

PUBLIC STATEMENT

The introduction of fallbacks in OTC derivative contracts and the requirement to exchange collateral

The European Supervisory Authorities (ESAs) are aware of the possible interplay between the introduction of fall-backs to increase the robustness of contracts referencing certain benchmarks and the requirement under EMIR to exchange collateral for certain OTC derivative contracts.

Fall-backs introduced in OTC derivative contracts, reflect written plans which set out the actions that counterparties would take in the event that the benchmark used in these contracts materially changes or ceases to be provided. The ESAs are of the view that amendments made to outstanding uncleared OTC derivative contracts (legacy contracts) for the sole purpose of introducing such fall-backs should not create new obligations on these legacy contracts. In particular, margining requirements should not apply to these legacy contracts where they were not subject to those requirements before the introduction of the fall-backs.

The ESAs believe it useful to ensure legal certainty on this, in case or to the extent this is not already provided in some jurisdictions. While, neither the ESAs nor competent authorities possess any formal power to disapply directly applicable EU legal text, the ESAs are in contact with the co-legislators to see how a legislative change could be achieved to ensure this legal certainty.

International convergence

Such an amendment would further ensure international convergence on the implementation of the bilateral margin requirements which reflect the global framework discussed and agreed with the BCBS and IOSCO. Indeed, the BCBS and IOSCO also clarified in March 2019 that that these types of amendments, made for the purpose of the benchmark reforms, were not meant to subject these amended contracts to the margining requirements:

“The Basel Committee and IOSCO realise that market participants may need to amend derivatives contracts in response to interest rate benchmark reforms. Amendments to legacy derivative contracts pursued solely for the purpose of addressing interest rate benchmark reforms do not require the application of the margin requirements for the purposes of the BCBS/IOSCO framework, although the position may be different under relevant implementing laws.”

It could also be noted that ESMA is of the same opinion with regards to the clearing obligation, i.e. that the amendments made to these legacy contracts, for the sole purpose of introducing such fall-backs should not subject these legacy contracts to the clearing requirements, when these contracts were not subject to the clearing obligation before the introduction of the fall-backs.

Next steps

The ESAs are mindful of the current efforts that counterparties continue to undertake in order to introduce such fall-backs in their legacy OTC derivative contracts across all asset classes. Therefore, while further legal certainty is expected on this via a legislative change, the ESAs do not expect competent authorities to prioritise their supervisory actions towards margining requirements (and thus the clearing obligation as well) arising as a result of the introduction of fall-backs in legacy uncleared OTC derivative contracts, and to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in this area in a proportionate manner.

In addition, the ESAs would like to draw attention on the fact that they will continue investigating, in the respective areas of competence, the potential regulatory and supervisory implications stemming from institutions' transition to alternative reference rates and assess the need to comment separately on these aspects where deemed necessary. This is also in line with the work currently conducted in some international fora, in particular the Basel Committee on Banking Supervision, as per its press release published on 31 October 2019¹.

¹ <https://www.bis.org/press/p191031.htm>