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ISDA¹ response to the ECON Committee questionnaire for the public consultation on enhancing the coherence of EU financial services legislation.

ISDA appreciates the opportunity to respond to this consultation, with the goal of contributing to a more robust and stable financial marketplace. In this response, we limit ourselves to commenting on 'Question Two' and 'Question Four' (issues directly relevant to '**Liquidity**' and '**OTC Derivatives Markets**'). There are, of course, many other important issues addressed in the consultation document that are beyond this scope, but regarding them we defer to other respondents who have greater expertise in or more focus on those areas.

Our starting point is that **OTC derivatives** play an important supporting role in financial markets and the **real economy**. The total gross value of OTC derivatives outstanding globally (before netting and collateral) is \$25 trillion², reflecting the wide range of risks to which – and entities to whom – these contracts are relevant. The fact that OTC derivatives can be and are **tailored** to the exact requirements of companies, sovereigns, asset managers and banks that are **managing** their asset-liability risks means they perform a targeted role that no other instrument (including listed derivatives) can play, in relation to **risks** that will continue to exist for savers and entrepreneurs.

Our full commentary on the consultation can be found in the attached questionnaire; however some **key points** are as follows:

- **Market making** is, at its heart, the provision of liquidity to the real economy and, as such, it directly contributes to **promoting long-term growth**. This activity is therefore not just a vital cog in efficient and effective market operation; even more importantly, it contributes to a reduction in transaction costs for end-user investors; it provides **enhanced risk management** options; and it allows improved **access to finance**. In this regard, special attention should be given to the possible impacts that EU banking reform could provoke³. Please note also that the EU is currently heavily reliant on bank lending (which, however, requires banks to borrow, to meet the funding gap); and that measures which reduce market liquidity will reduce the ability of the Union to diversify away from this.
- Unlike futures, liquidity in **OTC derivatives** markets is relatively fragmented, with a large number of products trading very infrequently, but in large sizes when traded⁴. **Liquidity and trade size vary** considerably depending on the specific product. In this regard, it is worth considering the result of a [recent study](#) undertaken by ISDA, of data held by the DTCC Trade Repository, of trading in Credit Default Swaps (CDS) and Interest Rate Swaps (IRS) early in 2013:
 - Over a 10 day period, out of 85 of CDS index products subject to clearing, only 37 were reported as having traded at all;

¹ Registration ID in the Transparency register: 466-43241096-93

² \$24,740 billion of claims, as of end-2012, according to the Bank for International Settlements, though only \$3.6 trillion of gross counterparty risk (because of the effects of netting) – see <http://www.bis.org/statistics/dt1920a.pdf>

³ IMF Staff Discussion Note "[Creating a Safer Financial System: Will the Volcker Rule, Vickers and Liikenen Structural Measures Help?](#)"-Page18

⁴ The average size of exchange-traded derivative transactions is \$100,000 and the average size of an OTC derivative transaction is \$126 million (Source: BIS, WFE, FIA, ICAP/TriOptima).

- In the IRS market, liquidity varies enormously among currencies;
 - Re IRS, certain 'benchmark' tenors trade with much greater frequency than surrounding dates, e.g., while around 200 10 year \$ fixed-floating swap trades traded on average per day during the period, 9 year and 11 year fixed-floating tenors traded an average of 24 and 3 times per day, respectively.
- MIFID2 and EMIR are actively pushing more of the market into transactional platforms and clearinghouses. Our concern is that this is creating a **mandatory obligation** to use commercial providers for whom scale is a determining advantage and who have not hesitated to leverage on their pricing power for market data or clearing services (See Q.2).
 - With the goal of preventing a weaker and **less liquid market**, upcoming Regulatory Technical Standards (RTS) specifying risk-management procedures (**Art. 11.3 of EMIR**), should carefully ponder the **consequences** of the proposals made by the BCBS-IOSCO on margin for normal (non-cleared) OTC derivatives Second Consultation (specifically relating to **initial margin, threshold, and re-hypothecation**) (See Q. 4.4).
 - **MiFIR** should recognise an **exemption** from OTF trading requirements for large-scale OTC derivatives transactions (and indeed also waivers from pre-trade transparency) (See Q. 4.3).
 - The **Financial Transaction Tax (FTT)** will have a negative impact on all risk management activities, because it will not be cost effective to conduct such risk management activities in the FTT economic zone. As a result, relevant Financial Institutions (FIs) will have **difficulties hedging** their own books and providing **liquidity** to the market (See Q. 4.2).
 - A mandatory **structural separation (Liikanen)** would reduce **liquidity** allocated to crucial banking activities (due to diversification reduction and the absence of parent guarantee), thereby increasing **funding costs and collateral requirements** (See Q. 4.1).
 - Concerning the **Short Selling Regulation (SSR)**, the nature of the exemption for market making activities (Recital 26) and restrictions on uncovered sovereign CDS causes a detrimental impact on **liquidity** (See Q. 4.5).
 - The cumulative effects of EMIR, FTT, MiFIR and SSR (addressed in Question 4) would create a problem of market liquidity: reducing the availability of funding and driving up the costs of capital. This, in turn, would increase the cost of hedging risks, force EU financial institutions to provide less funding at a higher cost; and restrict non-financials from investing and expanding their business (therefore undermining the prospects of the EU economy for growth and job creation).

We have been very pleased to be able to submit our responses, and we look forward to staying engaged with the ECON Committee as regards future legislative initiatives on these topics.

Yours faithfully,



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EUROPEAN PARLIAMENT
COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
- PUBLIC CONSULTATION -

**Questionnaire for the public consultation on
enhancing the coherence of EU financial services legislation**

The European Parliament's Economic and Monetary Affairs Committee is launching a public consultation on ways to further enhance the coherence of EU financial services legislation. Given the transition to a single rule book in financial services across the EU and the EU legislator's willingness to have "all financial markets, products and actors covered by regulation" it is increasingly important to ensure that legislation fits together seamlessly. The consultation will feed into a programme of reflection to determine future priorities for the remainder of this mandate and to inform the priorities for the incoming Parliament in 2014. All interested stakeholders, including academics and informed individuals, are invited to complete the Committee's questionnaire by 12 noon CET **on Friday 14 June and send it by e-mail to: econ-secretariat@europarl.europa.eu**. All responses to the questionnaire will be published, so please do not send any confidential material with your response. Please make sure you indicate the identity of the contributor. Anonymous contributions will not be taken into account.

IDENTITY OF THE CONTRIBUTOR

Individuals

Name of respondent:

Position:

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Organisations

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Main activity of organisation:

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

Registration ID in the Transparency register (where applicable): : 466-43241096-93

QUESTIONS

1. Are there specific areas of EU financial services legislation which contain overlapping requirements? If so, please provide references to the relevant legislation and explain the nature of the overlap, who is affected and the impact.
2. Are there specific areas of EU financial services legislation in which activities/products/services which have an equivalent use or effect but a different form are regulated differently or not regulated at all? If so, please provide references to the relevant legislation and explain the nature of the difference, who is affected and the impact.

ISDA would like to highlight that MIFID2 and EMIR are actively pushing more of the market into transactional platforms and clearinghouses. Our concern is that this **creates a mandatory obligation** to use commercial providers for whom scale is a determining advantage and who have not hesitated to leverage on their pricing power for market data or clearing services.

In order to illustrate the above, please find below the following examples:

- Despite the ongoing crisis, the price and revenues associated with market data have only gone up, culminating in a recent failed legal challenge in the US by users to rein in excessive cost increases. For more information, please click [here](#).
- We understand that several European clearinghouses have tried to introduce competitive clearing for OTC derivatives on EU benchmark equity indices such as the Eurostoxx50 index, but have failed to obtain a license from the index sponsor (Stoxx, which is owned by Deutsche Boerse, which also owns Eurex).
- The latest COREPER text on the ongoing MIFIR 2 (Art.30) proposes a 3-year transitional period for access to benchmarks, during which index providers could refuse all requests and build up a dominant position in OTC clearing on top of their listed derivatives clearing.

We think that the legislative reform is changing the trading and clearing landscape quickly, without giving due consideration to the impacts on competition at the level of market infrastructure, **with negative consequences for users. On top of this, we note that there is no** regulatory oversight (of the price of market data or of the use of intellectual property rights) to address such a restriction in the competition of clearing services.

3. Do you consider that the way EU financial services legislation has been transposed or implemented has given rise to overlaps or incoherence? If so, please explain the issue and where it has arisen, giving specific examples of EU financial services legislation where applicable.

4. How has the sequence in which EU financial services legislation has been developed impacted your organisation? Please identify the relevant legislation and, where applicable, specific provisions and explain the nature of the impact.

Our answers are based on the impact of EU financial services legislation **on liquidity**. Among the legislative instruments under discussion (MiFIR, FTT and EU Banking Reform), or in force (EMIR and SSR), the following ones are noted for comments:

1-EU Banking Reform: Structural separation (to be published)

- **Provision.** The European Commission is expected to publish a legislative proposal after the summer, whereby a mandatory separation (of trading activities) in line with the [High-Level Expert Group on reforming the structure of the EU banking sector](#) (Avenue 2) would be prescribed.
- **Impact**
 - Limiting competition in European capital markets activities, and further harming the development of the single market by leading national regulators to seek local, **'trapped' pools** of capital and funding, thereby inhibiting cross border flows of **liquidity** and capital.
 - As banks face significant funding pressure and downwards ROE pressure, higher funding and capital costs⁵ are likely to be passed on, at least in part, **to banks' customers**, and therefore could potentially discourage hedging activities and reduce banks' **liquidity** facilitation.
 - Reducing capital and **liquidity** allocated to crucial banking activities (e.g., raising capital, providing liquidity in their equity or debt, hedging), therefore making them more expensive or even

⁵ As recognised by the High-Level Expert Group on reforming the structure of the EU banking sector ([HLEG](#))-page 113

uneconomical for banks, and thus damaging their ability to **perform these vital roles**. Particularly, markets providing OTCs for risk management are characterised by a relatively low volume of trades and market-makers. In this context, market-makers are essential to the provision of **liquidity**, and a reduction in this capacity correlates directly with the cost of hedging transactions.

- Reducing diversification benefits and the absence of parent guarantees will result in a credit rating **downgrade** of several notches, increasing funding costs and impacting **collateral requirements**.
- Threatening the ability of the capital markets to meet European **financing needs** at a time of very subdued bank lending. S&P estimates that Europe has new financing needs of USD 1.9-2.3 trillion, and USD 8.3 trillion in refinancing needs for existing debt by the end of 2016 equivalent to around 75% of EU GDP.

2-Financial Transaction Tax (FTT) (under discussion)

- **Impact**

- **Reduction in liquidity.** The tax will have a negative impact on all risk management activities because it will no longer be cost effective for firms to conduct their risk management activities within the FTT economic zone. Therefore, the tax is likely to have a **direct or indirect impact** on **ordinary people, businesses**, and the real economy. Indeed, it will be more difficult for relevant Financial Institutions (FIs) to hedge their own books and to provide liquidity to the market, especially for those banks that cannot relocate their treasury activities outside the FTT economic zone⁶ (11 Member States).
- **Cumulative tax effect.** Each leg of a chain of transactions (apart from the exceptions⁷) will be taxed, producing a cumulative effect. All financial intermediaries (e.g., brokers) to a transaction, and to other transactions triggered by it, will be subject to the tax, creating a cascade. This will be passed on to customers as additional costs, which in turn will restrict **liquidity** and therefore increase volatility in financial markets.
- **Exodus.** Liquidity (and transactions) for relevant market participants would likely decrease, and thereby incline them to move to tax-free EU countries and, particularly, to third-country jurisdictions.

3-MIFIR (under discussion)

- **Provision:** Art. 26 (in the final text) should allow large-scale transactions (or block trades) to be executed away from venues. In order to do this, ESMA should take account of the fact that derivatives transactions might "only be sufficiently liquid in transactions below a certain size", in deciding which contracts are liquid enough to trade on Organised Trading Facilities (OTFs). In other words, an exemption from OTF trading requirements for large-scale OTC derivatives transactions (and indeed also waivers from pre-trade transparency), should be recognised.
- **Impact**
 - **Liquidity risk.** It is not clear that OTFs will have optimal or suitable functionality for execution of 'large-scale' trades. A non-sophisticated view of trading of financial instruments might assume that any trade can be executed around a prevailing price within a short period of time. However, in practice, we know that there are situations when a market cannot fully absorb the trading needs of a

⁶ Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain.

⁷ Clearing houses are exempt on their leg of a clearing transaction, and FI when acting as disclosed agent for another FI.

large portfolio. This is why, as is well worth recalling, **equities and futures exchanges** typically have **block trading facilities** available to members. Even in overall deep, liquid markets, there is an understanding and allowance for the fact that a requirement for a block trade to be transacted on-venue, would expose liquidity providers – and therefore their customers – to **liquidity risk** (the potential deviation between market price and executed price)⁸. It is considerably more difficult to offset risks taken on by liquidity providers in the low-turnover OTC derivatives business, with its relatively infrequent transactions. (These contracts are not traded in any secondary market.) Therefore, to **remove the tools by which risk offset** is achievable will have a proportionally much more damaging effect in such markets.

4-Regulation 648/2012 on OTC derivatives, CCPs and trade repositories (EMIR) (enforced)

- **Provisions:** Art.11.3 and 11.15(a) refer to regulatory technical standards (RTS) specifying the **risk-management procedures** (e.g., levels, type of collateral and segregation arrangements). These standards (to be published) are expected to be based on the regulatory framework on minimum standards for margin requirements for uncleared derivatives issued by the BCBS-IOSCO. With this goal, a second consultation (the 'Consultation') was launched in February 2013 making some proposals that could diminish liquidity in financial markets. Without careful consideration, these suggestions (if reflected in the above-mentioned RTS) would result in a **weaker and less liquid market** (that could be closed to market participants for whom centrally cleared derivatives do not fulfil their risk mitigation objectives).

- **Impact**

- **Initial Margin (IM).** The Initial Margin requirements on non-cleared OTCs proposed by the Consultation are extremely high and would severely **reduce market liquidity**. In addition, the funds needed by market participants to **acquire sufficient collateral** to post IM for these uncleared OTC derivatives are likely to reduce their overall business activities and this can in turn damage the real economy by draining liquidity from all financial firms and systemically-important non-financials that enter into uncleared OTC derivatives. For instance, assuming a total global IM requirement of EUR 700 billion, and a cost of funding that requirement in the range of 1.5% to 5% per annum, the global cost of IM would be EUR 10.5 billion to EUR 35 billion per year. Furthermore, such high IM requirements would make market participants (with already substantial capital requirements) to **abandon** their use of non-cleared derivatives, and that, as a result, volumes and liquidity in the market would shrink dramatically. Finally, increased IM requirements in **stressed conditions** will result in greatly increased demand for new funds at the worst possible time for market participants. For more information, please click [here](#).

- **Threshold.** The Consultation proposes setting a threshold of EUR 50 million on the requirement to post IM. This is **too low** and would create additional substantial demands relative to the overall collateral available in the market and therefore creating a drain on liquidity in the markets.

- **Re-hypothecation.** If regulators were to **ban re-hypothecation**, the assets used as IM for OTC derivatives transactions would not be available to the market to be used as collateral.

- **Phase-in.** The period of time proposed in the Consultation impose too short a timeframe (2015, 2016, 2017 and 2018 under certain conditions). If implementation is too rapid it is likely to exacerbate the liquidity, operational and other implementation issues posed by the IM requirement.

- **Netting.** BCBS and IOSCO should permit market participants to net OTC derivatives **exposure** against any other exposures (including exposure under products that are not derivatives) if such netting is legally enforceable.

⁸ For a further liquidity comparison between futures and OTC derivatives business, consider that in March 2013, Eurex's interest rate futures segment traded 46.8 million contracts, while there are approximately 6, 800 OTC interest rate derivative trades per day, globally (across all tenors, currencies etc).

5-Regulation 236/2012 on Short Selling and certain aspects of Credit Default Swaps (enforced)

- **Exemption for market making activities and primary market operations**

- **Provisions:** Importance of market making activities is recognised in Recital 26, which notes that *"Market making activities play a crucial role in providing liquidity to markets within the Union and market makers need to take short positions to perform that role. Imposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the Union markets. It is therefore appropriate to exempt natural or legal persons involved in such activities from requirements which could impair their ability to perform such a function and therefore adversely affect the Union markets."* However, the guidelines ([click here](#)) published by ESMA developing this exemption establish a narrow application, which would hamper certain market making activities (e.g., in corporate debt market).

- **Impact:** A detrimental impact on the liquidity of instruments key to maintaining an **appropriate cost of funding** for corporate and issuers, and on the quality of market making firms' risk management practices (CVA hedging).

Additionally, non-EU entities willing to provide liquidity are not able to benefit from the market making exemption, since no third-country regime equivalence appear to be under consideration.

- **Restrictions on uncovered sovereign credit default swaps**

- **Provisions:** Art.14 establishes the conditions to limit transactions on uncovered CDS.

- **Impact:** Although the time period between the entry into force of the SSR and the current review process has been short, some **consequences** of the restriction can be pointed out:

- Asian participation in the European bond market **fell by around 50%** immediately after the introduction of the SSR, thus demonstrating neatly one adverse impact of the SSR in general in driving investors away. The impact on European economic growth remains to be measured.
- Uncertainty over the precise implications of the Regulation, particularly for counterparties based outside the EU where the extraterritorial effect remains unclear, has led to many investors shunning CDS. **Liquidity** has therefore been reduced across the EU sovereign CDS markets. For smaller markets, such as Eastern European markets, liquidity has dried up completely in the CDS market.
- Similarly, sovereign CDS indices, with EU sovereign components, are effectively no longer traded. Sovereign CDS indices are a **useful hedging tool** where seeking to hedge exposure to supranationals.
- Market data shows that, as a result of the SSR, investors are replacing sovereign CDS with CDS referencing banks. This activity is occurring because the assets the investors wish to hedge do not meet the correlation test as described in the SSR. The result of this phenomenon is that it is **re-strengthening the link between sovereign** credits and their banks credits – a link which policymakers have been looking to break through fiscal, monetary, and other policy measures of late.

5.	Are there areas of EU financial services where the difference between forms of regulation (non-binding Code of Conduct or Recommendation to Member States vs legislative proposals) has affected your activities?
6.	How do you think the coherence of EU financial services legislation could be further improved? Please comment in particular on the extent to which the following would help to improve the coherence of future EU financial services legislation (please give examples to support your answer where possible): a) a framework for legislative reviews or review clauses included in initial pieces of legislation which link to the reviews of other related legislation? b) a unified, legally binding code of financial services law? c) different arrangements within the EU institutions for the handling of legislative proposals (please specify)? d) other suggestions?
7.	What practical steps could be taken to better ensure coherence between delegated acts and technical standards and the underlying "Level 1" text?
8.	Which area or specific change would you identify as the highest priority for the 2014-2019 mandate in terms of improving the coherence of EU legislation?
9.	Do you consider that the EU legislative process allows the active participation of all stakeholders in relation to financial services legislation? What, if any, suggestions do you have for how stakeholder participation could be enhanced?
10.	Do you consider that EU legislators give the same degree of consideration to all business models in the EU financial sector? Please explain your answer and state any suggestions you have for ensuring appropriate consideration of different business models in the development of EU financial services legislation.

Note on answering the questions

Please clarify in your answers whether your example relates to financial services legislation in force, or to proposals still under consideration. For example, if you refer to MiFID as an example, please specify whether your point relates to Directive 2004/39/EC ("MiFID 1") and accompanying implementing measures, or to the MiFID 2 negotiations based on Commission proposals COM (2011) 652 and 656.