Deutsches Aktieninstitut

ESA-Consultation Paper: Draft regulatory technical standards on risk mitigating techniques not cleared by a CCP

Comment of Deutsches Aktieninstitut e.V., 14 July 2014

Introduction

Deutsches Aktieninstitut[1] welcomes the opportunity to comment on the ESA's consultation paper on "Draft regulatory technical standards on risk mitigating techniques not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012". Our answers to the questionnaire represent the view of non-financial companies (NFCs) using derivatives almost exclusively to mitigate risks related to their commercial or treasury financing activities ("hedging").

Our comment focuses in particular on the following aspects of the consultation paper:

- The interpretation that non-EU counterparties should exchange collateral in their transactions with EU counterparties required to clear is not in line with EMIR and the BCBS / IOSCO's position on bilateral collateralization;
- The standards proposed by the ESAs should better reflect current collateralization practices, e.g. regarding the timing for the margin calls;
- Bank guarantees should be acknowledged as eligible collateral;
- The prerequisites for the exemption of intra-group transactions should not be too strict. Otherwise, the exemption would be rendered useless which would also contradict the political decision of the level-1-text;
- As in other jurisdictions, e.g. the U.S., the re-use of initial margins should be allowed. Otherwise, competitive disadvantages would result for European companies.

[1] Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and Berlin.

Our answers in detail

Q 1: What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

On p. 7 it is stated that "The RTS impose an obligation on EU entities to collect margin in accordance with the prescribed procedures, regardless of whether they are facing EU or non-EU entities. EU entities would have to collect margin from all third-country entities, unless explicitly exempted by the EMIR or under the EUR 8 billion threshold, even from those that would be classified as non-financial entities below the threshold if they were established in the EU."

The ESAs should be aware that many NFCs – large, but also small or medium-sized – are doing business via subsidiaries in non-EU-countries. Although the group-wide derivative risk management of most non-financial companies is centralized in a specialized entity or on the level of the headquarters, non-EU subsidiaries often conclude derivatives with banks on their own (e.g. due to currency or exchange controls or due to being located in different time zones). Even if derivatives are not concluded with a bank located in the EU, it is often a branch of an EU-bank that is located in the same country like the non-EU subsidiary.

The above mentioned statement could be read as that these non-EU entities would be required to exchange collateral in their derivative transactions with EU banks – although they are part of a group which is – as NFC- – exempted from the requirement for bilateral collateralization (see Art. 2 GEN para. 4 lit. b). This statement also contradicts the aim of BCBS / IOSCO set forth in the paper "Margin requirements for non-centrally cleared derivatives" according to which the requirements should not apply to those transactions exempted from the clearing mandate. Last, not least, it is not consistent to use a "world principle" (i.e. global derivatives business) to assess EMIR clearing requirements, and then to ignore a resulting exemption by demanding collateralization from some of the very entities declared to be within those EMIR limits.

Therefore, the ESAs should clarify that the obligation to exchange collateral should also not relate to transactions between EU-banks and non-EU entities/subsidiaries which would generally be classified as NFC- under EMIR.

Q 2: Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If so, please provide the rationale for the concerns and potential solutions.

From a non-financial company's perspective the standards are relevant for two reasons. Firstly, the standards are of course important for those non-financial companies exceeding the clearing thresholds and becoming therefore obliged to collateralize non-centrally cleared derivative transactions (NFCs+). Secondly, although not obliged to clear/to exchange collateral, some NFC- voluntarily collateralize at least parts of their derivative exposure for risk management purposes. It is very likely that future market practice on bilateral collateralization will strongly refer to the standards adopted by the ESAs. For these reasons it is very important that the standards adequately reflect common practice of NFCs.

Against this background ESAs should address the following aspects in an appropriate manner:

Art. 1 VM para.1 / Art. 1 EIM para. 3:

According to this provision counterparties are required to comply with their initial / variation margin obligations one day (!) after the execution of the contract. This time span is very ambitious, contradicts current market practice and should be expanded to at least up to one week after receiving the respective margin call / the entering into the contract.

Art. 1 VM para. 1:

The daily transfer of collateral is not justified from an economic point of view and would pose a high administrative burden for NFCs (e.g. the bilateral reconciliation of the market value between the counterparties takes much more time as market value deviations are rather normal than an exception). A weekly reconciliation and exchange of variation margins would better take into account that corporate´s personal resources in their risk management are restricted. An extension of the time period to one week would also be in line with the BCBS / IOSCO proposal (para. 2.1, p.9), which provides that parties "must exchange […] the full amount of variation margin […] on a regular basis (e.g. daily)." Of course, collateral should be exchanged regularly; the daily frequency mentioned by BCBS / IOSCO is only an example, but not an obligation.

Art. 6 MRM para. 2:

To require counterparties to have processes in place to verify at least annually the legal enforceability of netting agreements would overstretch capacities of non-financial companies. In a cross-border context this analysis would be too burden-

some due to huge differences in the respective insolvency laws, in practice resulting in significant costs from external legal opinions. Therefore, this requirement should be abandoned.

Art. 1 LEC:

The list of eligible collateral does not include bank guarantees. This is not in line with the collateral eligible for the clearing process under Art. 41 para. 1 EMIR, which explicitly states that for NFCs a CCP may accept bank guarantees. To accept bank guarantees as collateral under the regime of bilateral collateralization would be consistent with the clearing requirements. It would also better reflect the different nature of NFCs' balance sheets. Liquidity provided by NFCs will no longer be available for operative purposes (i.e. investments in growth and employment) and unlike FCs, they do not have access to central bank liquidity. As a result, the amount of available collateral in the form of liquid assets is very limited. Bank guarantees in fact work as a substitute for this natural shortage.

Art. 1 IGT para. 5:

After exceeding the clearing thresholds NFCs are forced to clear all relevant contracts within four months (Art. 10 para. 1 lit. c). The clearing obligation also triggers the obligation of bilateral collateralization for non-clearable derivatives.

The implementation of the necessary compliance procedures to fulfil the clearing / collateral obligation will take time. This will be aggravated by the fact that intra-group transactions are to be cleared / collateralized if supervisory authorities object to the request of NFCs to use the exemption foreseen in EMIR. As the competent authorities must inform the company within 3 months of their intention to reject the notification, there would be only one month left for the company to implement the respective processes for the collateral requirements after becoming NFC+. This is a very short time span. Therefore, in case supervisory authorities object the notification for the intra-group exemption NFCs should be granted additional four months (i.e. after the objection) to implement the respective processes. Until the supervisory authority decides upon the exemption, the corporate should assume that intra-group transactions do not need to be collateralized.

Art. 3 IGT para. 1:

The proposed definition of "practical or legal impediment", relevant for the intra-group exemption, is not feasible. For reasons of legal certainty the criteria should focus on aspects which reasonably can be assessed by companies. The exemption would be rendered useless if restrictions stemming from insolvency of the counterparty would have to be anticipated, which is impossible. As a matter of fact, any company / counterparty may become insolvent with a small, but certain likelihood.

The same holds true with regard to practical impediments and especially the term that "sufficient assets […] are or may be freely available […]". It is unclear, how the company should deal with the requirement, that sufficient assets may be available. It is only possible to assess the current situation, i.e. assets are at present available or not. Overall, ESAs should restrict the requirements for the intra-group exemption to aspects which could be objectively applied by companies.

In general, as intra-group transactions do not create any additional risk at group level – the losses and gains of the intra-group counterparties are compensating each other – ESAs should exempt intra-group transactions from the initial margining requirements. This being said, almost always the internal companies do not have sufficient cash reserves to post collateral, i.e. would need a loan from the counterparty that receives the collateral. This as a matter of fact would contradict the idea of mitigating credit risk.

Annex IV – Art. 1 SMI:

The proposed add-on factor for the initial margin calculation regarding foreign exchange and commodities appears to be rather high. Many large corporates have only low netting potentials as they most likely are "long currency" (sale of products in foreign countries). The netting effects and thus the liquidity impact on initial margin requirements would be unjustifiable high.

The same holds true for commodity derivatives, with an even higher add-on factor (15%). Commodity Derivatives are most likely used to hedge price risk from the purchase of materials leaving corporates with low to even no netting potential. This at least holds true for manufacturing companies.

Q 5: How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

Explicit concentration limits strongly restrict the possible collateral universe and should not be imposed as the requirements on initial and variation margins set forth in the standards are already very strict. It would be better to follow a more flexible approach and to leave it to the discretion of the market participants to avoid concentration risks. This should be part of the risk management strategy which could be monitored by the supervisory authorities or the external auditor.

Q 6: How will market participants be able to ensure the fulfilment of all the conditions for the re-use of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require re-use or re-hypothecation of collateral as an essential component of their business models?

Segregation and prohibition to re-use initial margins is highly problematic as rating agencies will assess the liquidity received from the other counterparty as „restricted“ whereas posted collateral will negatively impact the company´s net financial position. Therefore, the liquidity position of the firm will deteriorate and cash needed for investments is tied on segregated accounts. Overall, collateral segregation will decrease the creditworthiness of the company from a rating perspective, although it is the aim of collateralization to reduce counterparty risk. Therefore, re-use of initial margins should be permitted, which is e.g. possible under the U.S. regime for bilateral collateralization. Otherwise, a stricter initial margin regime would create a competitive disadvantage for European companies.

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