Coalition for Derivatives End-Users

Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland
Attn: Secretariat

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

28 September 2012

Dear Sirs:

Response: Consultative Document on Margin Requirements for Non-centrally-cleared Derivatives

The European Association of Corporate Treasurers and the U.S. Coalition for Derivatives End-Users[1] thank you for the opportunity to respond to the Consultation 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 do not use derivatives to take on risk for speculative or investment purposes. Instead, end-user companies use derivatives to hedge or reduce risk. This use of derivatives to hedge risk 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 customers.

[1] The U.S. Coalition for Derivatives End-Users is comprised of companies and trade associations, including: Agricultural Retailers Association, Business Roundtable, Financial Executives International, National Association of Corporate Treasurers, National Association of Manufacturers, National Association of Real Estate Investment Trusts, The Real Estate Roundtable, and U.S. Chamber of Commerce.

We support the broad policy objectives of the G20 regulatory reform agenda and its effort to ensure derivatives reforms are globally consistent. To that end, we support the creation of the Working Group on Margining Requirements ("WGMR") and believe it rightly focuses on the important goal of ensuring that few regulatory differences exist among international regulatory regimes. At the same time, we believe derivatives reform must be implemented in a manner that preserves the efficiency and utility of the OTC derivatives markets for end users.
We recognize that margin requirements play an important role in mitigating counterparty credit risk. The cost and liquidity burdens these margin requirements could impose upon certain market participants, however, may prevent end users from using the derivatives markets efficiently or may cause end users to stop using derivatives markets altogether. Either result is contrary to the clear objectives of policymakers in both the U.S. and Europe who have created exemptions that would help allow end users to continue managing risks in the OTC markets effectively and efficiently.

In this letter, we focus on the following issues:

1. Margin for non-financial entities
2. Margin for FX transactions
3. Initial margin thresholds
4. Eligible collateral
5. Transactions between affiliates
6. Interaction of national regimes in cross-border transactions

1. Margin for non-financial entities

Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

Yes. We support the WGMR's proposed determination that margin requirements should not apply to transactions executed by non-financial entities whose derivatives use is not systemically important. We agree that such transactions pose little or no systemic risk.

While some non-financial entities enter into credit support arrangements in which they post collateral to their counterparties when the market value of their positions exceed pre-agreed thresholds, many non-financial entities do not enter into such arrangements and, accordingly, post no cash or cash-equivalent margin. In some cases, these non-financial entities secure their derivatives transactions with non-cash collateral, including physical assets, guarantees from credit-worthy entities, priority interests in the equity of subsidiary entities, etc. In other cases,

prudentially regulated financial counterparties tolerate a limited quantity of unsecured exposure based on the overall financial health of the non-financial entity, which can be offered in the form of loans or derivatives.

End users often elect to enter into an OTC derivative without margin requirements for various reasons, including the following:

- Market participants, particularly those with higher costs of capital, may deem the opportunity costs associated with diverting funds into margin accounts as prohibitively expensive.
- Market participants may be party to credit agreements, including revolving credit facilities and bonds, that forbid the posting of collateral as a condition of participation.
- Entities that predominantly invest in physical assets may have limited access to cash or the other kinds of liquid assets required to satisfy initial and variation margin requirements.

WGMR's proposed determination to exclude non-financial entities that are not systemically-important from margin requirements would not undermine its objective of mitigating systemic risk in the derivatives market. Indeed, it is appropriate to exclude non-financial entities from the margin requirements for multiple reasons, which include the following:

- Non-financial entities represent a small fraction of the OTC derivatives market. Statistics released by the Bank for International Settlements ("BIS") indicate that non-financial entities comprise only 7.6% of the derivatives market;[2]
- Non-financial entities do not rely heavily on the kinds of derivatives that were closely associated with the financial crisis. Importantly, the products that these entities typically rely on do not exhibit the "jump-to-default" characteristic evident in the credit derivative transactions that were closely associated with the financial crisis. For example, less than 0.5% of derivatives products used by non-financial entities are credit default swaps.[3]

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[2] Source: Bank of International Settlements, OTC derivatives market activity in the first half of 2011, November 2011: www.bis.org/publ/otc_hy1111.pdf. The use of derivatives by non-financial entities is but a small fraction of the derivatives use of systemically significant users of derivatives. Large dealer banks are typically party to $50 trillion or more in derivatives contracts; AIG was party to $2 trillion at the time of its government bailout; Long Term Capital Management was party to $1.2 trillion at the time of its industry bailout; even the largest non-financial entity derivatives users are party to only a small fraction of these amounts.

[3] Source: Bank for International Settlements, OTC derivatives market activity in the first half of 2011, November 2011. www.bis.org/publ/otc_hy1111.pdf

- Derivatives accounted for less than 4% of total losses incurred by financial institutions as a result of the financial crisis. The vast majority of these losses emanated not from end-user hedges, but from transactions executed by systemically risky financial institutions like AIG.[4]
- Non-financial entities predominantly use derivatives to reduce risk and not to take on risk for speculative or investment reasons. Through hedging, an end user's loss on a derivative is offset by a corresponding gain in their business.
- Non-financial entity risks are heterogeneous and dispersed across tens of thousands of companies. As such, one company's loss on derivatives does not portend significant losses for non-financial entities in the aggregate. The risks may be heterogeneous in the following ways: (1) the hedged risk will differ for each company; (2) the direction of the hedge may differ; (3) the timing of the hedge will differ; (4) the currency of the hedge may differ; and (5) the duration of the hedge will differ.

The U.S. Coalition for Derivatives End-Users ("Coalition") appreciates that the WGMR's proposal would largely exempt non-financial end users from margin requirements, but believes that financial end users should be granted the same exemption. Financial end users include entities such as pension plans, captive finance affiliates, leasing companies and commercial companies with non-captive finance arms. These entities do not pose significant risk to the financial system and use derivatives predominantly to hedge risks associated with their businesses. In short, they use derivatives the same way non-financial end users do. The Coalition thus believes that margin should not be required for any end users, whether financial or non-financial, and encourages WGMR to recommend an exemption for all end users.

2. Margin for FX transactions

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

We believe the WGMR should recommend exempting foreign exchange ("FX") swaps and forwards from margin requirements. Because of the importance of both short- and long-dated contracts for end-users' risk management, the WGMR should not limit the exemption to short-dated contracts.

[4] Additional information on derivatives losses included in Appendix 1.

In normal economic times, an efficient FX market encourages global trade and job creation by reducing the risks associated with doing business globally. In times of economic stress, an efficient FX market facilitates the stabilization of the global economy by allowing market participants to shift their holdings into safer assets, while also providing market participants with cost effective ways to mitigate FX risks during such operations. Because of the importance of the FX market in reducing costs and risks, the WGMR should mitigate any unintended consequences that could diminish the efficiency and effectiveness of the FX market. Collateral requirements imposed on FX swaps and forwards employed by end users could increase systemic risk by introducing significant liquidity risks into the system where none existed and thus deter prudent FX hedging and risk management programs by corporations.

At the same time, we do not believe that the imposition of collateral on end-user FX hedging transactions will measurably achieve the WGMR's objective of reducing systemic risk because of important differences between FX products and other OTC derivatives. We believe this is the case for the following reasons:

The FX market has developed robust risk practices over the last two decades, including settlement systems that meaningfully contribute to mitigating the potential for the market to create systemic risk.

The predominant risk in the FX market is settlement risk. Settlement risk has been significantly mitigated through the development of the Continuous Linked Settlement System ("CLS"). Dealer-to-dealer transactions, and a growing number of non-dealer transactions, are settled through the CLS. As of 2009, approximately 90% of interdealer FX transactions and 55% of all FX transactions were settled through the CLS Bank[5]. The market's participation in CLS settlement has been expanding at an accelerated pace, and we believe this is a trend that will continue to reduce settlement risk, particularly among the largest dealers where systemic risk may accumulate. We believe that the use of CLS in the inter-dealer market and the use of "controlled-delivery" settlement[6] for non-inter-dealer transactions mitigate a significant portion of the overall risk in the FX market.

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[5] Commission of the European Communities, Staff Working Paper accompanying Commission Communication, Ensuring Efficient, Safe & Sound Derivatives Markets, at 41 [hereinafter EC Staff Working Paper] available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf

[6] In the absence of CLS participation, two counterparties can still elect to use controlled-delivery to settle FX trades. In such circumstances, the less creditworthy entity would wire its payment obligation first. Upon receipt of one leg of the payment, the more creditworthy entity would then wire its payment obligation.

With regard to counterparty credit risk, which is much smaller in magnitude[7] than settlement risk for FX markets, the highly liquid and transparent nature of the FX market facilitates significant agreement on market prices and bilateral margining amounts. Consequently, the FX markets already exhibit material collateralization practices, particularly between large financial institutions where systemic risk, if any, would lie. According to the 2012 ISDA Margin Survey,[8] approximately 70.6% of inter-dealer FX derivatives were subject to collateral agreements. At the same time, as discussed above, end users use of FX products to reduce risk and not to take on risk for speculative or investment purposes and therefore do not present the same counterparty credit risk that may otherwise exist.

The infrastructure, transparency and risk practices that have evolved in the FX market were put to the test during the recent financial crisis and permitted the FX market to function remarkably well and without disruption during Lehman's default in 2008.

FX swaps and forwards are different from other derivatives and should not be regulated as though they are the same.

The FX market is fundamentally different from markets with localized reaches, such as equities, credit and rates, because it plays a large role in the proper functioning of the global economy. The FX market facilitates both (1) the global flow of payments, investments and financing and (2) market stabilization by central banks of the world. Applying collateral requirements on FX swaps and forwards could deter hedging of FX risk, which could undermine the important role the FX markets play in the global economy.

FX hedges also differ from other derivatives because they tend to be short-dated, particularly when associated with global sales of goods and services. The BIS estimates that over 60% of outstanding FX contracts have a maturity of one year or less. The vast majority (approximately 80%) have a maturity of less than five years. Shorter maturities allow less time in which default can occur and also result in reduced counterparty credit risk.

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[7] EC Staff Working Paper at 41, *supra* note 4 at 4 (The predominant risk in FX markets is cross-currency settlement risk, i.e. risk that a settlement does not take place as expected.).
[8] 2012 ISDA Margin Survey available at http://www2.isda.org/functional-areas/research/surveys/margin-surveys/

Despite the prevalence of short-dated FX contracts, both short-dated and long-dated FX swaps and forwards should be exempted so that companies can efficiently and effectively mitigate their risks with hedges that match the maturity of their underlying risks. Longer-dated transactions are used as important risk mitigation tools for cross-border investments with longer horizons. For example, when end users purchase foreign assets, they face the risk that changes in currency rates will adversely impact the value of the assets. When the end users intend to hold the assets for long periods, they will frequently protect their net investments from currency risk with long-dated forward contracts. They are also important to secure the lowest cost cross-border financing and mitigation of associated exchange rate risks. Accordingly, a collateral requirement on long dated FX transactions would be inequitable and discourage end users from hedging their risks on cross-border investments with longer horizons.

Although hedging long-term risks with short-dated instruments by "rolling" or "extending" short-dated hedges periodically can work where there is no liquid market for a straight-forward long-dated hedge, such programs have the drawback of introducing new risk to market participants in the form of "roll risk." Roll risk occurs when companies have to cash-settle the short-dated hedges periodically, each time paying out (or receiving) cash that is equivalent to the value of the expiring hedge. These intermittent cash events can create undesirable liquidity issues for companies and multiplies the transaction cost of a long-dated hedge every time an end user has to "roll" a short-dated hedge. Eliminating roll risk allows companies to time the expiration and cash settlement of their hedge to the timing of their hedged cash flow.

Imposing collateral requirements on either short- or long-dated FX swaps and forwards used by end users to hedge their commercial risk would do little to reduce the risk in the FX market. Instead, it would introduce new risks by creating incentives for end users to refrain from hedging in an attempt to avoid collateral requirements and imposing new fluctuating liquidity requirements that would reduce hedging certainty for end users.

3. Initial margin thresholds

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements?

While we represent primarily non-financial businesses, many end users engage in financial activities as part of their corporate structure. For example, many commercial end users have pension funds, captive or non-captive finance affiliates, or centralized treasury centers that could be deemed financial. In each case, however, these businesses use derivatives for risk management purposes and not for speculation or investment purposes.

We support WGMR's proposed concept of initial margin thresholds and believe that such thresholds would reduce the substantial liquidity burden associated with initial margin without undermining WGMR's objective of mitigating systemic risk. We believe this approach—especially when compared to full initial margin requirements—is especially important for parties that use derivatives to reduce risk. Without initial margin thresholds, many end users might be deterred from hedging their risks because doing so would decrease their liquidity.

Initial or variation margin requirements can deter parties from hedging because of the opportunity costs created by the requirements. When a hedging entity diverts funds from its primary business into a margin account, it must consider how those funds might otherwise have been used. The opportunity cost that a hedging entity incurs is equal to the difference between the return an entity would have earned on those funds if they had been productively deployed and the return the entity earns by sidelining the funds in a margin account.[9] This opportunity cost grows as an entity's cost of capital increases because the foregone income associated with sidelining capital increases.

Uncertainty about the exact amount of margin an entity may have to post further complicates the analysis and is principally a function of variation margin. This uncertainty leads hedging entities to reserve liquid resources to ensure they are always able to meet margin requirements. Because failing to post margin when due would be a default under a margin agreement, entities must conservatively estimate possible future margin postings based on extreme assumptions. Consequently, an entity must sideline more capital than needed to meet margin requirements, which further increases a hedging entity's opportunity costs that arise from margin requirements. Consequently, in addition to a permitted initial margin threshold, we believe a variation margin threshold should be permitted for hedging entities.

In addition, we urge the WGMR to consider the indirect costs initial margin requirements may have for non-financial entities that are exempt from clearing. While non-financial entities may be spared from direct margin requirements, it is likely there will be indirect costs associated with the initial

[9] We recognize that differences in transaction price also factor into this analysis. Especially for firms with higher costs of capital, however, opportunity costs (instead of transaction price differences) dominate the analysis.

margin imposed on an end user's financial counterparty when it enters into transactions to hedge its exposure to the end user. When the costs associated with initial margin imposed upon our counterparties are taken together with the potential increase in costs associated with Basel III, it is a growing concern that OTC derivatives may simply become cost-prohibitive for end users. This outcome would undermine policymakers' objectives in both the U.S. and EU to provide an exemption for end users from burdensome collateral requirements associated with central clearing.

We urge the WGMR to look carefully at the indirect costs and the impact they may have on end users' risk management practices and the broader economy as additional capital is diverted from investment and job growth. We would ask that you consider reducing or eliminating initial margin requirements applicable to bank counterparties when such counterparties are hedging risk in connection with end-user hedging transactions.

Q5. What level of initial margin thresholds would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates?

We believe it is appropriate for banking institutions both to assess the total quantity of credit exposure they deem acceptable (i.e., credit exposure limit) to a particular entity and to ensure any initial or variation margin threshold is set at levels that ensure such credit exposure limits are not breached. Because the credit exposure a bank can tolerate for each particular market participant varies, regulators cannot easily prescribe a one-size-fits-all approach. Uniform requirements would also be difficult to establish because banks calculate credit exposure across all product lines, including debt and derivatives, to each counter-party. Setting a derivatives threshold that is not based on the entire credit relationship between a bank and a counterparty would be inconsistent with holistic risk management.

Q5. Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance?

Basel III capital requirements applicable to derivatives are sufficient[10] to ensure that banks are adequately protected against losses related to unmargined exposures and to induce many market participants to centrally clear their derivatives transactions or use exchange-traded futures. Such inducements would be particularly effective on speculators, who do not predominantly rely on the

[10] We further note that Basel III capital requirements are likely excessive for uncleared end-user derivatives and may create disincentives for end users to rely on the end-user exemptions designed for them in various regulatory regimes around the world.

OTC market. Because capital requirements guard against regulatory arbitrage, margin requirements are not needed to target the same objective.

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Should the systemic risk of an entity be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Could data on an entity's derivative activities (e.g., notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

We believe that setting different initial margin thresholds for various entities that are subject to margin requirements would promote the use of OTC derivatives market as an efficient market for risk mitigation. Whether an entity is hedging a commercial risk or whether an entity's use of derivatives could undermine financial stability if the entity failed could be used as criteria to set different margin thresholds. In assessing an entity's potential contribution to systemic risk, we believe that looking at the systemic risk of the entity's derivatives portfolio is appropriate. If a large entity with a small derivatives portfolio failed, the adverse impact on its counterparties would have little to do with its derivatives portfolio. Measuring the risk posed by an entity's derivatives portfolio is straightforward and can be done by reference to the quantity of exposure (i.e., current exposure plus potential future exposure) the portfolio creates. Unlike notional amount, an exposure measure would accurately reflect the risk of the portfolio.

Q7. Is it appropriate to limit the use of the initial margin thresholds to entities that are prudentially regulated, i.e., those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially regulated entities? If so, what are they and on what basis should they be considered together with prudentially regulated entities?

We believe including more than only prudentially regulated entities in the group of entities that are eligible for margin thresholds is appropriate. In particular, we believe any hedging entity that uses derivatives in a manner that is not systemically risky should be eligible for margin thresholds. This approach would acknowledge the benefits to the economy of risk mitigation activity and also distinguish the hedging portfolios of entities that do not materially contribute to systemic risk.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardized initial margin amounts?

We believe thresholds should be evaluated and specified on an individual basis, taking into account the particular risks of each entity, as evaluated by a dealer counter-party using an approved margin model. Further, we recommend that existing internal models should be grandfathered until they are approved and that internal models approved by other regulators should be grandfathered and eligible for the calculation of initial margin. We fear that the use of a standardized initial margin schedule is inflexible and cannot accommodate netting, resulting in drastically increased initial margin requirements. The grandfathering of such existing internal models would allow for end-users to continue reducing risks through netting while increasing liquidity.

4. Eligible collateral

Q20. Is the scope of proposed eligible collateral appropriate?

We support WGMR's determination that a broad pool of eligible collateral should be deemed acceptable, including, without limitation, 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 share WGMR's view that this approach would reduce the liquidity impact of the margin proposal and better align with central clearing practices. Any risk associated with a broad-collateral approach could be adequately controlled through collateral haircuts.

We further note that many end-users presently pledge physical assets (e.g., equipment, real estate or other property) to secure their derivatives positions and typically have limited access to the kinds of liquid resources proposed by WGMR. Such is often the case when an end-user obtains financing to support the purchase of a physical asset and hedges the interest rate risk on the financing with an interest rate swap. In such cases, the physical asset frequently secures both the exposure on the loan and the exposure on the swap. In such instances, the end-user's limited access to the kinds of liquid resources proposed by WGMR as eligible collateral may render a margin requirement intolerable, forcing the end user to alter its financing approach to one that is less efficient and flexible.

We urge WGMR to explicitly allow pledging of physical assets to continue for parties that rely on physical assets to secure their derivatives transactions. Such an approach would not increase systemic risk. For example, in the case of the swapped floating rate loan, the net exposure of the swap and floating rate loan would not exceed the exposure created by an equivalent fixed rate loan. We believe an approach that considers the needs of those that pledge physical assets is consistent with WGMR's statement, "…rules may be less stringent if an entity also enjoys some other effective protection against a counterparty's default."

5. Transactions between affiliates

Q25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why?

We believe that neither initial margin nor variation margin should be required with respect to inter-affiliate transactions between end-user affiliates. The requirements with respect to non-centrally-cleared derivatives between affiliated entities should square with economic reality: inter-affiliate transactions do not increase systemic risk. Unlike swaps entered into with third parties, end users use inter-affiliate transactions to transfer risk within a corporate group. Thus, requiring hedging entities to comply with the 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.[11]

Many end users execute a significant portion of their swap transactions through wholly-owned central hedging units. These central hedging units generate economic savings by allowing companies to manage commercial risk more effectively and secure better pricing for their derivatives trades—savings that the companies can pass on to customers or use to grow their business and create jobs. In this common hedging model, the central hedging unit may structure transactions to offset commercial risk for the parent company and its affiliates or follow specific hedging instructions from affiliated entities within the corporate group. Although variation in the structure of trades exists, the hedging unit typically serves as the primary market-facing entity for the entire corporate group, entering into both transactions with affiliated entities and corresponding hedge positions with unaffiliated third parties.

The Consultation posits that "[r]equiring variation margin on inter-affiliate transactions is advisable as it presents no net costs to a group but does protect against the possibility that one affiliate builds up a large and uncollateralized exposure to another affiliate or parent that could jeopardize the entire group." While these statements may be valid for certain market-facing swaps with third parties, such reasoning does not be apply to inter-affiliate transactions. Inter-affiliate swaps transfer risk within a corporate group so that it can be effectively managed, but do not create counterparty credit risk or contribute to interconnectedness among market participants. Margin requirements are aimed at mitigating systemic risk—which does not result from inter-affiliate swaps, and particularly those

[11] Note that, for the reasons described above in the section on margin for non-financial entities, the Coalition urges the WGMR to recommend that initial and variation margin requirements not apply to inter-affiliate swaps of *financial* as well as *non-financial* end users.

between commonly-owned affiliates. Further, under rules proposed by U.S. regulators, end users would be required to maintain a centralized risk management program that monitors and manages the risks associated with inter-affiliate swaps.

The Consultation's statement that "the posting of variation margin from one affiliated entity to another simply involves the movement of collateral among affiliated entities" and therefore "should generally not create incremental liquidity demands on a net, consolidated basis" does not consider the substantial liquidity that will be tied up for end users that use inter-affiliate trades in order to manage risks of a corporate enterprise. The notion that the exchange of variation margin is as simple as moving collateral from one pocket to the other pocket (i.e., that the exchange of variation margin results in no net change in the commercial enterprise's balance sheet) is false. With respect to end-user entities that use a centralized hedging model, affiliate entities will likely not have the liquidity to exchange variation margin. Accordingly, the affiliates would be required to borrow the money from the centralized hedging unit with which the affiliate is entering into the trade to satisfy variation margin requirements. This arrangement transfers the affiliate's loan obligation back to the centralized hedging unit, thereby effectively eliminating any perceived benefit of the exchange of variation margin in the first place.

Q26. Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

As discussed above, we urge that variation margin should not be required with respect to inter-affiliate transactions between end-user affiliates, regardless of whether affiliates are within the same national jurisdiction. Inter-affiliate transactions between end-user affiliates do not increase systemic risk and therefore should not be subject to variation margin requirements.

6. Interaction of national regimes in cross-border transactions

Q.27 Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

Many end users operate globally with numerous affiliates throughout the world and engage in cross-border derivatives as part of their corporate hedging programs. We agree with WGMR that home-country supervisors should permit entities to comply with the margin requirements of a host- Basel

country regime when it finds the host-country regime is comparable. This approach is consistent with historical practice and long standing principles of international law and will help to prevent duplication and conflicting regulations imposed on the same transactions and entities. It is fundamental to this approach that margin requirements be imposed consistently across jurisdictions; both to facilitate mutual recognition of regimes and to ensure competitive imbalances do not occur that may result in reduced liquidity or counterparty options for end users.

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.

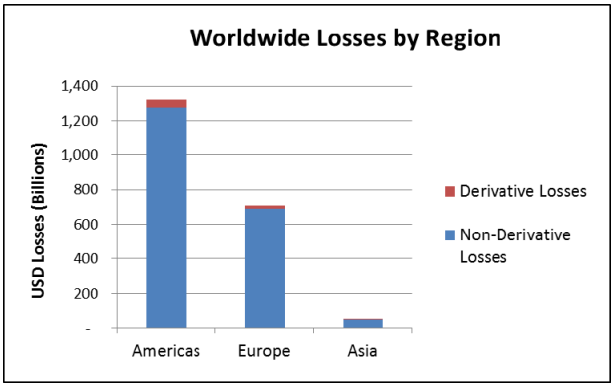
Sincerely,
U.S. Coalition for Derivatives End-Users
European Association of Corporate Treasurers

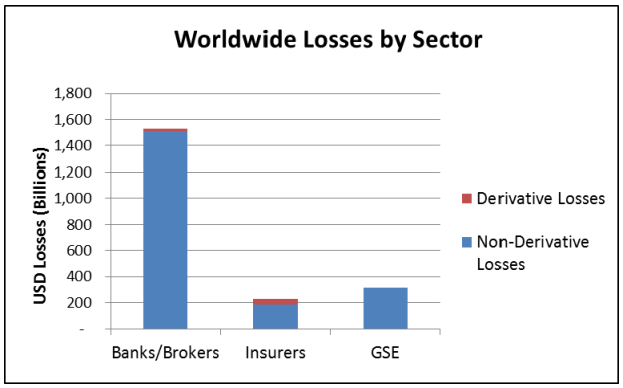
Appendix 1

We believe WGMR's proposal not to impose margin requirements on non-financial entities appropriately reflects the limited losses banks experienced on derivatives transactions executed with such entities. Whereas the failure of AIG and its subsequent government-funded bailout emphasizes the importance of managing the risk of derivatives market participants whose derivatives use is systemically relevant, an examination of available loss data on OTC derivatives suggests that the loss experience for market participants that are not systemically relevant is actually quite limited.

Since inception of the financial crisis, financial institutions worldwide have recognized approximately $2.08 trillion in losses on all types of financial products, including loans, CDOs, asset-backed securities, derivatives, etc.[12] Of note, less than 4% of such losses were the result of derivatives (more than half of which came solely from AIG – a systemically relevant derivatives user). In fact, of the financial products that resulted in losses for financial institutions, there were eight other categories of financial products that comprised a greater share of losses than derivatives. Loan losses exceeded derivatives losses by more than ten-fold.

The first graph below shows the distribution of worldwide losses by financial institutions across geographies and shows the component of those losses attributable to derivatives ($66.9 billion in derivatives losses out of $2.08 trillion in total losses). The second graph shows the allocation of losses across financial institution types and the component of those losses attributable to derivatives.





The data clearly show that derivatives – especially those executed by non-systemically relevant market participants – made a relatively small contribution to financial institution losses around the world.

[12] Source: Bloomberg WDCI function as of 11/15/2011