Position of DAI, BDI and VDT on the Joint Disussion Paper "Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories"

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Deutsches Aktieninstitut (DAI)[1], Bundesverband der Deutschen Industrie (BDI)[2] and Verband deutscher Treasurer (VDT)[3] welcome the opportunity to comment on the above mentioned Joint Discussion Paper of ESMA, EBA and EIOPA. 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 finance activities.

Although the obligation to collateralise non-centrally cleared derivative transactions is only relevant for non-financial companies exceeding the clearing threshold (NFCs+), the collateral requirements as defined by the ESAs should pay due attention to the specifics of these companies:

- Derivative transactions of NFCs almost exclusively are used to reduce "risks directly related to the commercial activity or treasury financing activity". Even exceeding the clearing threshold does not imply that the respective derivative portfolio of NFCs+ would mainly consist of "speculative" contracts. On the contrary, NFCs+ will continue to apply these risk mitigating derivatives although they are obliged to clear transactions centrally or to post collateral bilaterally. However, risk-mitigating derivatives do not constitute any risk for the stability of the financial system which has been widely acknowledged among regulators. In addition, while "systemic risk" might be reduced in financial markets as a consequence of the obligation to collateralise non-cleared transactions, for NFCs the commercial risk – and in particular the risk related to the commercial activity – will rise instead because costs for risk-mitigating derivatives are increasing significantly. This should be kept in mind when standards for bilateral collateralisation are to be developed.

- In general, NFCs are much more cash-constrained than financial counterparties and do not have access to central bank liquidity. As a result, capacities to collateralise derivative transactions are limited. Additionally, the cash which has to be delivered by NFCs+ as collateral will not be longer available for operative purposes. Therefore, any obligation to collateralise derivative transaction will restrict the NFCs+ ability to maintain or even expand their business

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2 Bundesverband der Deutschen Industrie e.V. (BDI, www.bdi.eu) is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and has 15 regional offices in the German Länder. BDI speaks for more than 100,000 private enterprises – 98 % small and medium sized – employing around 8 million people. Membership is voluntary.

3 Verband Deutscher Treasurer e.V. (VDT, www.vdtev.de) is the official German association of Corporate Treasurers representing more than 950 treasury professionals from 450 companies.

and thus create new employment opportunities, so that the potential negative macroeconomic impact of an overly demanding collateralisation regime should also be taken into account.

- It is also worth to stress that the opinion stated in the discussion paper that market participants would mainly avoid central clearing to circumvent regulation is flawed especially with regard to the "real economy". Locking in scarce liquidity through collateralised derivative transactions is reducing the operative flexibility of NFCs+. In addition, it will also lead to lower returns for clients of corporate institutions for occupational retirement provisions. This is not a question of "avoiding light", but of operative efficiency.

Bearing these key aspects in mind we would strongly recommend a proportionate collateralisation regime for NFCs+. ***Because of the lower risk of a large part of the derivative transactions in question and also in order not to inappropriately overstretch liquidity reserves, NFCs+ should be generally exempted from the obligation to post initial margins.*** For the reasons explained below in detail posting variation margins including a wide range of eligible collateral would be sufficient and adequate for NFCs+. Furthermore, the specifics of institutions for occupational retirement provisions should be carefully considered.

Please find below our responses to selected questions. We would appreciate if the ESAs would take our concerns and comments into account.

Q1. What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

In the interest of their investors IORPs use a professional and efficient risk management including appropriate derivatives. The need to deliver cash as collateral would force IORPs to sell long-term profitable assets and would decrease the payouts for (future) pensioners. Otherwise they would refrain from applying risk-mitigating derivatives to a certain extent which would increase the portfolio risk to the detriment of (future) pensioners.

EMIR acknowledges the specifics of IORPs in granting a transitional period of three years with respect to the clearing obligation. During the transitional period CCPs are requested to establish the infrastructure to provide IORPs with the possibility to post alternatives to cash collateral. Nevertheless, within the three years IORPs are required to comply with the bilateral collateralisation obligation of EMIR. Therefore, the collateral requirements outlined in the discussion paper should appropriately take into account the specifics of IORPs. Otherwise the transitional period would not be of any benefit for these entities.

Therefore, IORPs should be exempted from the duty to post initial margins. The range of collateral posted should include securities the IORPs have invested in (e.g. shares and corporate bonds). Regarding the latter point please refer to our answers to Q32/Q33.

Q2. What are your views regarding option 1 (general initial margin requirement)?

We are opposing the requirement to post initial margins for the following reasons:

Firstly, as mentioned introductorily margin requirements for OTC transactions are a serious cost burden for NFCs+, as they are blocking scarce liquidity for use in their operative business. This situation should not be aggravated by applying initial margins as an additional safety net, given that it is by now commonly accepted by legislators that risk-mitigating operations – which will remain a large part of the derivative exposure of NFCs even if the clearing threshold has been breached – do not pose systemic risks in general.

Secondly, the ESAs seem to assume that under the current and future regulatory framework there will still be an incentive to trade bilaterally (OTC) just to avoid using CCPs for derivative transactions of NFCs.

We do not share this view. It is pointed out correctly in the discussion paper that mitigating risk either by employing capital or by posting collateral does have comparable effects from an economic point of view. Prudentially Regulated Financial Counterparties (PRFCs) are already obliged by existing capital requirements (Basel II) to hold adequate capital in order to absorb potential losses resulting from derivative transactions. These requirements will even be tightened in the future, so that the banks' risk buffers will increase. Especially the proposed charges for CVA-risks applied only to OTC derivatives would require banks to put aside a notably higher amount of risk capital for non-cleared OTC transactions, will lead to a significantly increase of costs for NFCs and will reduce the availability of derivatives overall. In contrast to that, if banks channel transactions through a CCP the regulatory capital will be significantly lower.

Considering the upcoming Basel III rules in combination with the requirement of bilateral collateralisation it is not appropriate to assume that NFC+ would incur lower costs when trading OTC and therefore avoid central clearing. On the contrary, bilaterally agreed transactions would become more expensive than CCP-transactions from a NFC's+ perspective, if it would be required to post initial ***and*** variation margins for OTC-transactions as it is common practice for cleared transactions only, so far. Therefore, to call for initial in addition to variation margins would burden OTC-transactions disproportionally compared to CCP-transactions, although both transactions have the same risk profile.

Another issue to consider is the necessity to introduce a central, public register of NFCs+. A potential counterparty would therefore be able to assess the regulatory status of its non-financial customer, allowing different margin regimes. Provided that a public data base is available, we do not share the concern raised in the discussion paper that a counterparty of a NFC+ does not know whether the company in question is above the clearing threshold or not.

For these reasons, existing and forthcoming capital requirements in combination with mandatory, but bilaterally agreed variation margins should enable financial counterparties to absorb potential losses which might occur in derivative transactions with NFC+.

We therefore reiterate our opinion that NFC+ should not be required to post initial margins at all:

- As regards derivatives applied by NFC+ to mitigate risks related to the commercial or treasury financing activities collateral should be posted as variation margin only because these transactions do not pose a risk for the stability of the financial system.

- Regarding the remaining derivative exposure the requirement of a frequent exchange of variation margins together with the prudential capital requirements for PRFCs should be sufficient to cover the respective credit risk. Additionally, as regards the “speculative” exposure NFCs+ should neither be obliged to post initial margins as this would not be appropriate from a supervisory point of view (there are adequate capital provisions in place) and would overstretch liquidity reserves of NFCs+ disproportionally (see our introductory remarks).

Both should be combined with appropriate minimum thresholds.

Furthermore, in some cases variation margining already takes place between NFCs and their counterparties. The standards for variation margins to be defined by the ESAs should reflect the common practice for bilateral collateralisation:

- On the basis of the mark-to-market exposure the exchange of collateral with a specific counterparty takes place on a regular basis (usually monthly). The exposure per counterparty is calculated on a net basis. The daily transfer of collateral would in our view not be justified from an economic point of view and would pose a high administrative burden for NFCs+;

- Collateral is only transferred if the mark-to-market net exposure exceeds bilaterally agreed thresholds;

- Counterparties usually agree minimum transfer amounts to avoid multiple transfers of an insignificant amount of collateral.

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Yes, as PRFCs are already required by the existing regulatory framework to hold sufficient capital to address the counterparty credit risk (which will be further increased especially by the introduction of new CVA-rules under Basel III) we do not see the need for collecting initial margins on top (see also our answer to Q2). Furthermore, the statement made in the discussion paper that unregulated companies like NFCs+ are not mandatorily required to hold adequate capital is ignoring the fact that capital ratios of NFCs are on average much higher than comparable figures of regulated financial institutions. Therefore, it is not justified at all to conclude that unregulated NFCs+ are in principle riskier than regulated ones.

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

In general, the cash which has to be delivered as initial margin by NFCs+ will not be available any longer for investment purposes in the respective commercial operation. As a result the ability of the NFC+ to maintain or increase employment will deteriorate. Opportunity costs for NFCs+ would not only include additional interest expenses and commitment fees for extra credit lines to raise funds as collateral. This additional debt would have to bear also full capital costs (blended WACC for equity and debt) as it has to compete with investments into the operative business.

Q5. What are your views regarding option 2?

Option 2 inter alia proposes that the obligation to post initial margins will apply only in transactions between non-financial companies and PRFCs. In contrast to that derivative transactions between non-financial companies and NPRFCs (Non Prudentially Regulated Financial Counterparties – e.g. undertakings for collective investments in transferable securities – UCITS) will not be collateralised with initial margins.

We do not agree with option 2. As explained above (see our answer to Q2) it is more reasonable to exempt transactions by NFCs+ and a PRFC from initial margining as the latter has to comply with existing and forthcoming prudential capital requirements. Furthermore, the transactions described in option 2, e.g. between a NFC+ and a NPRFC, are not really of relevance in practice. Generally, it is more likely that NFCs deal with PRFCs.

Last, but not least we note that the discussion paper refers to the possibility that NFCs might be subject to collateralization under the Dodd-Frank Act, when being classified as “Major Swap Participant” (see p. 12). What the discussion paper omits is the fact that in order to be classified as a Major Swap Participant the respective counterparty would need to have uncollateralized, “speculative” (i.e. non risk-mitigating) positions with a mark-to-market value exceeding at least USD 1bn or even USD 3bn (“rate swaps”). We assume that the majority of NFCs will fall short of that threshold and will, therefore, not be obliged to post margins at all (neither initial nor variation margins).

Q7. What is the current practice in this respect, e.g.
- If a threshold is currently in place, for which contracts and counterparties, is it used?
- Which criteria are currently the bases for the calculation of the threshold?

As outlined in our answer to Q2 NFCs+ should not be obliged to post initial margins at all. Besides, thresholds restricting the derivative exposure and the requirement to post collateral (in case the posting of collateral is agreed by the counterparties) are commonly used for all kinds of counterparties in the form of credit limits. Any derivatives business being opened between a PRFC and a NFC will require a thorough analysis of the counterparty risks (to note, mostly on both sides) as a prerequisite. This is deemed reasonable within a comprehensive and coordinated risk management framework which takes into account price risk, credit risk and cash flow risk.

Normal credit assessment criteria are used for the calculation of the thresholds, based on external rating, internal models and due diligence. Taking into account the amount of credit risk that is considered acceptable a counterparty risk line will be defined that will limit derivative exposures in general and – in case of collateralisation – the amount which could be left uncollateralised, including mark-to-market risk. We believe this is a sound basis which would make the idea of an additional threshold superfluous. The credit line extended for derivatives business already defines the amount of acceptable risk per counterparty of a PRFC. In addition, we again refer to the CVA-charge under Basel III which will require banks to further increase capital for OTC transactions.

Q8. For which types of counterparties should a threshold be applicable?

Please refer to our answer to Q7. We do not think that such a threshold is appropriate as it is already common market practice to allocate specific limits to counterparty exposures from derivatives business. As outlined in our answer to Q2 NFCs+ should not be obliged to post initial margins at all. Nevertheless, in case the ESAs would decide to require also NFCs+ to deliver an initial margin the threshold approach should also be available for NFCs+.

Q11. Are there any further options that the ESAs should consider?

See our answers above.

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

As mentioned in our answer to Q2 a daily exchange of collateral is not common market practice for NFC-transactions and should not be required for NFC+. In general organizational structures in NFCs are focusing clearly on operative business and are less concerned by financial markets. It would be an excessive burden to demand daily collateral management from them.

Q15. What would be the cost implications of a daily exchange of collateral?

Please refer to our answer to Q4.

Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

Again, we are opposing initial margins for transactions with NFCs+. Nevertheless, ESAs should consider that NFCs+ should in general have the option to use less complex calculation methods in their risk management. Therefore, the calculation methods principally available under the regulation should range from relatively simple approaches which could be applied by NFCs+ to more sophisticated methods.

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

No, there is no reason to limit the scope using internal models to PRFCs. The compliance with the respective supervisory requirements given application of internal models should be allowed for all counterparties.

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

Q29. What are the practical problems with Tri-Party transactions?

Our answer refers to Q27 to Q29.

As already mentioned we are opposing initial margin requirements for NFCs+. Besides our arguments outlined above we want to stress that a regime stipulating posting of initial margins would lead to significantly higher credit risk for NFCs+ unless all Member States have regulatory rules and bodies that are able to:

a) effectively supervise and enforce segregation requirements, and

b) ensure unhindered and timely recovery of collateral by non-defaulting parties.

These aspects are of severe concern should ESA require initial margins to be posted outside the EU when transacting with NFCs+. ***In any case, posting of initial margins should not be mandatory unless parties that are required to post can be certain that appropriate segregation regimes are in place and effective, at the very minimum across all Member States.*** However, the discussion paper has provided us with no evidence that this is already the case.

Q32. What are, in your view, the advantages and disadvantages of the two options?

The eligibility of collateral should take into account that non-financial companies do not have access to central bank money. From this perspective alternatives to cash collateral are highly important. Therefore, bilateral collateralisation should provide for a wide range of collateral, including collateral which is less liquid and which does not fulfil the strict requirements as proposed by ESMA in its recent discussion paper (see p. 32 et seqq.). Furthermore, institutions for occupational retirement provision (IORPs) should be allowed to post securities they have invested in as collateral (see our answer to Q1). We therefore strongly prefer option 2 which proposes to refer to the list of financial collateral eligible under CRR (especially the collateral enumerated in Art. 193 CRR which includes sovereign and corporate bonds, equities and convertible bonds etc.). Haircuts posed on the collateral should appropriately reflect the different liquidity degree of the security and the purpose of the transaction (e.g. risk-mitigating or not – see our answer to Q39).

Nevertheless, important alternatives to cash collateral are bank guarantees. We therefore welcome the approach foreseen in EMIR to acknowledge bank guarantees as eligible to secure derivative transactions settled by CCPs. This approach should be available for bilateral collateralisation as well.

As laid down in detail in our response to the ESMA's discussion paper we are however of the opinion that the requirements for bank guarantees as envisaged by ESMA in its discussion paper need adjustment, as they are much too far-reaching (see page 33 of the ESMA discussion paper).

The obligation that a bank guarantee should not be issued by a clearing member is not justified, unless being limited to that clearing member who is acting as the "access point" of the NFC in such a transaction. The exclusion of any clearing member would limit the number of banks that are allowed to provide a bank guarantee for derivatives of NFCs+ as typically all banks providing bank guarantees are also clearing members.

We are also concerned that the option to provide bank guarantees is diluted by the requirement to back these guarantees with collateral that can be liquidated on a same-day basis. The additional costs occurring to the bank for the collateralisation would be passed on to their clients and disproportionally increase the prices for the bank guarantees. These costs are not justified for the following reasons: Firstly, the requirement to back the guarantee with collateral is superfluous because the risk arising from the provision of bank guarantees is mitigated sufficiently by the other requirements for bank guarantees also proposed by ESMA. Secondly, the obligation to fully back the guarantee lacks economic rationale: This would only be justifiable in the case that the whole amount of all respective bank guarantees provided by one bank is drawn by all clients at the same time. Without doubt, this is a very unlikely assumption. For this reason – if at all – only a partial collateral backing would be justified. Thirdly, for coherence reasons we would suggest to realign the collateral obligation with the Basel III / CRR rules concerning the liquidity coverage ratio which requires a **10 per cent liquidity coverage** for outstanding credit lines for non-financial companies.

In addition, it should be clarified what is exactly meant by "issued by an issuer which have a low credit risk". We suggest defining this as "investment grade rating by at least one major rating agency".

Bank guarantees should not be restricted to non-financial "clearing members" (as the wording "are issued to guarantee a non financial clearing member" indicates) as non-financials regularly do not intend to directly access CCPs and they are therefore clients of "clearing members". Therefore, the term "clearing member" should be deleted.

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

The range of eligible collateral should be broad and include less liquid assets as well. Furthermore, bank guarantees should be explicitly allowed for NFCs+ which are generally cash-restricted. Institutions for occupational retirement provisions (IORPs) should be provided with the option to use securities they invest in for collateral purposes as well (see our answer to the Q1 and Q32).

Q36. What is the current practice regarding the frequency of collateral valuation?

See our answers to Q2 and Q37.

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?

We strictly oppose a "one size fits all approach". Therefore, as outlined in our introductory remarks and under Q2 and Q14, the collateral regime for NFCs+ should be as lean as possible to accommodate operational capabilities of corporate customers. A daily valuation should not be mandatory for these counterparties. A monthly collateral valuation is common practice for NFCs in their transactions with financials and non-financials and would be sufficient for the future as well.

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

Standardised rules regarding the application of haircuts should take into account the purpose of the transaction ("speculative" / risk-mitigating). Haircuts applied to the collateralisation of risk mitigating derivatives should duly consider that these transactions are not of systemic relevance.

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?

In order to limit operational costs we welcome the approach to define a minimum transfer amount below which the exchange of collateral is not mandatory. The definition of this threshold should take into consideration common market practice (see our answer to Q2), the type of counterparty (e.g. financial / non-financial) and the type of transaction (e.g. "speculative" / risk mitigating). Having in mind that risk-mitigating transactions are not of systemic relevance we propose to set a relatively high threshold for risk-mitigating derivatives applied by NFCs+.

Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?

We think that the ESAs should consider the legal specifics in the respective jurisdiction where the group entities are domiciled (e.g. whether there are legal barriers hindering the flow of capital). The respective counterparty should confirm that there are no such impediments to its best knowledge (otherwise group transactions would not take place anyway).

Q46. What is the current practice regarding the collateralisation of intragroup derivative transactions?

Intra-group transactions in corporates are mainly used to deliver centralized treasury and risk management services internally. Therefore, they do not affect the net risk position of the entire non-financial group; at group level the risks are compensating each other: Potential losses of one group member are potential gains of another. From an economic point of view collateralisation of intra-group derivatives is not justified. Accordingly, a collateralisation of intra-group transactions in NFCs is not common practice.