ISDA Safe, Efficient Markets

FIA EUROPE

ISDA/FIA Europe Response to EC Green Paper: Building a Capital Markets Union

Question 21: Are there additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest?

Investment in capital markets is predicated on the ability of market participants to manage, recycle or transform risk. Significant uncertainty associated with either investing in financial instruments or issuing new debt/equity will disincentivise both investors and borrowers alike from participating in capital markets. ISDA and FIA Europe believe this is why derivatives play a crucial role in the development of capital markets. Derivatives are risk-management tools that reduce uncertainty, allow market participants to effectively recycle risk, and perform one of the main functions of capital markets.

It is essential to create a market where investors such as pension funds, insurers and other asset managers (the suppliers of funds) can be confident in their ability to hedge associated investment risks of capital markets instruments through the use of derivatives. Therefore, it is crucial that the implementation of derivatives reforms in Europe governing clearing, margining and trading of derivatives – which by and large go a long way to reducing systemic risk, and bring more transparency to derivatives markets – are calibrated to a standard that also facilitates efficient functioning of derivatives markets, and don't introduce new risks that damage liquidity.

ISDA and FIA Europe have welcomed efforts by regulators to increase the safety and soundness of derivatives markets post the financial crisis, and are supportive of current regulatory reform initiatives. However, we believe that in tandem with making derivatives markets safer, new rules should also ensure that:

- the continued availability and efficiency of derivatives markets is fostered to create certainty in the economy;
- non-cleared derivatives are treated appropriately and remain available to end users so as to provide corporates, insurance companies, pension funds, sovereigns, smaller financial institutions and others the best means to hedge their funding, operational and commercial risks; and
- the global nature of derivatives markets is preserved – end users' ability to manage risks appropriately is enhanced by a more liquid, connected market where risk is easier and more cost effective to recycle.

In particular, we believe that both the competitiveness and attractiveness of the EU as a place to invest will be greatly enhanced if the following is heeded:

Eliminate the uncertainty relating to frontloading measures: The current proposals for the implementation of the clearing mandates under the European Market Infrastructure Regulation (EMIR) to a large extent will reduce systemic risks and enhance the liquidity of the market, and will form a cornerstone of a robust derivatives market. But it is crucial to ensure that going forward the clearing obligation only applies to OTC derivatives contracts where those contracts are suitable for clearing, and that the mandates be implemented so as to minimize market disruption, ensure the

continuity of markets participants' hedging programmes, and foster an environment where derivatives users are encouraged to reduce bilateral risk. In their current form, there are some areas, in particular the application of the frontloading requirement, where the rules can be tweaked so as to smooth the transition to central clearing and reduce systemic risks.

Non-cleared margin rules should be globally consistent and appropriate: While the bulk of the proposals governing the margining of non-cleared derivative, which are designed to eliminate counterparty credit risk, are agreeable, it needs to be ensured that the rule-set is workable, globally coherent - especially in terms of product scope and obligations - and implemented according to a pragmatic timetable. The reforms should also be calibrated so as to safeguard the availability of non-cleared derivatives, which remain a crucial instrument in the risk management toolkit of companies, insurers, pension funds, sovereigns and others. Many risks borne by these types of counterparties simply can't be managed with standardised, cleared derivatives. Moreover, many of these counterparties also lack both the operational capability and the funding resources to trade cleared derivatives. Therefore, without the ability to use non-cleared swaps, these participants may experience greater earnings volatility due to an inability to qualify for hedge accounting, or be unable to offset risks (credit, interest rate, inflation, longevity) associated with placement of debt, capital markets instrument portfolios, and pension or insurance liabilities.

Liquidity thresholds in trading rules should be calibrated appropriately: where new pre-and post-trade price transparency requirements will be introduced. We are in favour of greater transparency in derivatives, which we believe will promote further growth and improve liquidity, but the thresholds for determining whether derivatives should be traded on a trading venue and subject to pre- and post-trade transparency under MIFID/MIFIR should be appropriately calibrated. If derivatives which are not sufficiently liquid in practice are subjected to the trading obligation and transparency requirements, there is a real risk that the requirements could make it near impossible for market-makers to safely provide liquidity and hedge themselves, which in turn could result in a severe drop off in liquidity in Europe in those products.

Proposals for a financial transaction tax should be abandoned: The imposition of a financial transaction tax (FTT) would produce harmful effects to both the financial sector and the real economy. The initiative runs counter to the CMU because it will both increase fragmentation and inefficiency. It would first and foremost increase the cost of hedging for end-users, thus acting as a disincentive to manage risk. These increased costs would act as an obstacle to accessing financial markets, restrict liquidity, and ultimately hamper economic growth. It is crucial that cost-benefit analyses be conducted before proposing new regulations that may have harmful effects on the liquidity of the market

Inappropriate regulatory distinctions between cleared and non-cleared derivatives should be excised from bank structure and money market fund proposals: If the CMU is to be a success whereby both investors and borrowers continue to benefit from the certainty brought by derivatives markets, it is important that tailored, non-cleared derivatives and standardized, cleared derivatives are both fostered and be made available to those who need to manage risk. It is therefore crucial that European policymakers do not attempt to introduce a false regulatory distinction, nor nurture asymmetric treatment of cleared and non-cleared derivatives inappropriately in regulation – which is currently the case in both Bank Structure and Money-Market reform proposals. For example, under Bank Structure reform proposals core credit institutions may only use (to hedge balance sheet risk) and sell to client's clearing-eligible interest rate derivatives, foreign exchange derivatives, credit derivatives, emission allowances derivatives and commodity derivatives. This restriction of hedging tools to clearing eligible derivatives not only undermines banks' ability to provide 'simple' banking services on a cost-efficient basis, but also undermines the ability of clients to manage risk bilaterally, leading to an increase in risk and costs.

Given that regulators in Europe and at global level are close to finalisation of a robust collateral regime for non-cleared derivatives, there is no risk basis for such asymmetric treatment.

This issue of inappropriate regulatory distinctions has also arisen in the context of EMIR, under which non-EU exchange traded derivatives are considered 'OTC' in the absence of recognition of the non-EU venues on which they trade (in accordance with Article 19(6) MiFID). Ensuring that European businesses are able to make use of well-regulated and transparent futures products should be a focus of the CMU. As such, we believe it is crucial that European policymakers expedite the recognition of equivalent foreign trading venues to remove this unnecessary and erroneous regulatory distinction.

Equivalence decisions should be granted in a timely manner to avoid creating market uncertainty: A further requirement to the efficient functioning of OTC markets is that derivatives markets remain global in nature. A global market brings immense benefits in terms of enhanced liquidity, and the sheer breadth of avenues through which to recycle risk. In order for OTC derivatives markets to continue to bring efficient levels of liquidity at a reasonable cost, it is essential that derivatives markets continue to benefit from the scale of operating on a truly global basis.

Regulators in Europe are currently endeavouring to ensure the global nature of derivatives remains viable. ISDA and FIA Europe support these efforts, and encourage policy makers to deliver important third-country equivalence decisions in a timely manner to avoid creating market uncertainty as to whether those markets can continue to be accessed. We also support further cooperation with other regulators on a global and bilateral basis, so as to develop workable recognition regimes that take into account the specificities, and unique characteristics of different jurisdictions.

The leverage ratio should be amended to incentivise central clearing: It is important that capital levels are appropriate to the level of risk of a given financial activity, in order to ensure that potential exposures arising from such activities are properly aligned and calibrated with the capital supporting them. However, as it stands the current leverage ratio requirements in Europe are not appropriate for cleared client transactions as they ignore the risk mitigating impact of segregated margin. This acts as a significant disincentive to central clearing. Not only will bilateral counterparty credit risk increase but the rules will constrict the ability of market participants to manage risk, thus reducing liquidity in hedging instruments and working counter to the aims of the CMU. Therefore, the leverage ratio should be amended to recognise the exposure reducing effect of segregated margin.

Capital rules should align with CMU objectives: Policymakers should also be aware that at a global level, the Basel Committee on Banking Supervision plans to finalise an overhaul of the capital framework for market risk, which governs capital levels for banks' trading activities, by year end. However, if the framework is finalised as per the current timeframe, key areas of the framework will not have been adequately considered. Addressing these areas is critical because the potential increase in capital could impact both sovereign and corporate derivatives and debt markets, making financing more expensive, and in particular, hampering SME's looking to graduate from traditional bank loan funding to the public market. Therefore, it is important that the end-2015 deadline be extended so that key components of the framework can be assessed via another quantitative impact study. This would not impact the overall implementation timeline. If this does not happen, one consequence is a heightened risk of jurisdictions transposing the rules differently to compensate for the significant adverse impacts on local markets. Such an outcome would undermine the specific objectives of the Basel Committee to ensure a globally consistent and coherent capital framework. ISDA and FIA Europe believe it is crucial that capital regulations be globally consistent, in order to ensure a level playing field across jurisdictions and to avoid regulatory arbitrage.

Post-trade risk reduction services should not be disincentivised: The clearing rules as currently drafted will require new trades that result from systemically risk-reducing processes such as multilateral portfolio compression cycles (which result from original trades which are not subject to the clearing obligation) be cleared. But this will act as a significant disincentive for firms to participate in both multilateral and bilateral compression exercises, and introduce new pricing risks for market participants. Compression cycles are designed to reduce risk, and allow firms manage exposures more efficiently, which in turn facilitates banks' ability to provide greater liquidity to the market. If firms are dis- incentivised or prevented from participating in these exercises, unnecessary risks will clog up bank balance sheets and liquidity will suffer. It is important that such trades are not required to be cleared.

Question 22: What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

The stimulation of foreign investment into EU capital markets rests on the assumption that the extra risks incurred by investors can be managed. The greater the certainty for investors, the greater the likelihood of investment. Foreign investors who invest in European assets will have to convert their own currency into European currencies to buy such assets. In doing so they will acquire the FX risk between their home currency and that of the underlying asset. Very few investors have the risk tolerance for large exposures to currency risk, and therefore, many will use FX derivatives to mitigate their currency exposures. The availability and liquidity of the FX derivatives markets is thus fundamental to facilitating and unlocking cross-border investment flows.

Similarly, EU firms' access to capital markets in third countries relies heavily on the use of derivatives. In order to improve access to financing and funding for European business and infrastructure projects, companies need to be able to manage the funding risks associated with new funding sources and bank loans. Derivatives help companies to reduce interest rate risk on new bond issuances and loans, access new investor bases, take advantage of cheaper funding rates in different currencies and eliminate mismatches between revenue streams with debt payments.

For example, if a business based in Germany determines that it will be cheaper to issue a bond in dollars rather than euros, it would face both interest rate and foreign exchange risks, as its base currency is euros. The most efficient way to hedge both the interest rate and currency risk is to trade a cross-currency swap, which would eliminate both the rate and FX mismatches.

It is also important to note that while derivatives will help facilitate the access of EU firms to investors and capital markets in third countries, they will also, crucially, help to reduce the barriers to single market investment, where barriers resulting from national differences remain: Europe will still have different currencies, different inflation rates, different growth rates and even different longevity rates. This will result in smaller liquidity pools. For example, pension funds looking to source sterling inflation will still face a UK-sized market rather than an EU-sized market. But derivatives can help bridge that gap and complement the CMU by allowing investors to source assets beyond their own borders and currencies by expanding the risk-hedging pool.

Thus it is essential that the current post-financial crisis regulatory framework in Europe is carefully calibrated and doesn't impede the effectiveness and efficacy of derivatives markets (see Question 21).

In particular, it is important that equivalence decisions are granted in a timely manner to avoid creating market uncertainty. A further requirement to the efficient functioning of derivatives markets is that derivatives markets remain global in nature. Regulators in Europe are currently endeavouring to ensure the global nature of derivatives remains viable. ISDA and FIA Europe support these efforts,

and encourage policy makers to deliver important third-country equivalence decisions in a timely manner to avoid creating market uncertainty as to whether those markets can continue to be accessed. We also support further cooperation with other regulators on a global and bilateral basis, so as to develop workable recognition regimes that take into account the specificities, and unique characteristics of different jurisdictions. Timely equivalence decisions will broaden pools of liquidity for EU firms, which will further facilitate access to investors and capital markets in third countries. For example, an EU firm issuing debt in a third country that has been deemed equivalent will be able to source a derivatives hedge from local liquidity providers as well as European dealers.

Question 23: Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

Derivatives are crucial to improve the functioning and efficiency of capital markets. They not only ease companies' access to capital markets and unlock cross border capital flows by enabling trade finance creditors to hedge market risks, but also provide price discovery and allow market intermediaries, such as banks, to manage securities inventories more efficiently. Without derivatives, securities markets would exhibit much lower levels of liquidity, which means transaction costs for issuers and investors would be much higher.[1]

Liquidity is core to the functioning of any financial market. If a market exhibits depth in liquidity risks can be managed and hedged in a timely and cost-efficient fashion, and both direct participants and end users alike will be incentivised to participate in the market. However, where liquidity is lacking and risk cannot be managed, there is often limited appetite to acquire positions in a financial instrument or commodity because the likelihood of being able to exit that position in a cost efficient manner are significantly reduced.

Therefore, the CMU project should aim to foster greater liquidity because it underpins well-functioning effective markets. With greater liquidity comes consistent observable prices, narrow spreads, and the ability to execute transactions or a series of transactions or strategies at lower costs. Derivatives will help facilitate greater liquidity in securities markets, therefore, ensuring derivatives markets are robust and effective will ensure the efficient functioning of capital markets activity (see Question 21).

Question 25: Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?

We believe that ‘no-action’ relief powers are an important policy tool for preventing market disruption and managing systemic risk in derivatives markets, and believe that the ESAs (and/or the EC) should be given such powers, similar to those employed by the US CFTC. This will allow more flexibility and give the ESAs the ability to prevent destabilising market events that are systemic in nature.

For example, under EMIR the clearing obligation cannot, in extreme circumstances, be terminated or suspended as a matter of urgency. This means that CCPs may find themselves clearing more risk in a

[1] The Social Benefits of Derivatives – Christopher L. Culp Ph.D. Senior Advisor, Compass Lexecon (Chicago, IL). Adjunct Professor, Institut fur Finanzmanagement, Universitat Bern. 29th ISDA Annual General, Munich, April 9, 2014.

contract or product than there would be market capacity to manage upon a member default. A CCP may therefore have no option but to encourage participants to reduce these cleared positions by increasing margin requirements to levels at which it is uneconomic to hold the positions, and thus force the risk to be closed out. A no action relief tool would allow ESMA to suspend the clearing obligation promptly, so as to prevent market participants from having to close out their hedges prematurely, and being forced to bear unnecessary risks.

Question 27: What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

Close-out netting is primarily used to mitigate bilateral counterparty credit risk in financial transactions, such as OTC derivatives. In short, netting allows counterparties to reduce gross exposures to a consolidated net exposure, which significantly reduces the size of the outstanding counterparty risk. This in turn reduces systemic risk, reduces costs and improves the liquidity of the market[2], and importantly improves the efficiency of collateral. Because close-out netting significantly reduces counterparty risk exposures, it follows that less collateral will be required to mitigate the remaining counterparty risk.

Most European member states do have netting legislation; however, rules are by no means consistent across jurisdictions, and there are jurisdictions where legislation does not exist, such as Bulgaria, Croatia and Latvia. This patchwork of netting legislation, or lack of it, is an impediment to the reduction of counterparty credit and systemic risk, the efficiency of collateral, and ultimately cross border capital flows. Therefore, ISDA is actively engaged in the design and implementation of efficient and robust close-out netting legislation globally, including in European jurisdictions, with the aim of creating level playing fields for financial market participants, lowering systemic risk, and improving the efficiency of both collateral and derivatives markets. To this end, ISDA has designed a Model Netting Act (the 2006 MNA) – which serves as a model law to lawmakers and policymakers intended to set out, by example, the basic principles necessary to ensure the enforceability of bilateral close-out netting, including bilateral close-out netting on a multibranch basis, as well as the enforceability of related financial collateral arrangements.

Question 30: What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

The imposition of a financial transaction tax (FTT) would produce harmful effects to both the financial sector and the real economy. The initiative runs counter to the CMU because it will both increase fragmentation and inefficiency. It would first and foremost increase the cost of hedging for end-users, thus acting as a disincentive to manage risk through use of derivatives. These increased costs would act as an obstacle to accessing financial markets, restrict liquidity, and ultimately hamper economic growth. It is crucial that cost-benefit analyses be conducted before proposing new regulations that may have harmful effects on the liquidity of the market. The proposal for an FTT should be abandoned.

[2] http://isda.informz.net/z/cjUucD9taT00MDg4MzIzJnA9MSZ1PTc1NjYzMzQ1NCZsaT0yNTE0NzI1NA/index.html

Question 32: Are there other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take?

The CMU project is designed to spur economic growth in Europe by rebalancing Europe's funding mix to ensure savings are deployed towards business growth and job creation. To achieve this, it is essential that capital is mobilized more effectively by sourcing new pools of financing by stimulating institutional and retail investment flows into capital markets instruments, and ensuring that businesses, notably SMEs, are given greater access to funding.

It is therefore crucial that impediments and roadblocks to the flow of funds from investors to businesses and investment opportunities be removed or sufficiently mitigated. One of the biggest obstacles to the mobilization of capital flows is increased investment risk and financial uncertainty – on both the supply (providers of funds) and demand (users of funds) side.

The CMU project will encourage the emergence of diversified funding sources by issuing debt and equity via public and private placement. But the issuance of debt, as with bank loans, carries with it significant interest rate and foreign exchange (if the debt is issued in a different currency) risks, and businesses will be reluctant to issue debt unless they can be certain those risks can be contained. Moreover, in order to successfully attract investment, companies will likely have to ensure that they maintain balance sheet stability by managing their financing and commercial risks, such as earnings uncertainty on foreign revenues.

Similarly, investment in capital markets instruments, such as debt and equity, carries significant risks including credit, FX, equity and interest rate risks. If the supply side (investors such as pension funds, insurers and other asset managers) is to direct substantial flows into constructing portfolios comprised of such instruments, they need to be sure the associated investment risks can be prudently managed.

Without the ability to manage, recycle or transform risk, the uncertainty associated with either investing in new instruments or issuing new debt will dis-incentivise both investors and borrowers alike from participating in the CMU project.

This is why derivatives should play a crucial role in the development of a CMU. OTC derivatives are risk-management tools that reduce uncertainty, allow market participants to effectively recycle risk, and perform one of the main functions of capital markets[3]. Derivatives enable corporates, irrespective of the funding source – banks or capital markets – to efficiently manage risk in their financing activities by allowing companies to tap new investor bases or access cheaper funding, and also allow infrastructure companies to eliminate the mismatch between inflation-linked revenues and fixed rate obligations on borrowings. Derivatives are also crucial to businesses that need to hedge risks associated with their day-to-day operations, such as eliminating exchange risk on foreign currency earnings.

On the supply side, derivatives allow investors like asset managers to manage the credit risk associated with corporate bonds, or equity risks on large stock portfolios, and can also help protect investors against market shocks and spikes in volatility, and to quickly rebalance asset allocations. For pension funds and insurance companies derivatives are an essential tool for hedging inflation and interest rate risk in long-dated liabilities.

---

[3] European Commission Staff Working Document on the CMU: Initial reflections on the obstacles to the development of deep and integrated EU Capital Markets.
http://eurlex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:52015SC0013&from=EN

Derivatives will therefore allow market participants to offset the risks they face more efficiently and ensure stability in financial performance. This increased balance-sheet security and certainty of income will encourage investors to direct funds into capital markets instruments, while at the same time allowing borrowers to manage their funding and business risks, paving the way for greater access to funding.

It is therefore crucial that the current post-financial crisis regulatory framework in Europe is carefully calibrated and doesn't impede the effectiveness and efficacy of derivatives markets. (see actions referred to in Question 21).