14 July 2014

Joint Committee of the European Supervisory Authorities

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Re: JC/CP/2014/03 – Consultation Paper on Risk Management Procedures for Non-Centrally Cleared OTC Derivatives – 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 648/2012

To Whom It May Concern:

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comment regarding the joint Consultation Paper of the European Supervisory Authorities (the "ESAs") containing the draft regulatory technical standards (the "Draft RTS") on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, dated 14 April 2014 (the "Consultation Paper"). The Coalition represents end-user companies that employ derivatives primarily to manage risks. Hundreds of companies have been active in the Coalition, with respect to both legislative and regulatory matters, and our message is straightforward: financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive business investment, and hamper competitiveness in the global economy.

End-users predominantly use derivatives to hedge or mitigate commercial risk. The use of derivatives to hedge commercial risks benefits the global economy by allowing a range of businesses—from manufacturing to healthcare to agriculture to technology—to improve their planning and forecasting and offer more stable prices to consumers and a more stable contribution to economic growth.

The Coalition supports the robust risk-mitigation procedures in the European Market Infrastructure Regulation ("EMIR");[1] however, multinational end-user companies are very concerned over the Consultation Paper's proposed imposition of margin requirements on certain non-financial end-user companies that are located outside the European Union ("EU"). Specifically, we are writing in response to the proposed requirement that financial counterparties ("FCs") and non-financial counterparties above the clearing threshold ("NFC+s") collect collateral from third-country non-financial entities below the clearing threshold ("TC NFC-s"), as set out in

[1] Regulation (EU) 648/2012.

Articles 1 GEN and 2 GEN of the Draft RTS within the Consultation Paper and as expressed at the end of the third paragraph on page 7 of the Consultation Paper.[2] As explained more fully below, we believe that collateral requirements should not be applied to derivatives transactions involving any non-financial entity that falls below the clearing threshold, regardless of its location. Article 10 of EMIR requires a non-financial counterparty to include all derivative contracts that are not objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity undertaken by the applicable non-financial counterparty, *together*, with those entered into by other non-financial entities within the group. Given the global group-wide approach to the calculation to determine NFC+ or NFC- status, it is inconsistent to interpret exclusions from EMIR's requirements along jurisdictional lines.

For the reasons discussed herein, the relevant provisions of EMIR should be interpreted such that FCs and NFC+s are not required to collect collateral from TC NFC-s (or NFC-s). Such an approach would have notable policy benefits, including a reduction in fragmentation and thus increased efficiency and interoperability of global markets. Applying collateral requirements to TC NFC-s would impose increased costs on TC NFC-s that trade with European FCs and NFC+s and will likely lead TC NFC-s to seek to hedge their risk with counterparties that are outside the scope of EMIR or could cause them not to hedge at all. Such result would not only negatively affect a TC NFC-'s ability to effectively hedge its risk, but also would lead to broader market effects including fragmentation and reduced liquidity.

Moreover, such an approach is more consistent with the level 1 text of EMIR. The relevant provisions of EMIR do not state that FCs and NFC+s are required to collect collateral from TC NFC-s, the clearing obligation provisions in EMIR exclude TC NFC-s, and any interpretation of the collateralization requirement in Article 11(3) of EMIR should be interpreted by the ESAs in line with the proposals of international standard setting bodies and the BCBS/IOSCO Final Paper.[3]

In this context, our comments focus on answering specific Questions 1 and 2 posed on page 17 of the Consultation Paper. We also address the issue posed in Question 6 in the attached Appendix A.

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[2] "EU entities would have to collect margin from all third-country entities, unless explicitly exempted by the EMIR or under the EUR 8 billion threshold, even from those that would be classified as non-financial entities below the threshold if they were established in the EU." Consultation Paper at 7.

[3] "Margin requirements for non-centrally cleared derivatives," as issued in September 2013 by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO"), developed in consultation with the Committee on Payment and Settlement Systems and the Committee on Global Financial System (the "BCBS/IOSCO Final Paper").

The Draft RTS Place Unnecessary Burdens on Derivatives End-Users

Many derivatives end-users with affiliates located in the EU also have affiliates located in other jurisdictions across the globe. Inconsistencies in margin requirements between global regulators can lead to significant costs and operational burdens on derivatives end-users. The Draft RTS would not only increase costs and operational burdens for TC NFC-s, but would likely significantly impact liquidity and fragment the global markets.

According to a recent Coalition survey of chief financial officers and corporate treasurers of non-financial end-user companies, released on March 26, 2014,[4] more than two-thirds of respondents indicated that a margin requirement on uncleared OTC derivatives would have a moderate or significant impact on capital expenditures and 86% of respondents indicated that fully collateralizing OTC derivatives would adversely impact business investment, acquisitions, research and development, and job creation. The Draft RTS would impose such collateral burdens on TC NFC-s. As a result, multinational end-user companies will likely choose not to have non-EU affiliates engage in swaps with EU FCs and EU NFC+s where possible, which will likely contribute to market fragmentation where only EU NFC-s trade with EU FCs and EU NFC+s and TC NFC-s trade only with third-country FCs ("TC FCs") and third-country NFC+s ("TC NFC+s"). Such fragmentation will ultimately reduce liquidity in certain markets, making it difficult and more expensive for derivatives end-users to hedge their risks.

Further, under the Draft RTS proposal, TC NFC-s would be forced to negotiate and agree to credit support arrangements with their European FC and NFC+ counterparties. According to the Coalition Survey, 65% of respondents do not use credit support arrangements.[5] The Coalition Survey responses indicate that many multinational end-user companies do not have existing credit support documentation in place with their counterparties and those TC NFC-s that trade with European FCs and NFC+s would be forced to put such documentation in place pursuant to the Draft RTS. Engaging in legal and business negotiations to put such credit support arrangements in place is costly and time consuming for derivatives end-users that are using derivatives to hedge or mitigate commercial risk. Further, inconsistent collateral arrangements among different affiliates of

[4] *See* Coalition for Derivatives End-Users: The Impact of Margin Requirements on Main Street Businesses (issued on March 26, 2014) (the "Coalition Survey"), *available at* http://coalitionforderivativesendusers.com/uploads/sites/351/EndUserMarginSurvey3%202014%202.pdf.

[5] The existence of credit support documentation, including, but not limited to, the requirement to post margin under a Credit Support Annex, is typically specified in Part 4 of the Schedule to the International Swaps and Derivatives Association's Master Agreement (both the 1992 and 2002 versions). For end-user transactions for which there is no collateral posting requirement, the counterparties typically would specify that there is no such Credit Support Annex in Part 4, or would specify other agreements that serve as credit support for the transactions between the two parties.

the same multinational corporation create inconsistencies and burdensome operational requirements.

As discussed herein, the distinction between collateral requirements for TC NFC-s and NFC-s is unnecessary and inconsistent with international standards. International standards reflect a common understanding of the limited systemic risk contribution of non-financial end-users. This understanding is predicated, in part, on the purpose underlying end-user derivatives use—i.e., they are predominantly using derivatives to hedge or mitigate commercial risk and not to speculate. Applying collateral requirements to non-financial end-users that are below the clearing threshold (i.e., NFC-s and TC NFC-s) would place burdens on end-users that many are ill-suited or ill-equipped to address, including increasing liquidity risks and ultimately reducing the ability for end-user companies to hedge their risks effectively. Any increased risks or costs placed on end-user companies ultimately would be borne by their customers.

The Draft RTS Are Inconsistent with EMIR and International Standards

The first line of Article 11(3) of EMIR states that "[f]inancial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after 16 August 2012." This requirement is reflected in the Draft RTS as a requirement on FCs to collect collateral. Article 11(3) of EMIR does not mention the classes of counterparties that an FC may face and from which the FC must collect collateral. Similarly, the second line of Article 11(3) of EMIR indicates that NFC+s, not NFC-s, must collect collateral, but does not denote from which counterparties NFC+s must collect such collateral.

We recognize that there is a difference in the language used in Article 4(1)(a) of EMIR, the clearing obligation, and Article 11(3) of EMIR, the collateral exchange requirements, of EMIR. Article 4(1)(a) of EMIR expressly states how the clearing obligation can apply to TC NFC+s and that such specificity is not found in Article 11(3) of EMIR with respect to the exchange of collateral. We believe it would be inconsistent to draw a distinction between non-financial derivatives end-users located in the EU (i.e., NFC-s) and those non-financial derivatives end-users located in a third country (i.e., TC NFC-s) with respect to collateral requirements, when no such distinction is made with respect to the clearing obligation. This is especially the case when those TC NFC- entities are in the same group as EU-based NFC- entities. Further, the clearing obligation and the collateral obligation are linked in that both require the posting of collateral. Therefore, requiring a non-systemically important non-financial end-user company that is exempt from the clearing obligation to exchange collateral for its non-cleared derivatives would substantially negate the benefits of being an NFC-.

Pursuant to Article 10 of EMIR, non-financial counterparties are required to calculate the clearing threshold on a worldwide group basis by including the derivatives contracts of their non-financial affiliates. While EMIR may exclude a non-EU NFC- entity from its requirements, we do not believe that EMIR would exclude an EU-based NFC- affiliate from its requirements, but not exclude a TC NFC- affiliate.

We believe that the correct interpretation of the language in Article 11(3) of EMIR is that FCs and NFC+s are required to collect collateral from all classes of counterparties that are subject to the clearing obligation, meaning FCs and NFC+s should collect collateral from FCs, NFC+s, TC FCs and TC NFC+s. However, FCs and NFC+s should not collect collateral from NFC-s or TC NFC-s. Such an interpretation would align more correctly with the following:

- Recital (24) of EMIR: Recital (24) of EMIR states that "to mitigate counterparty credit risk, market participants that are subject to the clearing obligation should have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral." Under Article 4 of EMIR, only FCs, NFC+s, TC FCs and TC NFC+s are "subject to the clearing obligation." TC NFC-s (like NFC-s) are not subject to the clearing obligation, so should not be subject to the collateral requirements. EMIR's recitals should be taken into account, as it is intended to aid interpretation.

- Article 11(12) of EMIR: Article 11(12) of EMIR applies (subject to certain conditions) the risk-mitigation provisions, including the collateralization requirement, to trades between two third-country entities. The text in Article 11(12) of EMIR matches almost exactly the text in Article 4(1)(a)(v) of EMIR, the provision that applies (subject to the same conditions) the clearing requirement to trades between two third-country entities. Both of these provisions apply only where both parties to the trade are TC FCs and/or TC NFC+s. This illustrates the link discussed above that collateralization should apply only where both parties are subject to the mandatory clearing obligation.

- Other provisions within the Draft RTS: The discussion box on pages 24-25 of the Consultation Paper describes the importance of gradual implementation and international consistency, and that the largest market participants should be impacted first, with smaller market participants being given more time to adapt. The Coalition agrees with these goals and notes that while an interpretation that FCs and NFC+s are required to collect margin only from FCs, NFC+s, TC FCs, and TC NFC+s would align with these goals, the Draft RTS approach would not. The Draft RTS would require corporate end-user companies in third-country jurisdictions, who use derivatives to hedge or mitigate risks associated with their businesses and whose derivatives activities do not increase systemic risk, to divert capital from their businesses that would otherwise be used for business investment, job creation, research and development, etc., and to instead set aside that capital to post collateral for those non-systemically important hedging activities. Additionally, such derivatives end-users would be required to review, negotiate, and execute new and complex collateral arrangements in the same time frame as that of the largest global financial institutions.

- International standards: The BCBS/IOSCO Final Paper sets out the internationally agreed upon best practice approach to margin requirements for non-centrally cleared

derivatives. The Draft RTS are based upon the BCBS/IOSCO Final Paper.[6] While the Draft RTS notes that "it is crucial to be consistent with international standards," the Draft RTS's requirement on FCs and NFC+s to collect collateral from TC NFC-s is a divergence from the internationally agreed upon standards.

Specifically, Requirement 2.6 of Key Principal 2 of the BCBS/IOSCO Final Paper states that its margin requirements only apply to derivative transactions between two covered entities (i.e., financial firms and systemically important non-financial firms).[7] Where one of the two parties is non-financial and not systemically important, the margin requirements do not apply. EMIR requires the European Securities and Markets Authority ("ESMA") to take into account the proposals of the international standard-setting bodies (as noted above, in Recital 24 of EMIR).[8] As above, there is no clearly expressed (or clearly implied) requirement in EMIR which requires the ESAs to divert from the internationally agreed upon position, so we submit that, particularly on such an important issue, the internationally agreed upon position should be followed.

We also note that the BCBS/IOSCO Final Paper states that one of the two reasons for imposing the collateral requirement is to promote central clearing. The interpretation that FCs and NFC+s should only collect collateral from FCs, NFC+s, TC FCs, and TC NFC+s aligns with this aim: counterparties subject to clearing are pushed to clear more transactions (including being pushed to clear voluntarily transactions which are not subject to mandatory clearing). The current interpretation in the Draft RTS would push clearing by entities that Europe has decided should not have to clear (i.e., by entities that are not subject to mandatory clearing). By definition, the majority of the derivatives transactions caught would be those that are used to hedge or mitigate commercial risk (as the third-country entities captured are below the clearing threshold). The majority of such derivatives transactions could well be tailored to the needs of the entity or are otherwise illiquid and unable to be cleared. The result is that trading becomes more

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[6] As the ESAs explain, the Draft RTS "consider the minimum international standards on margin requirements for non-centrally cleared derivatives transactions" issued in the BCBS/IOSCO Final Paper. The ESAs go on to note that the international standards outlined in the BCBS/IOSCO Final Paper "will help ensure global consistency." Consultation Paper at 6.

[7] The BCBS/IOSCO Final Paper explains, "[t]he precise definition of financial firms, non-financial firms and systemically important nonfinancial firms will be determined by appropriate national regulation. Only non-centrally cleared derivatives transactions between two covered entities are governed by the requirements in this paper." BCBS/IOSCO Final Paper at 9.

[8] Recital (24) of EMIR explains that "ESMA should take into account the proposals of the international standard-setting bodies on margining requirements for non-centrally cleared derivatives."

complex and expensive for non-systemically important, non-speculating, overseas derivatives end-users.

- Recital (6) of EMIR: Recital (6) of EMIR states that "the Commission will monitor and endeavor to ensure that [the G20] commitments are implemented in a similar way by the Union's international partners … [and] … cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between this Regulation and the requirements established by third countries." If the EU departs from the collateral principals as agreed upon and set out in the BCBS/IOSCO Final Paper, international consistency would be reduced, creating inefficiency in global markets and regulatory arbitrage opportunities, while also potentially preventing the European Commission from being able to determine equivalence with other jurisdictions (as the EU regime against which equivalence is decided will contain an unusual variation from the international norm), resulting in market participants having to meet conflicting and/or duplicative regulatory requirements.

  As an example of the disruption that could be caused, we note that EU financial institutions having to require collateral from TC NFC-s would be put at a competitive disadvantage to non-EU financial institutions when competing for international trade. Derivatives play a crucial role not just in the pure derivatives market, but in many other markets including lending (of all types), structured finance, energy and agriculture markets. The approach used in the Draft RTS would also mean that affiliated NFC-s and TC NFC-s will face different costs when entering into derivatives: the same derivative would be cheaper for an NFC- than for its affiliated TC NFC- and corporate groups could be encouraged to move their derivative trading from overseas into the EU for trades with EU counterparties.

  Movements away from the internationally agreed upon approach should only occur if clearly required by the level 1 text (which represents the agreed upon position of the European institutions). No such clear requirement exists. Given the global nature of the derivatives markets and the possibility of regulatory arbitrage, it is imperative that global regulators implement consistent margin requirements that ensure that all non-financial derivatives end-users not be subject to unnecessary margin requirements.

Conclusion

We urge the ESAs to revise the Draft RTS such that TC NFC-s (and NFC-s) are not subject to collateral requirements. Our proposal is consistent with the text of EMIR and with internationally agreed upon standards and would not impose unnecessary costs and burdens on derivatives end-users.

We thank the ESAs for the opportunity to comment on this very important issue to derivatives end-users. If you have any questions on our comment letter, please do not hesitate to contact us.

Sincerely,

Coalition for Derivatives End-Users

Appendix A
Summary of Specific Questions for Consultation

Question 1. What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

See discussion in comment letter.

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If yes, please provide the rationale for the concerns and potential solutions.

See discussion in comment letter.

Question 3. Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition in covered bonds, necessary ones to address the risks adequately? Is the market-based solution outlined in the cost-benefit analysis section, e.g., where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?

NA

Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

NA

Question 5. How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

NA

Question 6. How will market participants be able to ensure the fulfillment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can respondents

identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?

Derivatives end-users remain concerned about the indirect costs that margin requirements will impose on their transactions, even if non-financial end-users are appropriately exempt from direct margin requirements. When an end-user's counterparty enters into transactions to hedge its exposure to an end-user, the margin costs associated with that transaction will ultimately be passed on to the end-user. This indirect cost, when taken together with the potential increase in costs associated with Basel III requirements, fuels a growing concern that OTC derivatives may simply become cost prohibitive for end-users. Such an outcome would be directly contrary to the objectives of policymakers around the world. We recognize the ESAs' concerns regarding the implementation of conditions; however, we urge the ESAs to permit re-hypothecation of collateral when it is posted to secure positions used to offset a hedge of commercial risk for an end-user.