Commissioner Barnier
European Commissioner for Internal Market and Services
European Commission
BERL 10/034
B - 1049 Brussels

(by email)

26 November 2012

Dear Commissioner,

The Anglo-French Committee of the International Regulatory Strategy Group and Paris Europlace would like to set out its support for amendments to CRD4 proposed by ECON, which will positively assist the European economy by aligning the treatment of derivatives transactions entered into by corporates and pension funds in EMIR and CRD4. We would also support the EU going further by extending the exemption to all corporates globally, not only those established in the EU. We would be grateful if you could also reflect this in your engagement in the trilogue discussions on these issues. We attach a more detailed note of the individual provisions in the annex.

The focus of financial regulation since the crisis has been to deliver a stable and resilient financial system going forward. However, consideration needs to be given to the impact of this regulation on end-users to ensure that financial services can continue to play its role in delivering jobs and growth for the EU.

Derivatives play a vital role in managing risk for financial institutions, investors and nonfinancial corporates. Both exchange-traded and OTC derivatives have a clear social and economic benefit. That is why the final text of EMIR published in July included an exemption for corporate end-users from the obligation to centrally clear OTC derivative contracts where such transactions were for the purpose of hedging risk, thus saving corporate from the cost of posting collateral. Similarly, EMIR exempted pension funds from clearing OTC derivative contracts. However, the Commission proposal for CRD4, which implements the Basel III agreement, undermines these important exemptions by requiring banks to hold additional regulatory capital for the Credit Valuation Adjustment (CVA) risk. For corporates, this means significantly higher hedging costs, which in turn may lead to companies to reduce hedging activities leaving them directly exposed to business risks and/or price volatility. In addition, CVA can contribute to procyclicality and affect the price of CDS. This will result in in potentially negative implications for the real economy. For pension funds, this means significantly higher costs and therefore lower returns for pensioners.

The European Parliament identified and addressed many of these issues, which are included in the report on CRD4/ CRR by Othmar Karas MEP, approved unanimously in the Economic and Monetary Affairs Committee on 14 May 2012.

In summary, the positive steps taken by ECON are:

- **Corporates:** The Karas report exempts banks from holding additional capital (CVA) against OTC derivative transactions where the counterparty is a non-financial entity based in the EU and the derivative trade was for the purpose of hedging. This will reduce hedging costs for corporates and ensure consistency between CRD4 with EMIR.

- **Pension funds:** The Karas report exempts banks from holding additional capital against OTC derivative transactions where the counterparty is a pension fund. This will reduce costs for pension funds and align the treatment of such transactions in CRD4 and EMIR.

These exemptions from the CVA charge are crucial so as not to undermine the exemptions in EMIR and to ensure that the wider economy is not adversely impacted. We would support the EU going further than the Karas report by extending the exemption to all corporates, not only those established in the EU.

Should you require any further information or clarification of the points raised in this letter, we would be happy to discuss this further and we may be contacted via Elizabeth.gillam@cityoflondon.gov.uk.

Yours sincerely,

André-François Villeneuve

André Villeneuve
Chairman International Regulatory Strategy Group

V. Levy-Garboua

Vivien Levy-Garboua
Chairman Steering Group of Paris Europlace

ANNEX

Capital Requirements Directive IV - European Parliament CVA Exemptions

There is justifiable concern about the disproportionate impact of CRD4 on the wider economy, in particular corporates and pension funds, in terms of the capital charges and the upward pressure that this will put on the cost of hedging. Capital Requirements Directive IV (CRD IV) presents an opportunity to implement Basel III in a way that would limit the adverse effect on the financing of the wider economy.

Background: The Importance of OTC derivatives to the wider economy

Derivatives allow non-financial corporations to transfer financial risks to third parties, enabling them to focus on managing their core business. Derivatives support long term planning (e.g. through an exporter hedging foreign exchange exposure, or an airline hedging jet fuel prices) and enable capital intensive projects to be undertaken (e.g. through hedging of interest rate risk associated with the borrowings financing the project).

Derivatives allow users to manage exposures to price risk of a particular commodity, currency, interest rate, counterparty or equity. These risks can be complex and long-dates. The requirement for customized solutions accounts for much of the demand and growth in OTC derivatives (versus less flexible alternatives in the exchange traded and cash markets).

Key Recommendation 1: Support Parliamentary Amendments to CRD IV CVA exemption

The Parliamentary Rapporteur's report on CRD IV[1], recommends amending the Commission's proposal in a way that favorably impacts the treatment of hedging conducted by corporates and pension funds:

a. Corporates: The Karas report exempts banks from holding additional capital against OTC derivative trades where the counterparty is a corporate based in the EU. This exemption serves to align the treatment of such transactions with EMIR, where corporates are exempt from clearing OTC trades where such trades are for the purpose of hedging. Together, these exemptions will ensure that the cost of hedging remains viable for corporates to manage risk (Article 372- paragraph 3)

b. Pension funds: Similarly, the Karas report amends the Commission text by exempting banks from holding additional capital against OTC derivative trades with pension funds, thus aligning CRD4 with the EMIR exemption for pension funds to clear their OTC trades. These exemptions will ensure that pension funds can continue to hedge risk while maintain returns to pensioners. (Article 372- paragraph 1).

Key Recommendation 2: Extend CVA exemption to all corporates

The exemptions in EMIR and those introduced in the Karas report are limited to corporates based in the EU. We would support the EU going further and extending the exemptions to all corporates, not only those based in the EU.

Conclusion

The parliamentary package that amends CRD IV with regard to CVA charge recognizes the criticality of OTC derivatives to European companies and will help to ensure their ability to engage in hedging. The amendments respect the goals of CRD IV to create a stronger banking sector, without damaging lending to the real economy.

[1] European Parliament: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-478.506%2b01%2bDOC%2bPDF%2bV0%2f%2fEN