

June 25, 2013

International Swaps and Derivatives Association, Inc. (ISDA)

One Bishops Square

London E1 6AD

United Kingdom

www.isda.org

Register ID: 466-43241096-93

ISDA response letter to the European Commission's Green Paper on long-term financing of the European economy

General Comments

On behalf of its members, the International Swaps and Derivatives Association (ISDA) welcomes the opportunity to comment on the European Commission's Green Paper on long-term financing of the European Economy.

ISDA fully agrees with the European Commission (EC) that the long-term financing of the economy depends in large part on the ability of the financial system to channel the savings of governments, corporates and households efficiently through open and competitive markets.

We also agree that this need for new channels is caused in large part by the expected disintermediation of long-term financing due to the implementation of new capital requirement regimes for credit institutions. We therefore welcome the Commission's ambition to foster an environment enhancing Europe's overall attractiveness as an investment destination.

We support the list of factors identified by the Commission to enhance the long-term financing of the European economy:

- the capacity of financial institutions to channel long-term finance, efficiency and effectiveness of financial markets to offer long-term financing instruments;
- cross-cutting factors enabling long-term saving and financing and the ease of SMEs to access bank and non-bank financing.

We believe that the role of derivatives business as a key building block for economic growth should also be recognised, and we provide examples of their importance in our response. The use of derivatives to manage risk incurred through investment (by financial and non-financial companies alike) in tangible assets as listed by the Commission (energy, transport, communication infrastructures, industrial facilities etc) and intangible assets (education and research and development) is critical. The existence of a flexible, viable and sufficiently liquid derivatives business in which certain participants are willing to take on the risk that others wish to divest themselves of is a key ingredient in a robust investment climate.

We would remind the European Commission that ISDA, in its mission to foster safe and efficient derivatives markets to facilitate effective risk management, represents all market participants, including corporates and end-investors as well as credit institutions that are the motors of sustainable economic growth and of long-term financing.

In addition to the points listed in the green-paper, the Commission should, from our perspective, point out that:

- regulation should safeguard corporate access to effective risk management tools;
- reviewing the impact of existing legislation is critical in order to assess the possible unintended consequences of current texts;
- greater international alignment of market regulation is needed to prevent deglobalisation of capital flows.

The important role played by OTC derivatives in modern financing has been recognised by DG Competition in its Q&A published in February 2012 on the proposed merger between NYSE Euronext and Deutsche Börse:

“What is the role/importance of derivatives for the European economy?”

*Derivatives are contracts traded on financial markets that are used to transfer risk. **Derivatives are of key importance for the European economy. This is because they serve as insurance against price movements and reduce the volatility of companies' cash flows, which in turn results in more reliable forecasting, lower capital requirements, and higher capital productivity. Derivatives have in recent years developed into a main pillar of the international financial system and are an indispensable tool for risk management and investment purposes. Derivatives contribute to improve the operational, information, and allocation efficiency, thereby increasing the efficiency of financial markets. They help lower the cost of capital and enable firms to effectively invest and channel their resources, thereby making them an important driver of economic growth.”***

http://www.isda.org/uploadfiles/docs/20120201_EC_FAQ.pdf

While ISDA supports the development of a carefully calibrated clearing requirement for the counterparties and products most suitable for clearing, OTC derivative contracts that are not suitable for clearing also play a key role in the investment climate. Our recent paper on non-cleared OTC derivatives elaborates on this point: [Non-Cleared OTC Derivatives Paper](#).

This paper lists a number of examples on how OTC derivatives markets derivatives are essential to long-term financing and long-term investments:

- **swaptions** (option to enter into a swap) that play an important role in helping firms — large corporations, banks and financial institutions and asset managers — manage their interest rate, financing and other risks.
- **Cross-currency swaps** that are used: 1) by companies to achieve more favourable interest rates by issuing debt in alternative currencies; 2) by investors and pension funds to manage or eliminate foreign currency exposure from foreign assets that they purchase; 3) by pension funds, insurers and other liability-driven investment managers to manage the currency risk in their asset portfolios. In general foreign exchange is critical for external financing.

- **Interest rate options** that can be designed to cap, put a floor under or set parameters for floating rate payments.
- **Inflation swaps** that are used by pension funds as well as utilities and insurance where assets or liabilities are tied to price indices. In such situations, a fund or company may use an inflation swap to help ensure that its assets and liabilities are matched and that inflation does not adversely affect its ability to meet its obligations.
- **Credit derivatives** (CDS) that enable credit protection purchasers to hedge the credit risk of, or, alternatively create a credit risk position on a particular entity. CDS are very important risk management tools. They are often used to hedge the risk of default that may arise in holding debt (either bonds or loans). A company may hedge its exposure to a borrower to protect it should the borrower default.
- **Commodity and energy derivatives** that are tailored to meet the specific needs of an end-user (e.g. an airline using jet fuel, an aluminium producer consuming power).

We have limited ourselves to responding to only a subset of the most relevant questions in this response.

We hope you find our input useful, and are at the disposal of the European Commission if it would like to discuss these issues with us.

Contact: bgourisse@isda.org

QUESTIONS

1) Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

ISDA strongly supports the primary objective of channelling various sources of savings into long-term and productive investments.

ISDA also acknowledges that the financing of infrastructures, whatever the industrial sector, implies a long construction/investment period and requires sound long-term financing tools, as the cash flows generating return on investment will materialise only after a long period of time.

When investors (governments and sovereign funds, institutional investors such as insurers, pension funds or asset managers, and retail investors) commit their capital, they therefore critically need three features:

- Well calibrated prudential and accounting treatment of capital put into the project;
- Incentive for long-term investments through appropriate tax treatment;
- Access to effective risk management tools, i.e. appropriate and tailored derivatives to hedge risks arising from these investments (e.g. market, operational and credit/counterparty risk).

In this context, ISDA observes that while the EC accurately highlights the need for certainty about regulation and tax treatment of investments, the role of derivatives should be recognised.

3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

ISDA agrees with the EC that new capital requirements rules will imply some disintermediation of long-term financing.

Even if banks have a reduced role in providing long-term loans, they should continue to play a critical role in channelling savings of both institutional investors and retail investors, as distributors of a whole range of existing financial products: collective investment schemes, long-term deposits, securities.

ISDA notes that given the new capital requirements under CRD IV, even this role will come under pressure, and credit institutions may have different policies regarding the distribution of financial products.

In the OTC derivatives business, dealer banks also play a critical role in providing non-financial corporates and financial investors with liquidity, providing them with the risk management tools that underpin their investment decisions.

One key concern of ISDA in this context relates to the imposition of initial margin as a mandatory requirement for non-cleared trades, as is currently being considered by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO),

which would have significant adverse impact on financial market activity, liquidity and end-user risk management and consequently on the mitigation of systemic risk.

ISDA has long supported robust variation margin requirements, particularly for systemically important firms, but maintains a number of concerns regarding the initial margin proposal:

- The outright quantum of margin required even in “normal” market conditions is very significant. Increased initial margin requirements - with much of this margin possibly subjected to high levels of segregation - in stressed conditions will result in greatly increased demand for new funds at the worst possible time for market participants. This would be a major drain on liquidity, and damage the long-term investment environment.
- The initial margin requirements could force market participants to forego the use of non-cleared OTC derivatives and either: (1) choose less effective means of hedging, or (2) leave the underlying risks unhedged, or (3) decide not to undertake the underlying economic activity in the first instance due to increased risk that cannot be effectively hedged.
- The initial margin requirements should not be used as a tool to meet objectives of policymakers to reduce risk by encouraging more clearing. No incentive is sufficient to safely clear non-clearable derivatives, and an incentive that seeks to encourage such practices is inconsistent with efforts to create robust and resilient clearinghouses.

For further details, please see the ISDA letter on [Margin Requirements for Non-Cleared Derivatives](#) that was sent to the Basel Committee, IOSCO and the BIS in April 2013.

Questions 6 and 7

6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

As stated above, institutional investors that commit their capital for long-term financing need well calibrated prudential and accounting treatment of capital (*see responses to questions 20 and 24*), incentives through appropriate tax treatment (*see response to questions 17 and 19*) and effective risk management tools, i.e. OTC derivatives (*see introduction*).

In-depth analysis of the cumulative effect of EU legislation (Solvency II, AIFMD, UCITS, CRD IV and MiFID, EMIR) on both derivatives and debt instruments is critical here. For derivatives specifically, the cumulative effect of clearing requirements under EMIR, trading requirements under MiFID and initial margin may be significantly negative in terms of liquidity, efficiency, and accessibility of derivatives addressing specific investment risks for users.

We would also add that the application of an FTT would be a strong disincentive for investment in debt capital markets and for the use of derivatives underpinning debt financing.

10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicity of aggregate long-term investment and how significant are they? How could any impact be best addressed?

As stated above, the ability to properly hedge risks implied by long-term financing (for Corporates) and long-term investments (for Institutional investors and MDBs), depends to some extent on safe, efficient and accessible derivatives markets enabling derivatives users to find tailored hedging tools.

We believe that a number of recent and current legislative initiatives may prove to have undermined liquidity (and hence, liquidity) of derivatives business e.g.

- The **EU Short-Selling Regulation**, will, we believe undermine (rather than aid, as supporters of the legislation believe), liquidity in many financial markets, including sovereign debt, through the ban on 'naked' short sales through sovereign CDS.
- The Financial Transaction Tax (**FTT**) – which we believe could act as a significant disincentive to investment, by taxing each stage of the investment chain, with major impacts, ultimately, for the end investor (who may simply decide not to invest).
- **MIFID/MIFIR** – where inappropriate transparency and trade execution requirements could undermine market liquidity irreparably.
- **EMIR** – where demand for margin created by broad application of clearing and collateralisation requirements may act as a major drain on money supply (the final rules on bilateral collateralisation of non-cleared trades will be decided following conclusion of international level work on this issue), or at the very least, discourage entry into derivatives contracts, with consequences for investment appetite, and for underlying risk levels in the EU economy. One obvious example herein is the possibility of application of clearing and margin requirements entered into by EU counterparties transacting with non-EU counterparties in Foreign Exchange derivatives (as a means of hedging currency risk), which is potential impediment on foreign direct investment in Europe.

For both of the last two issues, we feel that extraterritoriality continues to give rise to concerns, (potentially) undermining both foreign direct investment in Europe, and the economic health of EU firms acting at global level.

In some instances, extraterritorial and reciprocal requirements in EU legislation have been inserted in response to similar requirements imposed at US level. Such actions can result in unintended consequences, and we would underline a number of nuances herein:

- Creating such barriers to investment in Europe sends out a negative signal to jurisdictions other than the United States about Europe not being 'open for business' (for example, the challenges created by EMIR requirements for clearing houses in jurisdictions outside the EU to seek recognition under EMIR, with all of the requirements associated with that recognition that are super-equivalent to CPSS-IOSCO standards) whatever the intention.
- Regulators in the US have greater flexibility to suspend regulatory requirements in US law – at least temporarily (e.g. through 'No Action Letters') – than is given to EU regulators (when the negative consequences of such requirements become apparent).
- Such extraterritorial requirements are actually contrary to the G20 commitment 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 therefore urge the EC to adopt a cautious approach when considering insertion of extraterritorial clauses in legislation, and to use international regulatory dialogue forums as a means not only to resolve such differences but also to prevent them.

We would also urge the European Commission to undertake an external, independent review of the cumulative impacts of financial regulation adopted in recent years – in particular with a view to assessing the impact on long-term investment in Europe – and to objectively adjust and calibrate the current and future regulatory framework as a function of the findings of such a review.

Questions 17 and 19

17) What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

19) Would deeper tax coordination in the EU support the financing of long-term investment?

ISDA supports the efforts of the European Commission to harmonise the selling practices of financial products across Europe through MiFID II (for the selling of financial products and the definition of investment advice) and PRIIPs (for packaged retail investment products and information that must be provided to the investor) but regrets that no assessment of different tax treatments of investments in financial products has been done. Such an assessment would have shown: 1) that taxation of financial products varies significantly across Europe; 2) taxation is one of the most powerful incentive for investors, in particular for retail investors.

More importantly, ISDA strongly believes that the legislative proposal for the implementation of a FTT in 11 countries of the European Union will be detrimental to the objective of enhancing long-term savings and financing. The current proposal will disincentivise investments and increase the cost of long-term financing as well as the cost of risk management.

In this respect, we note that the European Central Bank Governing Council member Christian Noyer recently stressed, about the FTT that *"The analyses we've done show that the project, as it has been prepared by the Commission, will first of all raise nothing at all, there'll be no revenue"* and that *"the immediate effect will be either to destroy financial sectors such as the repurchase agreement market, or to create conditions in which the cost of borrowing in the real economy will increase for everyone."*

As far as derivatives are concerned, the impact of this FTT would be significant because the costs will be borne by end-users. In the case most derivatives, the direct cost will be a tax that is a significant multiple of the bid-offer spread i.e., a much *higher* rate of tax in practice than on securities (depending on the type of product, this increase could be of a magnitude of up to 18 times¹). On its own, this constitutes a serious disincentive to use hedging tools. But the additional, indirect costs may be even greater, viz, the tax on a) market makers hedging the customer transaction (the

¹ Let's consider for instance a typical Foreign Exchange Swap such as the EUR/USD 1 week cross-currency swap with a notional of €25 million. In normal market conditions the end-user would pay €279 (as represented by the bid/offer spread). Under the FTT proposal, he would pay an additional €2,500 (0.01% of notional) to the dealer and an additional €2,500 to the counterparty if it is a financial institution (€0 if the counterparty is exempt, e.g. corporates). That would result in a total cost of €2,779 or 5,279, in other words a cost of 10 to 18 times the bid/offer spread.

'cascade effect') and b) the exchange of collateral (to mitigate counterparty credit exposure), where securities are used.

20) To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

The Green Paper cites research that highlights equity valuations can be more volatile than bonds. This is to be expected with respect to the volatility which relates to the risk of non payment, since equity is more junior to debt in the repayment hierarchy in the event of liquidation and therefore carries greater risk of non payment. Also, equity holders' returns are generally paid at the discretion of the company whereas debt is contractual in nature. The higher risk that equity holders therefore face compared to bond holders is compensated for by a higher return. However, debt instruments can demonstrate volatile valuations too where they carry a fixed (including zero) rate of interest, especially if they are long dated.

If investors have chosen to reduce their equities exposure due to equities' greater risk of non payment compared to debt, this is primarily an investment decision based on how well the characteristics of the different instruments match investors' objectives rather than a response to the accounting required for such investments. However, there might be situations where an accounting misrepresentation of the performance underlying financial transactions would impact the behaviour of the business and of investors. For instance, under the forthcoming IFRS9, the prohibition to recycle realised gains and losses into the profit and loss for equities accounted at fair value through other comprehensive income may be a disincentive to invest in such instruments.

It is worth noting that for many equities the calculation of fair value, whilst based on generally accepted valuation techniques, can be a judgmental exercise. This is particularly the case for private equity investments and other equities which are either unquoted, early stage investments and for which there is no comparative market information available. This gives rise to practical difficulties in arriving at a reliable fair value.

An alternative accounting treatment to fair value would be to hold such assets at cost less impairment. This is likely to provide useful information on the performance of the company in selecting and managing shareholders' investment and would more faithfully represent the realised gains and losses on long term investments. The track record of such gains and losses is indeed a key indicator of the expected performance of their investments aiming to create incentives to make long term investment decisions. In addition, management can supplement the performance statements with suitable disclosures regarding the fair values of the investments.

IAS 39 is the accounting standard which currently applies to listed European companies long term debt and equity holdings. Generally, except for those which are held for trading purposes, it requires them to be carried on balance sheet at fair value with gains and losses recorded outside profit and loss within a separate component of equity. Interest and dividend income is recognised in profit and loss. If the investment becomes impaired, the loss is recognised directly in profit and loss; otherwise the residual fair value change deferred to equity is released on disposal or maturity of the instrument.

IFRS 9 *Financial instruments*, which is intended to replace IAS 39, is expected to be effective in Europe in 2016 or 2017 once endorsed by the European Union. We agree with the fundamental measurement principles of IFRS 9, that financial reporting should reflect an entity's performance and business model. Under IFRS 9 long term debt investment is permitted to be held at cost – a non-volatile measure – provided the debt is plain vanilla and held in order to earn an interest based return. Relatively minor deviations from this fact pattern will result in the entire investment being held at fair value with gains and losses being included in profit or loss.

We consider that the accounting required in future by IFRS 9 should not define the amortised cost category too narrowly and should maintain, as under IAS 39, the recycling principle when gains and losses are realised from disposals of financial instruments. This would provide appropriate and decision useful information in the financial statements.

It is important to specifically note the accounting required for derivatives. These instruments may be used to reduce uncertainty and foster investments especially for debt / equity extended for a term greater than one year. Derivatives are used by companies to segregate categories of investment risk that may appeal to different investment strategies and different types of investors. In this way, derivatives help to reduce uncertainty and foster long term finance. It is appropriate that such instruments are reported at fair value. However IFRS requires the gross presentation of derivatives transacted under master netting arrangements, whereas US GAAP permits a net presentation. We consider a net presentation best reflects the actual risk and economic exposure of a company to derivatives and a gross presentation may appear to overstate the risk associated with such instruments. Gross presentation may increase the price of derivatives (in comparison with net presentation) and may have a negative impact in long-term finance in Europe by increasing the cost of capital.

24) To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

We favour integrated reporting where this serves to foster transparency and reduce duplication, and welcome its potential role in integrating the strategy of businesses with their long-term goals. We believe that it can be achieved without creating any additional requirements.

We consider that a robust framework already exists, and further requirements will soon be published, for the disclosure of non-financial information in the UK in the form of the requirements for a Business Review. This combined with the SEC requirements that already apply to companies that are US registrants, result in management reports that are comprehensive and include a wealth of information about strategic objectives and how the entity is delivering on its longer term goals. The EU should consider any additions to this framework in terms of cost benefit and also adding to the overall length (and hence transparency) of financial reports. We believe that the further consolidation of reporting requirements - with the aim of providing information to investors in a clear and consistent manner – would help informed decision-making

The UK guidance mandates the disclosure of key performance indicators, but leaves the choice of such indicators to the management of the company to enable them to select the indicators that are most relevant to understanding the companies' strategy and performance. We believe that this is appropriate and that such metrics should not be mandated.

We observe that the overall trend is towards, not away from, quarterly reporting for larger companies (especially those with a US listing) which is driven by investor demand more than actual requirements. Many UK companies with no such requirement provide investors with quarterly information that is becoming much more comprehensive. It is certainly possible therefore that quarterly reporting will be a permanent feature of European corporate reporting.

25) Is there a need to develop specific long-term benchmarks?

The key benchmarks which companies provide and investors monitor vary by industry but are generally well established. For example with regard to banks they include:

- return on equity, preferably adjusted to remove one-off items and thereby present a representative trend over time of business performance,
- cost income ratio, also adjusted as described above,
- Core Tier 1 ratio, under Basel 2.5 and pro forma calculation under Basel 3,
- Net Tangible asset value,
- Track record of realised gains and losses for long-term investments.

ISDA considers it is important for benchmarks to be able to evolve over time and reflect changing market conditions and investors' information needs, which sometimes change quickly. For banks for example, the current economic environment has resulted in greater interest in benchmarks such as the cost income ratio and capital ratios which are widely reported and commented upon. We are concerned that mandatory benchmarks would not be suitably responsive to investors' changing needs.

These and other benchmarks are calculated by reference to a point in time, e.g. balance sheet date, or a reporting period such as a quarter, half-year or full-year. Such widely used benchmarks tend not to extend over longer periods of time such as two or five years. However we consider the value of benchmarks to be greatest where they are used to identify or illustrate a performance trend over time or to highlight a risk and how the risk is being managed. This can provide an indication on how the business has developed and provides an indication of longer term performance and risk management. We therefore do not consider that any specific steps should be taken at this stage to develop additional long-term performance benchmarks.