

Comments

on ESMA's Consultation Paper on the "Evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Comments on ESMA's Consultation Paper on the "Evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps"

Preliminary remarks

The German Banking Industry Committee (GBIC) thanks ESMA for the opportunity to participate in the consultation of the "Evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps" and appreciates the possibility to provide input at this stage of the process.

According to Article 45 EU-Short Selling Regulation (SSR) the European Commission has to report by 30 June 2013 to European Parliament and Council on appropriateness and the impact of the requirements and restrictions of the SSR. This report is supported by Technical Advice of the European Securities and Markets Authority (ESMA). The German Banking Industry Committee doubts that the short time frame considered for evaluating the impact of the SSR which has only been in place since 1 November 2012 is properly set. Nevertheless we are thankful about the opportunity to support ESMA in its Technical Advice and we have the following remarks we would like to share with you:

Transparency and reporting requirements

Q1 Do you consider that the initial and incremental notification/publication thresholds for net short positions in shares and sovereign debt have been set at the correct levels? If not, what alternative thresholds would you suggest and why?

We consider that the thresholds for notification and publication for net short positions in shares are too low and may unintentionally penalise investors that do not have offsetting positions. Alternative thresholds of 0.50% to regulators and 1% to the public would be more appropriate and still meet the objectives of SSR.

For sovereign debt, we consider that the thresholds for notification to regulators for net short positions in sovereign debt to be adequate. But there exist problems for smaller countries with smaller markets (e.g. Slovenia). There the thresholds are not adequate.

Q2 What use are you currently making of information made available by competent authorities or the central website operated or supervised by the relevant competent authority on public disclosures of net short positions in shares?

The additional transparency of net short positions in shares is welcome, but the threshold for public disclosure is set too low.

Q3 If you had taken short positions in shares and sovereign debt before the Regulation applied, what impact have the notification/disclosure requirements had on your trading behaviour since 1 November 2012?

We cannot ascertain any impact until now, because the regulation is applicable since a short time (Nov. 2012). However, the recent publication of ESMA's final market making guidelines (ESMA/2013/158) will have an adverse impact on market makers who hedge financial instruments that are traded OTC. We also refer to our answer to Q22.

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Q4 Do you have any comments on the method of calculating net short positions in shares and sovereign debt (e.g. the requirement to duration adjust cash positions in sovereign debt)?

The methods for calculation the net short positions in shares and sovereign debt are onerous and complex. The proposed concept of duration adjustment in calculating a net short position in sovereign debt particularly in combination with the delta adjustment with (credit) derivatives is inconsistent and does not strike us as appropriate.

According to the delegated Regulation (Appendix II, Part 2, Article 11, Note 1) cash positions in sovereign debt should be taken into account with their nominal value duration adjusted. The ESMA's FAQ specify the approach and give the following method to calculate duration adjustment (question/answer 4b).

For each instrument (i) and being D=Modified Duration of each issued instrument and V=Outstanding volume (in €) of each issued debt instrument, the "nominal value duration adjusted" (NVDA) would be:

$$NVDA = \sum_{i=1}^n (D_i \times V_i)$$

As we understand it, with cash positions which are subject to short-term interest rates (e.g. floating rate notes) and where credit default swaps are used as hedges against the default risk on the basis of the above approach there arise particular situations, which are illustrated in the following example.

For positions with short remaining tenors and/or short-term interest rate fixing modified duration takes on correspondingly lower numerical values.

With a long position in an a) Floater, 6-month Euribor with a remaining tenor to maturity of 5 years and nominal value of € 50 million, the duration-adjusted nominal value would, for example, amount to € 25 million (50×0.5^1). The duration-adjusted nominal value of a b) fixed-coupon bond, on the other hand, would with similar other features amount to € 250 million (50×5^2).

If both positions are hedged with a Credit Default Swap (Protection Buy) in the amount of the nominal € 50 million, the calculation of the net short position in the case of the floater would show a short position of € 25 million. In the case of the fixed-coupon bond, on the other hand, a long position of € 200 million.

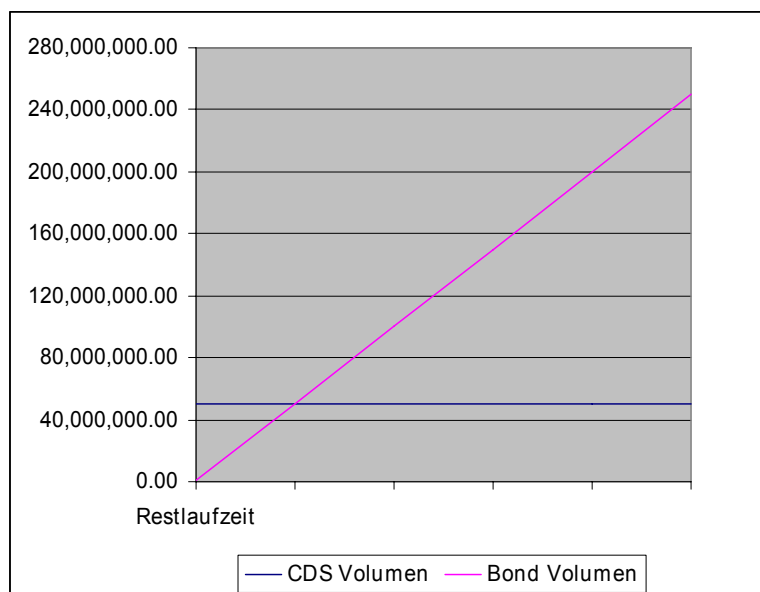
This appears inconsistent, as the positions including CDS hedging differ only in their interest rate structure. Viewed economically and/or with regard to the aim of the Short Selling Regulation, however, both positions should in our opinion be considered of equal value.

¹ Simplified, the modified duration of the floater in the example is 0.5 (interest rate fixing). Moreover, the modified duration for floating rate notes is not a typical key indicator.

² Simplified, the modified duration of the fixed-coupon bond in the example is 5 (remaining tenor to maturity).

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The following example shows the effect of the calculation with different factors (delta-adjusted vs. duration-adjusted) on a €50 million (nominal) 5-year bond position with concurrent purchase of CDS hedging.



In the year before maturity such a position always results in a net short position without there having been any economic change during the lifetime of both positions.

A further negative effect is the often used practice of closing a CDS position with a later final maturity than that of a bond position. The reason for this are the standard CDS expiry dates, which do not coincide with the maturity dates of bonds. To avoid the occurrence of an uncovered net short position after maturity of the note, the institution must either

- (1) chose a shorter CDS maturity and thus for a few days be exposed to the credit default risk of the bond issuer,
- (2) terminate the CDS position for a few days or
- (3) conclude a non-standard CDS, which will, however, be restricted by the clearing facilities stipulated by EMIR and lead to a higher level of CDS being concluded that are not subject to the clearing obligation.

In view of this, the multiplication by a factor that reflects inter alia the interest rate sensitivity of a position does not appear to us to be an appropriate choice.

We also consider that the aim "of enhanced transparency for both regulators and market participants", as stated in point 6, is not fulfilled in the cases described above. The reporting obligation for an economically secured position makes no sense and can result in misinterpretation by the regulator with the consequence of unnecessary market intervention. As market participants are aware of this purely technically necessary report their benefit from the report is essentially zero.

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Q5 What is your view of the decision to adjust the monetary trigger thresholds for reportable short positions in sovereign debt every three months? Is there an alternative you would favour and if so please explain why?

In our view, a yearly adjustment of the thresholds would suffice to achieve the desired objective. The volume of outstanding bonds does not change significantly in shorter periods. An interval of three month would therefore not enhance market efficiency nor would longer intervals open up the possibilities of regulatory arbitrage.

However, we see a lack of transparency and clarity concerning the figures each member state has to report. To assist firms with the operations process to keeping up to date with the latest monetary thresholds, we suggest ESMA to publish an alert when the thresholds have been updated and to explain the method for collation and changes from the previous period.

Q6 Do you consider that reporting mechanisms are operating efficiently? If not, explain why and how they could be improved.

The reporting process between member states is inconsistent. Some of the processes require lots of information and take a long time to be completed. We recommend that the registration process be streamlined, consistent and common across member states.

Q7 Do you have any other comments on the reporting and transparency requirements or on their operation since 1 November 2012?

Individual member states (like the Netherlands) are introducing additional disclosure regimes which will create further complex operational processes for firms and greater confusion on the market. We also suggest ESMA to consider amending the notification requirement from 3.30 pm local time to an end of day timing in order to ensure accurate data.

Restrictions on short selling of shares and sovereign debt

Q8 Have you observed any improvements in settlement performance (either your own or that of counterparties) since the Regulation became applicable?

As far as we can see, the improved settlement performance is primarily due to the increased processing of deals through the CCPs. In addition to that, there is no evidence that the short selling ban has also had positive effects in this context.

Domestic:	OEX (CCP): here settlement performance has improved.
OTC:	no noticeable trend
Foreign:	OEX & OTC: here too settlement performance has improved.

Until now, fines have not been imposed.

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Q9 Have you noticed any impact on the cost or availability of securities lending since the Regulation has applied? Please specify any effect you have seen.

From our perspective the Short Selling Regulation has until now had no effect on lending costs. Even before the EU short selling ban came into force, cover was effected by means of a securities lending transaction; the new regulation brought about only more timely cover. This merely temporary effect has until now not manifested itself in the lending costs.

However, when the ESMA guidelines on the EU short selling ban are going to come into force, lending costs will most likely increase. Market participants will be compensating the limitation of exemptions by increased holdings of securities for lending transactions, which might lead to supply shortages on the securities-lending market, resulting in increased lending prices.

Q10 Have you observed any improvements in reducing the risks of volatility, downward spirals or settlement problems (e.g. inflation of shares) since the Regulation became applicable?

Given the small timeframe between the application of the Regulation and the current evaluation, it is difficult to assess any improvements in reducing risks of volatility, downward spirals or settlement disciplines.

Q 11 Has the locate rule requirement affected the way you conduct short selling?

Because of the new regulatory requirements the locate agreement in its hitherto form will be led ad absurdum. The locate rule has adversely impacted the way firms conduct short selling due to the onerous operational requirements and little evidence of improvements in settlement performance. Actual lending transactions are concluded instead of the a locate agreement. In view of this, appropriate changes to procedures must be made.

Q12 Has the definition of 'third party' in the implementing technical standards limited or constrained the operation of the locate confirmation or other arrangements? If so, please specify in what ways.

The definition of "third party" has constrained the operational processes of the locate confirmation. This definition added unnecessary layers of complexity. Additionally we refer to our answer to Q11.

Q13 Are there any changes which could be made to the conditions for entering into a short sale which would improve the efficiency of the arrangements without undermining the purpose of the measures? Please explain any changes you would propose.

We remain of the opinion that, if there is an appropriate agreement, additional individual confirmations are superfluous and counterproductive.

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Q14 Do you have any other comments on the existing restrictions or their operation since 1 November 2012?

So far, we can see no tangible use of short selling restrictions that is worth mentioning. To make matters more difficult, the implementation of, and compliance with, the regulatory requirements induces significant costs as well as related negative effects for market efficiency and quality - or at least indications to this effect. In addition, these burdens and handicaps will affect market participants which with regard to the regulatory effect being aimed at here certainly do not belong to the intended target group.

Restrictions on entering into uncovered sovereign credit default swap positions

Q15 Have you noticed any effect of the prohibition on entering into an uncovered sovereign CDS transaction on the price and on the volatility of the sovereign debt instruments?

The market has become less liquid; the bid-offer spread has widened. Volatility is unchanged, but has tended to shift to the spot/cash markets.

Q16 Have any elements of the prohibition on entering into an uncovered sovereign CDS transaction had a noticeable effect on your ability to hedge your exposures? If yes, please quantify the impact and explain where the issue arises.

Yes, there are impacts on market participants' ability to hedge exposures, because market liquidity has decreased, price ranges have increased to the effect that hedges have become more expensive. Ticket sizes have halved; the bid-offer spread has doubled. Overall there is a noticeable trend towards alternative hedging instruments.

The Short Selling Regulation (SSR) looks at each market participant at a legal entity-level in order to calculate short and long positions. That means that every entity is separately treated, even if the entity is part of a group. That is the reason why the SSR does not take into account situations where one member of a group serves as the responsible for the hedging activities of the entire group. In other words, if a subsidiary of such entity enters a long position in a sovereign debt but the hedging of such position by way of a CDS is done by a dedicated entity of the same group such CDS would have to be considered as a "naked" CDS position and is prohibited. On group level however the CDS position is far from being naked. We believe it therefore appropriate to enhance the Regulation in this respect and allow group hedging activities under certain conditions. This possibility of hedging at group level would even lead to a reduction of market risks and would thus reflect the intention of the EU short selling Regulation.

Q17 Have the restrictions on entering into an uncovered sovereign CDS led you to use any alternative methods for hedging your exposures? If so, please elaborate.

As the correlation and proportionality tests are not workable sovereign CDS are not used to hedge exposures. We detect a tendency to the use of more liquid instruments in the markets.

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Q18 Do you have any other comments on the requirements concerning uncovered sovereign CDS positions or on how they have operated since 1 November 2012?

The ESMA guidelines will tend to exacerbate the negative effects described above.

Settlement discipline including buy-in procedures

Q19 What is your assessment of the effect on settlement discipline in shares since the application of the Regulation?

Taking into account the period from Oct. 2012 to Feb. 2013 compared to the period from Oct. 2011 to Feb. 2012 only a slight improvement of the settlement efficiency can be recognized (1,06%). No influence can be recognized as regards the number of buy-in-attempts and the number of successful buy-ins.

Q20 What effect, if any, do you consider this provision of the Regulation has had on liquidity in shares since its application?

The effect until now on the liquidity of the market for stocks and shares has been negligibly small.

Q21 Do you have any other comments on the requirements of the Regulation concerning settlement discipline in shares or on how they have operated since 1 November 2012?

With view to the future Regulation on Central Securities Depositories (CSDR) we would like to emphasize consistency in EU legislation concerning settlement discipline and buy-in procedures. Current discussions regarding settlement discipline under the CSDR will affect the existing buy-in and penalty provisions of the SSR.

Following the discussions in the Council, the last compromise text of the Cypriote presidency (Article 68a) to the CSDR suggests to delete Article 15 SSR completely and to replace it by the provisions in the CSDR. This would modify the existing buy-in procedures and, thus, change the effects on the current settlement discipline.

Following the discussions in the European Parliament, the ECON report to the CSDR suggests a number of changes regarding the settlement discipline provisions under CSDR without aligning them to the provisions under SSR. As a result, two different provisions will be applicable to the same set of circumstances. We are therefore concerned about an inconsistency of the settlement discipline regime, in particular in respect of the following discrepancies:

- Whereas Article 17 SSR does not provide for any exemptions for market making activities from the buy-in procedures, Article 7(7a) CSDR of the ECON report stipulates an exemption for financial instruments admitted to trading on an SME growth market. The provision of the SSR cannot be regarded as the more special provision for short selling and market making activities as Recital 15a CSDR of the ECON report states that Article 7(7a) CSDR should allow the activity of market makers in those less liquid markets.

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- Article 16 SSR provides for an exemption from Article 15 for shares where the principal venue for the trading of the shares is located in a third country. The proposals of a CSDR do not provide for such an exemption.
- Article 15(1)(a) SSR determines that the buy-in procedure starts not earlier than on the 7th business day (or at least 9th day) after the trade date (with an anticipated settlement period of T+2) whereas Article 7(3) CSDR requests that the buy-in starts on the third business day after the trade date and has to be finalised within another four days (not business days).
- Article 15(1)(a) SSR stipulates an automatically triggered procedure for the buy-in, the ECON report suggests one dependent on the request of the receiving participant
- The details for payments (penalties as well as compensation) in the buy-in procedure may differ under SSR and CSDR.

Exemptions

Q22 Does the current definition and scope of the exemption for market making activities allow sufficiently for liquidity provision?

One fundamental problem arises due to the fact that ESMA with its guidelines ESMA/2013/158 departs from the market making definition according to Article 2(1)(k) Regulation (EU) 236/2012 (SSR). With regard to the market making activity, however, the basic requirements listed under said Regulation must be seen as exhaustive. In our view it is not justifiable for ESMA to go beyond the wording of the SSR by stipulation of a "membership requirement". As a consequence, under the provisions Article 2(1)(k) SSR, it cannot be a requirement for a bank's activity to qualify as a market maker in specific financial instruments to be a member of the respective trading venue of the financial instrument; neither will the bank always have to deal as a principal in a financial instrument. The "membership requirement" ESMA introduces with its guidelines ESMA/2013/158, practically limits market making to listed products only. This contradicts Article 2(1)(k) SSR which encloses trading "on or outside a trading venue". Such a limitation makes it very difficult, if not impossible, not only for banks, but also for clients to properly manage business risks. Additionally the establishment of the membership requirement is actually harmful to reaching the goals of decreasing systematic risks in the market and providing stable liquidity. This is particularly true for products which simply do not have a trading venue. This is for example the case for CDS; further there exist other products which are traded on other means than trading venues. OTC markets for example fulfil requirements which make them comparable to regulated markets. The introduction of the membership requirement would therefore indirectly prevent banks from engaging in major parts of their current market maker activities. Also the client driven provision of hedging possibilities becomes more and more difficult.

The current requirements suffer from the ill-considered judgement that optimum market liquidity can only be guaranteed by one or at least a small circle of highly professional, constantly present market makers. However, market making is equally capable of increasing market efficiency and market quality even if it is not conducted with the unconditional consequence requested under the prevailing law. Monolithically focusing on large "systemically important" market participants during an analysis of the market mechanisms fails to appreciate the positive impact that a broad "SME-backbone" can have on market depth and market breadth. A revision of the current exemption rules needs to call for reporting evidence that is as conclusive as possible with regard to the motivation behind the short selling being legitimate

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without imposing disproportionate reporting burdens on the overwhelming majority of inconspicuous market participants.

Implicit in the prerequisites expressed in the ESMA guidelines is the impression that optimal market liquidity is guaranteed only by one or at least a small circle of highly professional, permanently present market makers. But market making enhances market efficiency and quality even when it is not pursued with the unquestioning resoluteness that is called for here. An analysis of market mechanisms solely focusing on big, "system-relevant" market participants underestimates the positive effects that a broad "mid-market" base has on the depth and width of the market. If one chooses the discriminatory approach of the ESMA guidelines, then at the end of this process there will be a supranational "market maker oligopoly" with concomitant implications for competition policy.

Q23 Is the process for obtaining the exemption for market making activities appropriate for timely provision of liquidity in all circumstances?

The instrument-by-instrument approach of ESMA in its Market Maker exemptions (ESMA/2013/258) leads to a range of practical challenges for market participants. Some of the procedures/methods selected here appear to be divorced from reality and not very practicable. The ex ante report of the relevant figures with regard to the exemption "client business" serves as a typical example of this. Particularly with query-indexed market making in the context of client business it is very difficult to assess specific client needs in advance and to reliably forecast the relevant product range on the filigree level called for here. An ex post approach would in our view make more sense and be more practical.

Furthermore, the notification process with the notification submitted to the competent authority 30 days prior to the market activity harms market making activities. In this respect it should be noted that institutions issuing financial instruments (especially derivatives) have a vested interest in the continuous, competitive quoting of these instruments from the very beginning of the emission of these instruments. Due to the notification process a quick provision of liquidity via market making becomes impossible. However this is of utmost importance in the case of new instruments. Therefore we would welcome if issuers would automatically fall under the market maker exemption for their respective financial instruments.

Q24 Is the current unavailability of the exemption for market making activities in third country markets having any impact?

No comment.

Q25 Do you have any other comments on the provisions of the Regulation concerning exemptions or on how they have operated since 1 November 2012?

Every two years ESMA publishes a list of shares admitted to trading in the Union whose principal trading venue is in a third country. These shares are not subject for the SSR-restrictions. Concerning this list the question arises how binding this list can be. What happens to newly issued shares which are not yet on this list? We would recommend ESMA to update this list more frequently, such as quarterly.

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We would like to highlight that the Regulation does not adequately provide for exemptions related to underwriting activities for new issues. We acknowledge the exemption associated to price stabilisation, but activities such as ancillary stabilisation, hedging any resulting positions from hard underwrites (which may require shorting sovereign debt) is unclear. We would appreciate further guidance from ESMA.

Intervention powers and emergency measures

Q26 What is your assessment of the effect of temporary restrictions imposed by competent authorities on short selling since the application of the Regulation? Please explain.

Market participant must be explicitly and reliably informed about the restrictions. Practical implementation is crucial. The information must reach dealers in good time.

Q27 In case of emergency bans,

a) is the information to be published according to Art. 25 of the Regulation sufficient?

b) If no, please explain what other/additional information should be provided when introducing an emergency measure.

We believe the information required to be published according to Art. 25 SSR is insufficient to enable immediate interpretation and application of emergency bans.

Until now the information given was not transparent enough. Publication must be proactive, maybe with an advanced notice. The establishment of a central register would be useful.

Q28 Do you consider the current thresholds set to identify a significant intra-day fall in the price of financial instruments are appropriate for all instruments? If not, what different thresholds should be set and why?

No comment.

Q29 Do you consider thresholds should be set for significant price falls in UCITS and commodity derivatives? If so, how should they be set and at what levels?

No comment.

Q30 Do you have any other comments on the provisions of the Regulation concerning intervention powers and emergency measures or on how they have operated since 1 November 2012?

No comment.
