European Federation of Energy Traders

Amstelveenseweg 998
1081 JS Amsterdam
Phone: + 31 20 520 7970
Fax: + 31 346 283 258
Email: secretariat@efet.org
Website: www.efet.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel – Switzerland
E-mail to: baselcommittee@bis.org

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid – Spain
E-mail to: wgmr@iosco.org

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RE: EFET response to the second consultation by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) on Margin requirements for non-centrally-cleared derivatives

The European Federation of Energy Traders (EFET) welcomes the opportunity to respond to the consultation by the BCBS and IOSCO on their proposed Margin requirements for non-centrally-cleared derivatives.

EFET welcomes some of the changes introduced by IOSCO/BCBS in the key principles and requirements for margining compared to its previous proposal under consultation in September 2012. In particular, EFET strongly supports the introduction of a phase-in period (which is necessary in light of the interaction with other regulatory requirements, the possible impacts on collateral needs, and the need to adapt the relevant arrangements) and the proposed threshold for the exchange of initial margin. Moreover, we recognise and support the clearer IOSCO/BCBS focus on counterparty risks when defining the general principles, rather than general risks associated to non-centrally cleared derivatives.

However, the rationale of some of the proposed requirements remains unclear. EFET would like to refer to its previous contribution to the September 2012 consultation[1] which highlighted its members' views on a number of principles with regard to margin requirements. EFET stands firm on these principles, most of which are still relevant for the present consultation document.

[1] EFET response to the consultation by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) on Margin requirements for non-centrally-cleared derivatives, 28 September 2012, available on the EFET website.

You will find our detailed comments on the various elements of the consultation document and our responses to the consultation questions in the annex.

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), Anya Bissessur (Chair of EFET Working Group on EMIR) and Peter Styles (Member of the EFET Board, Chairman of the EFET Electricity Committee).

Yours sincerely,

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

Jan van Aken
EFET Secretary General

Annex 1: Detailed comments on the consultation paper proposals

Element 1: Scope of coverage- instruments subject to the requirements

EFET has identified a number of issues in the proposals put forth by IOSCO/BCBS:

1. The consultation didn't take up the EFET proposal to "coordinate so that margin requirements for non-cleared trades are not mandatory at least until competent authorities have begun to designate which OTC derivative trades should be subject to mandatory clearing" (page 4 of our first answer).
2. The second consultation does not really provide any answer as to the treatment or exemption of FX instruments, as previously proposed by EFET. The proposals are still unclear and refer to a parallel supervisory guidance to be issued by BCBS on the management of settlement risks in FX transactions, which includes margining requirements. This is not satisfactory and does not provide for any clarity on exemptions.

   We believe it would make sense to exempt physically-settled FX forwards and swaps from both VM and IM, as the counterparty credit risk is very small (due to the very short average maturity of the contracts) and settlement risks are very well addressed through the widespread use of payment-versus-payment arrangements. This solution has been proposed in the United States, and following this path would contribute to ensuring a global level-playing field and avoid regulatory arbitrage.

   The exemption should not be restricted to a specified maturity as this will lead to an artificial accumulation of FX swaps and forwards with a maturity that would grant the exemption.
3. The fundamental problematic of margins remains: entities may be required to provide initial and/or variation margin for non-cleared derivatives. As mentioned in our previous contribution, if there is no CCP available to clear a certain type of derivative instrument, this is usually because such an instrument is not sufficiently standardised, liquid and with price information available and reliable on on-going basis to allow central clearing. Therefore it cannot be possible to replicate the margining approach where the basic conditions are not appropriate: the calculation of margins could require unprecedented efforts, potentially leading to never ending disputes.

   By definition (when considering in particular EMIR) the non-cleared OTC derivatives which NFC+ (i.e. non-financial counterparties exceeding the clearing threshold) have in their books are non-standard products. In the European Union, ESMA will have excluded these products from the list of derivatives to be cleared in application of Art. 5 EMIR because:

   - They are not standardised
   - They are not liquid
   - There is no general market price available

   In these circumstances, it is not realistic that market participants could agree on any price, in order to fulfil a possible margining obligation.

   Some contracts have undetermined volumes and prices at the time of execution of the contract. These parameters only get determined at the time of settlement, which may occur months afterwards. For instance, a swing electricity contract under ISDA master agreements provides the Buyer, Party A, with a possibility to financially purchase a fixed total volume of electricity during X hours per year (one year being 8760 hours, X is < 8760), at a given price. The price is agreed to be settled against an hourly reference price (often the spot price

published by the local exchange). Party B, the Seller, is the fixed price payer, while Party A is the floating price payer.

- When entering into this contract, Party A thinks that it will nominate only during the hours of the year when electricity is the cheapest and its price is below that of the fixed price of the contract. That way, Party B would have to pay party A the difference between fixed price and floating price.
- In Party B's opinion, Party A will not be able to nominate during the cheapest hours, so that payments should be made to Party B.

To summarise, when entering into that contract, each party considers the contract to be to its sole benefit. And certainly it is impossible in advance to know which hours Party A will purchase, and what the spot price during those hours will be. To calculate the price of such a contract, highly complex stochastic simulation models are required as it is a "path-dependent" calculation. Running these complex models requires high calculation capacity, time and manpower. Thus these calculations cannot be performed on a daily basis. It therefore seems unlikely that Parties would ever agree on an amount of collateral to exchange.

The same issue occurs for example with long term financial hedge of electricity. Prices are only published for the coming 5 years in average. Parties enter into bilateral financial contracts to reduce their risks out of this particular reason: there are no such contracts offered for clearing. As pricing is not available towards the end period of the contract, how shall parties agree on exchange of margins without disclosing their commercially sensitive information on future price curves and pricing models?

There is a similar issue for off-standard contracts, e.g. single hours or block contracts for which no market price is available.

The exchange of variation margin would force companies to reveal sensitive information regarding valuation models and pricing techniques. A risk would be that companies could minimise trading non-standardised contracts that currently make up the majority of their hedging tools. This would have a perverse effect on the hedging performance of individual companies and their counterparts, and ultimately increase systemic risk in the sector.

4. There is no exemption for contracts entered into for risk reducing purposes. EFET had suggested that "the requirement for non-financial counterparties to exchange collateral 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" (page 6 of our first answer).

If the parties qualify as systemically important, the IOSCO /BCBS proposals might have high negative effects on the markets, as the market participants will not be able to take out any risk from their non standardised contracts.

We should underline that if parties don't clear their non-standard contracts, this is not a wilful intent to "escape" the clearing obligation. We are confronted with a market reality that these products, which are needed by the market to hedge risks (for example by industrial companies to hedge their long term power purchases), are not available for clearing (see point 3 above). The basis assumption of IOSCO/BCBS that margin requirements will "promote central clearing" is erroneous and does not match the reality described above.

Element 2: Scope of coverage – scope of applicability

1. EFET welcomes the BCBS/IOSCO proposal that "margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party".

   This is a clear statement that any transaction involving a non-systemically important NFC is exempted from all margin requirements. However the Consultation leaves the definition of "systemically important /not important NFCs" to the discretion of each national regulator. This could be problematic and create significant distortion from one market to the other. Notably, this raises the question of how Parties would be supposed to know how the national regulators classify their trading partners.

   It would be advisable to set minimum criteria for the classification of systematically important NFCs to ensure some consistency and legal security, possibly on the model proposed by EMIR for the determination of NFC/NFC+.

2. On another note, there is no exemption from variation margins for systemically important NFCs and no real phase-in (but only a delayed applicability as from the 01.01.2015), which EFET previously recommended (see answer to Q1). In addition it is proposed that VM be exchanged on daily basis. The flexibility EFET advocated for has not been implemented (see Answer to Q17)

3. Considering that the focus of the principles/requirements is the counterparty risks generated by non-centrally cleared OTC derivative transactions, we do not understand the rationale of measuring the minimum level of non-centrally clearing OTC derivative activity in gross notional outstanding amount (2g). Clearly, this is not a measure of the counterparty risk, and we would suggest IOSCO/BCBS to propose a metric more appropriately reflecting the type of risk subject to quantification.

4. Further, a couple of fundamental requests from our answer to the previous consultation have not been considered in the current consultation paper, namely:

   - There is still no clear exemption for intra-group transactions. The consultation proposes that "local supervisors should review their own legal framework and market conditions and put in place initial and variation margin requirements as appropriate". However, we doubt that this approach will work in practice: If "local supervisors" – a non-defined concept – are to be understood as the national regulators, the proposed system would force NRAs to hold bilateral discussions with each of their foreign counterparts on the imposition of margins between companies established in their respective countries. This will lead to discrepancies and inconsistencies in practice.
     In addition a general requirement for margining of intra-group transactions contradicts EMIR Art. 11.5 – which exempts intra group transactions from the collateralisation requirement for companies established in the same EU Member State – and the spirit of EMIR Art. 11.6 which partly or totally exempts companies established in different Member States. Clarification is needed on the criteria for this total or partial exemption, as the ESAs are required to draft DTS on this subject, which would be appropriate to submit to public consultation (EMIR, Art. 11.15 (c) and (d)).
     Finally, any requirement to exchange margins between affiliates contradicts the principle that the framework on margin requirements is intended to restrict counterparty risks, i.e. risks between counterparties pertaining to different group, as acknowledged in many other parts of the IOSCO/BCBS paper.
   - There is still no clarification on the handling of margins, once a party falls below the clearing threshold (see EFET's first answer, page 6, last § of Q4).

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

1. Regarding the initial margin for the potential future exposure, market participants have to choose between a standardised and an approved internal model. The first is supposed to be simple and transparent, but less risk sensitive, and somewhat costly (roughly 15% of notional for commodities, independent of the maturity). The second is supposed to be more complicated but more risk sensitive (likely with cost hidden in development, training, software implementation, etc.).

   EFET sees particular difficulty in developing the internal model for non-standardised structured deals or deals with optionality. The proposed parameters of the internal model (99% confidence interval, 10 days closing period, and a volatility including a period of financial distress – a concept that still needs to be defined) seem acceptable, though the period appears a bit arbitrary (and it might be unwise to treat everything with the same closing period). There might be products that can be closed in 1 day (in which case we will overestimate by using the 10 days), or others that can be closed in 100 days (FO must know best). This is relevant since the potential future exposure will increase by the square root of the time period.

   It is not straightforward to judge which one is the better model, and market participants may need to perform a comparative study. It could also advisable to start with the simplified model, until we have the internal model up and running.

   We generally agree with other general aspects such as correlation within commodities allowed, robust dispute resolution procedures, no 'cherry-pick' switching between models and model back-testing.

2. We do not understand the rationale behind the proposal that "initial margin models may account for risk offsets within the same asset class, but not across asset classes" (3.4). The focus should be the counterparty risk and it should be recognised that some credit risk arrangements and netting agreement may well cover risks across different asset classes. The local (national) framework on insolvency and bankruptcy is much more relevant than the distinction between different asset classes. We suggest therefore that IOSCO/BCBS work on principles that would allow greater harmonisation of national insolvency regimes in the way that international netting agreements can be fully legally enforceable.

3. Regarding the variation margin (based on M2M), the proposed frequency is daily, which can be rather labour-intensive. To avoid margin calls on non significant amounts, a minimum amount to call could be agreed at BCBS/IOSCO level, e.g. EUR 500,000.

4. Regarding the M2M valuation of structured products, a common model has to be used, as well as agreed upon prices of illiquid markets. Although IOSCO and BCBS recognise that "non-centrally cleared derivatives (...) are likely to be relatively illiquid (...) and the process of agreeing on current exposure amounts for VM is more challenging", it is somewhat surprising that the proposed remedy is to establish "rigorous and robust dispute resolution procedures". This would not resolve the fundamental issue of the illiquidity of the products.

5. Regulators should provide a more detailed justification for the so-called "macroprudential add-on" (p.14), as it seems like an unnecessary addition to the two margins above.

6. It could be advisable to monitor the transaction, labour, software, and interest rate costs once margining for non-standard products is fully enacted, as this might have an influence on future business decisions (i.e. shift to probably less costly standard exchange cleared products).

Element 4: Eligible collateral for margin

1. EFET pointed out in the first consultation that "collecting IM should only be considered as an alternative 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 initial margin, if appropriate". (see Q5, page 7 of our first answer).

   This has not be taken into account in the present consultation document, as only a limited number of collateral types is permitted for margin use, provided they fulfil the key criteria set out by IOSCO/BCBS: collateral should not be exposed to excessive credit risk, market and FX risk; risk sensitive haircuts should be applied where possible; value of collateral should not exhibit a significant correlation with the creditworthiness of the counterparty.

   The overall proposal of IOSCO/BCBS seems to neglect the essential nature of non-financial firms. Non-financial groups normally perform investments into (physical) assets related to their industrial/commercial activity. The output/input of such assets and the need to manage the related price risks is the reason for entering into derivative contracts. This allows non-financial groups to reduce the financial and economic risks of their investments. It is therefore rather disappointing that IOSCO/BCBS require indistinctly financial and non financial firms to provide collateral in the form of cash, securities or gold, neglecting that the access to these type of collateral for non financial entities is much more difficult. By *de facto* excluding the use of parent company guarantees – wich allow to take into consideration the capitalisation of such companies, their credibility and the level of acceptable counterparty risk – the BCBS/IOSCO proposal would significantly increase the costs of trading of those counterparties submitted to the margin requirements. IOSCO/BCBS should therefore work on a proper framework allowing the consideration of such assets, included proper haircuts.

2. We welcome that BCBS/IOSCO propose that cash and non-cash collateral held as IM are not to be re-hypothecated, as per our suggestion in the previous consultation. Re-hypothecation tends to over-stretch liquidity reserves of non-financial companies.

Element 5: Treatment of provided initial margin

EFET trusts that the requirement that the gross initial margin should be exchanged between counterparties is inappropriate. IOSCO/BCBS seems to consider that the exchange of IM on a net basis is insufficient to protect the counterparties in the event one of those firms' failure. IOSCO/BCBS does not provide any evidence of this statement and the proposal contradicts the understanding that the exchange of margins should cover the underlying credit risk between counterparties. The counterparty risk is indeed the net and not the gross. Some limits to this approach may be only found in the operation of the local (national) insolvency regime on which however IOSCO/BCBS do not provide any principle/requirement.

Element 6: Treatment of transactions with affiliates

See comments to Element 2 on exemption for intra group transactions.

Element 7: Interaction of national regimes in cross border transactions

EFET has no specific comment on this element, but would like to stress the importance of well-functioning insolvency regimes at national level that should allow the full legal enforcement of netting agreements for cross-border transactions.

Element 8: Phase in of requirements

1. EFET welcomes the proposal of a phase-in period between 01.01.2015 and 01.01.2019 for the IM requirement.
2. However, no phase-in period for the VM requirements is proposed, which is an issue as the counterparties eligible for margining will be facing liquidity and administrative constraints for the calculation and exchange of margins. In addition, it would seem wise to determine the scope of margins and the feasibility of margins (for non-standardised transactions, with no available prices or no available volumes) before imposing an obligation that will most likely be difficult to implement by the counterparties.
3. We note that the requirement and calculations of thresholds are to occur at group level. There is no differentiation proposed per class of assets, and no limitation to non-financial companies in the group.

   EFET would suggest that the regime for the calculation of thresholds be aligned with EMIR, i.e.:

   - Setting a threshold per class of derivative
   - Excluding the financial counterparties from the group calculation
   - Excluding risk-reducing contracts