VIK Comments

Energie für die Industrie

Public Consultation on Derivatives and Market Infrastructures

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Question 4: Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

Non-financial companies are well established as end-users of OTC derivatives to mitigate risks arising routinely in their business. These companies and the derivatives that they use (commodity derivatives required for hedging the risk arising in principal business) were not involved in the extreme stress and systemic risk experienced in the financial sector, in response to which legislators on both sides of the Atlantic are rightly seeking to introduce a robust regulatory framework. It is important to note that the vast majority of industry when using derivatives just manages current and future risks arising from their operational businesses.

Mandatory central clearing relies on standardardization of derivatives. However real business is diverse, therefore standardized financial instruments will never fit to mitigate risk efficiently and effectively for corporates. As a consequence of non-fittting standardized derivatives industry which already makes use of Hedge Accounting under IAS 39 would face the risk of increased volatility in their results when hedges and underlying no longer match the strict IAS 39 requirements for hedge efficiency. At the same time, industry does not benefit from central clearing as they can easily manage their counterparty credit risks through diversification (as they have done in the past without additional costs that would be incurred by mandatory central clearing).

Banks can easily net positions of different counterparties because they are usually taking both long and short positions. In addition they have large securities portfolios qualifying as collateral (e.g. if requested by a CCP) and they have access to central bank liquidity facilities. In contrast industry usually have “only” one position either long or short depending if they are buyer or seller on a commodity market. They do not have collateral portfolios and would thus need to borrow money from banks first to deposit it as collateral with the CCP before hedging their business risks. This would lead to a potentially financially unstable situation as neither banks nor the capital markets would be easily willing or able to provide the additional liquidity needed. Industry’s profitability and solvency would be affected by rising interest expenses and indebtedness, while banks would benefit from the system (as lender and arranger of capital market transactions).

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Therefore, non-financial enterprises that use derivative instruments solely in the course of hedging their risk when conducting their principal business should benefit from a complete exemption from central clearing. Furthermore, in the elaboration of the EU rules, close attention should be paid to rules developed worldwide with the aim to prevent regulatory arbitrage.

In sum: the upcoming regulation of derivative markets shall regulate those derivatives used solely for speculation while a complete exemption shall apply to derivatives used as a risk management tool to hedge a real underlying risk industry is exposed to (i.e. combined with an existing or planned underlying transaction). This may be achieved in two different ways:

Either non-financial undertakings are explicitly and completely exempt from the obligation to clear contracts centrally. This appears to be the approach taken by the US. In this case, it is important that transactions between non-financial undertakings and financial undertakings are also exempt. Otherwise industry would loose an important hedging business partner.

Alternatively, certain classes of derivatives can be identified which do not pose a systemic risk and should therefore not be cleared centrally. For example: While strong regulation should be applied to Credit Default Swaps, commodity derivatives should be completely exempt from mandatory central clearing.

Either of the two ways must be constructed in such a manner that systemic risks are regulated while non-financial institutions can hedge their risks.

We believe the definition and application of effective **thresholds** is extremely difficult due to the complexity of the issue, i.e. shall the threshold be defined on a single commodity or cross-commodity, on nominal value or on market value? However, if the Commission wishes to pursue the idea that clearing obligations should apply to non-financial counterparties if they meet certain thresholds, the threshold should be geared to systemic risk, i.e. industry's trading activities which are not driven by the current or future business and, therefore, are of pure speculative character. The hedging and non-speculative character can be proven by appropriate companies' confirmation and documentation, referring to current or future business.

Without further documentation hedges falling under the own use exemption or IAS 39 hedge accounting should be exempt from mandatory central clearing. However, the volume should not be restricted just to the own use volume as industry needs hedging not only for the very restricted own use quantity, which is calculated taking into account all kinds of negative effects, but for the most probable production volume which is regularly higher than the own use volume. (The volume exceeding the own use quantity is continuously evaluated with market prices and reported in the company's financial statement.)

Mandatory central clearing should be applied only prospectively, recognizing that market participants negotiated existing trades based on the laws and market practices in effect at the time of these transactions.

Background

For further details, we refer to the VIK position paper on the planned regulation of the derivative markets (in German): http://www.vik.de/fileadmin/vik/Stellungnahmen/14-2010.pdf