EFET European Federation of Energy Traders

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RE: EFET contribution to the consultation on 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 (JC/DP/2012/1)

Dear Sir, Madam,

The European Federation of Energy Trades (EFET) appreciates the opportunity to respond to the consultation from ESMA, EBA and EIOPA on 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 (the "Joint Discussion Paper").

With operations in all parts of the value chain, our members are highly dependent on liquid wholesale energy markets and therefore closely follow the implementation of the European Market Infrastructure Regulation (EMIR), which could have substantial impact on our members. We have not an answer to all of the questions in the consultation but have set our key concerns and comments in this letter and its attachment.

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General comments:

- As explicitly stated in Article 5(4) (b) of EMIR, it is the specific goal of the legislation to reduce systemic risk in derivative markets. Given the significant consequences associated with capturing firms that do not pose a systemic risk to the financial system, the ESAs must carefully consider the extent to which the proposed measures would also be applicable to non-financial firms. Following the proposal from ESMA to set the clearing threshold at a low - rather than a systemic – level, this has only become more important. We strongly believe that capital should not be unnecessarily tied up in margining or segregation requirements without actually improving the stability of the market and providing significant benefits in terms of lower or more efficient risk management.
- The risk management framework in most energy companies is based on achieving an appropriate balance between commodity price risk, credit risk and cash flow risk. Setting clear limits for managing each of these risks and continuing to measure and manage/mitigate them on an ongoing basis is part of the daily business of energy trading firms. This integrated risk management approach allows flexibility to address business needs. Focusing on just one of these risks, by mandating a requirement to post Initial Margin (IM), would be at the expense of the other risks and would undermine the ability of firms to efficiently manage their risk exposure.
- Credit risk for NFCs, NFC+ and commodity trading firms within the energy (non-banking) sector is also mitigated through the utilisation by energy trading companies of contractual tools for credit risk management, namely the EFET standard Master Trading and Netting Agreements. The EFET form Master Trading and Netting Agreements have become the predominant market standard for physically settled wholesale energy transactions in continental Europe. They cater for performance assurance and permanent fluctuation of exposure in credit lines, payment netting, early termination and close-out netting.
- The requirement to post margin, but particularly initial margin (IM) – whether for cleared (where IM is posted but not received) or uncleared (where any receipts have to be segregated) transactions – will in effect require non-financials to divert capital away from productive economic activity. We believe that the intention behind EMIR's Article 5(4)b is to circumscribe any undesirable impact on the real economy by limiting the requirement for risk mitigation through collateralisation to circumstances where there is a

genuine and warranted need for it; i.e. when the non-financial poses systemic risks to the financial system.

- Especially for smaller companies the use of IM/VM is marginal and obviously a mandatory posting and collection of margins for all non-cleared products will have a significant impact on a firm's cash liquidity and will ultimately reduce market liquidity as firms find the costs of hedging their risks becomes too high. This would also have the perverse result of increasing the overall level of risk in the sector.

- In the energy sector some smaller players, large industrials, (companies similar to) Stadtwerke generally do not possess the infrastructure and the means to put in place bilateral margin agreements (be it IM or variation margin (VM)). Currently in the energy sector IM is only used for counterparties with very low credit-worthiness. Any forced IM requirements would therefore place an additional and unnecessary liquidity strain on energy companies that would increase the cost of business disproportionately, especially given the underlying value of their assets, the strength of their balance sheets and, in many cases, their high credit ratings. VM on the other hand is generally already calculated between more sophisticated (bigger) players in the energy market. Among the parties where margining is applied, well established market practices are already in place that are based on the ISDA and EFET Credit Support Annexes (which include the ability to take VM by way of full title transfer of collateral and the provision of standby letters of credit for this purpose). We ask the ESAs to carefully take these existing market practices into account when drafting requirements for non-financial firms and commodity trading firms within the energy (non-banking) sector.

- The Joint Discussion Paper disregards the credit quality of the counterparty, which drives the probability of defaulting on a particular transaction. Instead the Joint Discussion Paper only focuses on securing one particular transaction, regardless of the credit quality of the counterparty.

- The larger part of the OTC derivatives that will be subject to the requirements included in articles 6/8 of EMIR will most likely not be deemed eligible for clearing, because they do not meet the characteristics of being sufficiently standardized, liquid, and do not have available and reliable price information such as to allow mark-to-market evaluation on a daily basis. This element is important to consider the plausibility of the requirements proposed in the Joint Discussion Paper.

- In the Joint Discussion Paper, the ESAs specifically ask for an analysis of the costs and benefits of the proposed regulatory standards. Given the fact that it largely remains unclear which derivative contracts will be subject to EMIR it is very difficult to give precise cost impacts. Clarity on what contracts fall within scope of capital or collateral requirements under EMIR by virtue of being classed as “derivatives” is vital. It is EFET’s view that this should not include physically settled commodity forwards, no matter where or how they are traded.

If you have any questions regarding this response, please do not hesitate to contact: Karl- Peter Horstmann (Chair of EFET Task Force Market Supervision), Cemil Altin (Vice-Chair of EFET Task Force Market Supervision), Reinier Waters (Chair of EFET Working Group on EMIR) and Peter Styles (Member of the EFET Board, Chairman of the EFET Electricity Committee)[1].

Yours sincerely,

On behalf of the European Federation of Energy Traders (EFET)

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Specific comments to the discussion paper:

The use of initial margin (IM) and variation margin (VM) as systemic risk mitigation tools is at the heart of the Joint Discussion Paper. It is EFET's view that a number of issues should however be addressed with regard to the situation in energy markets.

Especially smaller players in Europe's energy market do not have any experience with margining

The ESAs' assumption that most counterparties use margining is false regarding energy traders in the EU. The ESAs should not assume that energy trading companies would be able to move to margining without any important additional costs.

The ESAs are of the opinion that the use of IM and VM is ideal because, upon a default, the collateral held can be liquidated or effectively netted by the non-defaulting counterparty to close out the transactions. This cannot be considered as an absolute assumption as the availability and enforceability of close out netting will depend on:

- the netting and insolvency laws of the relevant jurisdiction and in particular the transposition of the Financial Collateral Directive into national laws; and
- the existence of a master agreement (from e.g. EFET or ISDA) allowing the valuation of transactions.

Non-standards products are not suitable for margining

Assuming that margining must be regulated tightly in order to "attribute the right costs to trading bilaterally, thus not dis-incentivising central clearing or creating incentives to use less standardised derivatives" does not correctly reflect market realities in energy markets. In most cases, if an OTC derivative is not eligible for clearing, it's not the intention of non-financial counterparties (NFCs and NFC+), or commodity trading firms within the energy (non-banking) sector, to circumvent the clearing obligation, but rather the characteristics of the products being such that no clearing is available: the derivatives are not sufficiently standardised or liquid to make them suitable for clearing and/or price information is not available or reliable enough to allow daily mark-to-market.

Non-standard products cannot be margined, in particular on a short time basis, and as such should not be subject to any mandatory margining requirements. An important prerequisite for margining is a liquid market that gives proper price signals. Market practice shows that for less liquid products (the ones that are generally not cleared) it is very difficult to agree on market to model because of lack of information on future prices. The valuation and calculation of VM can be highly contentious, and can lead to lengthy discussions with a counterparty, which are time

consuming and potentially costly (and may not lead to an ideal solution with regard to risk mitigation).

Regarding the different options for posting Initial Margin

EFET does not support the proposed requirement under Option 1 that all firms post initial margin (IM). The proposal appears to be taking a one-size-fits-all approach, which fails to take into consideration other existing risk mitigation tools. There is a significant risk of severely impacting the financial system and the underlying activity of non-financial counterparties (NFCs and NFC+) and commodity trading firms within the energy (non-banking) sector from a requirement for mandatory IM.

Posting IM should be considered as only one approach to risk mitigation among others, including the BASEL III capital requirements, collateral reconciliation, use of credit lines and credit ratings and detailed credit risk assessments over the life a counterparties' life, and ODSG reporting and resolution procedures. . Imposing the IM requirement would lead to a significant cash liquidity constraint, increase costs, and would lower market liquidity.

EFET believes that Option 2 does not offer any significant improvement over Option 1. Option 2 still imposes a one-size-fits-all approach to the question of whether IM is appropriate and also imposes unnecessary and overly burdensome liquidity and cost requirements on PRFC firms which ultimately will be passed on to other firms and consumers. Not all prudentially regulated firms are systemic and it is not equitable that such firms should have the "benefit" of a statutory requirement to collect IM not available to others. EFET does not believe that IM should be required, and that all systemic risk resulting from transactions with prudentially regulated firms could be mitigated through other instruments, including prudential capital requirements, at the discretion of each individual market participant.

Regarding option 3, the practice of bilaterally agreeing on a threshold is comparable with the existing practice within the energy sector of agreeing credit lines based on an assessment of the credit-worthiness and overall risk profile of counterparties. This is a common practice for NFCs, NFC+ and commodity trading firms within the energy (non-banking) sector, and it explains why there is a level of counterparty risk that is acceptable for any given counterparty. EFET believes that this is a reasonable tool, when used within a wider set of risk management measures and should not become mandatory. Therefore, we believe that the ESAs should consider the current risk mitigation practices, bearing in mind that these practices have not created systemic problems within the financial markets or any unintended consequences in the energy sector.

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Non-cleared contracts "objectively measurable to reduce risk", should not be subject to risk mitigation requirements

NFCs, NFC+ and commodity trading firms within the energy (non-banking) sector use OTC derivatives to mitigate commercial risks arising from the underlying activity of these firms. We would welcome clarity from the ESAs that, by referencing the clearing threshold, the requirement for NFC+ to exchange collateral as required by Art 6.1b does not apply to transactions that are objectively measurable as reducing risks directly related to the commercial risk or treasury financing risks of the group. We believe this is the policy in the US, as embodied in the "end-user exemption" to requirements for clear or collateralise swaps which are used to 'hedge or mitigate commercial risks'.

As acknowledged by the CFTC, 'requiring end-users to divert scarce capital to margin would increase risk, rather than reduce it, by making hedging more expensive and thus less likely to occur." It would also impose unequal trading and capital costs to undertaking OTC transactions between the US and Europe, thus leading to a migration of such transactions to US entities / markets (and potentially regulatory arbitrage). Imposing IM on "risk-reducing" transactions will inevitably drive up the capital cost of, and dis-incentivise NFCs and NFC+ (and commodity trading firms within the energy (non-banking) sector who enter into such transactions on behalf of their group companies) from undertaking such transactions. So while "systemic" risk may reduce, "commercial" risk may rise instead. We should urge the ESAs to clarify their position and exercise caution in imposing such radical measures which may have unintended consequences.

Existing processes and systems currently used in the energy sector should be taken into account

The ESAs do not consider alternative credit risk management methods as adequate, concerning NFCs or NFC+. It is a reality that utilities and energy traders and commodity trading firms within the energy (non-banking) sector use, for example credit lines, external ratings (where in particular the rating agencies take into consideration the existing debts and liabilities of a company, before issuing their rating) and risk monitoring of counterparties to mitigate risks. These should at least be considered as sufficiently robust credit risk management to ensure that NFCs and NFCs+ are not subjected to mandatory IM requirements or for the application of any thresholds.

EFET believes that collecting IM should be considered as only one approach to risk mitigation among others. OTC market participants should be entitled to decide on their own risk-mitigation methods within a clearly defined set of sound business practices including the measurement and mitigation of counterparty credit risk using capital and other risk transfer instruments as well as IM, if appropriate.

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Mandatory segregation will result in substantial cost for NFCs, NFC+ and non-banking commodity trading firms

Segregation in principle is a good thing, at least with regard to IM (if this is posted). The ESAs should however be aware that mandating segregation will also substantially increase the cost of doing business for NFCs, NFC+ and commodity trading firms within the energy (non-banking) sector. If also made applicable to (smaller) non-financial firms, the additional cost for trading and resulting liquidity constraint might easily push smaller parties out of the market altogether.

Requiring companies to apply segregation would increase the following costs:

- cost of tying up liquidity for segregation;
- cost of additional borrowing to fulfil segregation requirements; and
- cost attached to the segregation itself (systems have to be installed).

A regime mandating the posting of IM will lead to significantly higher credit risk for those required to post collateral unless all Member States have regulatory rules and bodies that can:

- effectively supervise and enforce segregation requirements; and
- ensure unhindered and timely recovery of collateral by non-defaulting parties.

This aspect poses even greater concern should it be required for IM to be posted outside the EU when transacting with non-EU counterparties. The recent liquidation of MF Global has demonstrated how challenging it can be even for relatively sophisticated jurisdictions to ensure adequate protection of segregated assets. However, as the Joint Discussion Paper suggests (cf. § 43), "for IM to be effective, it should be held segregated". It follows therefore that posting of IM should not be mandated unless parties that are required to post can be confident that segregation regimes are in place and effective, at the very minimum across all Member States. However, the ESAs' Joint Discussion Paper has provided us with no evidence that this is the case.

Eligible collateral

The eligibility of collateral should take into account that NFCs, NFC+ and commodity trading firms within the energy (non-banking) sector do not have access to central bank money and liquidity facilities such as the ECB's LTRO (that is itself already under strain providing banks with liquidity to satisfy current market requirements, which will increase exponentially if the classes of eligible collateral for cleared and uncleared trades is too restrictively drawn). Alternatives to cash collateral are vital.

Therefore, we welcome the approach foreseen in EMIR to acknowledge bank guarantees and highly liquid collateral as eligible to secure derivative transactions cleared by CCPs. However we expressed strong concerns in our response to the ESMA consultation on Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories regarding the conditions to be fulfilled by commercial bank guarantees to be accepted as liquid collateral by ESMA, which we deem too strict to be effective in reducing the potential liquidity squeeze across the market.

We strongly support the possibility of using commercial bank guarantees as eligible collateral for central clearing and for bilateral collateralisation. This should not have a negative impact on setting incentives for central clearing but would rather produce the opposite effect, making central clearing less prohibitively expensive and burdensome to non-banking groups where and when central clearing is possible.

Intra-group exemptions

In principle we believe that there should not be practical or legal impediments if the counterparties of the same group are located within the same Member State. Possible issues related to local insolvency regimes may arise if they are located in different Member States; however these should be dealt reasonably to enable groups located in the EU to benefit from the intragroup exemption.

Intragroup transactions at NFCs, NFC+ and between commodity trading firms within the energy (non-banking) sector and the companies within their group on behalf of whom they trade are necessary and common practice because treasury and risk management services are typically performed centrally in order to optimise the needs of different entities within a group. Intragroup transactions are usually not collateralised, since the parties to an intragroup transaction will generally have no credit risk differential between them and will in many cases have credit support and financing provided at a group level. Hence, collateralising the risk would be inappropriate and unnecessary from an economic point of view and would be an inefficient use of liquid resources. Intragroup transactions do not affect the net risk position of the entire non-financial group; at group level the risks compensate each other: potential losses of one group member are potential gains of another.