oesterreichs energie.

GENERALSEKRETARIAT

ESMA
103 Rue de Grenelle
F-75007 Paris
Online submission

Kontakt	DW	Unser Zeichen	Ihr Zeichen	Datum
Alexandra Gruber	211	AG – 14/2012		22.03.2012

Joint Discussion 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, 6 March 2012
Comments by Oesterreichs Energie (Register ID number: 80966174852-38)

Dear Madam,
Dear Sir,

Oesterreichs Energie, the Association of Austrian Electricity Companies, welcomes the opportunity to comment on the Joint Discussion 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, 6 March 2012. Oesterreichs Energie represents more than 130 energy companies active in generation, trading, transmission, distribution and sales which in total cover more than 90 per cent of the Austrian electricity generation and the entire distribution.

As a preliminary remark, we need to note that our members consider themselves to be Non-Financial Counterparties (NFCs). Thus, our comments are particularly focused on the effects of alternative risk mitigation techniques on this type of counterparty.

We understand ESMA's fundamental consideration that alternative risk mitigation techniques should be designed in a way that do not result in dis-incentivising central clearing as the primary purpose of EMIR. However, we dissent on ESMA's tendency to place additional burdens on the NFCs which would cause serious impacts on their daily business operations. After they have been considered not to cause additional systemic risks on the relevant financial markets we reject such approaches as inappropriate and against the basic conclusions of the legislative process of EMIR.

- Most importantly, the discussion paper does not address any other risk mitigation techniques besides bilateral clearing and capital requirements. We consider this the major insufficiency of ESMA's approach. Internal risk management guidelines, exis-

Österreichs E-Wirtschaft

Brahmsplatz 3 Tel +43 1 501 98-0 info@oesterreichsenergie.at
1040 Wien Fax +43 1 501 98-900 www.oesterreichsenergie.at

DVR 0422100, UID ATU37583307, ZVR 064107101; UniCredit Bank Austria AG, BLZ 12000 Kto. 0064-20418/00

ting statutory valid collaterals, KYC-arrangements and permanent monitoring of counterparties are not discussed as alternatives although they are frequently applied in the market.

- Especially, the proposal to oblige solely NFC to post margins needs to be revised. In such event, such parties that are privileged by the main rules of EMIR for well-founded reasons would be heavily burdened by its fallback procedures.

- We would like to point out that EMIR provides for extensive phase-in arrangements if a NFC exceeds the threshold amount. These arrangements are not reflected by the alternative mitigation techniques so far. This deficiency becomes particularly burdensome as regards the provision of internal models to mitigate pro-cyclical effects (c.f. clause 10 of the Discussion Paper) or the frequency of collateral valuation (c.f. clause 50).

Moreover, we are reluctant to share ESMA's underlying assumptions that the basic characteristics of central clearing can be easily extended to bilateral clearing models as well.

- The discussion paper does not address the additional risks caused by maintaining additional banking accounts for bilateral clearing purposes. Whereas the Central Clearing Parties (CCPs) are subject to strict capital requirements, the risk of bankruptcy of the respective banks is not addressed for alternative risk mitigation techniques.

- Initial Margins are not considered appropriate for bilateral clearing.

- Besides that, we would add the following considerations.

- ESMA aims to introduce the obligation of bilateral clearing in all member states of the European Union and for transactions with counterparties outside the EU as well. We currently miss an evaluation of the legal consequences in the different jurisdictions. As we are aware of, the validity and enforceability of bilateral collateral arrangements are subject to the national law on securities, pledges, acquisition of ownership etc. The legal consequences of the proposed alternative risk mitigation techniques need to be addressed.

- ESMA's requirements on internal models in clause 10 are not considered realizable. In clause 10, advice is given to develop other criteria to assess creditworthiness in order to avoid sudden and large calls for margin. If ESMA envisages a more gradual approach only (i.e. leaving the overall amount of margins unchanged but starting to call for margins earlier and in smaller steps), the pro-cyclical effects remain unchanged as well. If the overall amount should be lowered, ESMA in fact orders the market participants to introduce internal systems that are intentionally less strict than external ones. This could result in imbalanced chances of market participants over

different national legislatures triggering regulatory arbitrage and increased cash allocation processes.

- The extensive prohibition to re-use collateral as outlined in clauses 43-45 needs to be questioned as well. Such prohibition would result in an excessive increase of liquidity demand. Especially, concluding financial transactions that reduce the exposure in financial trading as a whole would not reduce but increase this demand.

Q2. What are your views regarding option 1 (general initial margin requirement)?
We support the statement that any initial margin requirement for bilateral collateral can only work properly if any re-use is strictly prevented. However, as we will outline in more detail in Question 31, such prevention would result in additional burdens that we do not consider justified.

Consequently, we believe that any margin requirement should be limited to variation margins. To address potential future exposures, other alternative risk mitigation techniques (e.g. internal risk management guidelines, KYC-arrangements and permanent monitoring of counterparties) should be considered.

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 our opinion, ESMA's approach to discuss implications for NFCs+ only is incorrect. A wide range of NFCs will require making dispositions for the case that they might become NFCs+ in the future as well.

Bilateral collateral is more difficult to implement as every existing contractual relationship would have to be updated. Hence, NFCs will have to renegotiate their existing contracts. They will have to develop internal models (c.f. clause 10) to establish reasonable triggers for margins, they need to reorganise their liquidity needs accordingly. These examples indicate that any NFC would face additional costs to adapt its organisation, employ additional personal and to restrict its liquidity needs. As soon as a NFC becomes a NFC+ additional requirements will become due. For instance, NFCs are currently not in the position to organise a daily settlement of cash collateral. This will have to be updated. Moreover, additional personal needs to be employed, the credit limit of the local bank needs to be extended and the respective interest for the credit line will increase. As NFCs are a heterogeneous group of companies, it is not possible to provide any clear estimates.

Q5. What are your views regarding option 2?
We understand ESMA's fundamental consideration that alternative risk mitigation techniques should be designed in a way that does not result in dis-incentivising central clearing as the primary purpose of EMIR. However, we dissent on ESMA's tendency to place additional burdens on the NFCs. After they have been considered not to cause additional systemic risks on

the relevant financial markets we reject such approaches as inappropriate and against the basic conclusions of the legislative process of EMIR.

The proposal to oblige solely NFCs to post margins needs to be revised. Under EMIR, NFCs have been exempted from mandatory central clearing for well-founded reasons until their trading activities remain under a certain threshold. The European legislator has not provided any reason to believe that NFCs are more systemically relevant than PFRCs; there are no reasons to assume that they represent a greater threat to market stability; moreover they are not reported to be exposed to a higher level of default risk than PRFCs.

Consequently, option 2 is inconsistent with the main objectives of EMIR. Following this approach would reverse its direction of intended impact. Especially, it is incomprehensible to offer PFRCs additional securities at the sole expense of NFCs.

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?
NFCs+ would be forced to implement professional cash management and sophisticated rating models that come up to the needs of posting margins and to reduce financial costs. SME could therefore apriori be prevented from market access. Segregated accounts will trigger fees for fiduciary management.

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?
In the current bilateral agreements, a variety of contractual arrangements is possible. First, there is the solution of a clear threshold that just serves as a limit for the first exchange of collateral. As soon as this threshold is exceeded, margins have to be calculated for the whole contractual relationship (and not simply the exceeding contracts). In such case, the effect of the trigger can become detrimental. As soon as the value does not exceed the threshold anymore, the collateral can be returned.

In a second method, the threshold is simply subtracted from the calculated risk of the whole contractual relationship. This form is the easiest to be implemented and frequently applied. Sometimes, this threshold is only granted if the counterparty is willing to provide any form of credit support (parent company guarantees, bank guarantees etc.).

A third approach is to define a minimum transfer amount. It offers the additional benefit that transfers are minimised to a mutually agreed limit.

In any case, however, parties would be allowed to re-use their collateral. Consequently, these approaches are focused on variation margins which we regard as the more reasonable approach in general. Moreover, the current practice is voluntary and leaves room for alternative risk mitigation techniques.

Q8. For which types of counterparties should a threshold be applicable?
In principle, it should be applicable to every party but, at the same time, can be subject to certain requirements.

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?
There should be different ways to establish a threshold. Basically, there are four ways that should all be considered eligible.

First, it is possible to establish an absolute minimum (that would be quite comparable to the clearing threshold) for the overall trading operations of market participant that are subject to EMIR.

Second, risk amounts through uneffective hedge deals resulting to be over 20% of underlying positions – this resulting amount has to exceed at least 20 Mio. Euro – could be bilaterally cleared (analogous to existing Credit Support Annices). Hedge reports should be monthly available after consulting of certified public accountant.

Third, it should be possible to establish a threshold on a bilateral basis by issuing other credit support documents such as parent company guarantees.

Fourth, it should be able to substitute the collateral requirements by other means (internal risk management guidelines, KYC-arrangements and permanent monitoring of counterparties).

Q10. How – in your opinion - would a threshold change transactions and business models?
In our opinion, introducing a bilateral collateral system with the possibility to arrange for certain thresholds and other alternative risk mitigation techniques would have the least impact on current business models while still improving market stability.

Q11. Are there any further options that the ESAs should consider?
The discussion paper does not address the additional risks caused by maintaining additional banking accounts for bilateral clearing purposes. Whereas the Central Clearing Parties (CCPs) are subject to strict capital requirements, the risk of insolvency of the respective banks is not addressed for alternative risk mitigation techniques. In many jurisdictions, however, the insolvency of the bank, which market participants have set up their accounts with, would result in a total loss of the deposited collateral.

Moreover, EMIR provides for extensive phase-in arrangements if a NFC exceeds the threshold amount. These arrangements are not reflected by the alternative mitigation techniques so far.

Q12. Are there any particular areas where regulatory arbitrage is of concern?
ESMA aims to introduce the obligation of bilateral trading in all member states of the European Union and for transactions with counterparties outside the EU as well. We currently miss an evaluation of the legal consequences in the different jurisdictions. As we are aware of, the validity and enforceability of bilateral collateral arrangements are subject to the national law on securities, pledges, acquisition of ownership etc. The legal consequences of the proposed alternative risk mitigation techniques need to be addressed.

Q13. What impacts on markets, transactions and business models do you expect from the proposals?
In any case, bilateral collateral would directly result in additional burdens for the NFCs as regards liquidity, organisation and monitoring.

Full application without any transition period would definitely require NFCs to resort to external services (e.g. banks).

Furthermore, we expect massive and detrimental pro-cyclical effects since ESMA's requirements on internal models in clause 10 are not considered realizable. In clause 10, advice is given to develop other criteria to assess creditworthiness in order to avoid sudden and large calls for margin. Eventually, the discussion paper allows two interpretations. First, ESMA could envisage a more gradual approach leaving the overall amount of margins unchanged. In fact, any internal model would have to guarantee that counterparties are entitled to call for margins at an earlier stage of the economic downward movement. This would of course leave the pro-cyclical effects unaffected – this approach would even accelerate the downward movement as becomes effective at an earlier stage. Another approach would mean the overall amount of collateral should be lowered in circumstances that raise concerns regarding a counterparty's creditworthiness. In such case, ESMA would in fact orders the market participants to introduce internal systems that are intentionally less strict than external ones. Such models are not likely to be implemented. Hence, the pro-cyclical effects would not be mitigated. In order to do so, other approaches to mitigate risk need to be envisaged. However, the discussion paper does not address any other risk mitigation techniques besides bilateral clearing and capital requirements. Internal risk management guidelines, KYC-arrangements and permanent monitoring of counterparties are not discusses as alternatives although they are frequently applied in the market.

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?
Generally, we would like to point out once more that EMIR provides for extensive phase-in arrangements if a NFC exceeds the threshold amount. These arrangements are not reflected by the alternative mitigation techniques so far. This deficiency becomes particularly burdensome as regards the frequency of collateral valuation.

As experience has proven, the frequency of collateral exchange that NFCs are able to cope with needs to be positioned on a weekly basis. Moreover, ESMA is urged to consider transitional periods for the implementation of a collateral management system.

Österreichs E-Wirtschaft

Brahmsplatz 3 Tel +43 1 501 98-0 info@oesterreichsenergie.at
1040 Wien Fax +43 1 501 98-900 www.oesterreichsenergie.at

DVR 0422100, UID ATU37583307, ZVR 064107101; UniCredit Bank Austria AG, BLZ 12000 Kto. 0064-20418/00

We still believe, however, that collateral should not be the only alternative risk mitigation technique available.

Q26. Do you see other options for treating such differences?
As previously outlined, we urge to consider other alternative risk mitigation techniques besides bilateral collateral. However, we take a critical look at ESMA's proposals to allow for different approaches to calculate (variation) margins. In fact, every party could develop its internal model which would result in additional reconciliation processes.

Especially for NFCs that have recently become a NFC+, it would constitute an additional burden to validate the internal models of its partners.

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?
From a legal perspective, a segregated account (e.g. escrow account) at a third party that is subject to a level of supervision and regulation which is comparable to the standards for central clearing parties would be the safest approach.
Economically, however, this approach features several drawbacks as well. The fees for this kind of service would require to be regulated since an effective competition between the respective providers cannot be guaranteed. For this reason, we urge to consider other alternative risk mitigation techniques as well – they offer the sole opportunity to keep service fees at a moderate level. Otherwise, the mandatory nature of these services would result in an inappropriate price level.

Q31. What will be the impact if re-use of collateral was no longer possible?
The extensive prohibition to re-use collateral as outlined in clauses 43-45 needs to be questioned. Such prohibition would result in an excessive increase of liquidity demand. Especially, concluding financial transactions that reduce the exposure in financial trading as a whole would not reduce but increase this demand.

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?
In our opinion, no NFC (irrespective if it is an NFC+ or not) should be mandatorily subject to a daily collateral valuation. However, exceptions for entities that are permanently above the clearing threshold can be envisaged.

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?
Please refer to Question 9

Österreichs E-Wirtschaft

Brahmsplatz 3 Tel +43 1 501 98-0 info@oesterreichsenergie.at
1040 Wien Fax +43 1 501 98-900 www.oesterreichsenergie.at

DVR 0422100, UID ATU37583307, ZVR 064107101; UniCredit Bank Austria AG, BLZ 12000 Kto. 0064-20418/00

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

As far as NFCs are concerned, intragroup transaction are not subject to collateralisation as they would simply be passed on. As this would create additional administrative burdens without offering additional safety on the group level, most groups leave the collateral obligations to such entity that is in contractual relationship with the third/external party in the respective situation. Within the NFCs-Groups usually control and/or profit transfer agreements are established to ensure need for security.

Thank you for taking our comments into consideration. If you have any further questions, please do not hesitate to contact us.

Yours sincerely,

DI Dr. Peter Layr	Dr. Barbara Schmidt
President	Secretary General

Österreichs E-Wirtschaft

Brahmsplatz 3 Tel +43 1 501 98-0 info@oesterreichsenergie.at
1040 Wien Fax +43 1 501 98-900 www.oesterreichsenergie.at

DVR 0422100, UID ATU37583307, ZVR 064107101; UniCredit Bank Austria AG, BLZ 12000 Kto. 0064-20418/00