

**Response to the  
Public Consultation on Standardization and Exchange Trading of OTC derivatives**

The consultation is closely linked to the current regulatory developments in relation to further standardization for credit, equity, interest rate, commodity and foreign exchange derivatives. It is a great merit of the CESR Consultation Document to analyze the various markets and product categories with due differentiation. Deutsche Lufthansa AG supports this approach. Regulatory changes will only turn out successful if the particularities of the multiple markets, product categories and the particular interests of market participants are met.

Deutsche Lufthansa AG is one of the world's leading airlines and is an aviation group operating in five business segments strategically related to air traffic. Given our business set-up we have a natural exposure towards the foreign exchange, interest rates and commodity markets. Lufthansa is addressing these risks by hedging. Insofar the operation of derivatives provides an important contribution to our financial stability. Regulatory changes to the current market framework will have an impact on our business model and the perspectives for future earnings, investments, growth and the creation of jobs.

**I. General Remarks**

Deutsche Lufthansa welcomes the fair balance established by carefully weighting the benefits and disadvantages of standardization. We share the opinion that firms should be able to retain the flexibility to customize contractual aspects such as standard valuation, payment structures and payment dates. Customization is key for corporate risk management needs. Effective hedging requires flexibility. Predefined transaction terms are not suitable for industrial hedging purposes. Given the requirements of IAS 39 hedging transactions have to match the exposure resulting from the underlying business activity. We share the position of CESR. Standardisation is only beneficial for the financial system where appropriate. It is not appropriate where it limits risk management activities and lowers quality and effectiveness of corporate risk management.

The Consultation Document further addresses and analyzes transferring OTC trading to organised trading venues. We share CESR's views on the limitations. There are a number of limitations, which are to be considered prior to regulatory changes leading to mandatory use of exchange venues and central counterparty clearing for derivatives. Deutsche Lufthansa AG has joined the political consultation process initiated by the EC from the very beginning. We are happy to see the discussion now on a level with less political momentum and a stronger focus on facts. We support CESR in advocating for further exploration of the subject. There are reasons why some

OTC derivatives already shifted to trading venues and others not. Any regulation should reflect the differences in market structure, counterparties and product categories. Some derivatives may qualify for intensified use of trading venues, some derivatives may not. As pointed out by the CESR document, it is important to further analyze the market and elaborate regulatory answers, which address the particularities of each product and market segment.

## **II. Questions:**

### **1. Standardization**

**Q1 Do you agree with CESRs assessment of the degree of standardization of OTC derivatives? Is there any other element that CESR should take in account?**

Yes, this holds particularly true in view of 2.2.2. The limitations listed in 2.2.2 are the key drivers for non-standardized solutions in the market. We believe that market participants behave reasonable. Where standardization is appropriate and viable, standardization is applied and further developed. The best example insofar is the success of standardized agreements and master agreements. The legal uniformity established by the market is not a result of regulatory pressure; it is the outcome of an interactive process based on market principles. The same holds true with regard to the high degree of standardization in the interest rates derivatives market. Obviously market participants perceive it as more effective and presumably linked to lower transaction costs to trade these derivatives on a solid level of standardization. If market participants do not tend to more standardization, regulatory pressure could result being the wrong answer. There might be good reasons for this collective behavior.

**Q2 Do you agree with the benefits and limitations of standardization noted above? Please specify. Can you also describe and, where possible, quantify the potential impact of the limitations?**

Yes, increased standardization may facilitate the use of clearing, facilitate the use of electronic trading venues and ease unwinding of contracts. However we are still not convinced that these side effects of standardization are for the benefit of financial stability. This holds particularly true in view of Credit Defaults Swaps. Under 2.6 (53) it is explained that CDS are highly standardized compared to other asset classes. It is also true that the CDS transactions have a high degree of collateralization. Nevertheless the CDS market caused the biggest problems during the financial crisis. Credit Default Swaps posed a threat to the entire financial system despite the standardization and collateralization in place. It still has to be proven that all these aspects of standardization help safeguard financial stability. Operational risk reduction is often used as argument for standardization. We do not believe that it were

operational risks which caused the financial crisis and that these risks are typically risks, which have to be addressed by regulators.

We fully agree with CESR in view of the possible limitations of standardization and are deeply grateful that these issues have been raised in the Consultation Document. Future regulation will only contribute to financial stability if the legitimate need for bespoke products is recognized. Without the ability to customize hedging transaction to the underlying business risk, corporate end-users of derivatives could be forced to abstain from hedging with the further consequence of increased operational and market risks resulting from the underlying business. An incentive to abstain from hedging and reduce risk management activities could further be the loss of hedge accounting benefits. Without hedge accounting mark-to-market changes of the hedging portfolio would have a direct impact in the profit and loss statement of the current business year, ignoring the allocation of the hedges to future business periods. This will lead to higher volatility in p & l reporting and is not in the interest of equity markets and investors which rely on meaningful and sustainable financial reporting. Deutsche Lufthansa AG is one of the biggest private consumers of crude oil products having a yearly jet fuel consumption exceeding 60.000.000 barrel. The crude oil price fluctuation in 2007/2008/2009 without hedge accounting applicable would have caused extreme differences in the reported profits, on the upside easily exceeding + 1.000.000.000 USD. Sustainable and accurate financial reporting is very important for the integrity and functioning of equity market. The loss of hedge accounting benefits is likely to jeopardize this goal.

**Q3 Do you agree that greater standardization is desirable? What should be the goal of standardization?**

We agree that a higher degree of standardization is desirable. Experience tells that standardization is an important step for reducing transaction costs and increasing efficiency. However the importance of non-standardized instruments has to be fully accepted. We are strongly opposed to a “one size fits all” approach imposing standardization regardless of the underlying business reality. Such an approach would materially penalize corporates in their risk management and their ability to achieve hedge accounting. As a direct consequence there would be increased economic and financial reporting volatility.

Bilateral electronic confirmation is relevant and should be recommended or encouraged but not imposed in any sense for non-financial companies. These companies do not necessarily have a sufficient degree of automation and IT capabilities to electronically confirm all trades.

**Q4 How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact.**

Market participants push for standardization where standardization promises benefits. Sometimes the final step is missed due to market circumstances, different IT set ups or the simple fact that competition hinders the compromise. A good example can be found far away from the financial industry: Battery rechargers for mobile phones. Finally it was regulators which had to make the decision determining the standard. Regulators may investigate together with market participants where standardization failed despite a common desire for uniformity.

**Q5 Are there any obstacles to standardization that could be removed by regulatory action?**

The financial market operates on an international level. The legal framework for the transactions is still governed by national jurisdictions. Further harmonization in the legal dimension will contribute to a higher degree of standardization.

**Q6 Should regulators prioritize focus on a) a certain element of standardization and/or b) a certain asset class?**

Undecided, a prioritization of elements of standardization depends on the elements to be standardized. If the focus is on legal uniformity or process uniformity we could support option a). As product standardization influences the economic profile of a contract we would not support option a), if the focus is on product uniformity. With regard to option b) is to remark, that we assume market rationality behind the behavior not to standardize certain asset classes. This holds particularly true in view of the general principle that standardization is usually likely to provide operational benefits and reduce transaction costs. We suppose that there are valid reasons for a lack in standardization for some asset classes.

**Q7 CESR is exploring recommending to the EC the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such proposal? Please quantify your cost estimate.**

We are not in a position to estimate such costs.

## **2. Exchange Trading**

**Q 8 Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?**

We fully agree on the expressed limitations of exchange trading and agree in principle on the benefits listed under 3.2.1. However it is difficult to accept the benefits as benefits while ignoring the context. Transparency, price formation, liquidity, operational efficiency and equal market access are indispensable for the market infrastructure of the underlyings of OTC derivatives contracts. We doubt that these categories are of comparable importance for derivatives markets. The valuation of derivatives is usually determined by factors related to the underlying. Transparency, price formation and liquidity hence play a different role. Moreover it is usually the non existence of liquidity for a certain agreement which forces market participants to agree and apply formulas for the pricing, rather than having the option to rely on the equilibrium between supply and demand to determine a fair price. The listed benefits are likely to turn out as being of minor relevance.

It should be further taken into account that exchange trading has primarily a securities background. Securities are legally designed to be transferred, contracts are not. The main difference is the focus on the issuer. It is accepted by the market and hence suitable for exchange trading if the entitlement towards an issuer is transferred. This is not the case for bilateral obligations. It might be possible to transfer the entitlements out of a normal derivatives contract; it is not possible to transfer obligations without the consensus of the counterparty. Central counterparties are required for the intermediation. This would require a different market structure and central clearing for most derivatives transactions leading to further challenges for the stability of the financial system. Central counterparty clearing same as collateralization obligations turns market volatility into cash obligations. Counterparty risk is replaced by the more dangerous risk category liquidity risks. It further produces procyclicality.

**Q9 Which sector of the market would benefit from/be suitable for (more) exchange trading?**

The table on page 17 already gives a good indication. The share of exchange trading in options is fully reasonable. Options can be easily wrapped in a security because the related cash flows are often an up-front premium to be paid by the subscriber of the option and a cash settlement at maturity to be paid by the issuer. This legal relationship differs little from a normal bond and is hence perfectly designed for exchange trading. Plain vanilla long positions are suitable for exchange trading.

Exchange trading gets complicated if mutual cash obligations are involved, for example combinations of long and short positions. All transactions where either counterparty may end up as being the debtor at maturity require the intermediation of a central counterparty and central counterparty clearing. Otherwise exchange trading would not be suitable. It is likely that the intermediation of the central counterparty is not only necessary to overcome the legal hurdles; it will also be a matter of liquidity. OTC derivative markets function because of financial intermediaries performing the risk transformation process. There is no liquidity for complicated product combinations in the market. Intermediaries provide this liquidity by transformation of risks. We doubt that this can be performed on a trading venue.

**Q 10 In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify**

Market theory guides as to assume that the liquidity is already there, where exchange trading is viable. Liquidity will decrease for those asset classes and market segments where this liquidity requires risk transformation by financial intermediaries and this risk transformation is no longer viable due to changes to the market structure or regulatory restrictions. Central counterparties will not be able to replace the risk transformation function.

**Q 11 Do you identify any other element that would prevent additional OTC derivatives to be traded on organized platforms.**

No

**Q 12 How should the level of liquidity necessary/relevant to exchange trading be measured**

This is an extremely difficult question. Preparing the answer produced further questions, such as: What is the relevant scenario? Do we need different levels of necessary liquidity for pricing? Or managing an event of default of a clearing member? Or managing an event of default/ or stress of an underlying? Or should even an excess of liquidity be a matter of concern? The financial crisis had its roots in an excessive risk appetite; credit risk coverage (CDS) was available at too little cost. Due to the valuation based on the underlying and other market circumstances liquidity is not the only driver in derivatives markets. The risk transformation techniques and ensuring the risk absorption capacities of market participants have at least the same relevance.

### **3. Additional factors to consider**

**Q13 Do you agree with CESR's assessment of the characteristics and level of standardization which are needed for a contract to be traded on an organized trading platform?**

Yes, the characteristics and the described levels of standardization are the minimum requirements to organize trading platforms for OTC derivatives.

**Q14 Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organized trading platform? Please provide supporting rationale.**

Yes, because exchange trades are executed anonymously. The counterparty is unknown. The concept is only viable if market participants can easily skip the counterparty risk assessment. This is the case for equity and debt markets, where financial reporting obligations and published ratings serve for assessing credit risks. Central counterparty clearing is the technique to skip the counterparty risk assessment in derivatives transactions. Every market participant can rely on the financial strength of the central counterparty. There is also a legal dimension of the need for intermediation by a central counterparty. Entitlements can be transferred without the consent of the debtor. For obligations this is not the case. Central counterparty clearing is the technique providing the solution. What in a bilateral world would be the contractual relationship between A and B results in the multilateral central counterparty world in two contracts with the same terms and conditions: A and CCP + CCP and B. Having now 2 independent contracts allows resolving both sides independently from each other. Due to these economical and legal limitations CCP clearing is an essential pre-determining factor for exchange trading.

**Q15 Is contract fungibility necessary in order for a derivative contract to be traded on organized trading platform? If so, which factors would be necessary to achieve full fungibility, not only within the same market but across different execution venues? Please provide supporting rationale.**

Establishing and promoting trading platforms is only justified, if the trading platforms provide added value for the market. Trading as technique is based on the concept of fungibility. The economics behind it are standardization, attraction of liquidity and reducing transaction costs. These characteristics will only be met with fungible assets. Non fungible assets are better addressed by bespoke products.

As described under 3.3. (84) contracts are fungible if one contract fully substitutes the other one. Fungibility across different execution venues is a matter of definition. Economically a contract on one trading venue can be substituted by a contract on another trading venue. Different is the legal perspective. Given to the central counterparty clearing all contracts are linked to the concerned trading venue and not substitutable by a contract on another venue, unless there are special arrangements between the venues in place.

**Q16 No answer**

**Q17 No answer**

**Q18 In the OTC derivatives context, should any regulatory action expand the concept of “exchange trading” to encompass the requirements set out in paragraph 86 and 87 or only the requirements set out in paragraph 86? Please elaborate.**

The EC Communication dated 20 October 2009 attributes certain benefits to exchange trading and central counterparty clearing, mainly based on the politically motivated declaration of G20. Since then the discussion has made some progress, and as more and more experts are involved also the severe risks of counterparty clearing have been acknowledged. Central counterparty clearing replaces the harmless risk category counterparty risk with the dangerous risk category liquidity risk. It further introduces procyclical momentum into derivatives markets eliminating the necessary risk absorbance capacities of market participants. As consequence of the liquidity risks related to central counterparty clearing and collateralization obligations the Dood Frank Bill exempts corporate end-users from many regulatory restrictions. Any approach to expand the concept of “exchange trading” should take the severe risks inherent to central counterparty clearing into consideration. Particularly paragraph 86 should be reviewed carefully. We agree that the aspects in paragraph 86 provide added value to central clearing. However it remains the question if central clearing is still desirable in view of the threats it poses to general financial stability.

**Q 19 No answer**

**Q 20 Undecided**

**Q 21 Requires further internal elaboration**

**Q 22 No answer**

**Q 23 No answer**

**Q 24 The Commission has indicated that multi-laterality, pre- and post trade transparency and easy access are key aspects of the concept of “on exchange “trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular applying MIFID to derivatives trading?**

Analysis yes, because we doubt that the decisions made on the level of G20 and the EC were based on due impact assessments. Being very supportive of higher transparency we encourage CESR to further elaborate techniques and standards to enhance transparency in the derivatives markets. Mifid has been designed for equity markets. OTC derivatives markets differ in many dimensions. The analysis should take these differences into consideration.

**Q 25 No answer**

**Q 26 Not to our knowledge**

**Q 27 No answer**

**Q 28 Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardized OTC derivatives on organized venues? Please elaborate.**

The discussion on trading derivatives on organized venues overestimates market based pricing in derivatives transactions and underestimates the need for risk transformation performed by financial intermediaries. Where exchange trading is the appropriate technique to exchange and price derivatives contracts, exchange trading already takes place. Exchange trading requires a market situation, with supply and demand for the specific contract available at the same time or even better being available over a period of time. Many OTC products do not have this market depth and need financial intermediaries. It should further not be ignored that derivative in many cases do not need a market situation to be valued. The instruments often derive their value from the underlying and market circumstances. For many products exchange trading would only have an impact on the quality of the bid-ask spreads. The main price determinants are others. Price quality with regard to the bid-ask spreads is already provided by the competition among financial institutions. Insofar the benefits of such regulatory action needs to be further explored.

**Deutsche Lufthansa AG**