10 March 2012

AFME, ICMA, ISLA and ISDA joint input for ESMA Consultation Paper on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EU) No XX/2012)

On behalf of our members, the Association for Financial Markets in Europe ('AFME'), the International Capital Markets Association ('ICMA'), the International Securities Lending Association ('ISLA') and the International Swaps and Derivatives Association ('ISDA') appreciate the opportunity to contribute to the ESMA Consultation Paper on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EU) No XX/2012). We hope to continue further dialogue with the regulatory community and policy makers and welcome the opportunity to discuss in depth the responses provided in this paper at your convenience.

AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website www.afme.eu.

The International Capital Market Association (ICMA) is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. Further information is available at www.icmagroup.org

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has more than 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America. For more information please visit the ISLA website www.isla.co.uk

Since 1985, the International Swaps and Derivatives Association (ISDA) has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

AFME, ICMA, ISLA, ISDA, henceforth 'We' are pleased to provide the following input.

Executive Summary

We appreciate the opportunity to contribute to the ESMA Consultation Paper on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EU) No XX/2012). We hope our comments will be helpful in developing proportionate rules to deal with the issues of concern.

Our main feedback is as follows:

- We support ESMA in trying to offer market participants guidance on how to interpret the concept of 'correlation'. However, we do not support the introduction of a firm quantitative test for correlation. A level of 90% - as proposed by ESMA – is inappropriately high.

- A backward-looking test for correlation, based on historic data, is too restrictive; in dynamic markets and particularly during periods of volatility it would prevent market participants from deploying hedging techniques based on developing or anticipated correlations between assets.

- Any guidance on the assessment of correlation must recognize that price correlation (whether historic or expected) will not always be an appropriate measure. Sovereign risk may be an indirect, or only partial, contributor to price movements in a given asset, and yet such asset may still serve as coverage for a CDS. This principle is specifically acknowledged in Recital 21 of the Regulation.

- A geographic restriction on the use of sovereign CDS for hedging purposes is not justified by the Level 1 Regulation, will prevent legitimate hedging strategies that nevertheless meet the tests of correlation and proportionality from being employed, and is thus a disproportionate restriction on the operation of the EU Single Market.

- The introduction of a mandatory time limit within which sovereign CDS position holders must offload a proportion of their position when it becomes partially uncovered is inappropriate, and has the potential to significantly increase volatility in the sovereign CDS market.

- We are concerned that the provisions on grandfathering are unclear and will leave market participants facing considerable uncertainty about the legal status of particular trades.

We and our respective members again thank you for the opportunity to participate to this consultation paper. We have aimed to provide as much detail and constructive feedback to the questions posed in the document as possible. We remain fully at your disposal for further engagement and correspondence.

Yours faithfully

AFME	**ICMA**	**ISDA**	**ISLA**
Sander Schol	**John Serocold**	**Julia Rodkiewicz**	**Kevin McNulty**

General Remarks not relating to a specific question

Timing

We feel that the limited timeframe ESMA has had to prepare the technical requirements, and the three week consultation period available to market participants, has not provided sufficient time to thoroughly consider the impact the ESMA proposals will have on the market.

Consistent with the legal obligation ESMA faces under the terms of its founding Regulation to 'analyse the related potential costs and benefits' of the standards it proposes', we believe that more time is required to enable all affected parties to analyse in detail the costs of these requirements and how they will impact the operation, efficiency, and liquidity of the market.. Three weeks is a very short timeframe for stakeholders to provide detailed and realistic estimates of the cost and benefits impact of the proposals, let alone for associations to develop market-wide estimates.

We are particularly concerned that Article 46.2. of the Regulation (grandfathering provisions for uncovered CDS) could have implications for sovereign CDS contracts entered into after the date of entry into force of this Regulation, which is expected to be on an unspecified date in mid March. We understand from ESMA that relevant draft technical standards and advice on delegated acts are going to be published only on 31 March and mid April respectively. This timetable raises serious issues of legal certainty, for market participants, who will be given very little time to adapt to fundamental changes to the legal structure of key markets.

We understand that the process is significantly compressed compared to normal ESMA practice and that our concerns are shared by ESMA itself, as expressed in its letter to the European Parliament of January 17 last[1].

For further information on our general concerns in relation to the shortness of consultation periods, we refer to the joint associations' letter of 17 January 2012 to Commissioner Barnier and others, available at:

[1] http://www.esma.europa.eu/system/files/2012-smsg-6.pdf

http://www.icmagroup.org/ICMAGroup/files/50/501ee614-91c0-4b9b-b293-cbae53045020.PDF

Jurisdictional scope

Although it is not a matter reserved for delegated acts or implementing standards, we would welcome if ESMA officially clarified the territorial scope of the short selling rules. Specifically, we would like to ask for confirmation that Articles 12-15 and any measures taken under Articles 18-23 or 28-29 do not apply to persons outside the EU.

Feedback per question

On Ownership

Q1: Do you agree with the proposal concerning Article 2(1) (r) of the Regulation?

We are pleased to note that the selling of securities on loan does not constitute a short sale provided certain conditions are met, and we are generally happy with the proposal.

Whilst the proposed language refers to recalling of securities we would point out that it is very common for most agent lenders, when advised that securities on loan have been sold, to switch the loan of securities to another of the agent's clients. We assume that where such switching takes place in a timely fashion, this is covered by the proposal. Switching a loan to another client in the agent's books substantially reduces risk and costs - as no stock, collateral or associated payment moves in the settlement systems.

We note the comments concerning the lack of harmonisation in Member States, and wish to reiterate our support for the various workstreams that address anomalies in securities holding and settlement, which were originally set out in the Giovannini report. Whilst settlement failures could be a suggestion of an uncovered short sale, it must be recognised that the complexities of settlement, especially when it's cross-border, inevitably lead to some failures in the normal course of business. Securities lending is used to smooth out normal operational issues; for example market making operations and contingent settlement problems, and it is important that the activity is not subjected to unduly stringent requirements or disciplines.

Q2: Are there other cases which need to be excluded from the definition of a short sale?

We have no comments on this question.

Q3: Are there other definitions in Article 2(1), which need further clarification? Please explain which one(s) and why further clarification is required.

This section currently only appears to exempt Repos and SLA 'if the transferor recalls the securities so that settlement can be effected when it is due', and does not refer to Repos and SLAs where the securities will be returned on the scheduled date without the need for recall, and which will allow settlement of the sale. We believe this should be

reworded to state that 'All Repos and SLAs are exempt where the securities will either be returned, or the transferor recalls the securities, such that settlement can be effected when it is due'.

Furthermore, in Article 2.1., we would support a specification for the definition of credit default swap. There are some contracts that make reference to a 'reference entity' and to one or more 'credit events' but the payment there under is *not contingent* on the occurrence of a credit event. Therefore these contracts should not be treated as credit default swaps as defined for the purpose of this Regulation.

For example, transactions generated out of CDS credit event settlement auctions are documented as derivative contracts under ISDA Master Agreements and use some terminology that is also used in credit default swap contracts (like a 'credit event' or a 'reference entity'). However, these transactions are not contingent on the occurrence of a credit event, since the credit event has already occurred. These contracts are called Representative Auction Settled Transactions (RAST) and serve only as a legal framework for the obligations of the parties; in particular for the bondholder to deliver bonds in return for payment of the auction price (at recovery level). These are contracts which are entered into between the parties pursuant to an auction; the RAST effectively being a sale or purchase contract for deliverables at the final price of the auction. Contracts can be considered to be CDS, as understood for the purpose of this regulation, when the CDS buyer (e.g. a bondholder) agrees to pay a certain fee to the CDS seller in exchange for an obligation of the CDS seller to provide to the buyer the difference (e.g. €6m) between the nominal value of the bond (e.g. €10m) and the recovery (auction) price of the bond (e.g. €4m), contingent on the occurrence of a credit event.

Therefore we would welcome a specification saying that the contracts where obligations of the parties are not contingent on the occurrence of a credit event relating to a given reference entity (and on any other default, related to that derivative contract that has a similar economic effect) should not be treated as credit default swaps for the purpose of this regulation.

On holding

Q4: Do you agree with the above proposal? If not, please give reasons.

We have no comments on this question.

Q5: Do you have any suggestions on possible further criteria to describe the holding of a share or sovereign debt?

We have no comments on this question.

Having a net short position and method of calculation

Please note that some of the answers in this section are linked to or refer to our answers to the section on uncovered CDS.

Q6: Do you agree with the above proposal? If not, please give reasons.

We believe that delegated acts should include a clear statement that certain risks are automatically recognised as 'highly correlated' (for the purpose of Article 3 of the SSR) and hence also 'correlated' (for the purpose of Article 4 – please see the section on CDS), without the need for a correlation test. Such a statement should note that the automatic recognition of certain risks as 'highly correlated' or 'correlated' is not meant to, and should not be deemed to, preclude any other risks from being considered 'highly correlated' or 'correlated'.

This would significantly reduce administrative burden for market participants, especially for corporates and investors. For example, debt instruments issued by sovereign issuers within the same Member State, government guaranteed debt, debt of SPVs owned by Member State and local and regional government debt should be assumed to be highly correlated, without the need for a proof of correlation. We also believe that it is perfectly legitimate to assume that these positions show an adequate level of correlation without the need for a counterparty having to demonstrate this by reference to historic performance.

Term 'referenced sovereign debt'

We are concerned that the concept of 'referenced sovereign debt' and similar concepts included in the text of the consultation are too narrow. These concepts would be better expressed as '*obligations of the sovereign which are within the scope of the CDS*'. The point here is that the CDS will typically *not* reference any specific debt obligation of the Member State. CDS will instead include terms which identify, by way of obligation category and characteristics, a generic universe of debt obligations of, or guaranteed by, the Member State(s) which may be taken into account (i) in determining whether a Credit Event has occurred and (ii) for the purposes of settlement of the CDS. The test of correlation should be capable of being satisfied by reference to any obligations of the sovereign which are eligible for inclusion in the operation of the CDS.

For instance, we believe that in Box 3, paragraph 18 should read: 'If a sovereign CDS position is hedging a risk other than **obligations of the sovereign which are within the scope of the CDS** ~~referenced sovereign debt~~, the value of the hedged risk cannot be treated as a long position for the purposes of calculating whether a person has a net short position in the issued sovereign debt of a sovereign issuer.'

Please note that these remarks are also relevant to the section on uncovered CDS.

Debt instruments from issuers outside the EU

Furthermore, we do not agree with the restriction in Box 3, paragraph 10, that 'Debt instruments from issuers outside the EU should not be included.' At the very least it should be amended to permit netting for debt instruments issued by issuers outside the EU which are denominated in Euro or a currency of an EU Member State.

Securities lending

Finally, we note that a long position includes '...positions obtained by entering into a transaction in instruments whose value depends on the value of the share or sovereign debt […], and which confer a financial advantage in the event of an increase in the price or value of the share etc.' The advice provides a non-exhaustive list of instruments that this would cover.

Where an investor transfers securities under a securities lending or repo agreement, the transferor maintains full economic exposure to the transferred securities. Whilst the list of instruments provided by ESMA in its advice is non-exhaustive we would appreciate confirmation that exposure to shares or sovereign debt through a securities lending or repo contract would be covered.

Q7: Do you agree with setting a quantitative threshold for high correlation? If so, what would be the best correlation co-efficient to use for this purpose?

For the reasons we put forward in our response to questions 20-23 and in Annex 1 below, we do not agree with defining correlation in a quantitative manner. However, we recognise that the test here is 'high' correlation, rather than simply 'correlation' as per the CDS provisions.

However, to the extent that ESMA considers it necessary to define high correlation by reference to a correlation coefficient, we consider that both 80% and 90% are too high. Correlations which would meet such a test are rarely if ever reached or sustained, as we demonstrate in Annex 1. We consider that 50% would be a more appropriate figure to use for the purposes of defining high correlation.

Q8: Do you think it is practicable to measure correlation for sovereign debt with a liquid market price and a long price history on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out? Do you consider that a 24 month reference period is the most appropriate one?

Whereas historic correlation *may* be a basis for assuming future correlation in some cases, it would be unwise to make this the primary means of assessing correlation.

Historic correlations can break down, and there are also cases where there are reasonable grounds for assuming *future* correlation (for example in market stress conditions) despite no/little historical correlation existing – please see Question 20 and Annex 1 for further analysis on this point.

The level 2 provisions should therefore simply require an investor to be able to demonstrate to its regulator that it was reasonable to expect *future* correlation at the time the hedge was put on. We suggest ESMA's proposals provide that correlation during the previous 12 months should in itself demonstrate such a reasonable belief that relevant assets would be correlated going forward, but that historic correlation should not be the *only* way for an investor to demonstrate such a reasonable belief.

Q9: Do you think it is practicable to measure correlation for assets with no liquid market price or with no sufficiently long price history by using a proxy? What could be a good proxy? What criteria do you think are necessary?

We have no comments on this question.

Q10: Do you consider that this Delegated Act needs to provide further specifications on the calculation of whether the high correlation test is met? Do you have any suggestions on what they may contain (e.g. use of a maturity bucket)?

See our responses to question 7 and 8.

Q11: Do you think that there is a need for a buffer period addressing the issue of temporary fluctuations in the correlation of the sovereign debt (e.g. period of 3 months during which the correlation is less than the standard level (e.g. 90% or 80%) but at least met a prescribed lower threshold (e.g. 75% or 70%)?

Explanatory text 89 indicates that ESMA think it inappropriate to treat as an infringement situations whereby positions become uncovered through no fault of the position holder. We would believe that this principle should also apply in situations where a position holder holds securities denominated in currencies other than the Euro, and as a result of foreign exchange rate movement beyond their control, are otherwise deemed to be in breach of the rules.

Q12: Do you think it is appropriate the 'delta adjusted method' for the calculation of short position for shares?

Yes, we believe this is appropriate.

Q13: Is there any comment you would like to make in relation to the calculation of the position in shares set out in Box 4?

We have no comments on this question.

Q14: Is there any additional method of calculation for shares that you would suggest ESMA to consider?

We have no comments on this question.

Q15: Which in your view is the most appropriate method for the calculation of short position for debt instruments of a sovereign issuer? Are there methods other than the nominal or sensitivity adjusted ones outlined above which you think ESMA should consider?

The methods for calculating sovereign debt exposures may differ according to the relevant financial instrument traded. As ESMA identifies, each of the calculation methodologies has its advantages and disadvantages from the perspective of the usefulness of the resulting information to the regulator.

If ESMA considers that specifying one calculation methodology is absolutely necessary, then we would be in favour of the 'nominal' method, given the greater simplicity that this brings.

Q16: Is there any comment you would like to make in relation to the calculation of the position in sovereign debt of a sovereign issuer set out in Box 4?

We have no comments on this question.

Netting and aggregation

Q17: Do you agree with the approaches described above to cater for specific situations when different entities in a group have long or short positions or for fund management activities related to separate funds? If not, can you state your reasons and provide alternative method(s) of calculation?

The tracking of individual desks and 'decision makers' is an unnecessarily complicated approach, a point which duly ESMA recognises in paragraph 75, p.30. This approach is fundamentally inconsistent with the proposal in the first consultation paper which states that reporting should be done on a legal entity basis. It is furthermore inconsistent with the Level 1 text since the Regulation aims at disclosure of short positions so as to be able to assess the economic exposure of an entity as a whole, which would intuitively imply taking all relevant holdings in the legal entity into account for the calculation of the short position. We are deeply concerned about the ESMA proposal for the following reasons:

- First, in respect of public disclosure, the calculation methodology as proposed by ESMA would likely have a significant negative impact on the market.
    - Detailed disclosure of short positions taken by individual fund managers working in investment management firms could be easily misconstrued as negative firm opinions on a given company.
    - This signal would be especially unfortunate and misleading because investment managers would, in the vast majority of circumstances and especially where they have index businesses, have net long positions at the group or legal entity level.
    - The detailed short disclosures by the larger and more influential investment managers could then trigger herding behaviour leading to short squeezes, market distortion and ultimately reverse engineering of short positions due to the firm's proprietary intellectual capital being exposed to the public at large.
- Second, in respect of disclosure to supervisors, the duplicative reporting that would inevitably result from ESMA's proposed calculation methodology, would

impede effective ongoing market monitoring and ultimately impair the detection of market manipulation.

- Third, the one-off cost implications stemming from building complicated systems coupled with the ongoing surveillance and monitoring required to remain in compliance with the proposals, would ultimately erode the ability of investment managers to return optimal performance to end-investors.

Therefore we would propose that ESMA:

- Includes a **definition of 'fund management company'** in its advice to the European Commission. This would help to establish the appropriate reporting level for net short positions.
    - In particular, it should be clear whether this term is intended to refer specifically to an operator of a collective investment scheme or more broadly, an investment manager acting on behalf of its clients regardless of legal form.
    - It would also be helpful to ensure consistent use of terms and ensure clear definitions, for instance 'managed portfolio', 'managed fund'.
- **Clarifies the policy intent** behind requiring the fund management company to report when it does not act in the capacity of 'Decision Maker.'
    - We would assert that the 'Decision Maker' (and therefore the reporting-level entity) should be the entity managing the investments rather than other entities such as the operator of a collective investment scheme. Unless such person manages investments or is the holder of record (e.g. a depositary or holding-company).
- Remains faithful to the principle of reporting at the legal entity level as set out in the Level 1 text by limiting the reporting requirement to the fund and fund management company level.
    - It should also be possible to aggregate positions managed by the same fund management company, such that the legal form of the underlying

portfolio is irrelevant. This should include collective investment schemes and separately-managed accounts running similar strategies.

  - It should be possible to aggregate discretionary and non-discretionary managed portfolios (Box 5 only refers to the former)

- Sets out how its proposals would work where **fund management functions and decisions are delegated** to other legal and non-legal persons and/or entities.

  - In particular, paragraph 5 of Box 5 refers only to funds delegated 'to an external party'. Where management of portfolios are delegated to a group entity or other affiliated company, it would seem sensible that the reporting would be undertaken by this entity, not the entity delegating the portfolio. The reason is that decisions would be made by the entity managing the portfolio.

  - Where management of a single fund is delegated to more than one party, reporting should take place only at Decision-Maker level i.e. the legal entity that is the investment manager.

Q18: Which do you consider the better definition of a group for the purpose of this Regulation?

We have no comments on this question

Q19: Are there other situations that should be taken into account?

We have no comments on this question

Uncovered CDS

Please note that some of the remarks relevant to this section are included in the section on 'Having a net short position and method of calculation' and in Annexes, as indicated.

General Conditions and Correlation

Q20: Do you agree with the general conditions proposed for determining when a sovereign CDS position can be considered covered? Are there any modifications you would propose?

A. Executive summary

We reiterate our support for the clear intent of the Regulation on short selling and CDS, to provide sufficient flexibility to allow for hedging of a wide range of risks. Delegated acts should neither dilute the Regulation nor narrow the scope of permissible hedging.

We believe that ESMA should provide guidance on hedging arrangements which is *broad* in nature, rather than prescriptive, and should certainly be broad enough to permit the use of sovereign CDS for the purpose of responsible and prudent risk management (illustrated by a non-exhaustive list of examples of legitimate hedging techniques).

Therefore, we strongly support the general intent of ESMA's proposal to use *qualitative and flexible* methods to define:

- cases when a CDS is a hedge against the risk of default or decline in value (when a person holds sovereign debt or an exposure correlated to sovereign debt), and
- the method of calculation of an uncovered position in a CDS.

However, we consider that certain elements of the proposed measures regarding CDS narrow what was clearly intended (in the text of the Short Selling Regulation itself) to be a broad definition of covered sovereign CDS (CDS used for hedging exposures other then sovereign obligations). ESMA's proposals narrow the definition in 3 principle ways:

- by imposing a geographic limitation,

- by requiring correlation to be 'consistent' and 'significant', and
- by imposing as a condition that historic correlation exists between the relevant assets.

We provide below detailed arguments as to why each such restriction is inappropriate. Please also refer to Annex 3, which provides a detailed legal analysis in respect of why ESMA's proposals are inappropriate.

We also consider that the rules should be written in such a way as to *protect investors* who enter into a hedge with a sovereign CDS, *believing* that this was a *rational* hedge *at that time*. Even if correlations subsequently break down or other factors change, this should not be regarded as evidence of an illegitimate hedging strategy.

In summary, we would like to underline that the proposals on CDS as they currently stand could:

- risk discouraging investors from investing in European corporates and government debt if they are prevented from hedging their risk appropriately and in accordance with sound risk management principles (which are supported in other regulations such as the Capital Requirements Regulation) and
- risk increasing systemic risks if investors are forced into inappropriate hedges or do not hedge at all.

We strongly recommend that ESMA remains faithful to the clear intention of the Regulation and allow the hedging exemption to be broad and flexible enough to permit reasonable hedging activity.

B. Qualitative versus quantitative approach & correlation

Relying on quantitative or prescriptive criteria could have negative unintended consequences of limiting the utility of sovereign CDS as a hedging tool. It could lead to the situation where inappropriate rules prevent market participants from using legitimate hedging strategies. This might result in either market participants not hedging their exposures (and therefore leaving some risk unprotected, increasing risk in the system) or simply not investing or extending credit. This could also lead to increased funding costs for both sovereigns and corporates. In particular:

- A quantitative assessment would be reliant on **historical data**, which we do not believe should be the *only* basis of demonstrating correlation. We stress that a market participant's rationale for **hedging future** circumstances cannot be determined purely by considering historic market data. While historical correlation may be useful for demonstrating future correlation in certain cases, there may be other cases where other factors may be better indicators of future correlation despite no/little historical correlation. Moreover, at any point of time it may not be possible to quantitatively observe and demonstrate correlation, especially based on historic data. Therefore, market participants would have to make certain rational assumptions about their hedges. For example:
    - A bank/CVA desk should be allowed to hedge an illiquid position - e.g. a loan to a regional government or a municipality - with sovereign CDS. Since bonds/loans to this regional entity may be relatively illiquid and not traded in the market and there may be no CDS available on this counterparty (one may not be able to observe how CDS spread of this counterparty behave in relation to the sovereign CDS), having to demonstrate a historical quantitative correlation may be impossible – even though it is clearly reasonable for the market participant to anticipate that there is a 'qualitative' correlation between the financial position of the region and its sovereign.
    - During the crisis, in several examples of banks having difficulties, hedgers' assumption that the government would step in turned out to be correct. Again, the correlation here should be assumed to exist.

- Another assumption could be that stress on the sovereign (i.e. deteriorating economic conditions) will cause the counterparty to default; hence there is a rationale for hedging.
- Where an investor invests in an infrastructure project that relies on public funding or is underwritten by a government, it is reasonable to hedge this risk through a sovereign CDS. The investor is hedging the risk that, if that country's fiscal position deteriorates, the funding or guarantee may be withdrawn. However, the hedge is not related to the 'market value' of the infrastructure project itself, but is rather related to the risk that the government may ultimately be unwilling or unable to fund the project through to completion (which may be several years). It is therefore inappropriate to require a correlation between the value of the infrastructure 'asset' and the sovereign debt.
- For further examples of correlations that may not be observable at all times please see Annex 1.

If the historic data are required as the only basis of demonstrating correlation all these cases of legitimate hedging would not be permitted anymore, which we believe would increase systemic risk or prevent market participants from investing.

- The Regulation proposes that correlation for assets with a liquid market price should be measured on a historical basis using 12 months of data. However, it may be appropriate to utilize historical data from other points in time to demonstrate future correlation if the market conditions at such points in time are closer to current market conditions. Please see Annex 1 for explanations and examples showing that correlation may not be present for an extended period of time in the past but a particular hedge may be a legitimate one. Therefore, we believe that no **particular time-frames** should be prescribed to the extent that historical data is used to demonstrate correlation. Moreover, we are concerned that the bright line distinction that is being drawn between assets with a liquid market price and assets where there is not a liquid market price would not work given that liquidity can change over time and such distinctions could create

further uncertainty for market participants since no standards have been proposed for identifying assets considered to have a liquid market price and assets which do not.

- Furthermore, in line with the corresponding provisions of Articles 12 and 13, **the test in Article 14 should be applied at the time the transaction is entered into**. Otherwise, entering into a hedge could, for example, effectively prevent an investor realising the position which it had sought to hedge; even if the investor is able to agree with its counterparty on a termination of the CDS, the investor would be put at risk of loss if it had to do so before it realises its hedged position. It would also put the investor at risk of contravening Article 14 as a result of circumstances outside its control. This would create the risk that the Regulation would have a counter-prudential effect by discouraging market participants from legitimately using CDS to hedge their positions.

  Consequently, we strongly believe that the rules should be written in such a way as to **protect investors** who enter into a hedge with a sovereign CDS, believing that this was a rational hedge at that time. Even if correlations subsequently break down or other factors change, this should not be regarded as evidence of an illegitimate hedging strategy. Please see above examples and Annex 1 for further explanations showing that if correlation was present or anticipated in some form at the time of entry into a sovereign CDS, the person entering into CDS at that time should be assumed to have been using the position to hedge valid risks.

  Therefore we would welcome the following **clarifications**:

  - Where the CDS (at the time it is entered into) serves to hedge against a risk of default or decline in value in the manner described in Article 4 of the Regulation, a subsequent change in the person's positions, assets or liabilities or portfolio of assets or obligations taken into account for the purposes of Article 4 would not give rise to a contravention of Article 14.

  - Any requirement to justify to the relevant competent authority that the sovereign CDS position entered into satisfied the applicable conditions should be measured as at the time the position was entered into.

- The language under Point 6 in Box 6 should be revised to read 'It is the responsibility of the position holder to ensure that their CDS position *is not uncovered at the time of entry* and the duration of the CDS position should be aligned as closely as *practicable given prevailing market conventions and liquidity* with the duration of the assets/liabilities being hedged.'

- Furthermore, it should be clarified that the test would need to be satisfied by the buyer of the sovereign CDS only. As such, we would recommend that the language under Point 1 in Box 6 be revised to read 'Those entering into a sovereign CDS position *as a buyer of protection* should, on request of the competent authority, be able to justify to that competent authority that at the time the position was entered into it met the above conditions.'

- Moreover, the Regulation does not mandate any **particular degree of correlation**; therefore, imposing a restrictive and mandatory quantitative measurement would be contrary to the intent of the Regulation. We would therefore strongly recommend that the references to the adjectives ***'consistent'*** and ***'significant'*** should be removed from the qualification of the term correlation. Moreover, these terms would imply a continuous, stable and high level of correlation, which (as discussed earlier and in Annex 1) may not always be observable in situations where it is rational to use sovereign CDS to hedge exposures (which are recognised under the Article 4 and Recital 21 of the Regulation). Furthermore, such adjectives as 'high' and 'direct' were deliberately deleted from the draft Level 1 texts as a result of balanced and carefully negotiated compromise wording.

  Instead we would welcome a clarification in Box 6 Point 1b that 'There must therefore be a *reasonable* *expectation of future* ***directional*** correlation between the value of *the exposure* being hedged and the value of *the obligation of the sovereign which are within the scope of the CDS*.'

  - It could then further be clarified that the term 'directional' should be qualified as ***'positive'*** for assets and ***'negative'*** for liabilities. For positive

correlation, the 'value' of liabilities increases as sovereign debt value falls, rather than increases. This point is recognised in footnote 3 on page 35, but we would welcome further clarifications.

  - This wording also would address the above mentioned concerns about historic data. It would not exclude the possibility that historic data may be one of the methods used to demonstrate correlation.

  - The foregoing language change would also make clear that the correlation should be forward looking and that there would need to be reasonable expectation of future correlation.

- As noted above in our response to Question 6 and explained in Annex 1, there should be a category of transactions which are *assumed* to be 'correlated' with the relevant sovereign CDS. For the hedging provisions, however, this category would be wider then is contemplated in our examples in Question 6 for assumed 'highly correlated' transactions. In both cases, it should be clearly stated that such automatic recognition of certain risks as 'highly correlated' or 'correlated' is not meant to (and should not be deemed to) preclude any other risks from being considered 'highly correlated' or 'correlated'.

- We believe that there is a risk that the term 'correlation' may be defined too narrowly due to the fact that there is a **difference between referring to '*assets*' only and referring to the '*risk*' (or '*exposure*') undertaken via holding of these 'assets'** (please see Point D below, for detailed language recommendations). In particular, there may be a number of factors affecting correlation between the value of sovereign debt and a particular asset or liability. There could be very strong **credit correlation** between the two that is not reflected in the pure value terms due to non-credit factors, such as sensitivity to **FX and interest rates**. It is important that one can isolate the credit correlation and rely on that, even if the overall value shows less correlation. One example in this regard would be a sovereign bond issued at fixed rate of interest where the fall in value arising from the deteriorating credit worthiness of the sovereign is fully or partly offset by a rise in the value of the bond caused by a general fall in prevailing floating interest rates. We would welcome the recognition that a CDS

over that bond is not uncovered if there is an appropriate correlation between the sovereign credit risk to which a bondholder is exposed through its holding of the bond and the value of sovereign debt obligations, even if there is relatively less correlation between the increase in the risk profile of the sovereign and the decrease in value of the bond. Sensitivity to non-credit factors is also another reason why it is crucial not to impose quantitative requirements as regards 'correlation.'

Similarly, clear credit correlation may exist but not manifest itself in **price correlation** where, for instance:

- The relevant financial asset being hedged is an index or basket position which references a number of different reference entities, including the relevant Member State (or other entities correlated with the Member State). Such an index-based exposure is specifically contemplated by Recital 21. Positive credit migration of the other entities in the index/basket may offset the negative impact of the deteriorating credit of the Member State, such that the price of the asset as a whole does not correlate with the change in risk of the Member State. However it should be quite legitimate for a holder of the asset to buy protection against the Member State to hedge the exposure which it assumes through its investment. To provide otherwise would be to risk contradicting the clear intent of the legislators in Recital 2.

- More generally, Recital 21 makes specific reference to 'indirect exposures' forming a legitimate coverage for a CDS position. By their very nature such indirect exposures may have only an indirect, or partial, impact on the price of the relevant assets. To require a direct price correlation to be demonstrated for an indirect exposure would contradict Recital 21. An example of this would be the infrastructure asset described earlier.

C. Concerns with geographic limitation

We are very concerned by the proposal to require that 'the obligor of (or counterparty to)' the asset/liability that is being hedged is located in the same Member State as the reference sovereign under the CDS (condition 1 (c) in Box 6).

In addition to the strong policy reasons in favour of correlated cross-country hedging we believe that there are strong legal arguments against the proposed prohibition. Such a ban imposes a significant additional restriction that has no legal basis in the underlying Short Selling Regulation. Moreover, it would represent a disproportionate limitation on the Single Market for financial services, preventing a market participant from undertaking a hedge that would otherwise be justified purely on the grounds that it involved an instrument issued in another Member State. For examples of the impact on the real economy and detailed legal analysis please see Annexes 2 and 3 respectively.

1. Systemic risk increase

This geographic requirement would have the unintended consequence of restricting the ability of market participants to manage risk prudently, by preventing them from entering into numerous types of legitimate cross-country and macro hedging strategies that achieve a much better hedge of the risk they are taking. Examples of this are provided in Annex 2.

2. Negative impact on real economy and barrier to Single Market

This negative impact of the geographic limitation on the ability of investors, corporates and financial institutions to manage cross - country and macro risk, could further:

- disincentivise foreign investment and limit access to credit, whilst hurting the European economy, growth and jobs,
- limit banks' ability to raise regulatory capital and carry out hedging as incentivised by Capital Requirements Regulation (CRR),
- increase funding costs for Member States.

By imposing arbitrary national boundaries in relation to proxy hedging, this geographic limitation would also be a disproportionate barrier to the Single Market and to free

movement of capital between Member States of the EU. Detailed explanations and examples are included in Annexes 2 and 3 as well as below.

3. Inconsistency with Level 1 Regulation (SSR) and net positions calculation method (for detailed legal analysis please see Annex 3)

This geographic requirement is narrower than the corresponding provision of Article 4 and Recital 21 of the SSR, and would prohibit positions that the SSR itself does not prevent. It is inappropriate for a (supplementing Level 2) delegated act to seek to narrow the scope of a Level 1 Regulation.

For instance, Recital 21 of the SSR states that sovereign CDS can be used as 'a counterparty risk management tool for hedging exposure on financial and foreign trade contracts.' Recital 21 also explicitly states that 'no position or portfolio of positions used in the context of hedging exposures to a sovereign should be considered an uncovered position in a CDS' and that 'all exposures [including to private sector entities] should be considered in this context, including loans, [and] counterparty credit risk (including potential exposure when regulatory capital is required to such exposure)'. The SSR does not limit these trades geographically in the way that ESMA is now proposing.

In particular, we consider that this 'potential exposure' could refer to the anticipated exposure that one would want to prudently hedge, and therefore the activity of hedging CVA credit sensitivity risk (see Example 5 in Annex 2) should be included in scope of activities permitted under the SSR, in accordance with CRR.

Moreover, in relation to the provisions on the calculation of net shorts for sovereign debt for reporting purposes, cross-country netting is expressly contemplated and permitted in the final sentence of paragraph 23 of the ESMA consultation. The approach ESMA is taking therefore in relation sovereign CDS is inconsistent with the calculation approach which assumes that it is possible for the debt of country X and the debt of country Y to be highly correlated.

Furthermore, a proposal for a geographic limitation was deliberately deleted from Article 4 of the draft Level 1 text as a result of balanced and carefully negotiated compromise wording.

4. Inconsistency with Basel III/CRR framework

The geographic limitation seems to contradict Article 375 of CRR, with regard to the use of cross-country proxy hedging for counterparty credit risk.

CRR explicitly recognises the use of index CDS as an eligible hedge for the purpose of mitigating CVA risk (Credit Valuation Adjustment CVA risk- the risk that the creditworthiness of the counterparty deteriorates). By limiting the geographic scope of CDS hedges, the use of indices such as the SovX to cross-country hedge CVA regarding exposures in several Member States seems to be excluded.

CRR neither prohibits the use of proxy hedging nor prohibits cross-country hedging. Article 375 states that 'For all counterparties for which a proxy is used, an institution shall use reasonable basis time series out of a representative group of *similar* names for which a spread is available.'

5. Recommendations

The overarching requirement that there be 'correlation' and 'proportionality' already imposes a hedging obligation on market participants. Where a correlation exists (or is anticipated to exist) and a hedge is proportionate, market participants should be permitted to use CDS as a proxy hedging tool, irrespective of location. Given that the geographic limitation is both dangerous and unnecessary, we urge ESMA not to include it in its advice. We believe instead that the provisions of Recital 21 should be repeated by ESMA in its advice, in particular with respect to CVA risk hedging as incentivised by CRR.

6. Sovereign debt and sovereign CDS - facts and figures

We would also like to mention a few key facts and figures related to sovereign CDS and sovereign debt markets. L'Autorité des Marchés Financiers has recently published a study on CDS price formation.[2] This study contemplates that:

[2] http://www.amf-france.org/documents/general/10331_1.pdf?bcsi-ac-1411779732B63501=1E31317900000005V1+jExO8yNCUr0t6BCFt9hU8B707AAAABQAAAPRt6gBwYgAAPQQAANiLCQA

- For the time being it is not possible to establish a causal link between sovereign CDS prices and sovereign debt interest rates for the Member States with the highest ratings.
- There is an absence of a leading market as regards sovereign CDS and sovereign bonds.

The study also takes note of the impact that CVA hedging desks can have on the sovereign CDS market, due to the tendency of sovereigns not to sign bilateral CSAs. For further explanations please see Annex 4.

D. Other remarks on general conditions

CDS position

Regarding the last sentence in Point 1 on general condition, in Box 6, we would welcome a clearer statement that the test for whether the sovereign CDS position is covered or uncovered is as of the time that the '*sovereign CDS position'* is entered into, not just *any 'position'*.

Clarified and harmonised terminology

We believe that the general use of terms 'value', 'assets', 'liabilities' in the draft advice and consultation document will need to be clarified and harmonised, given that the SSR does not refer solely to 'assets' or 'liabilities' of the party entering into the CDS. Instead the SSR focuses on hedging the 'risk' that the 'value' of various 'exposures' may fluctuate depending on a number of factors, notably likelihood of default and estimated loss given default. For example, Recital 21 refers clearly to 'counterparty credit risk' and 'exposures'.

In particular, it is crucial to ensure that the terminology in the draft advice is not so narrow as to bring into question the scope of legitimate 'risk' and 'exposures' specifically contemplated in Article 4 and Recital 21. Please see the bullet point on 'credit risk' in the Point B above for detailed explanation of the importance of this issue - namely the difference between referring to '*assets*' only or the '*risk*' undertaken via holding of these 'assets'.

For instance in ESMA's Consultation Box 6 Point 1b, the term 'exposures' should be used. It could read as follows:

'In relation to hedges for the purpose of Article 4(1)(b), the CDS position must serve to hedge against the risk of **a change in the value of exposures which are** ~~decline of the value of assets/liabilities~~ correlated with the risk of the decline of the value of the obligations of the sovereign ~~debt which the CDS references~~ which are within the scope of the CDS. There must therefore be, a reasonable expectation of future directional correlation between the ~~value of the asset/liability~~ **exposure** being hedged and the value of ~~the referenced sovereign debt~~ the obligation of the sovereign which are within the scope of the CDS.'

Alternatively, at least the full text of Article 4 of the SSR should be quoted, namely: 'the risk of decline of the value of […] assets or […] liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations […]'.

Term 'referenced sovereign debt'

We are concerned that the concept of 'referenced sovereign debt' and similar concepts included in the text of ESMA's consultation are too narrow. These concepts would be better expressed as '*obligations of the sovereign which are within the scope of the CDS*'. For detailed explanations please see our response to Question 6.

Q21: Do you have any comments or alternative suggestions on the proposed test for correlation? Do you have any estimates of the costs which applying the qualitative test envisaged by ESMA would entail for market participants or the costs which would be associated with the imposition of a quantitative test?

Please see the response to the question 20.

Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

Please see the response to the question 20.

Proportionality

Q23: Are any changes required to the proposals for determining whether a sovereign CDS position is proportionate?

We support the proposal that an exact match is not required and that over-provision is permissible. This is necessary in order for sovereign CDS to be used as a proxy hedge (by definition not an exact hedge). As such, it would be difficult (if not impossible) to hedge exactly the right amount in every circumstance. In this context we would very much welcome clarifications and amendments on several relevant issues as presented below.

We would also like to underline that the below points suggest that there are numerous factors influencing proportionality, often outside reasonable control of market participants (e.g. market prices fluctuations, relative liquidity, other market conditions, future exposure, standardization), and therefore it would be inappropriate to impose an arbitrary quantitative limit. Moreover, such limit could have unintended consequences of restricting hedging, risk management and scope of CDS contracts eligible for CCP clearing.

Future exposure

We believe that delegated acts should clearly recognise that the proportionality of hedges should not solely be assessed in terms of the size of the risk/exposure at a given point of time, but should also take into account the need for anticipation of potential changes in the size of the risk/exposure in the future. Hedges may be put in place in anticipation of future potential changes in the value of the underlying or the value of the hedging instrument itself (e.g. expected changes in basis risk or tail risk). In particular it should be recognized that CVA hedging is often based on expected or anticipated future exposure rather than current exposure.

Given that it may not always be possible to foresee the exact evolution of the value of the exposure as it depends on future market changes, which may be significant and difficult to predict, an arbitrary quantitative limit imposed on the value of the CDS would not be appropriate and would prevent legitimate risk management.

To give an example, one could consider a case where, the mark-to-market value of an

interest rate derivatives moves in favour of one party, and therefore that party's risk exposure to the other party will increase as well. Prudent risk management practices may require hedging to address the potential increase in risk exposure (due to factors such as possible market movements, declines in counterparty creditworthiness or decline in liquidity), rather then solely the actual risk exposure at the time of entry into the hedge.

To give another example, an FX swap might have zero market value today, but might have an anticipated significant unknown and variable future exposure which should be prudently hedged today.

Reasonable control

We would also welcome an expansion of the language at the end of Point 6 in Box 6 to include positions becoming uncovered as the result of *'any other event that is beyond the reasonable control of the holder'.* The derogation should apply to all circumstances where the lack of coverage occurs on an involuntary basis and absent an active decision of the market participant. There may be a number of reasons why there could be subsequent changes in positions, assets, liabilities or obligations originally hedged by a CDS transaction that are outside the market participant's control, e.g. where assets mature or liabilities or obligations are discharged or terminated (such as prepayment of loans).

Standardised CDS contract

In terms of Point 6, we also believe that the language requiring the duration of the CDS position to be aligned '*as closely as possible'* with the duration of the assets/liabilities being hedged should be slightly modified. We recognise the anti-avoidance character of the provisions identified in paragraph 88, but we are concerned that the use of terms such as 'as closely as possible' will be impossible to operate in practice. Given the high level of standardization in CDS contracts, the language should be changed to *'as closely as practicable given market conventions*' to address the fact that maturities for CDS contracts are standardized so that they mature either on June 20 or December 20.

- While it is possible to negotiate for a non-standard maturity date, it is not practicable and would result in creating a bespoke contract that would not be

eligible for clearing. This will then force a much greater range of CDS on sovereigns out of the scope of the CCPs.

- Moreover, any requirement to match tenors will lead to a considerable increase in the cost of hedging since market participants will not be able to access the most liquid pricing in the market (5 year), but will have to arrange bespoke protection at much higher cost. This may prevent market participants from appropriately managing risk and therefore increasing risk in the system.

Relative liquidity and investment horizon of investor

We would equally welcome additional clarity that when determining proportionality, market participants should also be permitted to take into account relative liquidity of different maturities along the CDS yield curve and that CDS contracts tend to be executed to standardised maturities. Again, we also believe it is important for firms not to be restricted to entering into CDS with a similar maturity to the underlying securities, but that this decision should also be related to the investment horizon of an investor. For example, an investor may hold a 10 year liability, but only intends to hold this for 5 years. They should therefore be able to hedge this with a 5 year maturity CDS without fear that this would be construed as a breach of these regulations. Being forced to enter into a 10 year CDS and then subsequently cancel the trade after 5 years would introduce unnecessary risks and costs to the industry and ultimately end investors and clients, as well as restricting existing bona fide hedging activities.

Q24: Do you think that a position that had become partially uncovered due to fluctuations in the value of the assets or liabilities being hedged and/or the CDS used as the hedge should be allowed only for a certain period of time? If so, what would be an appropriate time limit?

As noted in Point 6 in Box 6, if the sovereign CDS was covered at the time it was entered into, it should not be treated as becoming uncovered if there is a change in value of the hedged assets/liabilities or value of the CDS. If it is not to be treated as becoming uncovered, then there should be no time limit on how long it remains uncovered.

It is also worth noting that, contrary to explanatory text 89, the sovereign CDS position will have a duration and will expire at maturity; therefore, the partially uncovered position will not remain outstanding for an unlimited period of time.

Moreover, with regard to the original intentions of the Regulation, the ban was introduced to curb perceived 'speculation' on the creditworthiness of Member States using sovereign CDS. However, the positions in sovereign CDS in the above context are the result of market fluctuations - not a desire to 'speculate'. In this sense, we are unsure why they should be treated as uncovered positions in sovereign CDS after certain period of time.

Furthermore such a time limit could actually significantly increase volatility in sovereign CDS markets. For instance one could consider a case where:

- A dealer enters into a Euro fixed-for-floating interest rate swap with a counterparty where the dealer receives a fixed rate and pays a floating rate.
- The Eurozone begins to experience difficulties.
- At the same time, Euro interest rates are likely to fall (given the correlation between rates and credit spreads), meaning that the mark-to-market value of the swap from the dealer's point of view increases (because they are receiving fixed and paying floating rate).
- This increase in value amplifies their exposure with that counterparty (and therefore their risk). The dealer will wish to hedge this increased risk (also known as hedging the CVA). To do this they may need to purchase sovereign CDS – just as the spread of the counterparty is widening (on account of the Eurozone experiencing difficulties).
- As the crisis subsides and the need for sovereign CDS decreases, the dealer would have to sell CDS protection if there is a time limit on holding any excess sovereign CDS.
- If another crisis comes, the dealer will *again* need to buy sovereign CDS protection, driving the spread right back up. This wouldn't be necessary if the dealer were allowed to keep the previously purchased protection.

The implication of the above example is that dealers are all forced to buy sovereign CDS at the same time, then sell at the same time, then buy again at the same time. This will only increase volatility in the sovereign CDS

To give another example, if an overhedge needs to be readjusted in 15, 30 or 90 days and market conditions stay so illiquid that orderly execution remains very difficult for a longer period of time, it would be inappropriate to force market participants to unwind their hedges, if they have reasons to believe that orderly execution will be possible at a later point in time. If at the elapse of the time limit, market conditions have not yet improved and the market has to cope with a number of similar transactions simultaneously, this could be disruptive for the market. A time limit would prove counterproductive as it could enhance procyclicality and systemic risk.

Q25: Do you agree that sovereign CDS positions which are obtained involuntarily as a result of the operations of a CCP clearing sovereign CDS should not fall to be considered as entering into a CDS transaction for the purposes of the Regulation?

Yes. In addition, concerning explanatory text 92, we would welcome a clarification or a confirmation that if the clearing member is required by the clearinghouse to bid for the defaulting member's portfolio and the clearing member wins the bid, that is not considered to be voluntary. Similarly, if the customer of a clearing member defaults, then that clearing member may be obligated to take over the defaulted customer's portfolio and it should not be considered as voluntary.

Regarding explanatory text 93 on sovereign CDS positions obtained involuntarily as a result of the operations of a CCP, it currently states that any involuntary uncovered sovereign CDS positions would be expected to be closed or rendered covered by the holder *'as soon as possible'*. We believe this should be changed to '*as soon as practicable taking into account factors such as market conditions, the size and complexity of such positions, orderly execution and its internal risk management practices.'* For example, if there is market stress, liquidating the positions as soon as possible may increase systemic risk. Also, firms need to comply with relevant internal risk management practices to ensure that they do not end up having to face counterparties that they have little credit appetite to face, if those counterparties are the only ones offering to provide the hedge. Moreover, market conditions should be taken into account in order to avoid

unnecessary risks where the CDS market or the required exposure market are at that moment too illiquid or even non-existent. Under those conditions, liquidating or covering CDS positions immediately, regardless of any adverse prevailing market conditions, could give rise to important losses and would be incompatible with prudent risk management. We therefore suggest that reasonable efforts in the existing market circumstances to rehedge or unwind positions should be permitted by the delegated acts.

Q26: Do you consider there are any other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position which should be included in the indicative list?

Our response focuses on cases in which sovereign CDS are recognised as covered, as described in Box 6 under the headings 'General conditions', 'Correlation' and 'Proportionality' . With regard to the heading 'Illustrative cases', we believe it should be underlined that this list is a non-exhaustive list.

We would just like to flag that we are particularly concerned about the geographic limitation, which is not in line with Level 1 text.

We also believe that it is important that exposures denominated in euro or any other EU currency should be allowed to be hedged with EU sovereign CDS wherever the issuer or obligor is located.

Q27: Do you agree that the net CDS position is the correct one to use in the calculations?

Yes, it should based on a portfolio of CDS trades, i.e. on a net position.

Q28: Do you consider that there should be different methods for calculating the value of the positions to be hedged by the sovereign CDS according to whether a static or dynamic hedging strategy is used?

We have no comments on this question.

Q29: Are there refinements which can be made to the proposed methodology? Are there any standard calculation formulae which can be used when applying risk adjustments which we should include in the draft advice?

Please see response to the question 23, heading 'Relative liquidity and investment horizon of an investor.'

Q30: Do you agree with the proposed method of treating indirect exposures?

We are concerned that the correlation requirement as proposed will not work in the case of index positions, even though those are specifically contemplated by Recital 21 and the illustrative examples. For instance, a portfolio of Reference Entities including one or more Member States could be considered here. The price movements of the portfolio may not be correlated with the sovereign debt simply because the Sovereign is not the dominant influence on the price (perhaps owing to its weighting in the portfolio, or because of more significant credit migration of the other constituents). This should not prevent there being an identifiable correlation between the risk arising from the inclusion of the Member State in the portfolio and the value of sovereign debt, even if one cannot track that correlation into the portfolio as a whole. Since the CDS is only hedging one element of the portfolio, the correlation should be tested against that element also, not against the portfolio price as a whole.

Levels of the notification thresholds for sovereign debt position

We have no comments on this section, consisting of questions 32 -37.

Liquidity thresholds

We have no comments on this section, consisting of questions 38 -40.

Significant fall in value

Illiquid shares

Q41: Do you agree that three categories are necessary? If not please state you reasons.

Q42: For the more illiquid shares, do you agree that EUR 0.50 is the correct cut off point to use? If not please state you reasons.

Q43: Do you agree that 10%, 20% and 30% are the correct percentages to use in relation to the fall in value? If not, what other levels would you propose; please state your reasons.

We would like to reiterate that we believe that if the restrictions impose normalized 'volatility interruptions' on the relevant share and its derivatives, where transactions are temporarily halted (for a minute or two, to allow the market to stabilize) then that might be acceptable and is already a relatively common practice on some markets. However, extending such restrictions up to the end of the following trading day may have unintended consequences and does not bring the effects expected. We believe that stopping trading for the next 24 hours would not be beneficial and it could actually lead to greater dislocations, as market participants try to find alternative and less efficient ways to offload the related risk.

Concerning the percentages, we would like to underline that 10% as a starting point for illiquid shares is not appropriate. A 10% move in an illiquid share (even if included in a main index) is not necessarily a significant number. Further, we believe it is not appropriate to start the thresholds at the same level as for liquid shares.

Sovereign bonds

Q44: Do you agree that an increase in the yield across the yield curve is the appropriate measure to use for sovereign bonds? If not, what other measure would you propose, please state your reasons.

We believe that in addition to percentage moves in yields, there should also be a threshold of an absolute change in yields. In the current low interest rate environment, it is possible that a 5 % movement in yield equates to only a few basis points in absolute

yield, which could occur as a matter of normal market movement. For example, if a central bank was to announce that it anticipated raising rates shortly. Note the example of a bond which currently yields 4%. A 5% change in yield would bring the bond to a level of approximately 4.2%; a threshold that would be hit regularly without significant volatility.

Q45: Do you agree that an increase of 5% or more in the yield across the yield curve is the correct percentage to use? If not, please say what alternative threshold you would favour and state your reasons.

It needs to be clarified for sovereign bonds that the text refers to an increase of 5% or more **during a single trading day.** This clarification is not currently in the text.

Corporate bonds, money market instruments, UCITS

We have no comments on this subsection, consisting of questions 46 -49.

ETF

Q50: Do you agree that 10% or more is the correct percentage to use for ETFs? If not please state your reasons.

The price of an ETF could move 10% on an 'at market' order due to extreme liquidity pressures. As such, we believe a better measure of the price fall should be of the *underlying* that the relevant ETF tracks, rather than the ETF itself. Furthermore, we believe ETFs should be treated in the same manner as single stocks.

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.

We believe that when looking at trading limits or triggers, it is important to ensure that the limits are relevant to the price and liquidity of the instrument in question.

Many stock markets globally have up and down limits where trading is suspended if there is a significant price movement over a short period of time. In the best examples of these, price movements are defined as being relative to the magnitude of the price and banding is employed to ensure appropriateness across the market place. As an example, a share that is priced in cents will move on an outright basis more than one that is priced in 1s, 10s or 100s of Euros. From this, it is clear that both the bands themselves and the limits for each band are key to ensuring the appropriate control of the marketplace.

Liquidity is also an important factor to consider when setting limits or triggers. An instrument that only trades once a month is likely to have more significant price moves than one that trades many times per day, therefore any limits need to be set relative to that liquidity.

These are both particularly important in some derivatives markets which have reduced liquidity, and whose prices are relative to an underlying; a price movement in the underlying can trigger more exaggerated movements in the derivatives. There is also a potentially increased likelihood and risk of significant price movements approaching an expiry as the price of a derivative with little or no time value can move substantially on minimal underlying price movement.

With regard to listed derivatives, we also believe that the approach of reasoning based on the underlying rather than the instrument is the only appropriate method. We agree with ESMA's conclusion that 'short selling' a derivatives contract is not a meaningful concept, and that therefore the appropriate measure would be to consider the limitation of transactions in the listed contract. However, as indicated in our response to question 43, such restrictions should be limited in duration (in minutes rather than hours or days); in order to allow the market to perform its price-discovery function efficiently after a 'pause for breath'.

Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward rate agreement or other derivative instrument, including financial contracts for difference? If not, what alternative would you propose?

We have no comments on this question.

Q53: What could be an appropriate threshold to define a significant fall in price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

We have no comments on this question.

On the method for calculating the fall

Q54: Do you agree with the abovementioned proposal for the methods of calculation for various types of financial instrument? Do you have alternative or complementary methods to suggest, in particular in relation to the yield curve calculation method?

We have no comments on this question.

Adverse events and threats

We have no comments on this section, consisting of questions 55 -56.

Annex 1: Case studies on correlation in the European markets

In this section we discuss how correlation in the debt markets can change over time - especially in crises - and discuss how risk management strategies function in these situations.

The corporate debt and equity (credit) to sovereign debt (sovereign) relationship is very important for European credit, although the correlations are not constant at all times. Correlations between credits and their sovereigns are never uniform, and in fact vary depending on the sovereign spread.

Research of members of our associations observing volatile patterns regarding correlation between credits and their sovereign:

When the sovereign trades below 100bps (i.e. low risk) the correlation with corporates domiciled in that sovereign is observed to be low. When the sovereign trades between 200-700bps (i.e. at levels when sovereign risk becomes a concern) then the corporate to sovereign CDS correlations are at elevated levels. When the sovereign trades >700bps (i.e. towards significant concern levels), corporates continue to move in sympathy with the sovereign CDS, although with a lower correlation than previously observed (potentially reflecting either that corporates will not automatically default if a sovereign defaults or restructures its debts, and/or that recovery values on corporate Credit Events could be higher than for that of the sovereign).

This research shows that correlations are sensitive to the spread level of the sovereign.

Portugal and Greece provide good examples of the correlation changes, given that their spreads are so wide. There is a consistent drop off/cliff effect for the correlation between Portuguese credits and Portugal CDS over time.

Correlations were low until Portugal reached 100bp, then very high until Portugal reached 700bp. Once Portugal widened past 700bp, Portuguese credits started to become less correlated to Portugal CDS.

For Greece, the pattern is even more volatile, and the rules hold at slightly different intervals.

The drop off/cliff effect pattern for the correlation between credits and sovereigns holds quite well for Spain and Italy as well. Correlations between credits and sovereigns rose quickly as the sovereign widened past 100bp.

We would like to mention that similar results have been recently obtained by l'Autorité des marchés financiers, which published a study on CDS price formation (mentioned above). In particular the study concluded that when spreads remain low (high), the correlation between CDS and corporate bonds is low (high).

The effect discussed above shows that:

- **Correlations may not be consistent for long periods of time**

  Correlations are not always constant. Correlations generally start increasing as sovereign spread levels widen. For the examples above, this only started occurring in the second half of 2011 as sovereign spreads widened.

- **Correlations are not consistently high (significant)**

  In every situation mentioned above, we note that correlations rarely reached or stayed at extreme high levels (e.g. 90% or higher).

- **Hedging practice: forward looking, prudently anticipating future risks and market trends**

  In times of market stress, measured by CDS spread levels, clients and dealers will begin to hedge exposures on a go forward basis in reaction to the correlation levels evidenced in the sections above. Rarely will a consistent and high correlation present itself for time periods such as 12 or 24 months prior to the need for sovereign CDS as instruments for hedging risks.

Therefore ESMA's framework may bring unintended consequences:

We believe that a likely unintended consequence of the current framework contemplated in the ESMA consultation paper is that investors and corporates will not

be able to evidence the quantitative correlation requirements and therefore will be unable to meet their hedging/risk management needs. They will not be able to do this because e: a) the high, or in other words significant, (e.g. 80 – 90 %) correlation may not be present at all times, b) the correlation may not have presented itself consistently in the past for an extended period of time, and c) the operational implication of managing the storing of correlations for these periods of time (12 – 24 months) will be significant.

These investors may exit the underlying sovereign debt and corporate bond markets because the most efficient hedge to these credits, the sovereign CDS, will be too burdensome or impossible for them to utilize (other instruments, such as futures, options, and securities are utilized to hedge interest rate exposures.)

If this investor base does not have the ability to use sovereign CDS instruments because they will not be able to prove the quantitative extended (consistent, high, significant) correlation levels suggested in ESMA's consultation paper, the investor base may stop investing in a Member State's corporate and sovereign debt to begin with. This outcome is clearly concerning as it may effect on the state's ability to fund itself.

Consequently, we would like to propose the below modifications:

We would like to propose the below modifications to the measures for determining correlation along with scope changes to allow for the current market structure.

- **Intra-state correlation carve out**

We propose that all hedging of exposures denominated in a local currency using the Member State's sovereign CDS should be permitted without the need for a correlation test to be proved. Netting of short and long positions within a Member State should be allowed without the need for a correlation test to be proved.

- **Look back period**

As shown in the studies above, correlation is not steady and present over long periods of time and only presents itself at heightened levels at times of stress, when investors require the CDS instrument to hedge exposures.

Therefore, for hedges that fall outside of the intra-Member State correlation carve out the correlation look back concept should be abolished.

We believe that it is reasonable and effective to require that proof for having entered into a sovereign CDS for hedging purposes is evidenced and maintained by the person buying the CDS sting from the time that the hedge is implemented. If correlation was present or anticipated in some form at that time, the person entering into the short sale at that time should be assumed to have been using the position to hedge valid risks. Adequate supervision and detailed reporting can be used to establish the rationale at the time that the hedge was made.

- **Correlation levels**

Very high (i.e. 80% – 90%) correlation levels are rarely if ever reached or sustained as observed in the examples above. The level must be lowered to approximately 50% for activity that falls outside of the Intra-State Correlation Carve Out for the purpose of Art 3.

- **Cross Member State hedging**

We note that it is critical that as long as a level of correlation is observed or anticipated across Member States at the time of the hedging transaction, this activity be permitted. These instruments/hedges may be the most efficient (cost and risk) instruments to hedge certain sovereign debt exposures at certain times and should therefore not be overly limited so as to potentially cause the unintended exit of these investors from the Member State's sovereign debt markets.

- **Non EU issuers of EU debt**

We note that many global companies issue debt in the European markets in European currencies. These corporate bonds therefore exhibit a high interest rate risk between the domicile of the issuing company and the European currency. To hedge this interest rate risk, market participants typically use local European government bonds as hedging instruments. As those exposures are most effectively hedged by the sovereign CDS of the Member State, restricting the hedging and net short or long position

calculation to only European issuers would potentially have the effect of the affected European investor base not investing in these companies' corporate bonds.

- **Other clarification requested**

We would welcome a clarification that in all cases in the Regulation and Consultation it is made clear that the correlation interpretation should be made at the sovereign issuer level and not at the country level.

Conclusions:

In conclusion we note that:

- Observed sovereign CDS correlation to underlying debt is not consistent, high, or observable for lengthy periods of time, especially at times of market crisis.
- It is at these times that investors require the CDS instrument as a method to effectively hedge their underlying sovereign debt risks.
- An unintended consequence of keeping the high quantitative correlation proposal and the 12 – 24 months look-back test will be that investors may exit the underlying sovereign debt market as their hedge instruments (sovereign CDS) will carry a burden of supervision that is impractical or impossible for them to meet.

We propose the following for determining correlation along with scope changes to allow for the current market structure and investor hedging practices:

- The establishment of 'correlation carve-outs' (e.g. for intra-Member State sovereign debt and CDS) to ensure that the intuitive and qualitative relationship between an exposure and sovereign obligations (e.g. between a sovereign and its issued debt) is reflected.
- An elimination of the look back period for other cases.
- Requirement that proof for having entered into a sovereign CDS for hedging purposes is evidenced and maintained by the person buying the CDS sartting from the time that the hedge is implemented. If correlation was present or anticipated in some form at that time, the person entering into the short sale at

that time should be assumed to have been using the position to hedge valid risks (investor protection).

- Adequate supervision and detailed reporting can be used to establish the rationale at the time that the hedge was made.
- A significant reduction in the level of correlation required to be present– to 50% - for the definition of high correlation (regarding Article 3 of the SRR).
- Removal of words 'significant' and 'consistent' as qualifications of the term 'correlation' in Box 6 and replacement of these terms by the word 'directional' (positive/negative for assets and liabilities respectively) as proposed in the answer to the question 20 (regarding Article 4 of the SRR).
- A widening of the hedging and netting language to include non Member State exposures.
- A widening of the overall interpretation of this Regulation with respect to net position reporting and hedging to account for global companies that issue debt in the EU.

ANNEX 2: Use of cross-border hedging strategies – detailed explanations and examples

Impact on real economy, cross-border business and foreign investments in Europe

- Example 1: Parent / Subsidiary Relationship - a parent entity may be in a different Member State to the subsidiary for which it provides implicit credit support. A counterparty offering a loan to the subsidiary would take account of this implicit credit support, and may choose to hedge its ultimate exposure through the purchase of sovereign CDS in the country where the *parent* entity is located, rather than where the subsidiary is located. If such a cross-country hedge is prohibited, the risk associated with the granting of this credit may remain unhedged (or hedged in a less appropriate way), which is undesirable from a prudent risk management point of view. Or alternatively the lender may simply decide to limit the credit that he/she is prepared to provide to this particular subsidiary, in order to ensure that his/her risk remains at an acceptable level.

- Example 2: Holding Company/Operating company - the parent entity may be the issuer of a bond, but all the real assets may sit within a subsidiary located in another country. Market participants purchasing the bond issued by the *parent* may feel that a sovereign CDS from the country where the *subsidiary* is located is actually a better hedge. If such a cross-country hedge is prohibited, the market participants may be less inclined to invest in the parent company, as it would be more risky, and the company may be less able to attract foreign investments.

- Example 3: Multinational corporation - it would be practically impossible to hedge exposure to a multinational corporation if the cross-jurisdictional restriction remains. We believe that is difficult to make the assumption that an 'asset' such as shares are 'located' in a single Member State. For example, a bank such as Dexia has operations in different European countries. Companies such as Reed-Elsevier and Unilever are dual-listed in the UK and the Netherlands. Standard Chered bank is headquartered in the UK but carries out most of its business in emerging markets.

Impact on ability of banks to raise regulatory capital

- Example 4: Bank Exposure – an investor may look at a bank's foreign exposures when determining whether to invest, and conclude that the bank's health is heavily dependent on the performance of its portfolio in foreign markets. The investor may therefore choose to hedge its investment in a bank through sovereign CDS in those markets where the bank has large exposures, rather than through sovereign CDS in the country where the bank is headquartered. But if this type of hedge is prevented, the ability of the bank to raise regulatory capital may be impacted.

Impact on cost of funding for sovereign and corporate issuers

- Example 5: CVA hedging– banks' CVA desks very often hedge the credit risk on a macro level. For example, they would hedge all European credit exposures by buying CDS on France and Germany (which are much more liquid, with tighter bid/offer spreads), rather than buying a CDS on other Member States. The use of German or French sovereign CDS to hedge the macro situation in the Eurozone is a reasonable position to take given the economic and monetary links between the Eurozone's two largest economies and the rest of Europe, especially the rest of the single currency area. If such cross-country macro protection via the most liquid sovereign CDS is no longer available, hedging of an investment in any portfolio of European exposures (including e.g. Italian, Spanish, French and German public or private debt) could become more expensive. This would increase funding costs for sovereign and corporate issuers.

Hedges covering multiple exposures

- Example 6: Moreover, as we strongly believe that cross-country hedging should be permitted, the situations illustrated by the following example should be not considered as an over hedge. For instance, if a CDS on Germany covers both an exposure in France (both countries correlated) and an exposure in Germany, we would welcome a clarification that it would not be treated as an outright overhedge (i.e. short position) on Germany.

Annex 3: Legal arguments against the restriction on cross-country hedging

We believe that there are strong legal grounds to contest the proposal to prohibit the use of cross-country hedges involving CDS.

Issue 1: Power to exhaustively define the scope of Article 4(1)

The first legal issue we deal with herein is the scope of the delegated powers granted to the Commission.

The relevant Article in this context is Article 4(2) which gives the Commission power to adopt delegated acts.

'specifying, for the purposes of paragraph 1 … cases in which a sovereign credit default swap is considered to be hedging…' (emphasis added).

This suggests that the delegated acts can specify cases but *cannot exhaustively define* the scope of the relevant provision.

In contrast, ESMA (consultation document, Box 6) appears to propose an exhaustive definition of the conditions a sovereign CDS must meet in order not to qualify as an uncovered CDS.

This is clearer than the position under Article 12(2) where the power is to adopt regulatory technical standards 'to determine the types of agreements, arrangements and measures that adequately ensure that the share will be available for settlement'. It is not clear whether that power is a power to give examples or is a power to specify exhaustively the circumstances where the relevant exemption applies.

In contrast, Article 2(2) SSR gives the Commission power to adopt delegated acts 'specifying the definitions laid down in paragraph 1 of this Article, in particular specifying when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale…'

In these circumstances, it seems that the delegated acts would further particularise the definitions and therefore limit their scope (although they would not be able to alter their essential essence).

Issue 2: Limits on scope of power

Even if the Commission had the right exhaustively to specify the cases which qualify as covered CDS, it still does not have an unlimited right to limit the scope of Article 4(1). Article 290 of the Treaty allows a legislative act to include a delegation of powers to the Commission to adopt acts of general application to 'supplement or amend certain non-essential elements of the legislative act'.

However imposing a geographic limit on proxy hedges does in fact change an essential element of Article 4(1), because Article 4(1) as adopted by the co-legislators is not geographically limited. It would be inappropriate for the Commission to seek to impose an additional condition not foreseen by Article 4(1).

Recital 21 indicates that an 'exposure to private sector entities established in the Member State concerned should be included [viz in the category of correlated risks]'. This Recital makes clear it is the intention of co-legislators that exposures to entities in the Member State concerned *should* be treated as correlated i.e. in the case there is a presumption of correlation. But this is without prejudice to the ability of a market participant to demonstrate that exposures to entities located *elsewhere* are *also* correlated. The Recital does not represent a limitation on cross-country hedging, but merely makes clear what the position is with intra-country hedging.

However, ESMA's proposal would appear to be fundamentally different. It has the result that a market participant must show that the hedged exposure is both correlated AND that the obligor/counterparty is located in the Member State in question. However:

- This is not supported by the text of Article 4(1). It imposes an additional requirement in no way foreseen by the regulation.
- It is not supported by the quoted extract from Recital 21, which rather supports a non-exhaustive presumption of correlation for intra-country hedges.
- It is also inconsistent with the last sentence of Recital 21, which states that 'This [the class of correlated risks] also includes indirect exposures to any of the referred entities obtained, inter alia, through exposures to indices, funds or

special purpose vehicles'. This clearly envisages a wide application of the correlated class – not limited by geography.

- It is discriminatory in that it treats similar cases differently. Two items which have identical correlations to sovereign risk are treated differently, based solely on residence or geographical factors.

- This discrimination also could create barriers to the Treaty-based freedom of establishment as it encourages companies to do business in their home country, rather than through subsidiaries in other countries, because their counterparties will be better able to hedge their exposures to entities in the home country.

Annex 4: Sovereign debt and sovereign CDS markets

This note compares the sovereign debt and sovereign CDS markets.

Sovereign CDS and sovereign debt prices

EU Member States routinely borrow money by issuing bonds and selling them to capital market investors. Naturally, investors demand a higher return (or 'yield') for bonds issued by governments more at risk of default.

Over the course of 2010, the yield on the bonds of many governments, notably Greece, rose significantly, reflecting the deteriorating fiscal situation in many European states. Some commentators, overlooking rising debt levels and current account imbalances, blamed this increase on holders of naked sovereign CDS contracts, arguing that speculative activity in the CDS market was sending a negative signal to investors in the underlying bond markets.

New Credit Valuation Adjustment (CVA) rules have increased CDS prices

Firstly, it is important to note that neither there is evidence of wide-spread speculative activity in the sovereign CDS market nor of speculation driving price changes in CDS markets.

Increasing CDS prices are largely driven by market participants hedging their exposure to sovereigns in reaction to accounting changes and to new capital rules introduced by Basel III. Under the new Basel III rules, banks are required to hold capital against changes in CVA (the market price of protecting against the risk that the sovereign doesn't pay).[i] One way to manage this risk is to buy a CDS referencing the country with whom the bank has entered into the swap transaction. The new Basel III rules have therefore contributed to a large increase in investors wanting to buy sovereign CDS contracts to hedge the risk associated with their derivative contracts, leading to an increase in CDS prices – as confirmed in the April 2010 IMF Financial Stability report..

The influence of CDS prices on underlying bond prices

Despite this increase in sovereign CDS prices, there is no strong evidence to suggest that sovereign CDS activity influences prices in the underlying bond markets. In August 2010, the IMF published empirical research on the relationship between bond yields

and CDS markets for a number of developed countries, including Eurozone countries, finding that both were strongly linked to fundamental factors, such as the deficit and debt level, current account balance, GDP growth, and GDP per capita. In the words of the IMF, 'sovereign CDS has unlikely exerted a significant influence on government bond markets, for Greece or other sovereigns.'

Moreover, as the European Commission explained in its in-depth report on the sovereign debt crisis: 'The CDS spreads for the more troubled countries seem to be low relative to the corresponding bond yield spreads, which implies that CDS spreads can hardly be considered to cause high bond yields for these countries.'

<u>CDS may actually moderate downward pressure on troubled countries</u>

Indeed, the sovereign CDS market may actually serve to moderate downward pressure on troubled countries. Without a liquid sovereign CDS market, those market participants hedging risks related to government bonds would instead move to short or sell any bonds or other country-related assets. This would put additional and more substantial pressure on the country and its economy.

The size of the sovereign CDS market

Furthermore, the size of sovereign CDS markets is very small in comparison with the underlying bond markets, so it is perhaps unsurprising that sovereign CDS markets do not guide the yield on government bonds. Data collected from the DTCC and the Organisation for Economic Cooperation and Development (OECD) illustrates this point – the net value of sovereign CDS positions (this netting reflects the fact that many CDS positions offset each other) represents just a tiny fraction of the total value of government bonds in issue:

Ratio of Net CDS to Central Government Debt Amounts in billions USD (as of Apr 2011)			
Sovereign	**Net CDS**	**Gov't Debt**	**CDS/Debt (%)**
Italy	26.0	2,256.1	1.2
Spain	18.4	733.9	2.5
Germany	16.7	1,482.6	1.1
Greece	5.5	454.7	1.2
France	19.4	1,754.5	1.1
Portugal	6.6	202.8	3.3
United Kingdom	11.9	2,068.5	0.6
Austria	6.3	249.5	2.5
Ireland	4.3	124.9	3.4
Poland	2.6	236.8	1.1
Hungary	3.7	96.0	3.9

Sources: DTCC (Apr 2011) and OECD (Dec 2010)

[i] When a government borrows money by issuing bonds it may decide to 'hedge' the risk associated with the interest payments it will need to make to investors. Since tax payments tend to rise roughly in line with short term interest rates, but bonds typically pay on longer term rates, governments often enter into a transaction to transform the short term rate that they receive into the longer term rate that they must pay. The most common way to do this is a swap – a form of derivative. The government enters into an agreement with a financial counterparty to receive a fixed interest payment in exchange for paying a variable or 'floating' one.

The value of the swap to either party depends on how interest rates change. Assume that a bank has entered into a swap with a sovereign issuer and, following a change in the interest rate, expects to receive money over the life of the swap. In calculating the value it expects to realise from the swap, the bank is required by accounting standards to take account of the cost of hedging against the sovereign's default. So a Credit Valuation Adjustment (CVA) is applied to the value of the swap reflecting the market price of protecting against the risk that the sovereign doesn't pay. If the price of this protection rises, then the CVA also changes.