European Association of CCP Clearing Houses

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# EACH paper – Use of bank guarantees as collateral for non-financial participants

## Executive summary


**Concern**
Non-financial participants may currently use bank guarantees as collateral for CCP clearing of power, gas derivatives and other commodities, without the guarantees being fully backed. This is possible further to the exemption of the EMIR requirement that bank guarantees must be fully backed by collateral. This exemption has been provided for a period of three years and will expire in March 2016.

**Impact on the market**

- **Shrinking of currently transparent, centrally-cleared market** - A failure to make this exemption permanent will hinder the ability of non-financial counterparties to hedge contracts beyond March 2016, resulting in the disappearance of currently transparent and cleared markets, therefore lowering the protection of non-financial counterparties.
- **Increase of costs with lower levels of protection**[1]
  - Expected annual increase of costs for the market: approx. EUR 127.7 million p.a.
  - Total increase of cost of collateral: up to approx. 1000%
  - Total market share represented by affected entities: up to 80%.

**Solution**
EACH proposes to allow the use of bank guarantees without full backing, by **urgently extending the current exemption based on a thorough assessment of its impact on the market** and in the future not maintaining section 2.1, point h) in Annex 1 in Regulation No 153/2013 (the EMIR 'Implementation Act').


## 1. Introduction

This paper aims to describe the benefits of using bank guarantees for the non-financial sector and to argue **an effective regime for the use of bank guarantee as collateral by non-financial counterparties beyond March 2016**.

There are several models used for clearing commodity products. In some CCPs the end user is a non-financial participant (e.g. energy trader, producer, consumer, etc.) which is the direct

[1] Based on calculations by IRGiT S.A., KELER CCP, BME Clearing, OMIClear and Nasdaq Clearing.

participant of the CCP, while in other CCPs there is a financial institution in between, acting as a general clearing member.

Non-financial counterparties may currently use bank guarantees as collateral for CCP clearing of commodity derivatives, including power and gas derivatives, without the guarantees being fully backed. However, in March 2016 the requirement for full backing will kick in. This will hinder the ability of non-financials counterparties to hedge contracts beyond March 2016, resulting in the disappearance of currently transparent and cleared markets in Europe where EMIR-authorised CCPs are active.

EACH believes that the regulation should **ensure an effective regime for the use of bank guarantee as collateral by non-financial counterparties beyond March 2016** regardless of the clearing model. In this paper we focus on the first model, although the same rules should apply in cases where a trading participant clears through a CCP which uses the latter model.

A failure to implement such a regime will **severely damage a substantial portion of the EU internal market**, in particular Denmark, Finland, Hungary, Poland, Portugal, Spain and Sweden. The prohibition of non-fully backed bank guarantees will result in reduced levels of liquidity and transparency. Non-financial counterparties will face a significant cost increase.

As contracts traded are longer than 2016, there are already signs of participants withdrawing from the market and reverting to bilateral trading outside transparent and supervised venues and without counting on the strong risk-management capabilities of CCPs. This reduces liquidity, increases market concentration, leads to less competition, transparency and ultimately to lower social welfare gains. Such a development **clearly contradicts the G20 objectives to create more transparent and resilient derivative markets**. The reduced efficiency will ultimately lead to higher energy bills for consumers.

## 2. The need to continue the exemption of fully backed bank guarantees

Article 46 of EMIR allows the use of bank guarantees as collateral by non-financial clearing members. Non-financial counterparties currently trade under an exemption from the EMIR requirement for bank guarantees to be fully backed by collateral. The exemption will expire in March 2016.[i]

Several CCPs in Europe currently allow non-financials to use bank guarantees as collateral, although the freedom to use bank guarantees should apply to all authorised CCPs. This is particularly the case for the CCPs in the following jurisdictions: Denmark, Finland, Hungary, Poland, Portugal, Spain and Sweden. As indicated in Table 1 below, up to 80% of the market share will be affected in the markets cleared by those CCPs: BME Clearing, IRGiT[2], KELER CCP, Nasdaq OMX Clearing, OMIClear.

If the exemption is not extended or not made permanent, a requirement for full backing will be triggered and the current grace period for using bank guarantees will come to an end. Non-

[2] Currently not authorised under EMIR provisions, however the removal of bank guarantees as an available collateral will have major negative consequences for NFC- in the Polish energy market.

financial firms using bank guarantees will face a **significant yearly cost increase** (see Table 1 below) whereas they do not have those amounts either in cash or in other collateral assets. It should however be noted that non-financial clearing members collateral assets do not consist only of bank guarantees, because of the concentration limits that CCPs apply. The preferred option would however always be for non-financial counterparties to provide collateral in cash.

**Table 1 – Estimated quantitative impact of the failure to allow bank guarantees without full collateralisation**

| | IRGiT S.A. | KELER CCP | BME Clearing | OMIClear | Nasdaq Clearing | **Total** |
|---|---|---|---|---|---|---|
| Market share represented by affected entities | 71% | 80% | 28%-49% | 39% - 43% | 24%[i] | **Up to 80%** |
| Maximum share of margins in non-cash collateral | 90% | 1.65 million EUR / Market | 70%-100% | 85% | Up to 100%[ii] | **Up to 100%** |
| Increase of costs of collateral | Up to 220% | Up to 500% | On average 680% | Up to 500% | 2,5%-1000% | **Up to 1000%** |
| Annual increase of the costs (for the whole market) | EUR 10 million | EUR 1.2 million | EUR 0.8 - 1.3 million | EUR 2.4 - 5.2 million | EUR 66-110 million | **Up to EUR 127.7 million** |

**Notes**

[i]68% of the market share in relation to entities trading in power and gas.

[ii]Collateral list available under http://www.nasdaqomx.com/digitalAssets/99/99267_150608-clearing-appendix-10---collateral-list.pdf

Under these circumstances it is understandable that **non-financial counterparties withdraw from the CCP cleared, multilateral, transparent market** and revert to bilateral trading, **in contradiction with the aims of EMIR** and recent legislative reforms originating from the G20 conclusions on marking derivative markets more sound.

## 3. Benefits and Risk Management of On-Demand Bank guarantees

There are clear benefits to the use of bank guarantees.

### Highly liquid products

On first demand, bank guarantees create a no accessorial, abstract obligation to the beneficiary, putting the beneficiary in a strong legal position ("pay first, sue later"). The guarantor remains liable even if the underlying obligation is extinguished, it must pay immediately and cannot object. The characteristic of bank guarantees as unconditional, irrevocable and on- first-demand, make them "highly liquid". For these continuing guarantees the guarantor assumes liability for any past, present and future obligations owed by a debtor to a lender or creditor. Even where the amount owing has been completely paid, the guarantor can still be liable under that line of credit if there is a subsequent indebtedness.

**Limited market risk**

The market risk of bank guarantees is limited in terms of volatility. In times of market stress, members might find it difficult to increase the bank guarantee limits. This is mitigated by concentration limits on posted collateral per member, i.e. limited percentage of its total collateral issued by one issuer.

**Limited credit risk**

The credit risk is managed by only accepting guarantees issued by investment grade rated banks with a certain minimum rating, external rating and evaluation using an internal score card. A deterioration of a bank guarantee issuer's credit worthiness will have implications on the applied haircuts and/or eligibility of the bank guarantees issued by the relevant bank. The lower the credit rating, the higher the haircut.

**Low correlation between financial and energy sector**

There are also risks, and EACH members insist that these risks can be measured and controlled and they do not motivate that bank guarantees need to be fully backed. The CCP is only exposed to a loss in case both the member and the issuing bank are defaulting simultaneously. The correlation of defaults in the energy sector and the financial sector has been historically low. Nevertheless, issuers may be added to the credit watch list for extra monitoring. If an issuer defaults, the member is required to immediately find another issuer or collateral.

## 4. Conclusion

EACH calls for swift regulatory intervention to maintain well-functioning markets and proposes to **allow bank guarantees without full backing, by urgently extending the current exemption based on a thorough assessment of its impact on the market and in the future not maintaining section 2.1, point h) in Annex 1 in Regulation No 153/2013 (the EMIR 'Implementation Act')**. As effects of the requirement for full backing are already being seen in the form of participants withdrawing liquidity from the market, the matter is urgent.

[i] EMIR Level 2, Regulation 153/2013, Annex 1 section 2.1, point h) and Article 62.