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Office of International Affairs  
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Dear Jacqueline,

Thank you very much for meeting with me last Monday to discuss the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), and specifically our request that derivatives executed by EBRD and the other multilateral development banks with the U.S. as a shareholder ("MDBs") be excluded from the Act. This would allow MDBs' derivatives transactions to continue to be authorised, monitored and controlled by all our sovereign shareholders collectively rather than through national legislation and regulation (including the Act and its implementing regulations).

As agreed, I expound below the main points of our discussion in support of our request, which cover the use of derivatives by EBRD, and the effective way in which EBRD is able to currently monitor and control the associated risks; the significant increase in credit risks, liquidity risks and costs that the Act would entail for EBRD; and the immunities and privileges that EBRD and other MDBs enjoy, which generally exempt them from market regulation in the United States and other member countries.

### **EBRD's Modus Operandi in the Derivatives Markets:**

EBRD has been active in the swaps market since the early 1990s and has, for several years, been able to hedge the risks inherent in exotic and complex bond issuance through the bilateral derivatives market, thereby widening the scope of the Bank's funding instruments, investor base and investment universe, and thus improving the cost of funding, and investment returns. EBRD has also been able to facilitate the hedging of risks for its clients by structuring loans to minimise project risks, including by fixing or capping rates on amortising structures, by hedging a project's sensitivity to inflation or commodity prices, and by offering local currency loans to non-exporters. All such client hedges are fully offset with the market, for which the over-the-counter ("OTC") derivatives market is usually the sole provider. In addition to promoting local currency usage, the EBRD has also sought to develop domestic capital markets in its countries of operations, including through the issuance of domestic bond issues, as well as through being an anchor investor in corporate bonds in domestic markets. These activities, which concord with the G20 action plan to support the development of local currency bond markets, have been enabled through hedging in the swaps market. EBRD currently has over 1,400 outstanding derivatives trades with 48 counterparties.

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EBRD minimises the credit risk inherent in bilateral swap transactions through the use of ISDA Master Agreements and Credit Support Annexes (“CSA”s). The Bank’s CSAs allow parties that are triple-A rated, such as EBRD, to not post collateral, whereas derivatives and FX transactions with Aa1/AA+ rated counterparties are collateralised when the net mark-to-market value exceeds US\$ 30 million, which declines with each rating notch to US\$ 5 million for A1/A+ rated entities. EBRD’s credit policy for Treasury operations is very conservative, and thus the Bank requires its few counterparties for derivative transactions that are rated below A/A2, to post collateral upfront (and over-collateralise transactions). Where CSAs with most counterparties are based on mid-market valuations, the EBRD has several CSAs that are based on the replacement cost of transactions. While CSA thresholds are, as aforementioned, based on credit ratings by Standard and Poor’s and Moody’s, the Bank uses internal ratings to govern the overall counterparty limit, and these may prove more conservative than those of external rating agencies. Usage of the counterparty limit for derivatives trades not only reflects the relevant counterparty threshold under the CSA, but also operational, legal and model risks associated with such transactions.

EBRD performs daily mark-to-market operations, calling (or returning) collateral accordingly. The valuation of the Bank’s largely complex and/or exotic currency trades has so far proved robust, with very few disputed collateral calls preventing the EBRD from receiving collateral on the same day. Indeed, the longest collateral dispute that the Bank has had over several years’ experience has not exceeded one-week. If there is a disagreement, we follow the ISDA/CSA requirements to seek market quotations, and have not come across a problem of lack of transparency of pricing and valuation. The EBRD receives weekly mark-to-market valuations from its counterparties to ensure that the portfolio of trades is matched, as well as to explore in advance differences in valuation that may prove problematic were a collateral call to be required. This also allows the Bank to compare differences for the same derivative structure across counterparties.

The Bank’s valuations are further validated by the EBRD’s frequent experience of unwinding and novating trades. This is typically the result of EBRD’s clients’ wish to prepay on loans that have been structured through an offsetting hedge with the derivatives market, or when EBRD buys back a bond from an investor on a private placement. Through such unwinds and novations the EBRD’s counterparty and overall credit risk is reduced. In the case of the Lehman’s default, the EBRD was able to novate its nine swap transactions, which included complex, structured trades for which EBRD received the requisite number of quotations at levels very close to its own valuation. This meant that EBRD returned the excess collateral held to the administrators of the bankrupt entity.

As the EBRD exactly matches bond and swap flows to ensure the same determination for all calculations, including by using the same calculation agent for both transactions, and by employing the exact wording of some of the detailed clauses of executed transactions (such as fallback provisions to determine a rate fixing if a screen-based rate is not available), this will only be finalised in the days between the trade date and the effective/payment date of bond and swap. By exactly offsetting payments under the bond

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with flows received under the matching swap, the EBRD is able to receive hedge accounting treatment under IAS 39, thereby ensuring that the Bank's profit and loss is a more accurate reflection of economic reality.

## **The Risks to EBRD from the Promotion of Standardisation and Clearing of Derivatives under the Act:**

As the majority of the EBRD's derivatives trades are exact hedges for the Bank's assets and liabilities, which are predominantly structured transactions and/or denominated in exotic currencies, it is unlikely that they will be hedgeable through standardised transactions. Therefore, any restrictions on the use of non-standardised derivatives would fundamentally impact EBRD's funding, lending and investment activities. It is worth noting that many of these will be guided directly by the end-user (client) needs and economics, or investor appetite (bondholders). In the former case, especially, the flexibility to change will either be non-existent or mean much higher residual risk on the part of the client.

If capital charges were to be increased for non-standardised derivative transactions, such charges will likely be passed on to EBRD, impacting the Bank's profit margins and liquidity position. Of a total derivatives portfolio of USD 61.3 billion (by notional amount), only USD 15 billion may be deemed sufficiently standardised to be included on a Derivatives Clearing Organisation ("DCO"). Even an increased capital charge of 1 basis point on EBRD's "non-standardised" trades would equate to a cost of USD 23.8 million, (and we understand that the increased charges are likely to be in excess of 1 basis point). It should also be noted that any imposition of capital charges on bilateral derivatives with a triple-A rated MDB, such as EBRD, would create a marked incongruity between the treatment of our bonds and that of our swaps. In recognition of our sovereign shareholders and excellent credit quality, our bonds are 0%- risk weighted assets, whereas our swaps which have the additional benefit of being subject to netting, as well as collateral were we to be downgraded to AA+/Aa1, would be treated as riskier instruments.

If there is a requirement for collateral to be posted by both parties to bilateral derivatives transactions, this will create significant liquidity risks and increased credit risk for EBRD. While currently, as aforementioned, EBRD does not post collateral for as long as it is triple-A rated, were the Bank's collateral agreements to have required the Bank to post collateral against its bilateral derivatives transactions that were in favour of the counterparty, the Bank would have needed to post as much as USD 891 million in U.S. Treasuries, other triple-A government bonds, or cash. This sum will rise exponentially with changes in interest rates and foreign exchange rates, especially as the majority of the Bank's derivative trades are related to Funding transactions in which the EBRD receives the fixed rate payment due under the bond, and pays floating rate (predominantly U.S. Dollars or Euro, which are the currencies in which the majority of the Bank's loans are denominated). As EBRD does not take deposits, and does not have access to a lender of last resort, it would have to take account of such collateral requirements by increasing its borrowing activities.

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It is likely that the volume, scope and counterparties to non-standardised derivatives will be more circumscribed, further impacting the variety of hedging transactions that EBRD can execute on its own behalf and that of its clients, as well as the pricing, liquidity, and ability to novate such non-standardised transactions. Restrictions on non-standardised derivative transactions will *either* enforce limitations on the types of bonds and loans the EBRD will be able to offer its institutional and retail clients, *or* it will require the Bank and/or its clients to bear risks that a standardised derivative contract will not fully cover. Indeed, following standardisation in the credit default swaps (“CDS”) market, we note that it is increasingly difficult to execute credit linked notes (“CLNs”) on terms that do not transfer inappropriate risks from the bank market to those least able to manage such risks (end investors or issuers), as banks seek to exactly match their standardised contracts by asking investors in CLNs to accept risks that they would not typically have borne prior to standardisation. These new risks include that the reference credit may have defaulted 60 days prior to the bond payment date, and that the auction process produces a mark-to-market value that reflects less on the true residual credit risk, but rather on the illiquidity of the specific (cheapest to deliver) bond selected. The results for a seller of CDS either through the swaps market or as an investor in a CLN have, in some instances been significantly worse than those attainable by physical settlement of a reference asset or assets that conform to specified criteria.<sup>1</sup>

If bilateral standardised derivative transactions were to be moved to a DCO, this would entail substantial risks and uncertainties for EBRD including the following:-

- EBRD would see an increase in the risks on non-cleared "exotic" products by limiting the scope for bilateral netting of vanilla products against exotic products outside the DCO.
- EBRD's transaction costs will be higher than those borne currently, and the Bank's liquidity position would be affected given that we do not post collateral while triple-A rated, whereas a DCO imposes initial and variation margin on all counterparties. This cost, which primarily covers the risk of default, will likely be uniform across counterparties irrespective of rating, notwithstanding the fact that the likelihood of a triple-A rated supranational defaulting is significantly lower than that of other less well-rated counterparties. The mutualisation of risk across all parties irrespective of rating implies a level of subsidisation by the best rated entities for trades executed by those with a lower rating. In relation to the liquidity position, as EBRD does not take deposits, and does not have access to a lender of last resort, it would have to take account of all margining requirements by increasing its borrowing activities and thus the overall liquidity it holds.

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<sup>1</sup> EBRD's concern about the auction settlement process for CDS was such that the Bank exercised its right to insist on physical delivery to settle an outstanding CDS contract following the conservatorship of a triple-A U.S. Agency in 2008. The auction process produced a recovery of just 94% of principal despite the Agency being explicitly guaranteed by the U.S. government and affirmed at AAA/Aaa/AAA. At the time of the auction the deliverable assets were trading at approximately 106%. EBRD's CDS counterparty therefore revoked its "credit event" notice, in effect declining to deliver a bond trading above par. Had the so-called "Big Bang" CDS protocol been in effect at that date, EBRD would have been forced to accept a loss of 6% of principal on a credit fully guaranteed by the U.S. government.

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- The average rating of counterparties in the DCO is likely to be significantly below that currently required by EBRD for swap trades. The Bank would have no control over this (both because we would not determine the acceptability of counterparties, as we do now, and we probably would not be able to buy protection to hedge the risk). Furthermore, it is not clear how easy and costly it will be to transfer swaps executed in one DCO to another.
- If all counterparties in a DCO are treated equally, irrespective of credit rating, this may increase the amount of business that less well rated entities may undertake, and decrease the exposure that better rated counterparties would be allowed (by their internal risk management) to take, skewing the risk within the DCO further. This would be in direct contrast to the more rational position that exists for bilateral trades, which sees counterparties impose size and maturity restrictions on vulnerable counterparties.
- If, as would likely be the case, commercial banks alone are accepted counterparties in a DCO, EBRD may be pushed to do standardised swaps on a DCO through an intermediary, concentrating our exposure further. This would contrast with EBRD's current position where our derivatives exposure is spread over 48 of the market's best rated counterparties, all of whom have entered into ISDA Master Agreements, and with 46 of whom EBRD has a CSA. (The remaining parties are rated triple-A.) In addition, we would expect that the overall price (given an intermediary) and the transparency to us would be far inferior to that of a bilateral arrangement, as we would have to analyse not only our counterparty but the counterparty's deals as cleared through a given DCO. As DCOs will under no circumstances be completely uniform across jurisdictions, we see this as a significant analysis and risk management challenge.
- Given that a DCO determines the margin requirements to cover derivatives' risks, all participants are effectively delegating the risk management of their swaps business to the DCO. The valuation and risk assessment is therefore more opaque for DCO counterparties, and whereas market counterparties are constantly cross-checking their trade valuations through market pricing and collateral calls, the validity of the methodology employed by DCO valuations will not be relentlessly scrutinised, thereby increasing systemic risk.
- Delegation of risk management to the DCO may become even more of an issue if the differential in capital and other requirements between DCO trades and non-standardised trades is too high, as it will encourage DCO members to push for more trade types to be accepted than can easily be managed. As the DCO would be fully matched on all its trades, the DCO has less impetus to constantly improve or fine-tune their valuation framework – especially as the profitability of the DCO is not commensurate with that of a market counterparty.

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- It is not clear that a defaulting party in a DCO does not have an asymmetric position i.e. that they can walk away from their obligations on defaulted contracts, but that these are not limited by imposing losses on their positive marked-to-market positions.
- If EBRD seeks to unwind a swap transaction having bought back a bond from an investor or having allowed a client to prepay a loan that is hedged through the swaps market, the Bank will likely have to enter into new swap transactions, increasing the exposure to the DCO, rather than unwinding or novating the swap transaction, as currently, which reduces credit risk.
- Customer fund segregation becomes critical in a DCO, and this has been exposed as an area of greater regulatory weakness in many jurisdictions following the default of Lehmans in September 2008. In the absence of global bankruptcy rules, this risk will remain very significant.
- The capitalisation of a DCO would need to be extremely robust. In the event of a DCO default, due to an inability for the DCO to cover losses on defaulting counterparties, it will need to be clear who will ultimately bail it out, as the systemic risk of a failure and the interconnectedness of the parties would be significantly greater than under the present system of bilateral derivatives trading. If the DCO is a multi-national entity, the need to clarify the ultimate guarantor of the DCO will be even more pertinent.
- Currently, if one counterparty has a problem in its own operations or with an agent, there is a custom of forbearance and tolerance while problems get resolved. A DCO is more likely to behave inflexibly, and increase the likelihood that a counterparty will be inappropriately put into default.
- Developing interest rate and currency hedging instruments for emerging markets (such as EBRD's region) is a critical part of the development of domestic capital markets, and the reduction of currency and interest rate risk for corporates and households in the region. If such products when denominated partially (i.e. CCIRS) or fully (i.e. IRS) in local currency are required to be traded on a DCO, the initial costs of developing the market may be prohibitive, and the infrastructural requirements will impose delays. If such trades are not deemed standardised, but are subject to new requirements for non-standardised trades, this will likely hamper the development of such markets by imposing greater costs and greater illiquidity.

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## **EBRD's Immunities and Privileges:**

As already mentioned in our previous letters to the CFTC (dated 5 April 2011 and 1 July 2011), EBRD, along with its sister organisations like the International Bank for Reconstruction and Development (the World Bank) and the International Finance Corporation, enjoys various privileges and immunities, and is generally exempt from market regulation in the United States and its other member countries. The 1944 Bretton Woods Conference led to, *inter alia*, the formation of the World Bank and the International Monetary Fund, and the founding members recognised even then that being subject to regulation under a variety of potentially conflicting national laws and regulations would be inefficient at best, and crippling at worst. As a result, member governments have been implementing privileges and immunities of MDBs in domestic law. Some examples of these and other instances where national regulatory regimes have exempted EBRD are set out below:

### United States

United States membership in the EBRD was authorised on 5 November 1990 by the European Bank for Reconstruction and Development Act (the “EBRD Act”). The EBRD Act provides that any securities issued by EBRD “in connection with the raising of the funds for inclusion in the Bank’s ordinary capital resources shall be deemed to be “exempted securities” within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, with the result that offerings and sales of securities by EBRD in the United States are exempt from the registration requirements of the former Act, and EBRD is not subject to reporting obligations imposed by the latter Act.

### Canada

Canada recognises EBRD’s status in the Privileges and Immunities of the European Bank for Reconstruction and Development Order. For example, the Exemption Order of the Ontario Securities Commission exempts EBRD from securities regulation of Ontario (and more specifically, the registration and prospectus requirements).

### Europe

In the European Union, there is a similar, consistent record of regulatory forbearance. The most pertinent one is in the draft European Market and Infrastructure Regulation (“EMIR”), which is the European counterpart to Title VII of the Act, where MDBs are largely, or even completely, excluded from the remit of EMIR. Both the Prospectus Directive and the Transparency Directive also provide far-reaching exemptions for “public international bodies” of which one or more EU countries are members.

### Japan

Financial Instruments and Exchange Act (Law No.25 of 1948) provides organisations like the EBRD with an exemption from its disclosure rules relating to debt securities.

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## Taiwan

In Taiwan, EBRD is exempt from the requirements for offering and issuance of bonds under the Regulations Governing the Offering and Issuance of Securities by Foreign Securities Issuers, the requirements for underwriting bonds under the Securities and Exchange Act and Taiwan Securities Association Rules Governing Underwriting and Resale of Securities by Securities Firms, the disclosing obligations for publicly announcing financial reports, and the requirements for the Regulations Governing Information to be Published in Financial Institution Prospectuses for Offering and Issuance of Securities.

As the aforementioned examples show, many regulations explicitly recognise the special status of EBRD and the other MDBs, minimising intrusion on their internal operations. Given that the Act is part of a G20 initiative to regulate derivatives, explicitly excluding us from the Act will also ensure international harmony in the treatment of MDBs, thereby reducing the likelihood of encroachment on the supervisory remit of other national regulators.

Yours sincerely,

Isabelle Laurent  
Deputy Treasurer & Head of Funding  
EBRD

cc: James Hudson, Director, United States, EBRD