sup>2</sup> The U.S. Prudential Regulators include: the Treasury Department (Office of the Comptroller of the Currency) ("OCC"); Board of Governors of the Federal Reserve System ("Federal Reserve"); Federal Deposit Insurance Corporation ("FDIC"); Farm Credit Administration ("FCA"); and the Federal Housing Finance Agency ("FHFA").

<sup>3</sup> *Margin and Capital Requirements for Covered Swap Entities*, Proposed rule and request for comment, 84 Fed. Reg. 59970 (Nov. 7, 2019) available at: <https://www.govinfo.gov/content/pkg/FR-2019-11-07/pdf/2019-23541.pdf>.

Specifically, ISDA supports the Agencies' efforts to: (i) provide relief relating to the LIBOR transition, (ii) extend the compliance schedule for the phase-in of initial margin requirements, in accordance with the statement issued on July 23, 2019 by BCBS and IOSCO and actions taken by other global regulators, and (iii) bring rules related to interaffiliate initial margin in line with global regulators as well as the CFTC.

## **I. Interbank Offered Rates**

ISDA strongly supports the Proposal's relief from the non-cleared swap margin requirements for counterparties that amend their swaps referencing LIBOR or other key interest rate benchmarks, and urges the Agencies to finalize the relief as soon as possible. We believe that the relief provided by the Proposal is critical to ensure that counterparties reduce their exposure to LIBOR prior to its cessation or, at a minimum, amend their legacy LIBOR contracts to include more robust fallback provisions.

Without the relief provided by the Proposal, certain swaps that were entered prior to the applicable compliance date under the Agencies' non-cleared margin requirements ("legacy swaps") may become subject to otherwise inapplicable margin requirements if the counterparties enter into amendments to address the risk that LIBOR or another key interest rate benchmark ceases. According to research<sup>4</sup> conducted by the Office of the Chief Economist of the CFTC, over 70% of cleared and uncleared legacy swaps may require amendments to address the cessation of LIBOR and other interbank offered rates ("**IBORs**"). The report concludes that although legacy swaps do not comprise a large percentage of outstanding swaps, they do account for a significant portion of uncleared swaps for particular market sectors, including asset managers, insurance companies and pension funds.

In addition, the report concludes that absent relief, approximately \$12 trillion notional of uncleared interest rate legacy swaps would become subject to regulatory margin requirements. The report further estimates that these non-cleared legacy swaps would be subject to the post and collection of an aggregate of over \$100 billion in gross initial margin, using the regulatory schedule to calculate. ISDA estimates that using the risk-sensitive ISDA SIMM<sup>TM</sup> to calculate IM for this same population would still result in a total of approximately \$44 billion additional initial margin exchanged and segregated for non-cleared legacy swaps amended due to the IBOR transition. These substantive initial margin obligations create tax, accounting and other implications which market participants, including the asset managers, insurance companies and pensions referenced above, would need to consider and which might delay or deter efforts to proactively effect the transition of legacy swaps to alternative risk-free rates ("**RFRs**") or to include fallback provisions.

The Proposal's flexible approach is critical to facilitating a smooth and early transition away from LIBOR and other IBORs, particularly given that the precise mechanics of such a transition are not yet known. Flexibility in transition mechanics is necessary to accommodate different

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<sup>4</sup> *Legacy Swaps under the CFTC's Uncleared Margin and Clearing Rules* (May, 2019 (Updated September and November 2019), available at: <https://cftc.gov/sites/default/files/2019-11/CFTC%20Legacy%20Swaps%20Analysis%202019.11.19.pdf>

conversion models that ISDA expects will be developed as market participants assess their particular swap portfolios and the tax, accounting, and other consequences of an early transition away from LIBOR in particular. In this regard, we encourage the Agencies to clarify in final rules that the relief from non-cleared swap margin requirements would apply to new swaps entered solely to effectuate the transition (e.g., IBOR-RFR basis swaps meant to offset IBOR exposure and increase RFR exposure), even if existing swaps are not terminated.

Consistent with the overall flexible approach in the Proposal, ISDA requests that Agencies not specify an end date by which IBOR-related amendments must be completed. Liquidity in SOFR and the other RFRs is expected to develop at different points on the maturity curve and across different product classes at different times. Because the timing and progression of these developments are uncertain, market participants in some cases may need to transition away from LIBOR (or other IBORs) through a multi-step process over an extended period of time. For example, swap counterparties may initially agree to rely on contractual fallbacks, but may want to replace the fallbacks with a new swap linked to SOFR or another RFR when the liquidity for that type of swap becomes more developed and the relevant RFR becomes established in the market.

In addition, ISDA recommends that the Agencies' final rules permit changes in maturity or total effective notional amount that are directly related to a transition from LIBOR or another IBOR. Such a transition may be accomplished through many mechanisms, some of which have not yet been developed. However, flexibility will be critical in the development of these mechanisms because of the inherent differences between LIBOR (and the other IBORs) and the alternative RFRs. The RFRs have different term structures and credit profiles and therefore trade with different market conventions. In some cases, relatively small changes in maturity or total effective notional amount may be necessary to address the different conventions.

ISDA also recommends a technical change to the lead-in language in §.1(h). ISDA has published several protocols, which allow parties to make contractual amendments with multiple counterparties simultaneously. The text of §.1(h) presents a protocol and a contractual amendment as alternative methods of amending a swap, but ISDA's protocols operate as contractual amendments. Any potential confusion here could be clarified by replacing the phrase "a protocol, contractual amendment of an agreement or confirmation" with "a protocol, *bilateral* amendment of an agreement or confirmation" (emphasis added).

Finally, ISDA encourages the Agencies to consider whether to extend the relief contemplated by the Proposal so that it covers implementation of fallbacks in all derivatives, as opposed to only interest rate derivatives. The risk of cessation applies to all indices, including those based on interest rates, equities, commodities, foreign exchange and credit. Without the type of relief provided by the Proposal, market participants are very unlikely to address a risk of cessation in legacy derivatives based on non-interest rate indices. In certain jurisdictions, counterparties are required to address these risks.<sup>5</sup> At a global level, IOSCO recognized the importance of robust fallback provisions for all benchmarks in its January 2018 *Statement on Matters to Consider in the Use of Financial Benchmarks*.<sup>6</sup>

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<sup>5</sup> See Article 28(2) of the EU Benchmarks Regulation.

<sup>6</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf>.

## **II. Non-Cleared Swaps Between Covered Swap Entities (CSEs) and an Affiliate**

As the Agencies discuss, covered swap entities (“CSEs”) use inter-affiliate swaps for internal risk management purposes, which the Agencies consider to be a prudent risk management practice that can enhance the safety and soundness of a covered swap entity.<sup>7</sup> They also note that the lack of an exemption has negatively impacted banking organizations’ asset liability management structure and increased their liability exposure to depositors and other creditors in the market. Finally, the Agencies concede that their application of the initial margin requirements to inter-affiliate transactions may have put U.S. firms at a competitive disadvantage, while presenting limited systemic risk benefits.

For the above reasons, the Agencies propose to exempt inter-affiliate swaps from the Rule’s initial margin requirements. The proposal would not affect the initial margin requirements pertaining to transactions between covered swap entities and non-affiliated swap entities, nor would it eliminate the requirement for affiliated swap entities to exchange variation margin.

ISDA strongly supports the proposed exemption, as well as the continued requirement to exchange variation margin. ISDA believes that the current requirement that firms collect and segregate initial margin between affiliates diverges from international and domestic rules<sup>8</sup> and has a significant impact on U.S. firms. For example, ISDA research has found Phase-1 firms collected \$39.4 billion of initial margin for inter-affiliate derivatives transactions at year-end 2018.<sup>9</sup> ISDA has long supported harmonization of global and domestic rulesets, and providing this exemption is an important step towards this goal as the Agencies bring their rules into convergence with those of the CFTC and many other global regulators.

## **III. Additional Compliance Date for Initial Margin Requirements**

ISDA supports the Agencies’ proposal to extend the phase-in period for initial margin requirements in accordance with the statement issued on July 23, 2019 by BCBS and IOSCO and actions taken by other global regulators. Analysis produced by ISDA and provided to global regulators estimates that the scale of counterparties coming into scope on or after September 1, 2020 will be exponentially greater than in all prior phases combined with over 1000 parties needing to build infrastructure, prepare for IM calculation, source collateral and execute IM CSAs, and establish custodial arrangements to cover more than 9500 relationships.

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<sup>7</sup> 84 Fed. Reg. 59976

<sup>8</sup> The CFTC under Chairman Timothy Massad exempted inter-affiliate trades from initial margin requirements, instead subjecting them to variation margin, centralized risk management, and anti-evasion requirements. In addition, regulators in Australia, Brazil, Canada, the European Union, Hong Kong, Japan, Korea, Russia, Singapore, and Switzerland have all provided similar exemptions from initial margin requirements.

<sup>9</sup> *ISDA Margin Survey Year-End 2018*, International Swaps and Derivatives Association, Inc. (April 2019), available at: <https://www.isda.org/a/nIeME/ISDA-Margin-Survey-Year-End-2018.pdf>

Changing the average aggregate notional amount (“AANA”) range for September 1, 2020 (Phase 5) to between USD 50 billion up to USD 750 billion and introducing a new final phase-in period for September 1, 2021 (Phase 6) with AANA range from USD 8 billion up to USD 50 billion will not solve all the challenges anticipated in the final phases, but it will give both dealers and smaller market participants newly coming into scope of the initial margin requirements a better opportunity to prioritize and manage their compliance efforts. ISDA estimates suggest that roughly one-third of counterparties and relationships will remain in scope for Phase 5 and two-thirds will move to Phase 6.

In the proposed amendments to §45.1, the Agencies have revised the period for calculating the AANA for Phase 5 from June, July and August of 2019 to March, April and May of 2020 in accordance with the BCBS-IOSCO revised timelines.

However, the Agencies have not proposed to move the material swaps exposure (“MSE”) calculation period to March, April, May for Phase 6 and on a going forward basis – a change that would bring the U.S. into alignment with the BCBS-IOSCO framework and all other global jurisdictions. Although we recognize the value of conducting the AANA/MSE calculation in the preceding year for purposes of the final phase-in date to give market participants a longer lead time following certainty for the timing of the application of the initial margin requirements, for annual AANA/MSE calculations following the phase-in period the global bifurcation caused by the U.S. will add cost and complexity for smaller market participants subject to both U.S. rules and any other jurisdictions, especially in cases where aggregating the gross derivatives notional of a consolidated group is challenging, like separately managed accounts. Not only will these parties need to use a different method for calculating the AANA for the U.S. (daily averaging vs. month-end average) but they will also need to conduct the calculation during different time periods and provide separate notices to their counterparties in the event of a change to their status.

To reduce burden on smaller counterparties, ISDA requests that the Agencies change the MSE calculation period to March, April and May beginning in 2021 for Phase 6 and for annual recalculations thereafter, in accordance with global practices.

#### **IV. Documentation Requirements**

ISDA supports the Agencies’ proposal to amend §45.10 of the current rules to provide clarity that a covered swap entity is not required to execute initial margin trading documentation with a counterparty prior to the time that it is required to collect or post initial margin. This proposal would align the Agencies with the March 5, 2019 statement issued by BCBS and IOSCO and the requirements of global regulators.

Allowing a pair of counterparties to delay the completion of initial margin documentation under these circumstances further increases the opportunity for parties to appropriately allocate their resources against the trading relationships most likely to exchange initial margin near to the applicable compliance date and affords them additional time to complete documentation in the cases where a relationship is unlikely to require the exchange of initial margin within close

proximity of the relevant compliance date. ISDA analysis estimates that, depending on whether IM is calculated using ISDA SIMM™ or the regulatory schedule, 59% to 72% of Phase 5 relationships are unlikely to breach an EUR 50M threshold within the first two years of their regulatory IM obligation. The same holds for 78% to 85% of Phase 6 firms.

ISDA also appreciates the confirmation provided in the rule proposal that the custody agreement requirements of §.7 of the current rules does not require these agreements to be in place before initial margin is required to be collected.

## **V. Other Technical Amendments**

ISDA supports the Agencies' proposal to clarify that amendments to legacy swaps arising from routine industry practices over the life-cycle of a non-cleared swap will not bring those legacy swaps into scope of the current rules. These types of amendments to transactions are not equivalent to entering into a new swap, which is the test for determining when a transaction becomes subject to the current rules under §.1(e) of the current rules. The proposal is therefore consistent with the intent and policy goals of the current rules. Clarity in this area would be welcome, to ensure that the current rules do not create unintentional disincentives for parties to carry out administrative tasks that reduce operational risk.

The CFTC's Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) addressed similar issues under the CFTC's margin rules in a no-action letter dated June 6, 2019.<sup>10</sup> The DSIO letter clarifies that amendments that do not “affect the economic obligations of the parties or the valuation of the Legacy Swap” would not bring the legacy swap into scope of the CFTC's margin rules. DSIO further clarified its belief that “an extension of the maturity date, expiration date, or termination date of a Legacy Swap will always affect the economic obligations of the parties and the valuation of the swap.” The Agencies' proposal refers to “technical changes, such as addresses, identities of parties for delivery of formal notices, and other administrative or operational provisions as long as they do not alter the non-cleared swap's or non-cleared security-based swap's underlying asset or indicator, the remaining maturity, or the total effective notional amount.”<sup>11</sup>

ISDA requests that the Agencies adopt the same test used by DSIO to capture technical amendments. While ISDA fully agrees with the Agencies that technical changes should not bring a legacy swap into scope, the meaning of an alteration to the “underlying asset or indicator” of a swap may not always be clear. For example, if the publisher of an interest rate were to change but the rate itself is calculated in the same manner, then parties may want to amend interest rate swap documentation to accurately reference the published benchmark. This would clearly be a technical, administrative change, but it might also be considered an alteration of the underlying asset or indicator of the swap. Any resulting uncertainty in this area could make parties less willing to make technical amendments, resulting in potential operational risk. Amendments that do not affect the economic obligations of the parties or the valuation of a legacy swap are not equivalent to entering into a swap transaction. For these reasons and to promote consistency

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<sup>10</sup> CFTC Letter No. 19-13 No-Action June 06, 2019: <https://www.cftc.gov/csl/19-13/download>

<sup>11</sup> Proposed §.1(h)(5)(i)

among swap margin regulations, ISDA recommends that the Agencies adopt a similar test based on amendments that do not affect the economic obligations of the parties and the valuation of the swap.

In addition to the points made above in response to the Agencies' Proposal, ISDA also notes two other areas where we and our members have provided commentary to regulators. These areas are outlined below.

### **Posting Cash and Money Market Funds for Initial Margin**

As noted in our letter of August 1, 2019,<sup>12</sup> ISDA also requests that U.S. prudential regulators and the CFTC provide relief or rule amendments to expand the types of money market funds ("MMFs") that can be used as eligible collateral, including allowing non-U.S. MMFs. We also request that the U.S. prudential regulators permit substituted compliance with EU margin rules.

Both in the United States and European Union, MMF regulations allow for the use of repurchase and reverse repurchase agreements, and the prospectuses for a large majority of MMFs in both jurisdictions contemplate the use of these transactions to properly manage short term liquidity. The U.S. Margin Rules restrict such activity in the conditions for use of MMFs as eligible collateral, even though these same restrictions do not apply to use of MMFs as collateral for cleared swaps. EU margin rules for uncleared derivatives transactions also do not restrict MMFs' use of repurchase or reverse repurchase transactions.<sup>13</sup> Consequently, parties subject to both EU and U.S. margin requirements have no options for using MMFs as collateral absent U.S. regulators granting substituted compliance with the EU margin rules. Unless remedied, the use of MMFs as eligible collateral for IM will be extremely limited and the global market will be bifurcated by regulatory regime.

### **Relief for Separately Managed Accounts ("SMAs")**

The application of the margin rules to separately managed accounts presents special operational and other challenges.<sup>14</sup> An SMA may have multiple strategies executed through separate asset managers, each of which, in turn, has no transparency or control regarding the derivatives activities of the others and of the SMA's aggregate exposures across all of its derivatives positions.

For these reasons, ISDA requests that regulators adopt the approach provided in CFTC No-Action Letter 17-12 to permit asset managers to adopt a fixed sub-MTA at each SMA level rather than having to actively share the aggregate MTA per each SMA owner with each swap dealer.

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<sup>12</sup> <https://www.isda.org/a/FHPTE/ISDA-Letter-to-US-Regulators-Cash-and-Money-Market-Funds-as-Initial-Margin-8.1.19.pdf>

<sup>13</sup> See Recital 27 of REGULATION (EU) 2017/1131 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 June 2017 on money market funds

<sup>14</sup> See September 13, 2019 SIFMA AMG letter for further explanation: <https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-AMG-Letter-on-the-Margin-Requirements-for-Non-Centrally-Cleared-Derivatives-Final-9-13-19.pdf>

In addition, the monitoring of initial margin amounts against the IM threshold is particularly challenging in the case of SMAs, since the aggregate IM amount cannot be assessed by the relevant asset managers, and would only be capable of being assessed by the dealer or the separate account client. As such, asset managers will not be able to accurately assess the appropriate timeline for completion of documentation, custodial arrangements and operational processes necessary to exchange IM, and will be dependent on accurate and timely information from their separate account clients and their dealers. ISDA believes that these challenges warrant further consideration by the Agencies and looks forward to engaging on these matters in due course.

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We appreciate the opportunity to comment on the Proposal and look forward to working with the Agencies as they continue to re-assess their margin requirements. Please feel free to contact me or my staff at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Tara Kruse". The signature is fluid and cursive, with the first name "Tara" written in a larger, more prominent script than the last name "Kruse".

Tara Kruse

Global Head of Infrastructure, Data and Non-Cleared Margin  
International Swaps and Derivatives Association, Inc. (ISDA)