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via ESMA Web Site

Response to the Joint Consultation Paper JC/CP/2014/03 dated April 14, 2014 / Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11 (15) of Regulation (EU) No 648/2012

Dear Sir or Madam,

We would like to thank you very much for granting us the opportunity to submit this letter in response to the above mentioned Joint Consultation Paper published on April 14, 2014 (the "**JCP**"). We would be grateful if the following comments would be taken into due consideration.

1. Background on KfW

KfW was established in 1948 by the Administration of the Combined Economic Area, the immediate predecessor of the Federal Republic of Germany (the "**Federal Republic**"). KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organized under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau*, or "**KfW Law**"). The Federal Republic holds 80% of KfW's equity capital and the German federal states hold the remaining 20%.

As a German state-owned promotional bank, KfW serves domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities. KfW's lending activities include domestic financing, primarily made through commercial banks, including, in particular, loans to small and medium-sized

enterprises and housing-related loans, export and project finance through KfW's wholly-owned subsidiary KfW IPEX-Bank GmbH and development finance for developing and transition countries.

The KfW Law expressly provides that the Federal Republic guarantees all existing and future obligations of KfW in respect of money borrowed, bonds and notes issued and derivative transactions entered into by KfW (KfW Law, Article 1a). Under this statutory guarantee, if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW's obligations mentioned above, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable. The Federal Republic's obligation under the Guarantee of the Federal Republic ranks equally, without any preference, with all of its other present and future unsecured and unsubordinated indebtedness. KfW is a public sector entity within the meaning of Article 4 (1) (8) of Regulation (EU) No 575/2013 (corresponding to Article 4 (18) of Directive 2006/48/EC).

In accordance with Article 1 (5) (b) of Regulation (EU) No 648/2012 ("**EMIR**"), EMIR does not apply to KfW except the reporting obligation under Article 9 of EMIR.

2. Comments on the Joint Consultation Paper

a) Scope of application of the draft regulatory technical standards

In accordance with Article 11 (15) (a) of EMIR, the European Supervisory Authorities shall develop common draft regulatory technical standards specifying the risk management procedures, including the levels and type of collateral and segregation arrangements, required for compliance with Article 11 (3) of EMIR. Article 11 (3) of EMIR requires that financial counterparties ("**FCs**") and non-financial counterparties referred to in Article 10 of EMIR ("**NFC+**"), shall have risk management procedures in place that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivatives contracts that are entered into on or after August 16, 2012, in the case of FCs, or on or after the clearing threshold is exceeded, in the case of NFC+s. However, Article 11 (3) of EMIR is neither applicable to non-financial counterparties other than those referred to in Article 10 of EMIR, i.e. non-financial counterparties below the clearing threshold ("**NFC-**"), nor to those entities which are explicitly exempt from the application oft EMIR according to Article 1 (4) and (5) of EMIR ("**Exempt Entities**").

Articles 1 GEN and 2 GEN of the draft regulatory technical standards (the "**RTS**") deal with the scope of application of the RTS. In Article 1 GEN (1) of the RTS, the European Supervisory Authorities ("**ESAs**") propose that the risk management procedures required for compliance with Article 11 (3) of EMIR shall include the collection of collateral except in the cases specified in Article 2 GEN of the RTS. Instead of collecting margin in accordance with Article 1 GEN (1) of the RTS, FCs and NFC+s may agree in writing or equivalent permanent electronic form "not to exchange initial and variation margin" with respect to transactions entered into with NFC-s and Exempt Entities (Article 2 GEN (4) (b) and (c) of the RTS, respectively). This means that the entities which are within the scope of Article 11 (3) of EMIR and, therefore, the RTS, do not have to collect collateral from the counterparties referred to in Article 2 GEN (4) (b) and (4) (c) of the RTS, respectively.

However, the wording of Article 2 GEN (4) (b) and (c) of the RTS ("agree not to exchange initial <u>and</u> variation margin") may lead to the interpretation that counterparties may only agree either a) that both initial <u>and</u> variation margin has to be exchanged or b) that no margin at all has to be

exchanged. From our point of view these interpretations would not be consistent with the scope of Article 11 (3) of EMIR.

Furthermore, it seems to be unclear whether the further requirements set forth in the RTS would apply in case the counterparties opt for the exchange of margin. Transactions of FCs and NFC+s entered into with NFC-s and Exempt Entities, according to our understanding, do not fall within the scope of Article 11 (3) of EMIR and the RTS. FCs and NFC+s should, therefore, be free to agree with those counterparties whether they post to and/or collect from these counterparties collateral and, if so, to which extent and which type of collateral. Therefore, if FCs or NFC+s enter into transactions with NFC-s or Exempt Entities and voluntarily agree on posting and/or collecting collateral, they should not be obliged to apply the requirements of the RTS in any respect, but should be free to agree on the terms of such collateralization as deemed appropriate from a risk management point of view (e.g. they may collect collateral for variation margin only but not for initial margin and/or may accept collateral other than eligible collateral as defined in the RTS).

We also note that FCs and NFC+s would be required to agree with each NFC- and Exempt Entity "in writing or equivalent permanent electronic form" not to exchange collateral. In our opinion this requirement does not add any value to risk management procedures as it only adds administrative burden, in particular on FCs facing a multiple number of NFC-s. It is not necessary in light of the general derogation granted by EMIR already.

To address all the aspects described in this section and, in particular, to avoid any uncertainty and misinterpretation by FCs and NFC+s in their implementation process of the RTS with respect to transactions entered into with NFC-s and Exempt Entities, we suggest that the ESAs consider to include in Article 1 GEN of the RTS an unambiguous provision on the scope of the RTS as follows:

"The provisions of this Regulation shall not apply to transactions entered into with

a) non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012,
b) entities referred to in paragraphs 4 and 5 of Article 1 of Regulation (EU) No 648/2012."

Article 2 GEN (4) (b) and (c) of the RTS would then have to be deleted.

The ESAs may also consider to extend such non-application provision to transactions entered into with other entities which are not within the scope of EMIR, e.g. neither financial nor non-financial counterparties because they do not qualify as undertakings ("**non-undertakings**") and entities established in third countries that would not be subject to the clearing obligation if they were established in the EU.

Alternatively, Article 2 GEN (4) of the RTS could be amended as follows in order to address the issues raised in this section:

"4. By way of derogation from Article 1 GEN, [...] financial counterparties and non-financial counterparties as referred to in Article 10 of that Regulation [=EMIR] may instead agree ~~in writing or equivalent permanent electronic form~~ on any of the following:

a) [...]
b) where they relate to transactions entered into with non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012, they may agree not to exchange initial ~~and~~ or variation margin;

c) where they relate to transactions entered into with entities referred to in paragraphs 4 and 5 of Article 1 of Regulation (EU) No 648/2012, they may agree not to exchange initial ~~and~~ or variation margin;

d) [...]

[...]

7. The requirements of this Regulation do not apply to collateral that is not required to be collected as initial or variation margin under this Regulation."

b) Application of concentration limits to securities issued by sovereigns, regional authorities and public sector entities (Question 5)

In the JCP, the ESAs state that, with the exception of collateral posted in the form of cash, "all other types of collateral is envisaged to be subject to concentration limits" (explanatory text for consultation on page 38 of the JCP). Article 7 LEC (1) (a) of the RTS requires that the sum of values of the debt securities issued by certain central governments, central banks, regional governments or local authorities and public sector entities shall not exceed 50 % of the collateral collected from the individual party. This concentration limit shall apply for single issuers, entities forming part of the same group or having „close links", in each case, as defined in EMIR. Article 7 LEC (1) (b) and (c) of the RTS provides for concentration limits on other types of assets. However, no concentration limits are actually proposed in the RTS for debt securities issued by multilateral development banks, international organisations as well as credit institutions and investment firms (Article 1 LEC (1) (h), (i), (m) of the RTS, respectively).

We assume that no concentration limits are proposed for the assets referred to in Article 1 LEC (h) and (i) of the RTS, because these assets are deemed to be riskless and thus are assigned a zero risk weighting in accordance with Article 117 (2) and 118 of Regulation (EU) No 575/2013.

We would like to draw the ESAs' attention to the fact that debt securities issued by central governments are assigned a zero risk weighing in accordance with Regulation (EU) No 575/2013, as well, if a) they are issued by a Member State's central government and denominated and funded in the domestic currency of that central government (Article 114 (4) of Regulation (EU) 575/2013) or b) a credit assessment by a nominated external credit assessment institution is available and credit quality step 1 applies (Article 114 (2) of Regulation (EU) 575/2013). Further, debt securities issued by regional governments or local authorities will be assigned a zero risk weighting, if (i) exposures to these issuers are treated as exposures to the central government in whose jurisdiction they are established because there is no difference in risk between such exposures due to the specific revenue-raising powers of the former, and the existence of specific institutional arrangements the effect of which is to reduce their risk of default (Article 115 (2) of Regulation (EU) 575/2013), and (ii) exposures to the relevant central government are zero-risk weighted. A similar principle applies with respect to exposures to public sector entities in accordance with Article 116 (4) of Regulation (EU) 575/2013.

Thus, the aforementioned assets should be exempted from concentration limits and an equal treatment with the assets already exempted should be achieved. Such amendment of the RTS would be in-line with Regulation (EU) No 575/2013 and correspond with our view, that neither central governments nor public sector entities with a statutory guarantee from a central government - such as KfW - should, due to their structure, purpose and governmental character, be subject to such a concentration limit. Such entities do not pose a higher risk to other counterparties and to the wider financial system than any of the entities referred to in Article 1 LEC (1) (h) or (i).

In light of the foregoing, we suggest that the concentration limits for central and regional governments, central banks, local authorities and public sector entities be restricted to debt securities issued by these entities that are not assigned a zero-risk weighting according to Part Three Title II Chapter 2 of Regulation (EU) 575/2013 in order to achieve the same treatment as provided for the entities referred to in Article 1 LEC (1) (h) and (i) of the RTS. This result could be achieved by adding the following subparagraph to Article 7 LEC (1) (a) of the RTS:

“The preceding subparagraph shall not apply to debt securities issued by central and regional governments, central banks, local authorities or public sector entities that are assigned a zero-risk weighting according to Part Three Title II Chapter 2 of Regulation (EU) 575/2013.”

Sincerely,

KfW

Name: Andreas Müller
Title: Senior Vice President

Name: Dr. Frank Czichowski
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