ISDA Safe, Efficient Markets

2 July 2014

ISDA comments – EU proposal on Structural Reform of the EU Banking Sector

1. Introduction

ISDA[1] welcomes the opportunity to comment on the European Commission proposal for a Regulation on **Structural measures improving the resilience of EU credit institutions. ISDA largely limits its comments herein to provisions of the proposal of most relevance to OTC derivatives business**. Although the legislative proposals address many other important issues, on occasion we defer to other trade associations with a broader or other specific focus.

ISDA hopes that its comments help to ensure adoption of legislation on Bank Structure which promotes a safe and efficient EU banking sector, conducive to the sustainable financing of the EU economy.

2. Executive Summary

- ISDA believes that restriction of 'Core Credit Institutions'[2] (CCIs) to use of cleared derivatives only for their own hedging purposes will damage the European banking sector and the wider European economy, and is inconsistent with other EU legislation.
  - It forces CCIs to either (a) leave specific commercial risks un-hedged; and/or (b) incur significantly higher costs, with implications for financing of the wider European economy; or (c) not partake in specific financing activities of value to the broader economy. For example, it will be more costly, and/or riskier for banks to offer fixed rate mortgages with an option for early repayment – and more costly for consumers to borrow at fixed rate.
  - It also makes it harder for EU banking groups to operate on a Europe-wide, multi-currency basis, with Eurozone-established CCIs restricted to use only of cleared FX derivatives to hedge currency risk associated with capital movements and investments in non-Eurozone countries in Central and Eastern Europe, Scandinavia, the UK (as well as outside Europe).
  - The EMIR Regulation (2012/648/EC) recognises that it is not appropriate for some derivative contracts to be cleared, for a variety of reasons, but that alternative risk mitigation techniques can instead be deployed, including the exchange of collateral on a bilateral basis. The European Supervisory Authorities are now finalising EU implementation of standards agreed at international level in this regard, with compliance by EU firms to begin by end-2015. There is no justification for denying CCIs the ability to use non-clearable derivatives if they are most appropriate for their risk management needs, as EMIR acknowledges. Such a restriction in use of hedging instruments that can be customised to clients' hedging needs actually increases risk in the 'real economy'.
- Similarly, there is no justification for preventing banks from being able deal in non-cleared derivatives with clients when seeking to meet their risk management needs. Furthermore, the proposal takes an overly-restrictive approach to the derivatives asset classes that may be covered by CCIs in providing hedging solutions to clients. Inflation swaps, for example – used by e.g. pension funds and utilities to hedge inflation risk at either end of the inflation risk market – could not be accessed by such clients if dealing with a CCI, as they are not cleared by

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 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. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

[2] Article 5.16

CCPs at present. This approach is inconsistent with relevant EMIR RTS, which recognise that legitimate hedges include a much wider range of cleared and non-cleared products, including equity derivatives and inflation derivatives, and recognise portfolio hedging.

- The metrics for measuring counterparty and market risk in core banks' derivatives trading activity in the proposal are inappropriate, contradicting Basel conclusions on Leverage and resulting in an inaccurate depiction of risk e.g. failing to account for netting and offsetting. These metrics would not actually measure risk (they would rather measure size). This is of concern, given that NCAs would assess banks against these non-risk based metrics before deciding if they should be required to cease certain trading activities.

- The restriction on credit risk mitigation in the proposal may create uncertainty in risk management and documentation of derivatives. It is not clear why the European Commission wishes to restrict credit risk mitigation techniques that are generally available under the CRD IV legislation to a limited set of CCIs only.

- ISDA is concerned that the proposal has diverged from the approach taken in all national initiatives addressing bank structure, necessitating major amendments in Member States where national regimes were recently introduced, often after lengthy consideration.

- The proposal as written does not align with any other structural reforms internationally and in combing prohibition with the separation of a potentially very wide range of trading activities, would appear to go considerably beyond any national legislation currently in place. This creates a risk of an uneven playing field between the EU regime and other jurisdictions, as well as adding considerably to the cumulative costs of structural reforms, the overall impact of which on financial markets are poorly understood.

- While stipulating that certain – if not all – hedging activities undertaken by clients (absent permissions from NCAs for CCIs to offer such services) would have to be pursued via trading entities of banking groups, such trading entities would not be able to hold deposits guaranteed by the Deposit Guarantee Schemes Directive – necessitating that such clients could not benefit from the 'one stop shop' they have previously benefited from in universal banks in Europe. Again this implies more cost and/or risk for clients.

- Lastly, we fear that these proposals create massive operational and legal demands associated with mass re-assignment of contracts within European banking groups, creating uncertainty and instability.

3. Detailed comments

a. Restrictions on CCIs to use of only cleared derivatives for own hedging activity (Article 11)

In limiting CCIs to use of cleared derivatives in certain asset classes in their hedging, the proposals create more risk for CCIs, undermine their ability to provide 'simple' banking services, hinder investment in Europe, and are inconsistent with the outcome of recent EU legislation governing risk management in derivatives business.

Article 11 of the proposal limits a CCI to using only certain types of derivatives for hedging (i.e. managing its capital, liquidity and funding needs). Only cleared interest rate, FX and credit derivatives can be used by CCIs. Such a limitation is significantly detrimental to the EU economy and its banking system, for the following reasons:

- **It increases risk for core banks, undermining their ability to provide 'simple' banking services on a cost-efficient basis:** Non-cleared OTC derivatives are valuable hedging tools and prohibiting their use undermines the ability of banks to manage risk in a way that may be more accurate for management of some risks than cleared derivatives.

  Example: *Swaptions, used by banks to hedge the risk associated with fixed rate mortgages with an option for early repayment (a product whose use the EC should be encouraging). Swaptions are not currently offered for clearing by CCPs. By depriving banks of their ability to hedge such products in the most risk-appropriate way, the proposal necessitates CCIs either not providing such products, or forcing them to use less suitable products, implying more cost for mortgage borrowers (associated with more risk for the CCI). The risk basis for such a requirement is questionable (see point on inconsistency with EMIR, below).*

- **It hinders free movement of capital within the EU**. The proposals as written may hinder movement of bank capital between the Eurozone and other currency areas (e.g., Euro and British pound) or between different non-Eurozone jurisdictions (e.g. between Scandinavian countries), as access to suitable and non-cleared FX risk-management tools (e.g., cross-currency swaps) may not be permissible (it is not clear that any FX products used by banks as part of normal hedging activities will be cleared under EMIR, but it certainly seems likely that some FX products used will not be cleared). This would constrain funding inside and outside the Eurozone. We understand, for example, that many non-Eurozone Central-Eastern European economies need Eurozone banks to meet capital funding shortfalls at local level – often via FX intragroup transactions between local subsidiaries and Eurozone parent entities.

- **The proposal is inconsistent with EMIR.** EMIR recognises that not all contracts are appropriate for mandatory central clearing, while setting out a framework through which contracts not suitable for clearing are subject to risk mitigation requirements of similar rigour (EMIR Article 11 states that 'procedures and arrangements must be in place to measure, monitor and mitigate operational risk and counterparty credit', including 'timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts' and 'an appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral'). Detailed rules in this regard are currently being drawn up by the European Supervisory Authorities[3], following conclusions reached at global level in September 2013 by the BCBS-IOSCO Working Group on Non-Cleared Margin[4]). Insisting that CCIs use cleared derivatives only, for hedging purposes, is not justified on risk grounds (the fact that EMIR recognises that some contracts are best risk managed centrally (and have to be cleared mandatorily if so), and others bilaterally, underlines that it is misplaced to try to incentivise clearing of contracts if they are fundamentally unsuitable).

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[3] See 'Consultation paper on draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11 (15) of Regulation (EU) No 648/21012', dated 14 April 2014

[4] See BCBS-IOSCO 'Margin requirements for non-centrally cleared derivatives', September 2013

We further note that **Article 11.1 of the proposal reverses the usual burden of proof** by requiring that CCIs demonstrate that use of derivatives seeks to reduce or mitigate specific risks[5]. This is a disproportionate and ill-defined obligation, with no guidance given on steps to be followed by CCIs to comply with this obligation.

While Article 11 and Article 12 of the proposal state that the EC may be empowered to adopt Delegated Acts adding to the list of instruments that the CCIs may be able to enter into for own hedging and provision of hedging solutions purposes respectively, we believe that this is inadequate. It would create a cumbersome and inflexible method through which market participants would be able to hedge legitimate hedging tools, and would fail to meet their hedging needs in a timely basis.

Lastly, we point out that the limitation of CCIs to use of cleared derivatives only for hedging purposes goes significantly beyond the recommendations set out in the Liikanen Group report, which stated only that 'the use of derivatives for own asset and liability management purposes, as well as sales and purchases of assets to manage the assets in the liquidity portfolio, would also be permitted for deposit banks'. No distinction was made between cleared and non-cleared derivatives in terms of their being valuable hedging tools for CCIs.

b. Provision of risk management services to customers (Article 12)

The proposal restricts CCIs to acting as market makers for certain types of clients for cleared derivatives only and only in certain asset classes, limiting the ability of clients to hedge commercial risks. This undermines EU competitiveness. It is also unjustified in risk terms.

Article 12 of the proposal allows CCIs to act as dealers to certain types of customer (as a risk management service), in cleared derivatives only, and only in the following asset classes: Interest rate derivatives, foreign exchange derivatives, commodities derivatives, emission allowance derivatives, and credit derivatives.

- **Limitation to cleared derivatives only**: Again, we underline that non-cleared OTC derivatives are valuable hedging tools and prohibiting their use undermines the ability of clients to manage risk in a way that may be more accurate for management of some risks than is the case for cleared derivatives.

  Example: *Inflation swaps are used as hedges by both pension funds and utilities (with pension funds seeking to hedge commercial risk associated with high inflation and utilities seeking to hedge commercial risk associated with low inflation). Inflation swaps are typically not cleared – not because in of themselves they are riskier than many cleared derivatives, but because there is a relatively small number of banks who act as dealers in this market, and hence there is only a small number of banks who could help a CCP to manage a default should one arise at a CCP clearing these products. It is prudent not to clear inflation swaps under the current circumstances. One could argue that seeking to incentivise clearing of inflation swaps in this context actually increases risk to the wider economy. As it is, preventing such clients from using inflation swaps (or making them more costly because these clients would have to be deal with the banking group's lower rated trading entity) will increase risks and costs for these firms.*

We again underline our concern about the inconsistency between EMIR and this proposal, and note that the definition of a hedging contract under EMIR is not restricted to cleared derivatives.

Furthermore, we repeat that the Liikanen Group report did not limit CCIs to being allowed to act as counterparty to clients (for hedging trades) only in cleared derivatives.

- **Limitation to certain asset classes only:** Again, we believe that the limitation of CCIs to interest rate derivatives, foreign exchange derivatives, commodities derivatives, emission allowance derivatives, and credit derivatives for purpose of provision of hedging solutions to clients is unwarranted.

  Example: *Equity derivatives are used by clients to hedge employee benefit schemes, with clients incurring liabilities in relation to expected cash flow or delivery of shares. There is no objective basis for excluding these contracts from the scope of asset classes permitted for sale to clients by CCIs.*

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[5] *"That the CCI shall demonstrate to the competent supervisor that the hedging activity is designed to reduce, and demonstrably reduces or significantly mitigates, specific, identifiable risks of individual or aggregated positions of the core credit institution."*

To further underline our concerns about the inconsistency between EMIR and this proposal, we note that definition of a hedging contract under EMIR includes both equity derivatives and inflation swaps under relevant EMIR RTS. There seems no justification for taking a different approach in this proposal.

We note, and welcome the fact that the European Commission has extended the types of client that can be provided with hedging tools by CCIs, relative to those we understand to have been permitted in earlier drafts.

Nevertheless, Article 12 will actually increase risk and costs in the European single market, namely

- Leaving clients with a choice between higher costs and greater risks (for example, a financial institution selling fixed mortgages with an option for early repayment will either have to accept risk associated with early repayment (and hence uncertainty regarding cash flow) or face higher hedging costs associated with having to deal with a low rated trading entity (rather than a CCI). This discourages this 'simple' and valuable financial activity (fixed rate mortgage borrowing).

- Making it harder for clients to qualify for hedge accounting, as it will be more difficult for cleared contracts to correlate sufficiently closely with the risks clients are trying to hedge. This will cause losses.

- Encouraging clients to interact with the shadow banking sector – rather than the more regulated and less volatile (in terms of it being a source of funding) banking sector.

Please see the comments in the previous section on the possibility for the EC to be empowered to adopt Delegated Acts adding to the list of hedging instruments that CCIs can provide to their clients.

Lastly, we suggest that it is not appropriate to refer to 'selling' of derivatives in Article 12 (referring to dealers acting as counterparty to hedging instruments with clients).

c. Metrics for reviewing counterparty and market risk through derivatives, are unrepresentative of risk (Article 9)

The metrics used in the proposal for measuring counterparty and market risk in core banks' derivatives trading activity **contradict Basel conclusions on leverage, and are in fact inaccurate** e.g. failing to take account of netting and offsetting.

Article 9 of the proposal addresses metrics against which NCAs may review counterparty and market risk by non-parent or non-sub EU CCIs, EU parents in a group including EU CCIs, or EU branches of 3rd country Credit Institutions. Under Article 9 and 10 of the proposal, the EC would adopt delegated acts specifying what these metrics are and how they will be measured, based on draft RTS by the EBA. Should these entities exceed these metrics, their NCA may require them to stop trading activities, based on the fact that they pose a threat to the financial stability of the core credit institution or to the Union financial system as a whole.

The metrics referred to in the draft for measuring fair value of derivatives assets (in Article 9) present a very inflated picture of the derivatives assets book, failing to adequately assess the liability side, and netting, offsetting, diversification, and portfolio effects. Counterparty credit risk is predominantly a function of the potential future exposure ('PFE') of derivatives assets positions, and PFE is much more than just a function of derivatives' fair value (depending, e.g., on maturity of positions, and volatility of market risk factors). The degree to which risk mitigation is reflected in the measure is even more important, i.e., ensuring that exchange of initial margin relating to a derivatives position is considered as reducing exposure and counterparty credit risk, instead of increasing the position's calculated exposure (as proposed in the revised Basel Leverage Ratio Framework).

It is unclear how the proposed metric for measuring the relative importance of market risk can achieve the stated goal. To reflect risk accurately, emphasis should be put on carefully examining (1) absolute value and volatility; (2) how the metric reacts to prudent risk management in a segregated bank structure world; (3) how the metric reacts to exogenous factors, e.g., market volatilities, how pro-cyclically damaging the metric might be; and (4) how unhedged and directional the position.

d. Restriction of credit risk mitigation techniques (Article 16)

The Assignation of powers to the EC to restrict credit mitigation techniques should not create legal uncertainty in derivative contracts.

We note that Article 16 assigns the European Commission (via Delegated Acts) with a power to restrict the recognition of credit risk mitigation techniques (CRMTs) when the separation of trading activities occurs (Chapter III).

ISDA is concerned to ensure that this limitation does not in any way undermine netting of exposures between derivatives counterparties, nor create unintended consequences for the documentation of derivatives contracts. The December 2013 bi-annual statistics of the BIS on OTC derivatives show that bilateral netting reduces gross credit exposure to just 0.43% of the gross notional volume figure, and just 16.27% of the gross market value (replacement cost) of OTC derivatives business.[6]

ISDA also observes that it is not clear why the European Commission wishes to restrict credit risk mitigation techniques that are generally available under the CRD IV legislation to a limited set of CCIs only.

e. International divergence and level playing-field concerns

The proposal is misaligned with bank structure regimes in EU Member States as well as in non-EU jurisdictions, which could lead to a non-level playing-field and unintended consequences for financial markets.

These proposals differ greatly from Bank Structure regimes which already exist in several EU jurisdictions and cover the majority of large EU investment banks. As drafted, the proposals create significant uncertainty over the ability of EU banks to effectively provide viable market-making and derivatives services to their clients.

The proposals also diverge from the Bank Structure regime in third-country jurisdictions. This raises concerns both for the potential creation of a non-level playing field in the global market for investment banking services, as well as for the ability to achieve third-country equivalence recognition. It is unclear to what extent entities in different jurisdictions would be able to make use of equivalence provisions in the Regulation. For example, there are differences in the approach to structural separation in the two regimes, and there is no reciprocity provision in the US regime (unlike in the European regime (Article 27(1)(b).

The EU proposal represents another regional variant on a global challenge, differing (as described) from the approach in the US. This divergence will likely encourage another variation of approach from Asian jurisdictions. The **proposals don't address coherence with international standards on bank structure** (the US and EU regimes front run IMF work on this issue). Fragmentation and resultant bank structural inefficiencies will damage the interests of the 'real economy'.

Lastly, we underline that there is a lack of clarity in the text regarding the treatment of EU branches of non-EU banks under Chapter III (Separation of certain trading activities). While the ‘duty to review activities’ in Article 9(1)(c) applies to EU branches of non-EU credit institutions, the separation provisions in Article 10 only refer to the ‘core credit institutions’. The deposit-taking qualification does not therefore appear to apply to EU branches of credit institutions established in non-EU jurisdictions, creating an apparent inconsistency of treatment of EU entities and non-EU entities. Further clarification may be necessary on this point.

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[6] http://www.bis.org/statistics/dt1920a.pdf

f. Inability for trading entities to hold deposits for clients (cross-reference to Deposit Guarantee Schemes Regulation)

Article 8.1a of the proposal prohibits the trading entity in a banking group from taking deposits that are covered under the Deposits Guarantee Scheme Directive (DGS). Bank customers - particularly non-financials - could therefore find themselves particularly constrained. While it would make sense to do as much hedging as possible via the CCI (as that is where its deposits would be located), it could, as mentioned, be restricted in the types of hedging activity it could enter into.

This limitation again implies significant extra risk for clients, or at best, significant extra costs associated with limited hedging options.

g. Operational risk and market uncertainty

Transfer of contracts (from the CCI to the trading entity), will create **operational risk and increase market uncertainty.**

The legal separation mentioned in Art. 13 *(trading activities to be separated may be carried out only by a group entity that is legally, economically and operationally separate ('trading entity') from the core credit institution')* would create uncertainty, market disruption and undermine hedging by financial institutions and non-financial institutions alike. Due to this structural separation requirement, financial institutions with open contracts with clients would be required to transfer ('novate') open derivative contracts to trading entities within the group.

Unintended consequences of this requirement would include:

- **Operational risk.** These transfers would represent a major logistical exercise, requiring every customer of every affected firm to give formal consent to the change. This requirement would affect Europe's largest financial institutions and their clients in a short window of time.

- **More market uncertainty.** The trading entity within the banking group may well be significantly less well rated than the pre-separation bank. Clients now facing a new counterparty for the purpose of this contract may well be of a mind to revisit the pricing of the contract in question for this reason. Again, there is a concern that this could result in a widespread renegotiation of derivative contracts within a short timeframe, with significant systemic and possibly de-stabilising effects. At the same time, restructured European banks could also be renegotiating derivatives contracts previously agreed among themselves, exacerbating the situation.

- **Risk management disruption**. Counterparties to contracts transferred to trading entities of restructured banking groups may well choose to terminate these contracts (under the terms of these contracts) if they are not satisfied with the terms on which these contracts can be transferred (e.g. in terms of pricing). If contracts are terminated (see above), important hedges for one or either of the counterparties would no longer be at their disposal, implying greater risk and a disincentive to further investment.

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