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Comment of DAI, BDI and VDT on the European Systemic Risk Board (ESRB) Response to the ESMA Consultation Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories"

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Deutsches Aktieninstitut (DAI)[1], Bundesverband der Deutschen Industrie (BDI)[2] and Verband Deutscher Treasurer (VDT)[3] represent the view of non-financial companies using derivatives almost exclusively to mitigate risks related to their commercial or treasury finance activities. We have followed closely the legislative process regarding the "European Market Infrastructure Regulation" (EMIR), expressing support, where the proposed regulation and the technical standards promise a more resilient financial system and stressing concerns, where we doubt that the proposed measures are viable and appropriate.

As non-financial companies are much more cash-constrained than financial counterparties we welcome the approach taken in EMIR to exempt non-financial companies from the clearing obligation and the margin requirements, provided that their positions are risk reducing or do not exceed a certain threshold. Otherwise, the cash which has to be delivered as collateral would be no longer available for operative purposes. The European legislator acknowledges with this exemption that derivatives applied by non-financial companies to reduce risks related to the commercial and treasury financing activities do not pose a risk to the stability of the financial system.

Unfortunately, the ESRB's response to the ESMA consultation paper does not reflect the economic rationale behind the EMIR exemptions for non-financial companies. As a consequence, the ESRB's reasoning as regards the systemic risks related to risk-reducing derivatives used by non-financial companies is not accompanied by conclusive evidence and therefore not viable. It has to be firmly rejected by the real economy. Furthermore, the conclusions drawn on the methodology for defining and calibrating the clearing thresholds are in some parts not reasonable.

Overall, we are deeply concerned that the debate on risk-mitigating derivatives used by non-financial companies will be negatively affected by the ESRB's response to the ESMA consultation. We do not believe this is justified.

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1 Deutsches Aktieninstitut e.V. (DAI, www.dai.de) is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

2 Bundesverband der Deutschen Industrie e.V. (BDI, www.bdi.eu) is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and has 15 regional offices in the German Länder. BDI speaks for more than 100,000 private enterprises – 98 % small and medium sized – employing around 8 million people. Membership is voluntary.

3 Verband Deutscher Treasurer e.V. (VDT, www.vdtev.de) is the official German association of Corporate Treasurers representing more than 950 treasury professionals from 450 companies.

Against this background, this comment intends to dispel several misconceptions in the analysis and the conclusions drawn by the ESRB. Our remarks refer to the ESRB's accompanying document.[4]

1) Risk-mitigating derivatives used by non-financial companies are *not* systemically relevant

Unlike European legislators ESRB concludes that risk-mitigating derivatives used by non-financial companies "are not zero-risk operations for the economy as a whole" (p. 9). In the following we discuss the arguments brought forward by ESRB regarding the systemic relevance of such financial instruments.

a) Anticipative hedging should not be confused with "speculation"

On the one hand ESRB correctly states that non-financial companies are using derivatives to reduce risks related to the conduct of their operative businesses and that they are not expected to enter into derivatives which are beyond this risk-reducing purpose. On the other hand non-financial companies are suspected to long for gains from "speculation" by applying more derivatives than necessary from a risk management perspective. ESRB considers especially those derivatives as problematic which are related to *expected* revenues and which might turn out to be superfluous when initial projections change over time. If this view became consensus, for example the automotive industry in Europe would be seriously harmed: the risk to launch new models without being able to hedge a planned product cycle in advance would probably be unbearable for producers. The same message applies to long-term infrastructure projects.

Therefore, non-financial companies mitigate risks related to expected revenues as a core feature of corporate risk management. In strong contrast to ESRB's understanding the reason behind this is not "speculation" but to improve the planning ahead and to reduce future income volatility (which is one of the key objectives for applying derivatives).

Nevertheless, it is part of the normal course of business that a plan may not evolve as expected and derivative positions originally concluded for risk mitigation purposes may transform into open positions lacking an underlying. To handle the associated risks, non-financial companies typically have risk management guidelines in place that define in advance procedures to neutralise such open positions that are no longer required from a risk management perspective. As a general rule the respective positions would be closed according to these guidelines. This is also done in order not to jeopardise the credit standing of a company and/or the overall availability of financing. Furthermore, many non-financial companies apply IAS 39 (hedge accounting) for at least a part of their derivatives, which requires that a forecasted transaction must have a high likelihood of occurrence. In addition, non-financial companies are obliged under IAS 39 to determine a sound procedure when this likelihood is no longer given.

4 See European Systemic Risk Board: Macro-prudential stance on the use of OTC-derivatives by non-financial corporations in response to a consultation by ESMA – based on Article 10 of the EMIR Regulation, accompanying document to ESRB/2012/2, 31 July 2012.

Therefore, the hedging of expected revenues/expected business should not be regarded as speculative as it does not increase the counterparty risk of the respective non-financial company and does not pose a risk for the stability of the financial system. On the contrary, it increases the financial stability of those companies which apply such techniques.

Furthermore, ESRB should acknowledge that ESMA as well as the U.S. Commodity Futures Trading Commission (CFTC) explicitly recognises anticipatory hedging, i.e. reducing risks related to expected revenues, as “risk-mitigating” in its standards concerning non-financial companies. To confuse these widespread risk management practices with “speculation” contradicts the common perspective among important supervisory authorities.

b) “Hedging can lead to an economically unjustified, inefficient level of production”

ESRB argues that the use of derivatives might incentivise non-financial companies to engage in more risky operations than economically efficient. This might inappropriately increase their default risk. For illustration purposes, ESRB refers to Mortgage-Backed-Securities or Collateralized-Loan-Obligations which were overextensively bought by financial institutions because the default risks inherent to these instruments were secured by credit default swaps provided for instance by AIG. Further examples are two case studies from the corporate world (p. 10). These examples require commenting.

To judge corporate activity from a financial market participant’s point of view is inappropriate in the first place. It is commonly acknowledged that the financial market crisis was not triggered by malinvestments of non-financial companies. Therefore, investment decisions of non-financial companies should not be compared with those of financial institutions.

ESRB further presents the case of Metallgesellschaft, which tried to expand their energy business while neutralizing the additional risk with hedges, but failed on those risk-mitigating structures and went bankrupt. ESRB uses this example to stipulate that production could be increased merely as a cover for the “objective of making speculative gains from derivative operations” (p. 10). The following aspects should clarify that Metallgesellschaft was a very individual case and should not be regarded as a “typical” hedging strategy of a non-financial company:

- Although ESRB refers to the “basis risk” (p. 45) as a result of the maturity-mismatch between the hedge (short term futures) and the underlying (long-term oil commitments) it fails to draw the right conclusions. As a general rule non-financial companies apply tailor-made derivatives in order to exactly reflect the characteristics of the underlying business especially regarding maturity and cash-flows. *Avoiding* basis risk is the rationale behind this, a fact that Metallgesellschaft unfortunately ignored;

- ESRB mentions the “liquidity crisis” (p. 46) of Metallgesellschaft but does not detail the reasons which triggered the crisis. Metallgesellschaft used exchange-traded futures to mitigate risks related to their long-term supply contracts. As the price of oil declined the market value of these instruments turned negative. Although these losses would have been offset by gains in the value of the underlying business (i.e. the long-term commitments), Metallgesellschaft only received margin calls on the former, which overstretched its liquidity reserves (aggravated by mismatching cash-flows between the hedge and the underlying). Therefore, Metallgesellschaft is a perfect example how central clearing and bilateral margining can lead to a serious liquidity drain and finally threaten the existence of a company. This is the most important reason why non-financial companies object mandatory central clearing.

In addition, we do not share the assumption that the application of risk-mitigating derivatives leads to an inefficient level of production. On the contrary, if derivatives were not available or too expensive (e.g. due do the clearing obligation) efficient investment decisions would most likely not be possible or production would be moved outside Europe. Take, for example, an engineering company which has focused on the European market so far and now wants to diversify its business by expanding to the U.S. or Chinese markets. Without doubt diversification in order to become more independent from the business cycle in a certain market (e.g. the Eurozone) should be considered as an efficient production decision. However, the company would only be willing or even be in a position to expand its business if it was able to mitigate the emerging foreign currency risks efficiently. Therefore, the availability of derivatives is much more a precondition for an efficient level of production and not an incentive to malinvestments as assumed by ESRB.

Moreover, ESRB should consider the fact that an “unhedged” non-financial company which for instance is exposed to foreign exchange risk is a much riskier counterparty than a “hedged” non-financial company. Both shareholders and bond holders would require a much higher risk premium from an unhedged company, not to mention rating implications.

Last, not least, we would like to state that ideas to limit commercial and treasury financing activities, i.e. core operational aspects, per regulatory action (p. 5) would be serious and unjustified state interventions into the market economy as a whole. It is further not up to the regulator to decide if companies prefer paying fees to clearing houses or to bank counterparts. The assumption of ESRB that uncollateralized transactions of non-financial companies are in general charged with a “poorer price” does not hold up to the experience in the corporate world, either. This, however, is not due to a “race to the bottom” in fees for risk taking, but to the fact that banks apply combined costing across their customer relationships, which are usually not limited to derivative business. Furthermore, the ESRB should take into account that derivatives used for risk-mitigating purposes are in general tailor-made products matching the respective underlying, therefore not standardised, so they will often not be clearing eligible. Standardised exchange traded or clearing eligible derivatives are frequently no adequate match for the underlying which would increase the basis risk (see also our remarks on Metallgesellschaft above).

c) “Hedging transactions pose a risk to the respective counterparty”

ESRB concludes that as a rule derivative transactions of non-financial companies pose a risk to financial counterparties.

Although specifically risk-mitigating derivatives do not increase the counterparty risk of the non-financial company (see our points above), we agree that a general counterparty risk exists which has to be considered by the contract partner. However, this counterparty risk is already properly addressed by the legislator with a number of regulations. Banks are for example obliged to determine the counterparty risk of the non-financial company (through sound risk assessment procedures, e.g. internal ratings), have to assign credit limits and to reflect the respective risk in the prices the counterparty is charged. Furthermore, banks have to put aside capital for unexpected losses which might occur from its derivative business with such customers. Bank capital requirements will even be increased significantly if the Basel III accord will be adopted as proposed. Additional safety nets to handle the counterparty risks on the side of banks – e.g. clearing or bilateral margining – are not needed from a corporate end-user perspective.

Taken these aspects together we strictly oppose the ESRB's assumption that hedging activities create risks for the economy as a whole. On the contrary, risk-mitigating derivatives used by non-financial companies stabilize the flow of income, increase their ability to plan ahead and therefore decrease counterparty risk in the real economy.

2) Calibration and definition of the clearing thresholds

a) Derivative activities by government-related entities are <u>not</u> limited

ESRB bases its opinion in part on statistics provided by BIS. However, the assumption that the BIS category "non-financial customers", which combines non-financial companies and government-related entities, comprises mainly the activity of non-financial companies while the activity of governments in the OTC derivative markets would be "rather limited" (footnote on p. 27, no empirical evidence given) is fundamentally flawed. On the contrary, some market participants involved in this business have estimated that the ratio of government-related activities in derivatives to those of corporate customers is rather two to one. These further include much higher market value risk as the maturities traded by sovereign-linked entities tend to be much longer on average than those of non-financials.

The following examples show that also the type of this involvement is often rather discomforting: The IMF stated that in 2010 French municipals (involving over 1,100 cities) had outstanding derivatives of over € 11 billion and also voices concern about holdings of other European local authorities.[5] Other sources show that as of 2011, 300 Italian municipalities recorded over € 900 million in derivative losses, with the City of Milan alone holding 30-year interest rate swaps with highly speculative elements of € 1.7 billion notional[67]. The French city of Saint-Etienne had ca. € 100 million in market value losses in 2010 due to derivative bets plotting USD against CHF (maturity: 2042)[8]. The German city of Pforzheim also made

5 See IMF: Municiple Bombs, http://www.imf.org/external/pubs/ft/fandd/2010/06/dodd.htm).

6 See http://www.businessweek.com/news/2012-02-17/city-of-milan-negotiating-new-swap-terms-with-foreign-banks.html.

7 See "Banks go on trial over Milan derivatives deal", http://www.ft.com/intl/cms/s/0/716f29c2-5930-11df-adc3-00144feab49a.html#axzz2893fmdlH.

8 See http://www.bloomberg.com/news/2010-04-14/saint-etienne-swaps-explode-as-towns-in-europe-reel-from-financial-weapons.html.

headlines in 2010 by booking € 57 million of losses from complex derivative transactions[9].

Therefore, it is not justified to conclude from the BIS-data that non-financial companies contributed in any significance to “the exuberant growth of OTC markets” (p. 27) between 2002 and 2008, while ignoring examples as given above. It is also worth to note that due to the reporting exemptions given in EMIR to government-related entities, cases like these will still not be traceable in the future, which we believe should not be tolerated from a financial stability point of view – especially if counterparty exposure figures are comingled as done by BIS.

b) Calibration of the clearing thresholds

The clearing thresholds calibrated under step 2 are extremely low and would be breached easily by many companies although derivatives applied are predominantly used for risk-mitigating purposes (especially if anticipatory hedging would not be acknowledged as “risk-mitigating” as proposed by ESRB). In particular, as it is not clear from the definitions given that all macro hedging strategies used in many companies would be fully qualifying as “risk-mitigating”, a sensible amount of leeway for non-hedging items in EMIR is a necessity. Otherwise European non-financial companies becoming clearing obliged would face serious disadvantages. This holds particularly true vis-à-vis their U.S. competitors as the approach of the CFTC much more appropriately reflects the risk management strategies of non-financial companies. Other than proposed by ESRB, the U.S. rules deliberately set hedging definitions and threshold levels more broadly (subject to later review, as also scheduled under EMIR) to avoid disruptions in the real economy. We believe this is a very sound policy approach.

In general we doubt that the ESRB’s calibration proposal for the clearing thresholds properly reflects the regulations’ overarching objective to take into account the “systemic relevance of the sum of net positions and exposures per counterparty” (rec. 31 EMIR). As a starting point ESRB states that “only those derivative positions which represent 1/200 of the total European market for OTC derivatives would be, in principle, subject to mandatory clearing” (p. 34). This number appears to be chosen arbitrarily since the ESRB does not explain (or even substantiates empirically) why a share of 1/200 of the (estimated) total European derivative portfolio of non-financial companies or roughly 1/80.000 (0.000124 per cent!) of the global derivative market would constitute systemic relevance.

In fact, since the ESRB wrongly regards the hedging of expected revenues as “speculative” (see above), almost all bigger European companies may find themselves forced to clear. As it is not the objective of EMIR to expand the clearing obligation on every somewhat larger company we strictly oppose the calibration proposed by the ESRB.

c) Gross market value is not a risk sensitive measure

We agree with ESRB that the market value would better reflect the risk related to the respective derivatives compared with the notional value. However, referring to

9 See http://www.bloomberg.com/news/2012-01-16/jpmorgan-pforzheim-urged-to-settle-71-million-swap-lawsuit.html.

the gross market value as the ESRB is not the correct methodology, as this does not appropriately reflect the overall risk position of the counterparty which is for instance mitigated by netting effects. Therefore, the best possible indicator for the associated risks would be the *net negative market value of the uncollateralised derivative exposure*, which would adequately mirror the current downside credit risk of the non-financial counterparty. This approach was e.g. taken by the CFTC in order to define one of the “substantial position tests” regarding the Major Swap Participant, which is comparable with the clearing threshold according to EMIR. We are aware that the regulator has to balance out different objectives. In particular, the “uncollateralised net negative market approach” is relatively complex and would be difficult to implement for smaller and medium-sized companies which do not mark-to-market their derivative exposure daily (and are fortunately not required to do so under EMIR). Against this background, the approach of ESMA referring to notional values in determining the clearing threshold is acceptable.

d) “Step one” should consider “speculative” derivatives only

To consider the amount of capital and reserves in the calculation of the clearing threshold adequately reflects that a buffer for unexpected losses from the derivative portfolio may be of importance (see step 1 of the ESRB’s clearing threshold). Nevertheless, to refer to the total amount of derivatives for calculation purposes, i.e. “speculative” plus “risk-mitigating”, is not justified. As risk mitigating derivatives do not increase the counterparty risk of the non-financial company (as explained above) there is no need to employ additional capital and reserves for these items. At least, the threshold defined in step 1 should include “speculative” derivatives only. Otherwise, the derivative position which has to be buffered by capital and reserves would be hugely overstated.

Conclusion

The response of ESRB to the ESMA consultation paper does not adequately take into account the specifics of risk-mitigating derivatives used by non-financial companies and also includes some very questionable ideas about how non-financial companies perform their risk management with derivatives. Therefore, we strongly recommend that ESRB should seek the dialogue with non-financial market participants to discuss common risk management practices and to erase prevailing misunderstandings.

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