FIA.org

6 June, 2017

Vice-President Valdis Dombrovskis
European Commission
Rue de la Loi/Wetstraat 200
1049 1049 Brussels
Belgium

Dear Vice-President Dombrovskis:

As a global trade association representing the cleared derivatives industry with membership in 48 countries, FIA supports strong and vibrant markets that allow market participants to hedge risk and discover prices in a safe and cost effective manner. This important goal is best achieved when markets participants can access deep and liquid markets and collateral-efficient clearing.

FIA has grave concerns that the forced relocation of clearing of euro-denominated derivatives to the European Union (EU) would fragment these markets, raise costs for end users, and weaken the stability of the financial system, and we therefore oppose such a policy. We fully agree that the EU has monetary policy and regulatory interests in these markets, but we strongly believe the EU can address these interests through enhanced oversight. The location of clearing activity should be driven by legitimate market forces operating within a regulatory framework suited for a global market.

The euro is one of the world's great reserve currencies. If it is to maintain this status, it should be traded freely and openly. Policymakers should proceed with caution on possibly restricting the use of the euro currency.

Background

On 4 May 2017, the European Commission published a Communication[1] to the European Parliament, the Council and the European Central Bank responding to certain challenges for critical financial market infrastructures and for further developing the Capital Markets Union. The Communication concluded that "[i]n light of considerations set out in this Communication and after offering the opportunity for stakeholder feedback on the basis of the present Communication and subject to an impact assessment, the Commission will present further legislative proposals in June to ensure financial stability and the safety and soundness of CCPs that are of systemic relevance for financial markets across the EU and to support the further development of the Capital Markets Union (CMU)."

[1] https://ec.Europa.eu/info/sites/info/files/170504-emir-communication_en.pdf

Specifically, the Communication explores options for ensuring appropriate protection for the financial stability and monetary policy of the EU and mentions that "this includes, where necessary, enhanced supervision at the EU level and/or location requirements."

The purpose of this letter is to set out FIA's concerns about the potential approach of forced relocation of euro-denominated derivatives clearing to the EU, which we hope will inform the Commission's impact assessment and decision.

Derivatives play a critical role in the real economy

One of the core functions of the derivatives markets is to service the real economy by providing safe and efficient tools for companies to manage their exposure to price risk. Thousands of companies, both large and small, use futures, options and swaps to hedge the price volatility of currencies, commodities and interest rates so they can focus on growing their business. Whether a farmer, pension fund or manufacturer, these instruments serve as shock absorbers that help productive enterprises thrive in an uncertain world. This protection translates to more stable prices for European producers and consumers, more certainty for future investment in the EU, and more predictable growth for the EU economy.

A key component for making these markets function safely and efficiently is central clearing. Clearing through regulated CCPs helps mitigate systemic risk by requiring these instruments to be collateralised through daily margin collections and backed by significant reserves funded by their members.

The central clearing of derivatives was a key element of financial system reform in the aftermath of the financial crisis. The G20 Leaders agreed at the 2009 Pittsburgh Summit that all standardised derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. At the same time, regulators raised international standards for CCPs, which are now followed by all major derivatives CCPs. These standards include principles on how supervisors should cooperate on the cross-border oversight of CCPs.[2]

The cleared derivatives industry is truly a global marketplace that has long relied on the principle of comity among regulators in order to oversee and grow the markets. This regulatory recognition and cooperation enables significant portions of trading volume for these global exchanges and CCPs to provide liquidity from outside their jurisdictions. For example, non-U.S. institutions hold nearly 40 percent of customer margin for futures and swaps that clear on U.S. regulated CCPs. Another example is that around 90% of U.S. dollar denominated interest rate swaps are cleared outside the U.S. CCPs in the EU experience similar flows from outside their home jurisdiction, all made possible

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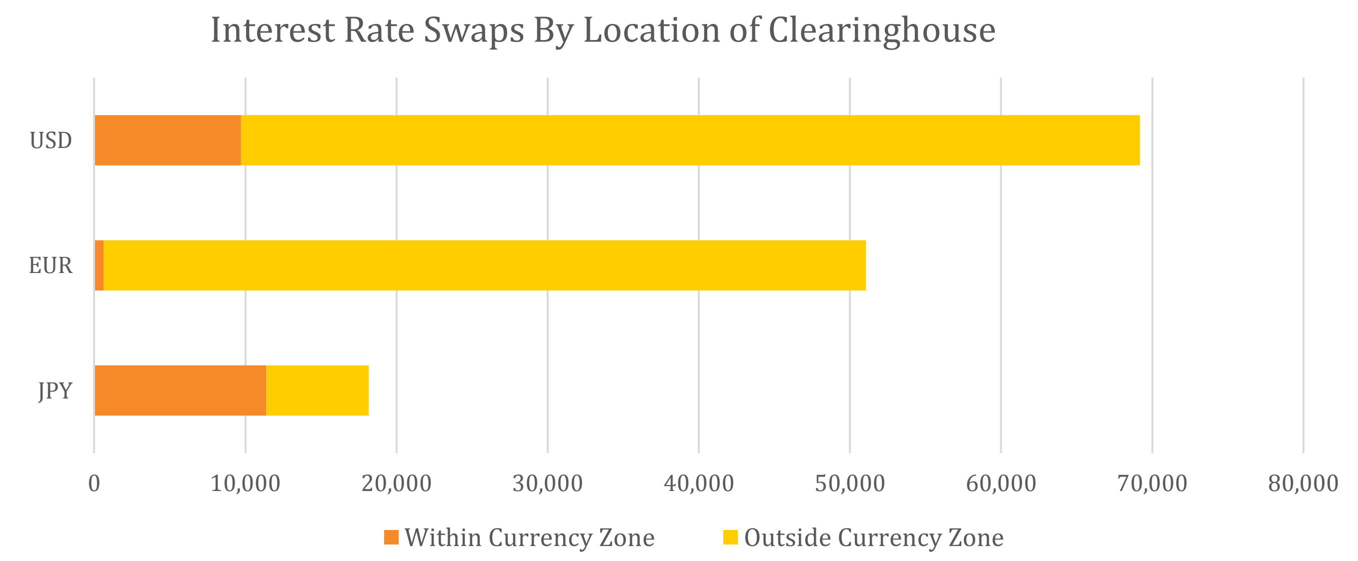
[2] Responsibility E of the *Principles for financial market infrastructures (PFMIs)*, Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO)

through the global regulatory community's willingness to recognise and cooperate with jurisdictions of comparable regulatory standards. Such recognition policy has worked well over the years to enable these markets to grow and thrive for the benefit of end users.



Note: Data obtained from CME Clearing, Eurex Clearing, Japan Securities Clearing Corp. and LCH as of May 29, 2017. Bars show notional amounts outstanding in billions of USD.

<u>Forced relocation of Euro-denominated derivatives would harm the markets</u>

FIA believes that forced relocation of euro-denominated cleared derivatives would be the most disruptive and expensive approach to overseeing third-country CCPs, without improving the oversight of this activity. EU end users likely would suffer the greatest increase in cost and loss of liquidity as a result of any forced relocation, as they will end up accessing the smaller part of the bifurcated euro-denominated derivatives market. In addition, there would be fragmentation between euro-denominated derivatives cleared in the EU, and non-euro denominated derivatives, which are likely to continue being cleared as they currently are outside the EU. This fragmentation of the market would have an adverse effect on systemic risk.

This is not the first time that a jurisdiction in the global cleared derivatives market has considered enforcing a location policy. Canada and Australia have both considered imposing location requirements for derivatives denominated in their currency but both jurisdictions ultimately rejected the idea. In the case of Australia, the regulators decided in 2014 that a location requirement should not be required for AUD interest rate derivatives cleared by LCH.[3] The regulators explained: "the AUD interest rate swaps market is part of a much larger global market for OTC interest rate derivatives. International participants in this market organise their trading activity and post-trade processes on a multicurrency basis. The clearing service provided by [LCH] is similarly organised on a multicurrency basis and Australian-based participants constitute only a small share of [LCH's] highly international participant base." This logic applies even more so to the euro given its global reserve currency status.

Impact on systemic risk

Forced relocation of euro-denominated derivatives may fragment the market, resulting in the creation of two distinct pools of trading liquidity. Today, 75% of the LCH SwapClear Euro-denominated interest rate swaps currently do not have EU counterparties. A forced relocation could therefore create an offshore pool for the majority of euro-denominated swaps that are traded by foreign institutions and a much smaller and less liquid on-shore pool for swaps traded by EU institutions.

We believe that such a fragmentation of the interest rate swap market could impact a CCP's ability to successfully port or auction client positions of a defaulting clearing member. A key part of promoting financial stability through the use of CCPs is having a significant pool of clearing members available to accept clients or positions from a defaulting clearing member. If a location policy is applied, some clearing firms may decide that it will be too expensive to set up separate clearing services for onshore and offshore clients, and may decide against providing clearing for EU clients. We note that the number of clearing firms has been in decline since the financial crisis. A location policy could exacerbate this trend and increase concerns around the market's ability to absorb clients of a defaulting clearing member.[4]

A location policy also would reduce access to alternative locations for clearing of euro-denominated products. Potentially only one CCP based in the EU would be available to clear such products, creating increased concentration risk at a systemically important CCP without a viable alternative. This would be of particular concern in the event that a CCP is unwilling or unable to continue clearing a specific class of OTC derivatives, or where there is a serious threat to financial stability and no other CCP is able to take over clearing without interruption.

There are also significant risks that such a location policy could lead other non-EU regulators and governments to reassess their approach to third-country CCP oversight, further fragmenting this

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[3] Australian Council of Financial Regulators, *Application of the Regulatory Influence Framework for Cross-border Central Counterparties*, March 2014, http://cfr.gov.au/publications/cfr-publications/2014/pdf/app-reg-influence-framework-cross-border-central-counterparties.pdf
[4] https://fia.org/fcm-tracker

and other markets.[5] Other major reserve currencies do not currently maintain a location policy. For example, approximately 90 percent of the U.S. dollar-denominated interest rate swap market is cleared outside the U.S. Such a change of policy in the EU may cause a shift in the global approach to these markets, which could result in EU end users finding it significantly harder and more expensive to hedge their risks in other currencies beyond the euro.

Impact on end users

Such a location policy would most certainly increase costs on EU end users. The fragmentation of clearing among multiple CCPs will reduce the benefits of portfolio margining. Risk offsets will be lost and end users will have to post more margin to accommodate this heightened risk. Specifically, if euro-denominated derivatives were forced to relocate to the EU, these contracts would no longer benefit from being cleared in the same pool as other contracts denominated in other currencies. It has been estimated that the margin requirements would rise by as much as $77 billion USD, nearly doubling the amount of margin required from $83 billion USD to $160 billion USD.[6]

With a more fragmented market, EU end users would also face higher execution costs as a result of lower volumes and a reduced number of participants in the marketplace. It will be harder for those seeking to enter into euro-denominated contracts to find available counterparties for such transactions. This lack of market liquidity could significantly increase the cost of hedging.

This loss of efficiencies caused by the bifurcation of the clearing pool would also increase the amount of capital to be held by each respective clearing member bank, further increasing the cost of clearing for end users. Clearing members would need to contribute sizeable amounts to a second default fund, along with the operational costs of creating a new service in the EU. This would add significant cost pressure to the diminishing number of clearing firms that clear derivatives globally, and would likely require such costs to be passed through to end users.[7]

Recognition and Enhanced Supervision are more effective and less disruptive alternatives

FIA believes that the Commission's suggestion of recognition and enhanced supervision are more effective ways to protect financial stability than forced relocation of the clearing of euro-

[5] CFTC Acting Chairman Giancarlo stated the following regarding an EU location policy, "To date, the US has not deemed a body of water – even as large as the Atlantic Ocean – as an impediment to effective CCP supervision and examination. Given the closeness of the US and European derivatives markets, what Europe chooses to do on the supervision of CCPs undoubtedly will inform the evolution of US regulatory policy for cross-border swaps clearing."
http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22

[6] https://www.clarusft.com/moving-euro-clearing-out-of-the-uk-the-77bn-problem/

[7] Five global clearing firms have announced their departure from swaps clearing since mandatory clearing has come into effect. Deutsche Bank: https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655; Nomura: https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de; RBS: http://uk.reuters.com/article/uk-rbs-primeservices-divestiture-idUKKBN0DY0PU20140519; State Street: https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules; BNY Mellon: http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business

denominated products. As the EC previously noted in public comments: "*The purpose of the third-country regime in EMIR is to protect financial stability while supporting firms to operate across borders in global markets. These decisions will contribute to market certainty and avoid fragmentation.*"[8]

The EU has been a noted leader in developing "equivalence" regimes for third countries. Equivalence provisions are tailored to the needs of each specific act and are for the mutual benefit of both the EU and third-country financial markets and institutions. One of the great strengths of today's EMIR equivalence regime is that it contains a mechanism to avoid duplicative and conflicting rules on clearing, reporting and risk mitigation requirements.[9]

The review and recognition of third-country regimes by the EU is rigorous and has often raised standards by requiring regulatory changes in third countries in order to gain the equivalence decision from the EU. As you stated when adopting a number of equivalence decisions in December 2016, "We carry out a rigorous, case by case assessment of each country."[10] This process promotes higher standards while avoiding overlapping and conflicting rules for the regulated entity.

Importantly, it is not possible for a third-country CCP to be recognised under Article 25 of EMIR without the third-country's legal and supervisory framework being recognised as equivalent to EMIR pursuant to Article 25(6) EMIR, and following cooperation agreements being been put in place between ESMA and the relevant competent authorities of the third-country. These cooperation agreements are comprehensive, requiring (i) access to all information requested by ESMA regarding CCPs authorised in third countries, (ii) immediate notification to ESMA where a third-country competent authority deems a CCP in breach of its authorization, and (iii) established procedures for coordinating on-going supervisory activities including, where appropriate, on-site inspections.

As demonstrated in its recent equivalence determination of U.S. CCPs, the EU has broad discretion to condition such recognition in ways that address risk concerns of the home country authority.

EU should consider other jurisdictions' experiences in supervising third-country CCPs

FIA believe that the EU's system of equivalence of third-country CCPs currently has tools necessary for on-going information gathering, inspections and oversight where necessary. However, if EU authorities believe they need enhanced oversight powers with respect to systemically important third-country CCPs, we believe that the EU should ensure such increase in powers is carefully calibrated.

The Communication notes: "…taking into account as necessary relevant experience from other jurisdictions, specific arrangements based on objective criteria will become necessary to ensure that, where CCPs play a key systemic role for EU financial markets and directly impact the

[8] http://Europa.eu/rapid/press-release_IP-16-4385_en.pdf
[9] Article 13 EMIR
[10] http://europa.eu/rapid/press-release_IP-16-4385_en.htm

responsibilities, including financial stability and monetary policy, of EU and Member State institutions and authorities, they are subject to safeguards provided by the EU legal framework. This includes, where necessary, enhanced supervision at EU level and/or location requirements."

Other jurisdictions have utilised both recognition and direct supervision in their oversight of third-country exchanges and CCPs to tailor the supervisory needs to the specific policy objective. For example, the U.S. CFTC has developed a third-country CCP regime that requires registration but also allows exemptions in certain cases. Specifically, the CFTC applies its full rule set on foreign Derivatives Clearing Organizations (DCOs) with minimal exemptions when third-country CCPs intend to clear products for U.S. customers. CCPs such as Eurex, LCH and SGX are currently registered as DCOs for this purpose.

The CFTC also recognises as Exempt DCOs certain third-country CCPs that clear only the proprietary positions of U.S. institutions. Currently the CCPs of HKEX, ASX, JSCC and KRX are recognised as Exempt DCOs for this purpose. Exempt DCOs are subject to robust conditions, including being subject to comparable, comprehensive supervision and regulation in its home jurisdiction, designating an agent for service of process, demonstrating continual compliance of the order and PFMIs, regulatory access to books and records, and reporting requirements. However, due to the fact that U.S. customers are not parties to the transaction, the CFTC provides greater deference to the home authority for such activity.

It is not practicable for each major jurisdiction that has a regulatory interest in CCPs to directly enforce the entirety of its rules against CCPs located in foreign countries. Therefore the third-country regime in EMIR is an efficient way to facilitate firms operating cross border by mitigating the impact of conflicting or duplicative rules. A relocation policy would directly contravene EMIR's goal of facilitating firms operating across borders.[11] This is why Article 13 of EMIR was created – to mitigate the impact of conflicting or duplicative rules for just such an instance.

FIA recognises that further enhancements between EU authorities and the UK supervisory authorities post-Brexit may be desirable. However, as history has shown, such supervisory considerations do not require a location policy in order to meet their intended regulatory objectives.

[11] "The purpose of the third-country regime in EMIR is to protect financial stability **while supporting firms to operate across borders in *global* markets** *[our emphasis]*. These decisions will contribute to market certainty and avoid fragmentation." http://Europa.eu/rapid/press-release_IP-16-4385_en.pdf

Conclusion

As the trade association for the globally cleared derivatives markets, we support policies that promote healthy and safe markets and allow market participants to hedge risk in the most stable, efficient and cost-effective manner. We recognise the need for the EU to oversee important activities that impact its markets, but we strongly believe that a forced relocation of euro-denominated derivatives clearing would be severely detrimental to the economic interests of the EU. As explained above, we believe that supervision can be enhanced to meet the needs of the EU supervisors.

We look forward to continued engagement on these important issues.

Sincerely,

Walt L. Lukken

Walt Lukken
President and CEO, FIA