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Lowering Barriers to Capital Deployment in Europe

A Vision for Derivatives Markets in the Capital Markets Union

INTRODUCTION

The Capital Markets Union (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.

The CMU project makes no reference to derivatives, but without the ability to manage, recycle or transform risk, the uncertainty associated with either investing in new instruments or issuing new debt will disincentivise 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. 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[1]. 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.

Derivatives are also crucial to fostering economic growth. 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 allow market intermediaries, such as banks, to manage securities inventories

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[1] 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

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.[2]

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.

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 also important to note that while the CMU will help to reduce the barriers to single market investment, barriers resulting from national differences will 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.

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.

This paper is organised as follows. First, we explain how derivatives will play a key role in the CMU project; second, we sketch out high level principles for an effective, efficient and safe derivatives market, and assess current derivatives reforms; and third, provide an annex detailing specific areas where current reforms can be fine-tuned.

[2] 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.

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PART 1: HOW DERIVATIVES WILL PLAY A KEY ROLE IN THE CMU PROJECT

The three key aims of the CMU project are:

- to improve access to financing for all businesses across Europe (in particular SMEs) and investment projects such as infrastructure;
- to increase and diversify the sources of funding from investors in the EU and all over the world; and
- to make markets work more effectively, linking investors to those who need funding more efficient and less costly, both within Member States and cross-border.

Derivatives will play a fundamental role in meeting all three objectives. Derivatives are indispensable to both the supply and demand side of the CMU equation, and form the risk management glue that make markets work more effectively and link investors to those who need funding more efficiently both within Member States and cross-border. They give companies the confidence to tap wider funding sources, and provide the basis for institutional and retail investment flows into capital markets instruments.

Derivatives will help facilitate greater liquidity in securities markets – and 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 is significantly reduced. 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 (i) allow companies to hedge their funding and currency risks on both newly issued debt and banks loans, thus instilling confidence in companies to tap new funding sources; (ii) ensure infrastructure projects can eliminate mismatches between their revenues and liabilities, thus making such assets more attractive and safer from an investment perspective; (iii) give companies the ability to hedge their commercial and day-to-day risks resulting in a strengthening of their balance sheets, and create certainty in financial performance, which will in turn generate greater investor confidence to invest in businesses; (iv) facilitate cross-border capital flows; (v) enable the development of a high quality securitisation market; (vi) help investors hedge the risks inherent in capital markets instruments; and (vii) aid flows of foreign direct investment into Europe.

Managing funding and foreign exchange risk on liabilities
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, the CMU project will encourage businesses to source new funding, potentially cross-border. If a business based in Germany determines that it will be cheaper to issue a bond in sterling 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.

Companies will also seek to create certainty in future interest payments on liabilities. Derivatives can be used to transform floating rate debt or loans into fixed rate liabilities by trading fixed-to-floating interest rate swaps, which will change their floating rate obligations into fixed payments. This provides extra balance sheet certainty, allowing companies to invest for the future with greater confidence, creating jobs and economic growth.

Helping infrastructure projects attract investment

A key aim of the CMU project is to encourage greater investment in infrastructure projects. These long-dated projects, however, typically have revenues that are inflation-linked, but will issue bonds that pay a fixed rate. This means many infrastructure projects have structural balance sheet mismatches between their revenue streams and liability obligations. In the event that inflation plummets, so will the company's revenues, which may impact its ability to service its debt. In order to prevent this situation and assuage investor concerns, projects typically seek to eliminate the mismatch and ensure financial stability and certainty of future cash flows by using derivatives.

For example, by trading inflation swaps, where an infrastructure project will commit to pay inflation and receive a fixed rate, the company can eliminate its mismatch and ensure it will receive fixed payments to service its debt. This type of hedge is essential to both managing the company's funding risks and instilling confidence in investors, that the company is able to service its debt.

Providing balance sheet stability and increasing investor confidence

Mitigating commercial and business risks through the use of derivatives so as to ensure balance sheet and revenue stability will both keep funding costs down, and give investors more economic certainty and confidence to invest in businesses. For example, many companies have earnings in different currencies and are hence exposed to FX risks. If a French company has significant revenues in US dollars, it will be exposed to movements in the dollar-euro rate. If the dollar were to weaken against the euro, the company's revenues would deteriorate. Thus, companies can use FX forwards and options to hedge the movement in FX rates, stabilising their future revenues.

Similarly, companies that rely heavily on the use of commodities, such as airlines (whose major expenditure is jet fuel), can use commodity derivatives to protect against spikes in oil prices. Companies can even use credit default swaps (CDSs) to hedge the credit risk associated with short-term trade receivables. Increased hedging by companies will be a significant contributor toward boosting investor confidence in the credit-worthiness of companies, and thus encourage supply side investment in capital markets instruments.

Facilitating cross-border capital flows

Derivatives can also facilitate the matching of investors and business needs in the CMU. Investors, such as pension funds, often seek specific inflation or duration exposures for their portfolios in order to meet future pension liabilities. However, euro-denominated inflation-linked bonds issued by companies based in the Eurozone are not always easy to come by. Thus it may be necessary to find corporates and businesses in other jurisdictions to gain access to inflation-linked bonds issued by corporates. For example, if a UK utility was looking to issue an inflation-linked bond, but a Dutch pension fund wanted euro inflation exposure, the UK utility could issue a euro-denominated inflation-linked bond, swap the proceeds to convert its exposure back to sterling so that it was paying UK RPI inflation – on which its revenues are based.

Developing high quality securitisation markets

The development of a high quality securitisation market is intended to form a key building block of the CMU project, which will make it easier for banks to lend to households and businesses. Securitisations often contain a structural mismatch between the coupon due on the notes issued by the securitisation vehicle and the return generated on the underlying portfolio of bundled

loans/mortgages. In order to eliminate the mismatch, securitisations rely heavily on basis swaps to swap the yield on the underlying portfolio for the rate due on the notes. Without the ability to use derivatives to control basis mismatches, severe limitations would be placed on the types of securitisations that could be structured, which would inevitably stunt the availability of funding.

Helping investors hedge risk associated with capital markets instruments

On the supply side, if institutional and retail investors are to divert funds to capital instruments, they need to be sure that they can recycle or hedge the new risks they are assuming. Asset managers typically use derivatives to hedge unwanted interest rate or foreign exchange risk and to protect portfolios against a sharp fall in markets or volatility more generally. If asset managers are to be encouraged to build new portfolios comprising less-liquid SME equities and debt, it is essential those investors have the flexibility to hedge related market risks such as credit, equity risk, and FX and duration risks. Because such equities and debt are likely to be less liquid, investors should be able to employ proxy hedges to manage macro risk.

For example, if a pension fund increases its allocation to SME equities, it may have recourse to equity derivatives to better manage the liquidity impacts of its investment flows, and to protect itself against market risk. Similarly, insurers, which are traditionally large buyers of corporate bonds, would hedge the credit risk associated with these portfolios with CDSs. The ability of investors to use derivatives to hedge unwanted risks will play a significant role in boosting investor flows in capital markets instruments.

Stimulating foreign direct investment into Europe

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 fundamental to facilitating cross-border investment flows.

PART 2: APPROPRIATE DERIVATIVES REFORM AS AN AGENT OF CAPITAL MARKETS UNION

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.

By and large, the implementation of derivatives reforms in Europe, in particular proposed rules governing the clearing, margining and trading of OTC derivatives, will go a long way to reducing systemic risk, and bring more transparency to derivatives markets – and therefore promote economic growth and the aims of the CMU. It is important that these rules are calibrated to a standard that also facilitates efficient functioning of derivatives markets, and don't introduce new risks that damage liquidity.

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 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 venue and subject to pre- and post-trade transparency under MIFID/MIFIR should be appropriately calibrated. If derivatives which are not liquid 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 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.

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ANNEX: FINE-TUNING DERIVATIVES REFORM

EMIR Clearing Obligation

Suitability: A clearing mandate for a certain class of OTC derivatives should only be imposed if the class is sufficiently liquid and standardized, CCPs have a proven track record of clearing and risk-managing the product, and there is sufficient price reliability and availability in the given class. A requirement to clear products that aren't suitable for clearing will not only increase systemic risk, but also drain liquidity in the product making it more difficult for market participants to effectively manage risk.

Frontloading: European clearing rules require that, subject to certain parameters, OTC derivatives traded during a phase-in period be cleared at the end of the period. This is known as frontloading. However, market participants are unable to accurately price trades that will be cleared at a future date – which will likely lead to a divergence in pricing and overall market disruption. This will likely hamper market liquidity during phase-in periods, and may even disincentivise some market participants from hedging. To facilitate and ensure market liquidity is not disrupted, frontloading should be removed for the clearing rule-set.

Post-trade risk reduction services: 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 disincentivised 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.

Suspension of clearing mandate in extreme circumstances: 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 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. It is crucial that regulators be granted the ability 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.

EMIR Non-Cleared Margin

Global consistency: As it currently stands there is lack of harmonisation between the sets of rules in different jurisdictions – in particular the differences between the EU and US requirements. It is crucial that any differences in the rules be ironed out before the rules are finalised because if a jurisdictions finalises its rule-set before harmonization is achieved, the chances of having very divergent rules will be significantly higher, and will be difficult to reconcile. The consequence of having very different rules will be that any attempt by jurisdictions to grant equivalence to their peers' rule-sets will be very difficult to achieve. This will also create significant operational burdens on counterparties, and will likely lead to a fragmentation of markets, and a significant drop off in cross-border liquidity. For example, we recommend that the EU remove the non-EU NFC- from the scope of the EU margin

rules because the requirement is not aligned with the Working Group on Margin Rules (WGMR) recommendations.[3]

Smaller counterparties: Many small market participants do not currently post variation margin (VM) or initial margin (IM) because of operational constraints, and the fact that many only use short-dated foreign exchange swaps and forwards for hedging purposes, which generate minimal exposure. The likely result of imposing VM requirements on these market participants is that they would be forced out of the market because they are not able to meet VM operational and documentation requirements. A mechanism needs to be established to permit non-systemic market participants to remain in the derivatives market.

Securitisation derivatives: Securitisations are used by key sectors of the economy (SMEs, mortgage lenders etc.) as essential funding tools. However, the requirement that OTC derivatives traded by securitisation vehicles be subject to bilateral margining (or indeed clearing obligation) will ultimately reduce access to a substantial funding resource, and increase their costs of financing. Securitisation vehicles typically have limited functionality and resources and are also generally set-up as pass-through vehicles which do not retain excess cash from underlying assets to comply with material, operational requirements. Imposing margining requirements could result in significant amendments to the commonly accepted structures for many transactions with the potential to have inadvertent impact on other regulatory changes that have affected and will affect securitisation as a source of funding. It should also be noted that the European Central Bank and the Bank of England both believe that derivatives are an important ancillary service for securitisation vehicles, and that derivative collateralisation requirements for securitisation special purpose entities (SSPEs) should apply in the same way as for derivatives executed by covered bond issuing entities, "i.e. that all STS securitisation vehicles, meeting the definition of an SSPE under Article 4(1)(66) of the Capital Requirements Regulation should be exempted from the legislative requirements to provide collateral."[4]

EMIR Reporting

Single-sided reporting: The EMIR reporting requirements are designed to provide transparency, protect against market abuse, improve data quality and mitigate systemic risk. However, recent experience has shown that the dual-sided reporting requirement has failed to meet these objectives. Instead, as a result of substantial operational difficulties significant trade data gaps exist today. In particular, under a dual-sided reporting regime, trades need to be linked/matched. This increases the number of trade records, which amplifies the challenges on aggregation, consistency and implementation costs for the industry. The matching process across counterparties and repositories, especially when a large number of transactions are executed on the same day, is extremely laborious and has proved extremely challenging and open to interpretation. We believe that the adoption of single-sided reporting would remove the dependency between counterparties to report the trade consistently to achieve match rates, and significantly lessen the operational burden for buy-side firms, which lack resources to reconcile across multiple sources. We also believe that while one of the aims of dual-sided reporting is to improve the quality of data between counterparties and serve as a form of dispute resolution, there already exist market mechanisms and EMIR requirements designed to improve data quality between counterparties and resolve disputes, and thus dual-sided reporting is in fact duplicative.

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[3] In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the reform programme and called upon the BCBS and IOSCO to develop, for consultation, consistent global standards for these margin requirements. To this end, the BCBS and IOSCO, in consultation with the CPSS and CGFS, formed the Working Group on Margining Requirements (WGMR) in October 2011 to develop a proposal on margin requirements for non-centrally cleared derivatives for consultation by mid-2012.

[4] http://www.ecb.europa.eu/pub/pdf/other/ecb-boe_response_ec_consultation_on_securitisation20150327.en.pdf

MIFID II/MIFIR

Definition of liquid market: The current application of thresholds used to define liquid markets in the proposed rules designates a number of instruments liquid, when they, are in fact, illiquid. This will subject illiquid product classes to liquid instrument transparency requirements, which will potentially damage overall liquidity in those products. More appropriate thresholds, which more closely reflect market reality, would reduce the coverage ratio slightly for some instrument classes, and more significantly for others. The risks of getting thresholds wrong are significant, in that market makers will become reluctant to provide quotes on less-liquid products, as other market participants may trade against them. The end result will be higher costs for end users.

Packaged Trades: Packaged trades are commonly used by market participants to reduce transaction costs and manage execution risk. It is essential that the MiFID II/MiFIR transparency framework is calibrated in a manner that continues to provide for the execution of packaged trades whilst not placing market participants at undue risk. If meaningful calibration is not provided for, packages might no longer be traded in the EU disadvantaging the clients that use them due to increased transaction costs and less efficient execution.

Financial Transaction Tax (FTT)

The proposal to impose a broad-based financial transaction tax (FTT) will ultimately increase the costs of hedging for large, medium and small corporations and entities, which use derivatives products to manage interest rate, currency, credit and counterparty risks. The introduction of new taxes mean that financial institutions will pass on the additional costs to customers, and this would act as a barrier to accessing financial markets, as well as restricting liquidity and increasing volatility in those markets. A FTT proposal is counter-productive to the aims of the CMU and should be abandoned.

Appropriate treatment of non-cleared derivatives:

Bank Structure: As a part of EU proposals that advocate the mandatory separation of proprietary trading and other high-risk trading activities into a separate legal entity within a banking group, core credit institutions may only use (to hedge balance sheet risk) and sell to clients clearing eligible interest rate derivatives, foreign exchange derivatives, credit derivatives, emission allowances derivatives and commodity derivatives. The requirement 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. Limiting the types of derivatives will also restrict the ability of clients to effectively hedge complex risks. In addition, the proposed separation undermines the objectives of the CMU by weakening European banks' market-making operations.

Money-Market Funds: Current amendments to draft money market fund regulation seek to limit the ability of money market funds (MMFs) to use OTC derivatives, by restricting their use of derivatives to those which trade on regulated markets. This restriction will discourage investment in European MMFs, and investment by European MMFs into corporate and sovereign debt, by limiting the range of hedges funds will be able to use to manage risk. Funds will be particularly constrained when seeking to limit the credit risk of their portfolios, and will find it much hard to tailor their forex and duration profiles.

Equivalence decisions and regulatory cooperation and recognition frameworks

EMIR Central Counterparty (CCP) Recognition: While the first sets of 'equivalence decisions' for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore were granted last year, and the Capital Requirements Regulation transitional period extended by a further six months[5], the EC needs to continue its work with other jurisdictions, like the US, to ensure that positive equivalence assessments are complete as soon as possible and latest by 15 December 2015 for all jurisdictions where CCPs have applied to ESMA for recognition. If equivalence decisions are not forthcoming, EU firms will incur onerous capital requirements if they continue to access third-country CCPs that have not yet been recognised. Meanwhile, EU counterparties may be unable to clear OTC derivatives contracts through non-EU CCPs that have not been recognised under EMIR by the time the Clearing Obligation comes into effect in end 2015, even if clearing via a local clearing member.

EMIR Intragroup Transactions & Article 13 Equivalence: In order for market participants to benefit from clearing and margining intragroup OTC derivatives with entities established in third countries, an equivalence decision needs to be made under Article 13(2) of EMIR, which determines that the legal, supervisory and enforcement arrangements of a third country regarding clearing, margining and trade reporting are equivalent to the EU's. No such equivalence decisions have been forthcoming despite the expectation that mandatory central clearing will take effect in late 2015/early 2016. This means that that market participants may be unable to take advantage of exemptions enshrined in EMIR because of the lack of equivalence determinations. In order to facilitate the equivalence decision process ISDA has articulated a principles-based approach for achieving harmonized rule sets, which establishes a conceptual framework and substantive processes for inter-jurisdictional recognition of derivatives regulation through a principles-based substituted compliance methodology. We believe such an approach prioritises the achievement of the G20 goals for derivatives.[6]

Third Country Regulated Markets: Under MIFID I, unless the EC has determined a regulated market based in a third country as equivalent, derivatives traded on that regulated market by EU counterparties will be considered OTC derivatives, rather than exchange-traded derivatives. The EC has yet to deem equivalent any third country regulated markets under Article 19(6) of MIFID. This is particularly problematic for non-financial counterparties (NFCs) that trade on third country regulated markets, as those exchange-traded derivatives will now count towards the clearing threshold in EMIR, and could force such NFCs above the threshold and thus subject to the EMIR clearing and margin obligations.

[5] Under the EU Capital Requirements Regulation (**CRR**), EU banks are required to hold significant amounts of capital for direct or indirect exposures to third country CCPs which are not Qualifying CCPs (QCCP). However, a third-country CCP will only be considered a QCCP if, as per Article 4(1)(88) of CRR, it has been recognised by ESMA under EMIR Article 25. No third-country CCP that has applied for recognition has been recognised as yet. EU firms continue to be able to benefit from transitional provisions under Article 497 of CRR, which allow them to treat third country CCPs as QCCPs for capital purposes until June 15, 2015.

[6] https://www2.isda.org/attachment/NTgwNw==/Methodology%20for%20Regulatory%20Comparisons%202013 0820.pdf