ISDA/AFME Comments on Hungarian Presidency text on EMIR dated 29 April (EMIR)

12 May 2011

ISDA and AFME are pleased to have the opportunity to comment on the Hungarian Presidency text of 29 April on EMIR.

ISDA and AFME would like to state support for the following new developments in the Presidency text:

- The interim solution (in square brackets in the text) proposed for pension funds (they should be subjected to bilateral risk mitigation requirements (and not a clearing requirement) in relation to risk-reducing contracts) for 3 years after entry into force, at least until a report on the Regulation, delivered by December 2015, addressing this question inter alia.

- The clarification that CCPs *shall* use own resources before using the non-defaulting clearing members' contributions to the default fund once the default fund contributions of the defaulting clearing member have been used.

Other comments

1. Scope (broad or OTC-only)

We support a broad scope of application for EMIR, including exchange-traded derivatives. We have already commented in detail on this, but, to summarise

- A broad scope will 'future-proof' EMIR so that all platforms are required to clear contracts;

- A broad scope will address long-standing (for well over a decade) concerns held at EU level on the anti-competitive restrictions implied by vertical siloes, with consequent impacts for pricing;

- It is important to understand that expanding the product scope of EMIR to include exchange-traded derivatives **does not** amount to introducing full CCP interoperability for derivatives clearing at this time. A requirement for an exchange to provide trade feeds on a non-discriminatory and transparent basis to any authorised (for clearing of those products) CCP would ensure that two members of a given exchange could choose to use a CCP of which they are both members to clear a trade, rather than being forced to use the venue's preferred CCP. This is not the same as interoperability, which would enable the parties to the trade to use **different** CCPs to clear their positions.

2. Backloading/Frontloading (Recital 12aa, 12c, Article 3 & Article 4)

We continue to believe that the frontloading requirement will – for reasons explained in previous commentaries – result in legal disputes and, as a result, a large number of non-compliance cases for national regulators to deal with.

3. Phasing-in (recital 12, Article 4)

We continue to believe that the clearing requirement should be rolled out in an orderly fashion. While dealers and large clients will be ready to clear quickly, the practical application of the clearing requirements to smaller clients will be much more challenging, operationally (with associated risks), and in terms of the financial impacts felt by those smaller clients.

We note that the US rulemakers are applying phasing-in to clearing requirements under Dodd-Frank.

Article 3 of the 29 April text suggests allowance for phasing-in for 'frontloaded (i.e. contracts entered into between the date of entry into force of the Regulation and the date from which a clearing requirement as decreed by ESMA takes effect) contracts (to be decided by the EC, following advice by ESMA) – although we note that text in square brackets in recital 12 suggests that phasing-in might be applied for other contracts.

4. Intra-group transactions (Article 2a)

We have addressed this issue in detail in other commentary. To recap, we feel that the exemption as drafted in the latest Council text

- May be too restrictive, geographically;
- Is silent on how intra-group transactions between a group entities within the EU and a group entity outside the EU should be treated.

Intra-group transactions are of particular importance in Europe due to the preferences often expressed by clients and regulators in different Member States for these clients to deal with locally-based entities. Centralised portfolio management then allows a) banks to manage risk in a consolidated way, potentially allowing optimal pricing for the client and b) allows regulators to scrutinize a consolidated risk position in the financial institutions that they supervise.

We further add that a clearing requirement for intragroup transactions would increase operational risk (because of the amount of clearing transactions with the CCP that would ensue, for different entities) without enhancing counterparty risk management in material terms.

We believe it is important that EU regulation of intragroup transactions should be proportionate and internationally coherent. Thus, we advocate

(i) (At least) exemption for transactions between EU-based group entities;

(ii) In addition, an exemption for intragroup transactions between group entities located in Europe and those located in jurisdictions deemed to have an equivalent clearing regime to that in the EU;

(iii) alternatively (to ii) a requirement to bilaterally collateralise intragroup transactions between group entities located in the EU and in third country jurisdictions.

5. <u>Clearing criteria (Article 4)</u>

We support inclusion of all of the eligibility criteria listed in the 29 April text, including the criteria (on counterparty risk and competition) in square brackets.

6. <u>Bilateral risk mitigation (Article 6)</u>

We have some concerns about Article 6.

Firstly, this article now suggests that ***both*** collateral and capital requirements should be applied to counterparties (financial and non-financial, whether exempted from clearing requirements or not) to non-cleared contracts. This departure from earlier texts is one we disagree with. Capital requirements should be risk-sensitive – and this text implies that there would be a limitation to the extent that this would be the case (e.g. capital would be applied to all contracts no matter how highly collateralised). Secondly, this creates a new liquidity risk for all counterparties, who may prefer that the costs resulting from capital requirements are applied to contracts, rather than being forced to provide high quality, liquid collateral to their counterparty on a regular basis (with attendant costs).

Secondly, we believe that the text as written (paragraph 1b) should make clear that it is *Initial Amount* that should be segregated at the option of the counterparties (to clarify, dealers should offer this option and clients should have a right to it), and not *Variation Margin* (which is passed back and forth frequently, subject to netting calculations). ISDA sell- and buy-side members have agreed to a framework in this regard (in an ISDA working group), which ISDA has shared with the Hungarian Presidency and the European Commission – as well as text which we believe would rectify this problem. A requirement to segregate variation margin would have serious liquidity effects.

Further to this point, we also believe that the text should make clear that the option of segregation (to any level) should be mandatorily offered at the outset of each derivative contract, and not during the course of the contract. If counterparties had a right to demand segregation (to any level) during the lifetime of the contract, this would have an effect on the price, and will lead to legal disputes if counterparties cannot agree that price. Such requests would also typically happen at moments of market difficulty, implying dangerous pro-cyclicality (liquidity effects). Again, ISDA has shared text with the Hungarian Presidency and the European Commission which we believe would rectify this problem.

7. Non-financials and hedging (recital 16a, Article 5)

We would welcome the clarity as suggested in the 29 April as to

- when a clearing requirement would have to be honoured, if a non-financial end user exceeds the threshold (3 months);
- the amount of time over which the non-financial end user in question would have to exceed the threshold in order for it to be required to clear (1 month);
- the amount of time over which the counterparty would again need to remain below the clearing threshold in order to no longer be required to clear (3 months).

While we welcome the attempt to begin to define the characteristics of hedging contracts, we don't believe that recital 16a is adequate for this purpose (referring only to derivatives hedging interest rate, inflation, commodity and FX risk). The use of CDS to hedge counterparty risk by non-financials is well known, and equity derivatives could legitimately be used to hedge risk in relation to employee share schemes, for example.

8. Access to central bank liquidity

Our views on this point are well known, and we oppose the most recent changes to the text.

Furthermore, there are a number of other issues that have not been dealt with in the text which are very important:

Territorial scope: We continue to be concerned that the draft Regulation continues to offer no clarity on its territorial scope. This at best creates uncertainty, and at worst raises the fear that many firms will find themselves facing duplicative regulatory requirements in the EU and other G20 jurisdictions, with worrying consequences for the competitiveness of EU financial business.

At the very least, if these issues are not to be addressed explicitly in the Regulation, it is important that some thinking should be done (and clarity provided) as to how these issues will be resolved.

To give an example of the uncertainty in this regard, we invite Council working group members to consider how/if EMIR would apply in the following circumstances:

- US Fund using a UK fund manager trading with a US bank for a $ or € IRS (interest rate swap)
- UK Fund using a US fund manager trades with a Japanese Bank for a Yen IRS or CDS
- US Fund using a UK fund manager trades with a Japanese Bank for a Euro IRS
- UK Bank trading with US Bank
- UK Bank trading with EU Branch of US Bank
- UK Bank trading with non-EU Branch of EU Bank
- Non-EU branch of UK Bank trading with US Bank
- UK Bank trading with EU Based subsidiary of US Bank
- UK Bank trading with Japanese Energy Company
- UK Bank trading with US Energy Company [latter subject to Dodd Frank]
- UK Bank trading with US Energy Company [latter not subject to Dodd Frank]

Indirect clearing: The proposed Regulation envisages that where an EU counterparty subject to the clearing obligation is required to clear an eligible OTC derivative contract it must do so either by becoming a clearing member or a direct client of a clearing member. However, it may not always be practical for EU counterparties to become clearing members or direct clients of clearing members, in particular where the relevant CCP is located outside the EU. In those cases:

- The non-EU CCP may not be able to admit EU counterparties as clearing members if they are not subject to local regulation (and, even where this is theoretically possible, EU counterparties may not be willing to submit themselves to local regulation because of the extent of third country supervision and rules that will apply to their business outside the third country).

- Clearing members of the non-EU CCP may not be able readily to transact business with all categories of EU counterparties, in particular because they may be prohibited from seeking business in the EU by local licensing requirements in the EU (see e.g. the European Commission's proposals as part of the MiFID review which appear to limit the ability of third country firms to deal with EU counterparties unless the third country firm meets a strict equivalence criterion and restricts its business solely to business with professional clients).

Within the EU, there are also likely to be financial counterparties that have significant volumes of OTC derivatives business with clients where the clients will themselves also be subject to the clearing obligation, but the counterparty does not wish to or is not able to become clearing members of every relevant CCP across the EU. In these cases, the counterparty may wish to use other clearing members to clear its own and its clients' trades, on an omnibus basis.

A similar issue arises today where EU counterparties wish to access third country futures exchanges and clear their transactions through a non-EU clearing firm that is a member of the third country exchange and its related CCP. In that case, the EU counterparty will often trade through an EU bank or investment firm that maintains an omnibus account with the third country clearing member. Corresponding issues arise for EU firms that wish to access an EU futures exchange where they do not wish to establish a direct relationship with the clearing member.

ISDA has already provided written briefings to Council negotiators (included suggested amendments) on both of these issues and will be happy to do so again, on request.