

EXAMPLES OF MARKET FRAGMENTATION

NOTE : The tables below based on documents submitted by Ms.Tomoko Morita (Senior Director and Head of Tokyo Office,ISDA) at the 10th meeting of the Study Group with some modification.

(1) Extraterritoriality

Regulation	Source of Fragmentation	Impact
<p>Scope of Application of a Jurisdiction's Rules: Most jurisdictions require (1) transactions executed outside of their borders by entities they define to be within their regulatory purview, or (2) activities conducted inside their borders by third-country firms, to comply with their rules even when they would fall under the oversight of a third-country regulator.</p>	Overlap	Counterparties, particularly derivatives end users, seek to mitigate inconsistencies and uncertainties in the scope of application of a jurisdiction's rules by transacting within, and with firms governed by, their home markets. This essentially leads to regionalized markets and creates inefficiencies in providing and using derivatives risk management products.
<p>Equivalency/Substituted Compliance Determinations: The process by which regulators in one jurisdiction determine the regulations in another jurisdiction to be comparable is often conducted on a granular, rule-by-rule basis.</p>	Competition	Rather than being forced to comply with the rule sets of two jurisdictions, putting market participants in the position of running duplicative and (in many cases) conflicting compliance programs, firms regionalize their activity to ensure their activities are not captured by other jurisdictions, decreasing competition and liquidity.

(2) Capital

Regulation	Source of Fragmentation	Impact
<p>Market Risk Capital Rules (Fundamental Review of the Trading Book, FRTB): Significant uncertainties exist about the timing and extent of implementation of these rules in key jurisdictions.</p>	Desynchronization	Inconsistencies in the substance and timing of implementation of the market risk capital rules in key jurisdictions will have significant impact on the relative abilities of firms to offer, price and risk manage derivatives to their counterparties and to support strong, liquid markets.

Regulation	Source of Fragmentation	Impact
<p>Net Stable Funding Ratio (NSFR): The global standard developed by the BCBS as part of its review of the net stable funding ratio gives national jurisdictions the ability to impose a gross derivatives liability add-on (GDLA) for derivatives that ranges from 5% to 20%.</p>	<p>Competition</p>	<p>Inconsistent application of the GDLA by individual jurisdictions would have the potential to adversely affect the ability of banks to provide market services that facilitate client financing, investing and hedging.</p>
<p>Credit Valuation Adjustment (CVA): Jurisdictions differ in their implementation of the BCBS CVA risk framework.</p>	<p>Competition</p>	<p>CVA risk can affect the cost of capital of derivatives trades under the Basel standards and therefore in determining the price of those trades. The differing treatment of CVA risk could consequently affect the cost and availability of derivatives for end users in certain jurisdictions.</p>
<p>Leverage Ratio: Jurisdictions differ in whether they require segregated margin posted by clients with their bank counterparties for cleared swaps transactions to be counted in calculating banks' capital requirements under the leverage ratio.</p>	<p>Competition</p>	<p>Cash collateral posted by clients, which reduces credit exposure, would count as on-balance-sheet assets and therefore increase the capital requirement in the leverage ratio for banks in such jurisdictions. This could consequently increase the cost of clearing and limit access to it in these jurisdictions.</p>

(3) Non-Cleared Margin

Regulation	Source of Fragmentation	Impact
<p>Timeframe for Posting Margin: Jurisdictions differ in the time frame they impose for the calculation and settlement of both initial margin (IM) and variation margin, with some requiring it in T+1, and others requiring T+2 or later, depending on the standard settlement cycle of the relevant collateral.</p>	<p>Overlap</p>	<p>Inhibits timely settlement when two counterparties are not located in the same time zone. In particular, counterparties in Asian time zones find it difficult to transact with US counterparties for which T+1 settlement is required.</p>

Regulation	Source of Fragmentation	Impact
<p>Collateral Eligibility Requirements: Collateral eligibility requirements vary considerably across jurisdictions.</p>	<p>Competition</p>	<p>Firms may be disincentivized to trade with entities subject to different collateral eligibility requirements because doing so requires both parties to the transaction to follow the strictest requirements applicable, potentially limiting the sources of collateral for the relevant portfolio.</p>
<p>Posting of Initial Margin for Inter-Affiliate transactions: Some jurisdictions (eg, US prudential regulators) require swap dealers that are banks to post and collect IM for their inter-affiliate transactions. The US Commodity Futures Trading Commission (CFTC) provides an exemption, as does the JFSA and many other jurisdictions.</p>	<p>Discrepancies</p>	<p>Banks subject to inter-affiliate IM rules are incurring substantial funding costs for trades that pose no systemic risk.</p>
<p>Standard Initial Margin Model (ISDA SIMM) Backtesting: Some jurisdictions (eg, EU and Japan) may require all counterparties, including non-dealers, to monitor and back- test industry standard models used to calculate IM for their trades.</p>	<p>Discrepancies</p>	<p>End users generally do not have the resources or expertise to perform this type of testing and, as such, may be disadvantaged and forced to use the standard grid, which could potentially lead to higher prices.</p>
<p>Documentation for Phase 5 Counterparties: Some jurisdictions (eg, US) require counterparties to have in place regulatory IM documentation (including collateral support agreements) if they are above the \$8 billion notional threshold that's effective September 2020, even if they would not exchange IM under the rules because their IM calculation is less than the allowed IM threshold (up to \$50 million).</p>	<p>Discrepancies</p>	<p>Counterparties that are not required to post IM would be subject to time-consuming and expensive documentation negotiations and dormant custodial accounts in jurisdictions with this requirement.</p>

(4) Clearing

Regulation	Source of Fragmentation	Impact
<p>Clearing Location Policy: Some jurisdictions require certain trades executed within their borders to be cleared at central counterparties (CCPs) within their borders that are subject to local supervision. Clearing mandates in jurisdictions with closed currency markets also create de facto CCP location policies.</p>	<p>Competition</p>	<p>Clearing location policies adversely impact liquidity, as evidenced by the basis risk that arises from time to time at different CCPs clearing the same product. In addition, clearing location policies force firms to split their netting sets, which can significantly increase capital and margin requirements and related costs. Competition is therefore stifled and global systemic risk is increased.</p>
<p>Client clearing: Some jurisdictions require persons/clients that are not members of CCPs to only clear swaps with CCPs that are registered locally (eg, registered with the CFTC as a derivatives clearing organization).</p>	<p>Competition</p>	<p>This requirement prevents firms from providing liquidity and hedging for certain customers at offshore CCPs. In the US, this is the result even where local CCPs have obtained an order of exemption from the CFTC.</p>
<p>MPOR for IM Requirements: Jurisdictions differ in the minimum margin period of risk (MPOR) they require CCPs to use in setting IM they require for cleared transactions.</p>	<p>Competition/ Discrepancies</p>	<p>Differences between jurisdictions in the minimum MPOR required for cleared IM could result in customers having to post different amounts of IM for the same transaction, depending on the jurisdiction of the CCP in which their trade is cleared.</p>

(5) Trade Execution

Regulation	Source of Fragmentation	Impact
<p>Trading Location Policy: Requirements that certain trades must be executed on designated platforms within a particular jurisdiction.</p>	<p>Competition</p>	<p>Location-based trading regulations have fragmented liquidity across platform and cross-border lines, resulting in separate liquidity pools and prices for similar transactions. While the 2018 US-EU trading venue equivalence determination has alleviated some market fragmentation concerns, the lack of trading venue recognition across other jurisdictions continues to fragment global markets.</p>

<p>Trading Personnel Location Policy: US rules require trades between non-US entities that are arranged, negotiated or executed by US personnel (ANE transactions) to be cleared, executed and reported pursuant to US rules.</p>	<p>Competition/ Overlap</p>	<p>This discourages non-US entities from using US personnel for fear of being captured by US rules and subject to duplicative (potentially conflicting) requirements.</p> <p>Non-US entities that seek to engage in these transactions must build duplicative compliance systems to ensure they are compliant with CFTC rules and local clearing and trading rules, which may not be consistent.</p>
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(6) Data and Reporting

Regulation	Source of Fragmentation	Impact
<p>Trade reporting: Jurisdictions differ in whether they require one or both counterparties to a trade to report the transaction to a trade repository.</p>	<p>Discrepancies</p>	<p>Buy-side market participants and end users in a jurisdiction that requires them to report their derivatives transactions are disadvantaged, being burdened with onerous obligations that duplicate the data reported by their counterparty.</p>
<p>Required data fields: Different jurisdictions have different definitions, formats and allowable values for the trade data required to be reported</p>	<p>Discrepancies</p>	<p>Lack of consistency in the type and format of data required across jurisdictions creates inefficiencies that not only inflate the requisite cost and resources, but also impede the ability of regulators to aggregate and reconcile data.</p>

(7) Netting

Regulation	Source of Fragmentation	Impact
<p>Scope of Eligible Counterparties: Jurisdictions differ in the scope of eligible counterparties covered by netting legislation. Some differentiate based on type of bank (state-owned vs. privately owned) and others by type of firm (bank vs. securities vs. insurance).</p>	<p>Competition/ Overlap</p>	<p>Differences in the scope of eligible counterparties restricts the benefits of netting (which includes, among other things, a reduction in counterparty credit exposure) to a minimum or limited number of counterparties.</p>
<p>Scope of Eligible Transactions: Jurisdictions differ in the scope of eligible transactions covered by netting legislation. For example, some jurisdictions do not recognize physically settled commodity transactions as eligible transactions, but do recognize financially settled commodity transactions.</p>	<p>Competition/ Overlap</p>	<p>Differences in the scope of eligible transactions restricts the benefits of netting, which is an important tool for reducing counterparty credit exposure.</p>

(8) Benchmarks

Regulation	Source of Fragmentation	Impact
<p>Certain jurisdictions require that only approved benchmarks or indices can be used within their borders in order to ensure their accuracy and integrity. Benchmark administrators and data contributors are subject to new rules and processes. Providers and users of unapproved benchmarks may be fined.</p>	<p>Competition</p>	<p>If benchmark administrators and contributors find the rules too onerous or do not receive approval, the number of available benchmarks will decrease, fragmenting liquidity and reducing investment choices</p>