Deutsches Aktieninstitut

ESA's 2nd consultation paper: Draft regulatory technical standards on risk mitigating techniques not cleared by a CCP

Comment of Deutsches Aktieninstitut e.V., 10 July 2015

Introduction

Deutsches Aktieninstitut[1] welcomes the opportunity to comment on the ESA's second consultation paper "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").

For the time being our member companies are exempted from the clearing obligation and are not obliged to collateralize their derivative transactions bilaterally. However, it is very likely that the standards proposed by the ESAs will become market practice in the medium term. This would also concern those companies which collateralize their derivatives voluntarily and not for regulatory reasons. Therefore, it is very important that the standards set out by the ESAs adequately reflect existing and well established collateralization practice.

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

- The time periods for the exchange of variation and initial margins should be appropriate from an economic perspective and should not overstretch capacities of non-financial companies.
- The re-use of initial margins should not be restricted to avoid negative effects for balance sheets.
- The use of bank guarantees as collateral should be allowed.

[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

Question 1. Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

We very much welcome the clarification that non-financial companies not exceeding the clearing thresholds are not be obliged to exchange collateral irrespective whether these companies are domiciled in the EU or not.

Nevertheless, the wording of Art. 2 GEN is confusing, especially that certain non-financial counterparties other than those referred to in Art. 10 EMIR are exempted. The word "certain" is superfluous and should be deleted, as effectively there are only two possible cases: those companies which are obliged to clear in accordance with Art. 10 EMIR, and the others which are not. There is no necessity to restrict the scope of the exemption to *certain* non-financial companies not exceeding the clearing thresholds.

Question 2. Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.

We reiterate our proposal set out in our comment to the first consultation paper that the time span for the *first* collection of the variation and the initial margins should be expanded to at least one week after receiving the respective margin call / the entering into the contract. Although we appreciate the proposal made by the ESAs that variation margins should be collected within 3 business days from the calculation date, we however deem this time period as too short for NFCs. Regarding initial margins ESAs propose to collect the margins within one business day following the execution etc. This is also too short and should be extended at least to a period "within one week".

Furthermore, it should be made clear that permanent reconciliation and exchange of variation margins should optionally take place within a week and not necessarily on a daily basis. In contrast to banks NFCs have less access to short term financing. 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 in the respective calculations are rather normal than an exception). A weekly transfer would take into account that corporate personal resources in risk management are limited. In addition, a common way of financing collateral is the issuance of commercial paper, which is very tough to execute within a day (exposures need to be reconciled, investors need to be contacted, rates to be agreed, etc.), especially in uneasy markets typically being a catalyst for strong movements in market values.

Question 4. Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

Explicit concentration limits strongly 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. Therefore, we appreciate the thresholds introduced by the ESAs in Art. 7 LEC para. 2 (the concentration limits should apply only for government debt collateral collected in excess of 1 billion Euro). However, it is not justified and not comprehensible why these thresholds should be limited to government debt securities. Also, ESAs do not provide any rationale for this limitation. It should also be considered that the availability of related securities may be limited in times of ECB quantitative easing measures and may cause a price risk for the period of holding the government debt security.

Therefore, we ask ESAs 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. At least, the thresholds proposed (see above) should be available for any collateral posted and not restricted to government debt securities.

Question 5. Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.

Question 6. Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.

The following represents our answer to question 5 and 6. We reiterate our concerns that the requirement for counterparties to perform at least annually an independent review about the legal enforceability of netting agreements and segregation arrangements would overstretch capacities of non-financial companies. In a cross-border context this analysis would be too burdensome due to huge differences in the respective insolvency laws, in practice resulting in significant costs from external legal opinions. To note, the typical market standard framework agreements (e.g. ISDA) which we believe to be sufficient to meet the given requirements are neither being reviewed on a yearly or comparable basis by market participants. Therefore, this requirement should be abandoned.

Question 7. Does this approach address the concerns on the use of cash for initial margin?

We reiterate our concern that initial margins should not be segregated. Rating agencies will very likely assess the asset position "receivable" from the counter entry of the paid collateral and the "cash" position from the received collateral as "restricted" and therefore as not being part of the general liquidity position, whereas the financing of the posted collateral via debt (e.g. commercial paper or credit facilities) is fully reflected in the debt position. In addition, the collateral received enters into the balance sheet as a liability against this counterparty and further increases the debt position. Hence, via this "trapped cash" a deterioration of the company's creditworthiness might be the consequence, maybe including leading to rating downgrades.

Apart from the detrimental rating effect, the liquidity position of the firm will deteriorate and cash needed for investments is tied up in unproductive items from a corporate view. Overall, collateral postings will decrease the creditworthiness of the company, although it is the aim of collateralization to reduce counterparty risk. Therefore, re-use of initial margins should be permitted at the very least for cash collateral, 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.

The solution proposed by the ESAs, that cash collateral could be invested in securities and that this investment should be segregated and not re-used, does not solve the above described general problem caused by a segregation requirement. The investment of the cash received into securities would not be feasible process-wise (high operational effort for corporate back offices not used to securities handling), apart from the fact that there might be bottlenecks in security supply for the sometimes rather small amounts required, next to gains and losses in the security´s prices which could undermine the overall value of the posted collateral.

Other aspects not addressed by ESA's questions

Art. 3 IGT para. 1:

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 at least from the initial margining requirements especially considering that both companies have to post and segregate it, i.e. the trapped cash position (see above) would be doubled. The exemption from the initial margin requirement should apply without any application process. This would be e.g. in line with MiFID II which acknowledges the "risk neutrality" of intra-group transactions in Art. 2 para. 1(j) with its exemption from the calculation of the thresholds regarding the ancillary activity exemption.

That being said, almost always the internal companies do not have individual cash reserves to post collateral due to intercompany pools concentrating cash at group level, i.e. would need a loan from the counterparty that receives the collateral. This as a matter of fact would contradict the very idea of mitigating credit risk, as well as the efficiency of centralized cash management.

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. Regarding foreign exchange (add-on factor 6%) 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.

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 as well as the problem of limited access to short term funding compared to banks, contradicting existing credit line documentations and other issues described above. 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. Bank guarantees in fact work as a substitute for this common shortage.

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