The European Association of Corporate Treasurers (“EACT”) and the U.S. Coalition for Derivatives End-Users1 (“the U.S. Coalition”) thank you for the opportunity to respond to the Second Consultative Document (“the Consultation”) on behalf of thousands of end-users of derivatives across Europe and the United States. The businesses and professionals we represent come from diverse sectors of the economy and serve as job creators and engines of economic growth in local communities in 17 countries of the European Union, the United States and on a global scale.

End-users predominantly use derivatives to hedge or reduce risk. The use of derivatives to hedge commercial risks benefits the global economy by allowing a range of businesses—from manufacturing to health care 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.

We support the broad policy objectives of the G20 reform agenda, and we believe the creation of the Working Group on Margining Requirements (“WGMR”) rightly focuses on minimizing differences among international regulatory regimes, and reducing counterparty credit risks in the derivatives markets. At the same time, the cost and liquidity burdens margin requirements could impose on certain market

participants may prevent end-users from using derivatives markets efficiently or may cause end-users to stop using derivatives markets altogether. Either result is contrary to stated objectives of policymakers in the U.S. and Europe.

Together, this Trans-Atlantic coalition of end-users commented on the Consultative Document issued in July 2012, and we are pleased to have the opportunity to do so again. In this letter, we respond to the consultation by summarizing comments we previously submitted, and submit comments on the following issues:

1. Margin for FX Transactions
2. Margin thresholds
3. Re-hypothecation
4. Phase-in of Requirements

Although we primarily represent non-financial businesses, many end-users engage in financial activities as part of their corporate structure that may make them “financial” under the new regulatory regimes, particularly in the U.S. For example, many end-users have pension funds, captive or non-captive finance affiliates or centralized treasury centers that could be deemed financial under new regulations. Nevertheless, these businesses use derivatives for risk management purposes and not for speculation or investment purposes. Unless otherwise specified, the term “end-users” is used in this letter to refer to both non-financial and financial end-users that use derivatives to hedge risk and that would be subject to the relevant requirements.

Summary of Comments to July Consultative Document

- **Non-financial end-users pose little to no systemic risk and margin requirements would impose a significant liquidity burden on non-financial end-users that will reduce their ability to contribute to economic growth or deter them from hedging altogether.**

  We strongly support the WGMR’s recommendation that margin requirements should not apply to transactions involving non-financial entities whose derivatives risk is not systemically important. We believe that financial end-users whose derivatives exposures are not systemically significant should be granted the same exemption. Like non-financial end-users, they do not pose significant risk to the financial system and they use derivatives predominantly to hedge risks associated with their businesses.

- **Acceptable collateral should include a broad pool of collateral that includes physical assets. This broad pool will reduce the liquidity impact that the margin proposal would have on end users.**

  We continue to support the WGMR’s proposed approach to broaden the pool of eligible collateral to include cash, high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices and gold. We agree that haircuts and other risk mitigants can be used appropriately to reduce the risks associated with a broad-based approach.

  We believe, however, that WGMR should consider expanding the pool of collateral to include physical assets when such assets are used to cross-collateralize a loan that an end-user’s
derivative is hedging. That approach would recognize that (a) many end-users presently pledge physical assets (e.g. equipment, machinery, real estate) to secure their derivatives; and (b) the physical asset frequently secures both the financing obtained to purchase the asset and the swap used to hedge the interest rate risk of the financing. Permitting the use of physical assets as collateral will greatly reduce the liquidity burden for end-users, particularly those end-users that would face acutely onerous collateral requirements because they are heavily invested in physical assets.

- **Neither initial nor variation margin should be required with respect to inter-affiliate transactions between end-user affiliates.**

  We believe that requiring end-user affiliates to comply with requirements that were designed to address systemic risk for market-facing swaps with respect to their inter-affiliate transactions would create costs without a corresponding benefit and place substantial burdens on end-users and consumers. While we appreciate the WGMR’s recommendation to permit local supervisors in each jurisdiction to make determinations regarding inter-affiliate swaps, we believe that the WGMR should explicitly exempt end-users’ inter-affiliate transactions from margin requirements.

- **A system of mutual recognition/substituted compliance will prevent the application of duplicative or conflicting rules on end-users’ cross-border transactions.**

  We support the WGMR’s recommendation that the home and host regulators should apply only one set of rules for cross-border transactions in which two sets of rules may apply by recognizing regimes that are compatible and consistent with international frameworks and IOSCO guidelines. We agree that margin requirements in a jurisdiction should apply to entities established in that jurisdiction, and we urge the importance of international regulators in developing consistent rules regarding margin requirements for uncleared swaps.

1. **Margin for FX**

   Q1. *Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?*

   As we have previously commented, the FX market is fundamentally different than markets for other derivatives. The difference arises from fundamental characteristics of the FX market, including robust risk practices and infrastructure that have developed to reduce settlement risk, the prevalence of short-dated contracts that result in reduced counterparty credit risk, and the significant role the FX market plays in both the flow of cross-border investment and the proper functioning of the global economy. Due to these important differences, we believe that physically settled FX forwards and swaps should be exempt from mandatory initial and variation margin requirements for end-users. The exemption should apply regardless of tenor. In addition, because end-users enter into non-deliverable forwards (“NDFs”) to hedge currency risk for the same economic purpose in a functionally identical way to the use of deliverable forwards, we urge the WGMR to recommend exempting NDFs from the Consultation’s scope.
In our previous comment letter, we highlighted the fact that initial or variation margin requirements imposed on physically settled forwards and swaps used for hedging purposes will force end-users to choose between locking up precious liquidity or leaving themselves exposed to considerable exchange rate risks. In effect, the proposed margin requirements would significantly deter cross-border investment. It is important to note that, generally, end-users are more likely to remain unhedged when faced with new collateral requirements for FX than they would be for other derivatives, such as interest rate swaps. FX hedging is more frequently elective, whereas lenders often require interest rate hedging in conjunction with financing.

We also continue to believe that an exemption that bifurcates forwards and swaps based on tenor will not reduce risk enough to justify the costs of the hedging transactions. If end-users are driven to a strategy that involves rolling or extending short dated products, it will introduce new liquidity risks for end-users each time the short-dated hedge needs to be cash settled. This risk would not exist if end-users are able to time the expiration and cash settlement of their hedge to the timing of the hedged cash flow. In addition, each time an end-user rolls a short-dated hedge, there are additional transaction costs for each roll, multiplying the overall costs to the end-user to hedge long-dated exposures.

Further, there is no discernible policy reason for treating FX forwards and NDFs differently. End-users will consider using FX forwards where the currencies involved have sufficient liquidity and can be exchanged at settlement of the trade. Some transactions involving emerging market currencies simply cannot be delivered. This occurs, for example, when the onshore deliverable FX forward market is not developed or is illiquid or when delivery at settlement is impractical due to local legal restrictions. In such instances, end-users will choose an NDF that can be settled financially in a deliverable currency. The NDF mirrors the risk mitigation and economic result that they would have achieved through an FX forward. Neither the risk nor the functionality of an NDF justifies disparate regulatory treatment.

In its determination to exempt foreign exchange forwards and swaps from most provisions of the Dodd-Frank Act, the U.S. Department of the Treasury described that nearly 95% of foreign exchange trading occurs between banks.2 In light of the concentration of foreign exchange trading within the global banking system and the important role of FX markets in market stabilization, we believe it is appropriate to address margin requirements for FX through supervisory guidance issued by the Basel Committee on Banking Supervision (BCBS), rather than through national regulation. We believe local prudential supervisors, in adhering to BCBS supervisory guidance, may be best positioned to appropriately and prudently account for the unique attributes and risks of the FX markets and the likely impact collateral requirements may have.

2. Margin Thresholds

We support the WGMR’s proposal to recommend initial margin thresholds below which covered entities are not required to post margin. As we commented previously, we believe this will

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reduce the substantial liquidity burden associated with initial margin without undermining WGMR’s objective of mitigating systemic risk.

We urge the WGMR, however, to provide a threshold below which non-systemically important financial end-users would not be required to post variation margin for hedging transactions.

The WGMR identifies variation margin as a widely adopted best practice, and states that there are “no net liquidity costs as variation margin represents a transfer of resources from one party to another.”\(^3\) While this statement may be true for entities that have readily available pools of liquidity (e.g., an investment portfolio of unencumbered securities), the statement is not true for end-users that do not have immediate access to highly liquid collateral. For example, end-users with capital that is heavily invested in physical assets often pledge the physical assets as collateral to secure derivatives. When a loss on a derivative is offset by a corresponding gain in the value of the underlying asset, the asset cannot be immediately liquidated to transfer cash to a counterparty to cover the mark-to-market.

Thus, despite what may be a widely adopted best practice among banks and large market participants, the ability to hedge without posting variation margin, or posting variation margin only when positions exceed a credit threshold, is a critical element of the OTC market for end-users.

In addition, uncertainty regarding the exact amount of margin an end-user would be required to post requires end-users to reserve liquid resources to ensure they are able to meet variation margin requirements throughout the life of the derivative. This involves conservative estimates based on extreme assumptions, adding to the drain on liquid resources required to meet variation margin requirements. For hedging entities that do not have the ability to pose systemic risks, a threshold for variation margin is necessary to reduce the liquidity burden that full variation margin requirement would create.

3. Rehypothecation

Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

End-users remain concerned about the indirect costs that margin requirements will impose on their transactions, even if many end-users are spared from direct margin requirements. When an end-user’s counterparty enters transactions to hedge its exposure to an end-user, the margin costs associated with the counterparty’s hedge position will be passed to the end-user. In particular, a counterparty will increase the transaction price paid by the end-user to compensate for the cost of funding initial margin on its market or credit risk hedges of the end-user’s swap. This indirect cost, when taken together with the potential increase in costs associated with Basel III requirements, contributes to a real and growing concern that OTC derivatives may simply

\(^3\) Section 2(e) of the Consultative Document.
become cost prohibitive for end-users. This outcome would be directly contrary to the objectives of policymakers around the world. We urge the WGMR to consider taking action that would limit indirect costs imposed on end-users, including the following:

- Permit re-hypothecation in limited circumstances: permitting re-hypothecation of collateral when it is posted to secure positions used to offset a hedge of commercial risk for an end-user.
- Eliminate initial margin in limited circumstances: eliminating initial margin requirements imposed on covered entities when such initial margin would otherwise be applied to transactions used to hedge exposures that arise when a counterparty hedges risk associated with an end-user hedging position. We believe this would similarly serve to limit indirect costs that could deter end-users from hedging or unnecessarily increase their costs.

4. Phase-In of Requirements

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements?

We strongly support the WGMR’s recommendation that the margin requirements should not be applied retroactively, and should be applied only to those trades entered into after the requirements take effect.

In addition, we support a phase-in approach for initial margin, believing it is warranted and necessary to provide end-users time to prepare for the significant impact that margin requirements will have on end-users and their counterparties. A phase-in approach would also facilitate regulators’ ability to monitor the impact of new requirements on the market at large. We support establishing a threshold for when margin requirements would apply based on the amount of derivatives activity in which an entity engages.

We believe, however, that the WGMR should also propose a phase-in period for the introduction of variation margin requirements. Although variation margin requirements may be standard practice for large or systemically important market participants, as we previously noted, many end-users currently do not post variation margin. Because end-users hedging business risks pose little to no systemic risk, a transition period to prepare and adapt to the liquidity burden imposed by new collateral requirements will not undermine the WGMR’s objectives. Similarly, we believe that establishing a threshold of activity for initial margin, below

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which end-users do not need to post variation margin, would appropriately balance the costs and benefits.

In addition, we suggest the WGMR consider permitting jurisdictions the flexibility to establish the recommended permanent notional level of activity as a floor, making adjustments based upon the specific characteristics of their markets and legal and regulatory framework. In year five, the proposed notional value reduces from €750 billion to €8 billion, which is a significant step-down in size over a one-year timeframe. In light of the potential for differences in the scope of products and entities covered under the relevant regulatory regimes, it may be reasonable to consider that some jurisdictions may wish to increase the threshold in year five. For example, if certain FX products are considered in scope in some jurisdictions and not in others, the result may be that far more end-users are captured under one regime than another, creating competitive imbalances that the WGMR is attempting to avoid.

Conclusion

We thank the WGMR for the opportunity to comment on these important issues. If you have any questions on our comment letter, please feel free to contact Richard Raeburn (+44.20.8693.7133) at the European Association of Corporate Treasurers or Jess Sharp (+001.202.463.5842) at the U.S. Chamber of Commerce (on behalf of the Coalition for Derivatives End-Users).

Sincerely,

European Association of Corporate Treasurers
U.S. Coalition for Derivatives End-Users