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ISDA/AFME briefing: Why EMIR must apply a proportionate, internationally-coherent approach to regulation of intra-group transactions (10 May 2011)

It is important that EMIR address intragroup transactions in a way that is (a) proportionate and appropriate for the real level of risk involved (taking into account that the client–facing transactions will be either cleared or bilaterally margined (depending on whether the contract is clearing-eligible) and these are internal group back-to-back transactions, which do not increase inter-connectedness in the financial system) and (b) internationally coherent, in such a way that European and US (and other) financial groups can continue to compete for clients on a safe basis, and ensuring that risk management is not compartmentalised geographically (EMIR should not promote trade barriers).

In this regard, we make the following points

1. **If EMIR does not allow a proportionate approach to intragroup transactions, it will result in competitive disadvantage for Europe**

Though there is no explicit exemption for intra-group transactions in US legislation (the Dodd-Frank Act), the regulatory treatment of transactions between affiliates with financial groups is currently being considered in rulemaking on mandatory clearing for swaps (CFTC) and securities-based swaps (SEC).

It is worth recalling that market participants whose activities are based entirely or largely in the single sovereign territory of the United States have less of a need for intragroup transactions than do – for example – European banking groups with activities across several different EU countries. Given regulatory requirements in many Member States that client facing transactions be locally 'booked' (recorded and accounted for), such groups often have to book transactions with same/similar risk characteristics in more than one legal entity. In addition, clients (and/or eligible counterparties, under MIFID classification) in different jurisdictions sometimes prefer to have their contracts governed by local law, for example under a domestic Master Agreement.

Transferring risk between the local trader and the central book enables centralized portfolio risk management. This means the overall risk picture is consolidated, as preferred by the group's home country regulator. In addition, centralised portfolio management allows the group the potential to offer the client a better price (thanks to netting efficiencies).

It may well be that US (-only) market participants have less of a need for intragroup transactions when compared with EU financial market participants operating across some or all of the 27 Member States. If both the EU and US were to fail to allow an exemption, European groups and their clients (who would feel the impact in higher hedging costs and reduced liquidity) would be more affected than their US counterparts.

2. Europe should not create an EMIR regime which acts as a trade barrier

International banking groups (and Europe has many of the leading international banking groups) need intra-group transactions for the same reasons as described above, for dealings with clients in third country jurisdictions. Local clients or local regulators will often require the involvement of a local group entity in the transaction. That local entity can then enter into a back-to-back transaction with the centralised portfolio manager, for the reasons described above.

As described under point 4, an EU requirement to clear this transaction would create significant cost, which we believe will simply discourage centralised risk management of this type, due to the cost. This will mean that the global risk picture becomes more fragmented for regulators, and risk management is done on a regional basis. This would be a regressive and costly outcome ('balkanisation')..

As such, we believe that it is important that EMIR should include an approach concerning intra-group transactions which is both proportionate and internationally coherent.

3. Requiring clearing of intra-group transactions would create more operational risk, and have little benefit in terms of counterparty risk

Most groups will have only a small number of entities that are clearing members of a CCP. These CCP clearing members are typically not the group's risk aggregation entities, nor are they client-facing entities. Thus a typical intra-group transaction between a client facing entity ('CFE') and a risk aggregation entity ('RAE') would have to be cleared by both CFE and RAE – as clients of the group clearing member ('CM'). One trade, CFE to RAE, would therefore generate four separate transactions, CFE to CM, CM to CCP, CCP to CM, and CM to RAE. The operational burdens and costs associated with this are considerable. Moreover, note that it multiplies rather than eliminates intra-group transactions: one intra-group trade CFE to RAE has become two, CFE to CM and CM to RAE. Thus there is no obvious reduction in counterparty risk.

If a contract falls within the mandatory clearing requirement it will be cleared at least once. Typically, if it is (1) a dealer-to-dealer contract, clearing will result in each dealer facing the CCP. If it is (2) a client trade – with the client subject to a clearing requirement – then the client will face the group CM who will present the trade to the CCP for clearing and the appropriate segregation model will apply for this trade. For both types of trade - either (1)

dealer to dealer or (2) dealer-client - one of the entities within the group is clearing the trade facing the CCP. If that entity then reallocates that risk to another entity within the Group it should not be required to clear that trade yet again.

As firms manage counterparty risk at consolidated level and report information to local regulators, regulators already have the information necessary for oversight of all of the group entities as well as of the consolidated risk position.

There are more effective tools for managing intra-group risks already in use and being considered by regulators, including market risk limits, concentration risk reporting, liquidity ratios and minimum capital requirements with additional buffers for other risks. Changes under Basel III and related higher capital requirements will also strengthen these tools.

There is a strong argument that requiring clearing of intra-group contracts will actually increase risk (contradicting the aims of EMIR). A clearing requirement would have to be applied unnecessarily to these transactions, creating the necessity for multiple transactions with the CCP, with the extra operational and counterparty risk this implies.

4. **Requiring clearing of intra-group transactions would drain liquidity away from group and would result in higher prices for clients.**

We are sensitive to the fact that cost-based arguments are not of great interest to regulators in the post-crisis world, but feel that this a further relevant consideration once Europe's competitive disadvantage (e.g. vs. the US), creation of trade barriers, and increase of operational risk (and lack of impact for counterparty risk) – as result of a clearing requirement for intra-group transactions - have been addressed.

The effect of clearing of these transactions will be to either soak up valuable liquidity in groups (as group entities are forced to buy cash (in return for illiquid assets) to post as collateral at CCPs). Resources used in this process could otherwise be used to invest or to extend to clients as part of group financing services, or to make hedging more expensive. Global banking groups originating in Europe will no longer be competitive when compared with global rivals. As already explained this may not be justified in risk terms.

Conclusion

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.