Deutsches Aktieninstitut

Non-Financial Companies Need Uncleared OTC Derivatives for Hedging Purposes

Exemptions from the clearing obligation should be preserved and contradicting regulation should be rethought

Position Paper of Deutsches Aktieninstitut on the report "Incentives to centrally clear over-the-counter (OTC) derivatives", 5 September 2018

General Remarks

Deutsches Aktieninstitut[1] appreciates the opportunity to comment on the consultative questions raised within the recent report "Incentives to centrally clear over-the-counter (OTC) derivatives".

This position paper thus summarizes the view of German non-financial companies on the issues raised. Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut which is the central forum of opinion building for the treasury departments of the largest German non-financial companies (NFC).

The focus of the report is to assess whether the regulatory changes in the past are incentivising central clearing for derivatives dealers and their clients. Overall, we believe that the report correctly summarizes the main drivers of incentives to clear centrally.

However, the main policy objective has always stood in contrast to the NFCs' need to use derivatives to hedge their currency, interest rate and commodity price risks resulting from their operative business. In general, NFCs prefer uncleared und uncollateralised OTC derivatives over centrally cleared derivatives.

The NFCs' need and preference to use uncleared derivatives has also been rightly recognized by policy makers in a number of jurisdictions who agreed on exemptions from central clearing and collateralisation for NFCs' derivatives used for hedging purposes. The reasoning behind this decision is rooted in some **specifics of NFCs' use of derivatives**:

- **No systemic risk:** The main purpose of clearing is to enhance financial stability. However, derivatives portfolios of NFCs typically have a low risk profile and do not create systemic risks because they are simply mirroring "real economy" business and thus are typically linked to commercial or treasury financing activities. A negative market value of the derivative is offset by a positive performance of the underlying exposure from operative business (and vice versa). The total risk arising from that constellation is actually zero, making these exposures a form of "right way risk". Consequently, an unhedged NFC poses more counterparty risk to banks, bondholders and stockholders than a hedged one. Furthermore, it has to be noted that NFCs – even the larger ones – are typically less interconnected with the financial sector and as a group more diversified in terms of business models, so that contagious effects resulting from a defaulting NFC are less likely than in the financial sector.

[1] Deutsches Aktieninstitut represents the entire German economy interested in the capital markets.

- **Dramatic negative impact on liquidity and potential negative consequences for banks' risk exposure:** If NFCs were forced to collateralise or centrally clear their derivative portfolio this would result in a dramatic additional need of liquidity and funding which is neither necessary from a risk perspective nor available. To demonstrate the potentially negative impact of clearing obligation Deutsches Aktieninstitut in its working group on corporate finance/treasury more recently conducted an illustrative survey[2] which showed for the 11 participating companies that a total of 48.9 bn. Euro additional liquidity was needed to cover potential margining requirements. In many companies this would count for between 10 and 50 per cent of the annual earnings. In some cases the liquidity needs could be up to 100 percent and – in extreme – up to six times of the annual earnings. This liquidity will not be available for other investment purposes and for the creation of employment. Even worse, contrary to banks, NFCs usually do not have significant amounts of freely available cash or even financial assets on their balance sheets that could be used for collateralisation. Most neither have NFCs access to central banks' refinancing facilities so that the NFCs' liquidity need for margin requirements would have to be raised in the banking sector. As a consequence, transforming uncollateralised derivatives with NFCs into collateralised derivatives would not improve overall counterparty risks from the perspective of the banking sector. The counterparty risk will simply take another form – instead of counterparty risk from a derivative exposure banks will face a counterparty risk from financing facilities they are providing to NFCs for margining purposes.

In sum, due to their specific situation NFCs have always been concerned about the respective negative effects of central clearing and/or collateralisation and thus have welcomed the exemptions already adopted. This reasoning has not changed: **NFCs are still strongly interested in uncleared and uncollateralised OTC derivatives being available also in future to a sufficient scale and at competitive prices.**

Against this general background, the report appears to be somewhat ambiguous from the perspective of NFCs. On the one hand, the report accepts that for smaller and less active clients clearing may be less relevant from a systemic perspective and that G-20 reforms focused on standardised derivatives so that non-standardised derivatives may not be appropriate for central clearing (see p. 14f. as well as p. 23). On the other hand, **we miss a clear statement that exemptions from the obligation to clear and to collateralize for NFCs have been the right policy conclusion both from microeconomic and systemic perspective.** For example,

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[2] Deutsches Aktieninstitut's Position Paper "Corporate data regarding EMIR - Likely liquidity drain of the clearing obligation – administrative burden of EMIR-reporting, 20 December 2016", available on www.dai.de

question 13 of the report can be read as if the FSB may put into question the existing exemptions.

In the same vain, we are concerned that the report again raises the issue of the treatment of CVA risks in stating "there may be a case to consider whether a different treatment of CVA risk for non-financial counterparties who are exempt from the clearing mandate and the uncleared margin requirements is warranted" (p. 71). We strongly support the policy conclusion drawn in the European Union in that respect: **To ensure consistency with the clearing exemption the EU also rightly exempted banks from CVA own funds requirements for clearing exempted clients.** In contrast to that, the current Basel standard on CVA risks contradicts the policy objective behind the clearing exemption, because more own funds have to be put aside if derivatives are uncleared/uncollateralized. **The Basel Standards should, in effect, also exempt banks from own funds requirements for clearing exempted clients.**

Thus, we overall agree with the analysis that "capital, clearing mandates and margin requirements for uncleared derivatives have been the key reforms in driving regulatory incentives to centrally clear" (see p. 3). **We, however, do not agree with the G-20 judgement that creating such incentives is always beneficial from a macroeconomic perspective.** From the NFCs' perspective rather the opposite is true. Incentivising central clearing too much will result in increased hedging costs and reduced availability of suitable hedging instruments for NFCs. Thus, **the incentive to clear creates a disincentive to hedge with the possible result that NFCs may ultimately bear more financial market risks than before the reforms by reducing hedging**. This would also not be beneficial from a financial stability point of view.

Please see below some additional remarks on selected consultative questions:

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

As mentioned above we agree with the evaluation, that some categories of clients have less strong incentives to use central clearing.

We, however, do not agree with the implicit judgement that creating such incentives is always beneficial from a macroeconomic perspective. We would rather argue that for NFCs the opposite is true. Incentivising central clearing too much will result in increased hedging cost and reduced availability of suitable hedging instruments for NFCS. Thus, the incentive to clear creates a disincentive to hedge with the possible result that NFCs may ultimately bear more financial market risks than before the reforms by reducing hedging.

3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

As mentioned above we generally do not regard the incentives to clear as adequate for NFCs using derivatives almost exclusively for hedging purposes. This would result in a dramatic additional liquidity and funding need, would rather reduce than raise financial stability and would, as the ultimate consequence, reduce the willingness and ability of NFCs to hedge against currency, interest rate and commodity price risks of the operative business of the non-financial sector.

We therefore strongly support exemptions from the clearing and collateralisation requirements for NFCs implemented in the European Union and in a number of other jurisdictions, e.g. the US, Japan, Canada, Australia. In addition to that, the activities at the Basel level should not contradict these important policy decisions. In particular, Basel standard on CVA own funds requirements should generally exempt banks from additional CVA own funds requirements if clients' are exempted from the central clearing and/or margining obligations. This would ensure consistency and would not create an incentive to clear where is not appropriate.

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

a. central clearing mandates (both in terms of product scope and entity scope);

The report appears to be somewhat ambiguous. On the one hand, the report accepts that for smaller and less active clients are less relevant for systemic reasons and that G-20 reforms focused on standardised derivatives so that non-standardised derivatives may not be appropriate for central clearing (see p. 14f. as well as p. 23).

On the other hand, we miss a clear statement that exemptions from the obligation to clear and to collateralize for NFCs have been the right policy conclusion both from practical as well as from a systemic perspective.

b. minimum standards for margin requirements for uncleared derivatives;

N/A

c. capital requirements for credit valuation adjustment (CVA) risk;

The capital requirements for CVA risks incentivise central clearing. However, we doubt that this is appropriate for exposures with NFCs using OTC derivatives for hedging purposes.

We are therefore concerned that the report raises again the issue of the treatment of CVA risks in stating “there may be a case to consider whether a different treatment of CVA risk for non-financial counterparties who are exempt from the clearing mandate and the uncleared margin requirements is warranted” (p. 71).

We strongly support the policy conclusion drawn in the European Union in that respect: To ensure consistency with the clearing exemption the EU also rightly exempted banks from CVA own funds requirements for clearing exempted clients. In contrast to that, the current Basel standard on CVA risks contradicts the policy objective behind the clearing exemption, because more own funds have to put aside if derivatives are uncleared/uncollateralised. Thus, the Basel Standard should in future also exempt banks from own funds requirements for clearing exempted clients.

d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

N/A

e. G-SIB requirements; and

N/A

f. The leverage ratio.

N/A

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks?

Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

Though NFCs typically prefer uncleared and uncollateralised derivatives for the reasons mentioned above (i.e. extra funding needs, individual nature of underlying commercial activity and resulting individual hedging needs), some NFCs in particular from the energy sector also use cleared derivatives with respect to commodity derivatives.

Here, our members report that they also observe a trend of withdrawal of clearing brokers (bank affiliates) as described in Part E of the section. This increases inherent risks (concentration of portfolios with certain brokers), reduces competition, and makes it harder to change clearing brokers either voluntarily or even worse in case of a clearing broker default. Therefore the access to central clearing for non-financial companies (NFCs) and the mechanism for porting portfolios from one clearing broker to another needs to be improved (and standardized). There are access issues for smaller participants but also for larger NFCs with net positions.

13. In light of the finding in this report that economic factors generally incentivize central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

The report rightly observes that the incentive to clear OTC derivatives on a voluntary basis has increased, because the cost of using uncleared derivatives has risen due to regulatory changes. This actually reinforces the justification for the clearing and margining exemptions, in order to avoid that NFCs are forced to use uncleared derivatives where it is inappropriate.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

Besides the clearing and margining exemptions for NFCs using derivatives for hedging purposes it could be considered if also long-term investors, in particular pension funds and similar vehicles operating pension scheme arrangements, should be exempted from the clearing obligation in general. These vehicles typically minimise the allocation of their assets to cash in order to improve long-term returns, so that they - quite similar to NFCs – have relatively little cash available that can be committed to margin requirements from CCPs or in bilateral derivative transactions. This problem has for example been recognized by European policy makers who temporarily exempted pension schemes from the clearing obligation under the EMIR.

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