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ISDA-AFME comment paper on Langen Report (EMIR) – 27 June 2011

- Ahead of vote in plenary session

ISDA and AFME welcome the opportunity to comment on the Economic and Monetary Affairs Committee report (adopted 24 May 2011) on the EC proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (EMIR), under the rapporteurship of Dr Werner Langen MEP.

We recognise the efforts of the rapporteur (and shadow rapporteurs) to adopt a report ensuring high standards for counterparty risk management and reporting of derivatives while preserving the ability of users of derivatives for risk management purposes to source these tools.

There is much in the ECON Committee report that we welcome, including:

Indirect clearing: We welcome the adoption of recital 19, stating that '*as not all market participants that are subject to the clearing obligation are able to become clearing members of the CCP (or clients of clearing members), they should have the possibility to access CCPs as clients or through investment firms or credit institutions that are themselves clients'.* We believe clients and local and medium sized banks should be able to maintain existing relationships at local level. We remark, however, that legislators should address the practical application and effects of segregation and capital rules in this circumstance.

Non-financial counterparties: We welcome the recognition of the need for an exemption for non-financial firms hedging risks, and the decision to ask ESMA to undertake work defining hedging and the thresholds themselves (the fruits of which will be adopted by the EC).

Capital charges on bilateral contracts: We welcome the adoption of

- A recital (14a) stating that '*counterparties who are not mandated to centrally clear should not face higher capital charges on continued bilateral arrangements'.* These counterparties are sufficiently 'low-risk' that they should not be punished through bilateral capital charges;

- A recital (14b) stating that capital charges for contracts that are risk managed bilaterally should be calculated considering '*levels of potential loss associated with the risk of default, measured for each counterparty'* – an appropriate risk-sensitive approach.

- The recognition (in Article 8) that capital imposed should be '*commensurate with the risk, in accordance with the regulatory capital requirement for financial counterparties'.*

Collateral requirements in bilateral contracts: We support the requirement that counterparties be offered the option of segregation of initial amount at the outset of the contract.

Pension funds: We agree that pension funds should to be treated differently in the Regulation, at least pending a review of appropriate counterparty risk mitigation for pension funds, and/or development of suitable clearing solutions for them (they will be allowed to bilaterally collateralise contracts, pending a review).

Phase-in: We welcome the support for the ability of ESMA to phase in clearing requirements (following consultation with industry and national competent authorities). This will ensure a more orderly, less risky transition to clearing.

Backloading: We believe that recital 13a is correct in its assessment that '*a retrospective clearing obligation is hardly feasible on legal grounds'* and welcome the language mandating ESMA to decide the *'future date from which the clearing obligation takes effect'* for a class of derivatives, as well as the specification *'this date shall be no earlier than the date on which the clearing obligation is imposed'.* We believe this approach will prevent legal disputes and confusion, and ultimately will ensure a higher level of compliance with the clearing obligation (it is very difficult for a single counterparty to comply with a clearing requirement for a class of derivatives if that counterparty cannot agree on the place, price, basis etc for clearing of a bilateral contract with their counterparty).

Foreign Exchange: We welcome the recognition that the different characteristics of the foreign exchange markets should be taken into account when determining eligibility for clearing. Furthermore, we support the need to take into account international convergence and consideration for foreign exchange forwards and swaps. We welcome

- Recitals (12a and 12b) that highlight the importance of settlement risk and that this, along with existing market infrastructures for addressing this risk (12b), should be taken into account when determining eligibility for clearing.
- Recital (12c) that recognises the need for international convergence and mutual recognition of relevant infrastructures given the international and global payments system nature of the FX market and support consideration of an exemption for foreign exchange swaps and forwards.

Legal Certainty: We welcome the addition (via amendment 3A to Article 9) of a provision to preserve the validity of an contract in the event of an infringement of EMIR.

However we also have a number of **<u>concerns</u>** with the ECON Committee report:

1. Collateral at CCPs (Article 43)

We are concerned to ensure that the breadth of types of collateral that could be accepted by CCPs under this Article should not undermine the stability of CCPs, and be the cause of a future serious financial crisis. We believe that – as this is a technical issue - ESMA is best qualified to consider this issue at appropriate length, and to advise the EC on (a) what types of collateral

(cash, corporate and sovereign bonds, gold and (for non-financials) commercial bank guarantees are mentioned) should be accepted by CCPs and (b) conditions associated with acceptance of these types of collateral, bearing in mind the level of risk concentration at CCPs and the vital importance of CCPs being able to fulfil their obligation to ensure that counterparties to a defaulting clearing member can be speedily and fully repaid (the primary function of a CCP).

There are varying views as to the wisdom of allowing government and corporate bonds and gold to be posted as initial margin (subject to haircuts).

We have serious concerns about the provision of ***commercial bank guarantees*** as collateral ***(for non-financials)*** to CCPs:

We believe that allowance of bank guarantees for margin calls to non-financial counterparties undermines the purpose of a CCP and immediately creates the danger that CCPs and their participants will be exposed to uncollateralised credit risk, with potentially disastrous consequences, given the level of concentration of credit risk at CCPs. A CCP needs to be able to act quickly in a crisis situation, to liquidate assets provided to it by defaulting firms, and make good on that firm's obligations to other clearing house members. How quickly will a CCP be able to liquidate a bank guarantee for this purpose? Our understanding is that the key aim of EMIR is to prevent financial market participants from taking risks that they cannot afford – which is exactly what a commercial bank might be able to do in simply offering a guarantee in place of collateral from the clearing member concerned. A CCP's key purpose is management of a default situation, and we fear that in this compromise, MEPs are setting CCPs up to fail. [1]

At the very least, we urge that ESMA be given a role in examining limitations to the extent to which a CCP can be dependent on these types of collateral. In the absence of such a process, we believe that the EMIR Regulation could facilitate a 'race to the bottom' among CCPs as to types of collateral that can be accepted with disastrous systemic risk consequences.

2. **Scope**

We continue to 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;

[1] Note that CCPs *have* failed in the past: One of the first, the New York Gold Exchange Bank, failed in the aftermath of the defaults by two large gold speculators in the aftermath of Black Friday in September, 1869. More recently, the Caisse de Liquidation failed in 1974, the Kuala Lampur Commodity Clearinghouse failed in 1983, and the Hong Kong Futures Exchange Clearing Corporation failed in the aftermath of the Crash of 1987).

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

We also remark that European exchange groups are increasingly acquiring or building their own vertically-integrated CCPs (see the almost daily recent media coverage on consolidation and prospective consolidation in the post-trade business). Thus, the vertical siloes that regulators agree (hence the Code of Conduct adopted under the last European Commission) represent an unhealthily anti-competitive characteristic of the EU post-trade landscape (maintaining fragmentation and leading to higher costs of clearing in Europe than apparent in competing jurisdictions) are likely to become more prevalent. It is a pity, therefore, to miss an opportunity to address this issue.

3. Intra-group transactions

We welcome the ECON Committee's recognition that a clearing requirement for intra-group transactions is not appropriate. However we believe that there is a case for exempting intra-group transactions between group entities located in the EU and in equivalent jurisdictions from bilateral collateralisation requirements in addition to an exemption from the clearing obligation.

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.

4. Segregation and Portability at CCPs

The ECON Committee report requires clearing members to distinguish in accounts with CCPs the positions of each client unless the clients "opt-out" of this by written request. This encouragement of full segregation does require the CCP to facilitate a choice for clients. We believe that full segregation should be offered as an option to clients by clearing members, with this option facilitated by the CCP.

The ECON Committee report also requires CCPs and clearing members to publicly disclose the levels of protection and the costs associated with the different levels of segregation they provide. The disclosure of protections should include a description of the main legal implications of the various levels of segregation offered including information on the relevant jurisdictions'

applicable insolvency law. The CCP is also required to require clearing members to inform their clients of these risks and costs.

It is unclear why a clearing member should be compelled by the CCP to inform their client of the CCP costs when the CCP itself is made to disclose this information publicly. It is also unclear why a clearing member should publicly disclose the commercial terms of a private service with a customer. Furthermore, these disclosure requirements are vague: it is not clear what is included in the 'costs associated with the different levels of segregation' (direct administrative costs or indirect costs (e.g. increased segregation means that, in a default, a CCP cannot take margin out of the omnibus client account so there are costs associated with addressing that shortfall)).

As mentioned, we also believe that there needs to be some consideration of the segregation rules that should apply when clearing takes place via a chain of intermediaries (in direct clearing).

5. Extra-territoriality including concerning 3rd country CCPs (article 23)

The G20 commitments included a commitment to '*fight protectionism'* and to *'take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage.*' We believe that officials and legislators in different jurisdictions should discuss and try to avoid conflictual or incoherent extra-territorial legislation wherever possible.

There are several instances of harmful extra-territorial legislation in the EMIR proposal and in the ECON report:

- In Article 23 (3rd countries) it is not clear to us that all decision-makers have focused on the fact that this provision applies to all 3rd country CCPs – clearing any type of financial instrument (e.g. shares, bonds, futures etc) – which clear the assets of 3rd country regulated firms, including assets held by EU investment managers. All of these CCPs will have to seek recognition or benefit from an exemption from authorisation requirements, in order for these firms and investment managers to be able to continue to use them. In a situation where only one CCP (e.g. in a vertically integrated exchange/CCP structure) clears a certain product, this will mean that these EU firms will be shut out of the market for that product, causing disruption to the investment strategies of EU investment managers (and affecting EU savers) and undermining the competitiveness of EU firms. We have serious doubts about the ability of the EU authorities to manage the recognition or exemptive process for all of these hundreds of CCPs in a timely way, meaning that the practical consequences outlined above will become a reality.

- In Article 3, we believe it is inappropriate to require third country-established counterparties dealing with EU counterparties in derivatives business to be licensed under MIFID. This requirement would basically shut EU licensed firms out of global

markets, as counterparties in other jurisdictions would prefer to deal with market participants outside Europe in order to avoid such a requirement.

We also note that the ECON Committee report – like the EMIR proposal – does not sufficiently clarify the territorial scope of the proposal. For example, will the Regulation require branches of EU-licensed entities operating in the US to submit to EMIR as well as Dodd-Frank rules? This will put EU firms at a major competitive disadvantage without reducing risk (given the legislation that will be in place in the US).

6. Access to a CCP (Article 5)

The ECON Committee text states that access to a CCP could be refused if venues do not comply with the '*operational, technical and legal requirements by the CCPs'*. We believe that these requirements should be fair and should not artificially create barriers to competition between infrastructures.

7. Straight-Through-Processing

While we welcome the references to the need for 'international communications procedures and standards for messaging and reference data', we believe that the caveat that international open industry standards should be used only insofar as they do not '*adversely affect risk mitigation*' should not be abused to artificially create barriers to competition between infrastructures.

8. Multilateral Development Banks

Article 1 of the ECON Committee text amends the proposal to state that 'the clearing obligation' shall not apply to a range of counterparties, including multilateral development banks (MDBs).

We believe that MDBs (such as the European Bank for Reconstruction and Development and the World Bank) should not have to clear contracts, nor post margin on derivative contracts (we believe that this is justified by the risk profile of these entities, the reasons they use derivative contracts and the costs that these requirements would imply – ultimately to be paid by the developing economies they aid). As such we believe that the wording of this exemption should be amended.