Deutsches Aktieninstitut

Clearing regime must support the energy transition

Increase the clearing thresholds und evaluate the hedging definition

Position Paper on ESMA's consultation "Review of the clearing thresholds under EMIR", 18 January 2022

Introduction

Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin. We followed the legislation process regarding EMIR very closely, expressing the view of non-financial companies using derivatives in their risk management.

Deutsches Aktieninstitut proposes…

- …to evaluate the hedging definition in order to better reflect financial instruments regarding sustainability and renewable energy;
- …to increase significantly the clearing thresholds in particular for suppliers of commodity derivatives thus broadening the availability of these instruments, improving the market liquidity and facilitating the energy transition.

Answers to selected questions

Q1. Please explain if you see a need for further clarification on how to identify OTC contracts for the purpose of the calculation of the positions to be compared to the clearing thresholds.

Clarification would be helpful with regard to embedded derivatives which are e.g. part of sustainability linked bonds. The coupon of a sustainability linked bond reflects the performance regarding key ESG indicators agreed by the issuer and the investors in the term sheet. Therefore, the coupon varies with the issuers capability to achieve these predefined ESG objectives within a certain time line.

So far, the German national competent authority BaFin provides clarity regarding embedded derivatives by referring to the purpose of the instrument. If financing is the main purpose of the instrument, the embedded derivative will not be classified as derivative. As sustainability linked bonds are clearly issued for financing purposes, the derivative embedded in the bond is not regarded as a derivative from a regulatory perspective. This should be clarified by the European legislator as well.

Q2. Please explain if you see a need for further clarification to identify OTC contracts that can be considered as reducing risks directly relating to commercial activity or treasury financing activity. And please mention any additional aspects to be further considered with regards to the hedging exemption.

Basically, the hedging definition works well in the risk management practice of non-financial companies.

Nevertheless, especially regarding instruments concerning the energy transition cases of doubt aroused in the past:

Sustainability linked derivatives (SLDs): SLDs provide a link between traditional derivative markets and ESG objectives. SLDs include a component linked to defined ESG indicators. Should these be achieved more favourable terms (e.g. a positive spread) may result.

Virtual power purchase agreements (virtual PPAs): Under a virtual PPA, the supplier of renewable energy agrees with his client on a fixed rate for wholesale electricity. If the market price of electricity is higher than the contracted price, the supplier pays the client the difference. If the market price falls below the contracted price, the client must pay the difference (a cash settled fix-for-floating swap). In return, the client receives a certificate proving that the power purchased is based on renewable energy, hence helping the client to comply with ESG requirements and

contributing to the net zero carbon emissions goal set by the politics. Virtual PPAs provide flexibility for the supplier and the client as there is only the need for cash settlement and no need for physical delivery.

Both instruments are linked to the commercial business of the non-financial company, as they provide incentives to become more ESG compliant and enable the energy transition. Therefore, it should be clarified that SLDs (especially the ESG component) and virtual PPAs are covered by the hedging definition.

Another issue is a derivative entered into with an external counterparty (e.g. the bank) and corresponding intra-group derivatives, which are both counted against the clearing threshold if, for example, the reason for hedging ceases to apply. In this case, the intragroup transactions increase the number of derivatives that must be counted against the clearing thresholds, although these transactions do not increase the group's overall risk. Therefore, we ask ESMA that in this case only the external transaction and no intra-group transactions have to be calculated against the clearing threshold.

Q4. Please provide data and arguments to illustrate the potential impact of the lack of an equivalence decision under Article 2a of EMIR and what could be done to alleviate your concerns (besides an equivalence decision)? Please specify the kind of transactions and activities that would be affected and the purpose of those, and whether there are alternatives.

As provider especially of energy derivatives have to classify derivatives traded on UK exchanges as OTC derivatives, they will decrease their supply of OTC derivatives. Otherwise, they face the risk crossing the clearing thresholds and becoming obliged to clear their derivatives portfolio. A shortened supply will negatively impact the liquidity on OTC derivatives markets, therefore prices and availability.

Q5. Please describe the scenarios when transactions do not qualify as hedging transactions.

Regarding our concern, that liquidity on the commodity derivatives markets will be negatively impacted, see our answer to Q4.

Q6. Please describe your views on how the EMIR framework works (also compared to other regimes) for the purpose of the clearing thresholds and the requirements triggered by those? Please provide examples and supporting data.

For the following reasons we see the need for improvements in terms of higher thresholds especially for commodity derivatives in the EMIR framework:

- Financial innovation particularly regarding sustainability linked instruments may lead to uncertain-ties for non-financial companies whether a derivative could be classified as hedging (see our answer to Q1 and Q2). Although the legislator is asked to declare the above-mentioned instruments as hedging, other instruments may enter the market in future and require further clarification. In order to avoid that non-financial companies face the risk to cross the clearing thresholds or re-strict the use of these instruments resulting in inefficiencies, the legislator should provide more leeway for to handle forthcoming instruments and associated legal uncertainties by increasing the thresholds.

- The EU EMIR framework provides EU energy firms with limited headroom to offer suitable OTC hedging transactions to renewable energy producers and its clients in the EU and elsewhere in the world. These capacities are even more restricted by the lacking equivalence decisions for UK exchanges. As banks more and more leaving these markets there is only little chance that the fi-nancial sector compensates the supply of commodity derivatives. Direct adverse effects on the liquidity of OTC derivatives markets, the energy transition and European competitiveness will be the consequence.

Last but not least, compared to other jurisdictions like Australia, Singapore or the US, the EU EMIR rules are very restrictive as a study commissioned by the European Federation of Energy Traders (EFET) shows. The study focuses on the international treatment of OTC commodity derivative transactions relating to the clearing and margining obligation with a particular emphasis on non-financial market participants and their regulatory obligations.

The headline conclusion of the analysis is that the EU EMIR regime includes the lowest clearing threshold applicable to the largest set of entities, products and activities:

- Australia and Singapore limit the application of OTC-clearing regulations to financial institutions and, consequently, non-financial market participants are not limited to trade OTC markets as they are not subject to any clearing threshold test (hence, there is no hedging exemption for non-financial firms either);

- The US and the EU offer privileges for hedging transactions of non-financial companies which are not considered for the clearing threshold. However, the definition of eligible commercial risks for hedging under EU EMIR is rather restrictive and the privilege correspondingly narrow;

- The US offer a commodity clearing threshold of 8 bn USD per group, the threshold is 20 bn SGD per entity in Singapore and 100 bn AUD per entity in Australia;

- Only the EU applies its regime to all trading activities around the globe without restriction, i.e. all world-wide energy and commodity derivatives activities count against the EMIR clearing threshold, even if no EU-product, EU-venue or EU-entity is involved;

- Only the EU includes any centrally cleared OTC derivatives as well as physically settled exchange traded derivatives into the threshold calculation.

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