
EACH Paper – Enhancing the eligibility of collateral with fully committed on demand bank guarantees and EU Emission Allowances

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Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 18 members from 14 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

Bearing in mind the importance and well-underlined interest of all European economies to ensure the sound and safe operations of the energy markets under the current energy crisis, EACH acknowledges the initiatives of other association such as EFET, Euroelectric, Eurogas and Europex to make the case for the widening of collateral types acceptable by CCPs¹².

The objective of this paper is to present the EACH views concerning the possibility of enhancing the EU list of eligible collateral acceptable by CCPs³ by ensuring an efficient regime for the use of fully committed on demand bank guarantees already allowed by EMIR. This will only require a level 2 change, as detailed below. We also propose allowing the possibility of using EU Emission Allowances as eligible collateral within EMIR.

Due to upcoming winter and unfortunately forecasted further deepening of the energy crisis a swifter solution than the usual regulatory change process, which at best could take months, is needed. EACH therefore supports the consideration of a fast-tracked measure that allows the above-mentioned adaptations to collateral requirements as soon as possible.

1. Fully committed on demand bank guarantees

1.1. What are fully committed on demand bank guarantees

A bank guarantee is a financial backstop issued by financial institution(s) offering the fulfilment of the payment and performance obligations of the debtor in case it defaults. The bank shall, under the conditions specified in the bank guarantee statement, effect payment to the beneficiary. Unless stipulated to the contrary, the bank guarantee is irrevocable (i.e. it cannot be cancelled or amended without the consent of the parties).

The relevant bank has to pay the debt owed by the original debtor thus, the relevant credit risk for the CCP from a bank guarantee would only materialise in the event that both the debtor and the issuing bank simultaneously default, at a time when the market value of the position is negative.

¹ https://eachccp.eu/wp-content/uploads/2022/05/20220419_Joint-associations-position-on-support-for-well-functioning-energy-markets_Executed.pdf

² EFET (European Federation of Energy Traders), Euroelectric (Federation of European Electricity Industry), Eurogas (Association of companies in the gas value chain) and Europex (Association of European Energy Exchanges)

³ Article 46 of the EMIR Legislation (<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN>) and Annex II of the EMIR Regulatory Technical Standards No 153/2013 (<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0153&from=EN>)

'Fully backed bank guarantees' in the current regulation refer to the requirements that CCPs face under EMIR, namely that bank guarantees are only eligible if they are fully covered by cash, and CCPs have access to the underlying cash collateral in case the issuing bank is not able to fulfil its payment obligation deriving from the guarantee undertaking (*guarantees issued with the condition prescribed in Annex I Section 2(1) of EMIR RTS 153/2013*). Current regulation makes a distinction between eligible collateral for financial and non-financial firms, in that financial firms may not post bank guarantees as collateral.

Several clearing houses in Europe historically allowed non-financial market participants to use bank guarantees as collateral, especially energy clearing houses, as non-financial participants in those markets have limited amount of cash or other collateral assets compared to financial participants. This is particularly the case for the clearing houses in the following jurisdictions: Hungary, Poland, Portugal, Spain, Sweden and Norway.

Fully committed on demand bank guarantees should be used as a complement to other EMIR-compliant eligible collateral types, with the clear intent of CCPs to restrict the acceptance of bank guarantees in line with EMIR risk management framework requirements and risk limits (e.g. bank guarantees not to be accepted in default funds as well as if potential exposure lacks limits / exceeds limits, or include any other term not in line with CCP's risk management requirements.).

Fully committed on demand bank guarantees referred to in this paper are on-demand, unconditional, irrevocable and continuing as described below:

1. On-demand - The guarantor must pay upon demand, without making any objection.
2. Unconditional and irrevocable - An unconditional guarantee is a pledge by the guarantor to make payments, as stated in the guarantee, without any conditions. An irrevocable guarantee cannot be cancelled or modified without explicit consent by the affected parties.
3. Continuing - A continuing guarantee is a guarantee where 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

This paper aims to describe why the regulatory framework should allow CCPs to accept fully committed on demand bank guarantees for non-financial participants. This would be similar to the practice of strictly regulated and supervised banks and financial institutions, who currently accept bank guarantees from each other, even though banks are heavily engaged in all types of exposures to each other, and wrong way risk can similarly occur.

We believe that CCPs should apply **appropriate risk management frameworks** to manage and limit the risk deriving from such fully committed on demand bank guarantees by:

1. **Establishing strict and regularly supervised/approved risk management framework** and risk strategy (with specified risk appetite and limits), e.g. the total amount guaranteed by a bank, including to different Members, not exceeding a certain % of its shareholder's equity, with limits set according to rating of the guarantor.
2. **Maintaining appropriate rating and limit management framework** for the identification/mapping, assessment of the creditworthiness of counterparties (rating), any interdependencies between the Clearing Member and the issuing Bank and establishing limit systems for concentration risk and the maximum risk appetite for each counterparty.
3. **Operating systematic monitoring system** to have regular update of the creditworthiness of counterparties, radar screen/watchlist and regular view on the standing of risk portfolio and limits, also monitoring of potential relevant market movements that can strengthen the probability of wrong-way risk.
4. **Specific compliance with additional conditions**, such as: that the clearing member under which the position is held approves of the institution issuing the bank guarantee or that the guarantor and guaranteed do not belong to the same group.

1.2. Current situation: Article 46(1) of EMIR already allows the use of bank guarantees as collateral by non-financial clearing members

Article 46(1) of the EMIR legislation⁴ allows CCPs to accept, for non-financial counterparties, *"bank guarantees, taking such guarantees into account when calculating its exposure to a bank that is a clearing member"*. Until March 2016, market participants had the possibility to trade under an exemption from the EMIR provision of requiring bank guarantees to be fully backed by (cash) collateral. This was possible due to a 3-year exemption after entry into force of EMIR (from 2013 to 2016). From the expiry of the exemption, bank guarantees were hardly used as the current requirement to have full (mainly cash) collateral behind the guarantees is a requirement that market participants have no economic reason to fulfil, as once they are providing full (cash) collateral behind a guarantee, this cash could be directly provided to CCPs as direct coverage on their exposures to CCPs.

This problem is particularly challenging in the current volatile and extreme energy market, for both CCPs and non-financial clearing members.⁵ Although the problem had been highlighted to the EU institutions and authorities in the past⁶, no solution has yet been implemented despite the fact that the use of bank guarantees is widely accepted and used by banks and financial institutions themselves, and risks of similarly accepting bank guarantees as collateral by CCPs could be measured and controlled in a similar manner. Current liquidity concerns

⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN>

⁵ EACH can provide detailed supporting data upon request by Authorities.

⁶ Please see page 25 of the EACH response to the European Commission targeted consultation on the review of the central clearing framework in the EU: <https://eachccp.eu/wp-content/uploads/2022/05/EACH-response-European-Commission-targeted-consultation-on-the-review-of-central-clearing-in-the-EU-March-2022.pdf>

bring the need for solutions. This is a tested and functioning measure, which could be re-introduced to help in the current market conditions. Due to adding the need of full collateralization, it *de facto* had the effect of not being used in the forward cleared markets. However, bank guarantees are still used in the non-cleared environments and in the spot markets, where it is a standard procedure.

1.3. Swift regulatory intervention is needed to maintain well-functioning markets

In this volatile economic environment, maintenance of well-functioning energy markets is of utmost important. Supporting this fundamental goal, the energy clearing sector (including market participants and central counterparties) has proposed to allow non-cash collateral in case of non-financial, direct clearing members, by removing section 2.1, point h) in Annex 1 in RTS (EU) No 153/20134. In the current context of energy prices increases in particular, we believe that allowing CCPs to accept fully committed on demand bank guarantees for non-financial participants will help prevent participants withdrawing liquidity from CCP cleared, multilateral, transparent markets and reverting to more bilateral trading (OTC) ultimately reintroducing counterparty credit risk to the market.

In April 2022, EACH cooperated with the European Federation of Energy Traders (EFET), the federation of the European electricity industry (Eurelectric), Eurogas (a European association whose Members cover gas wholesale, retail and distribution, along with companies manufacturing equipment) and the Association of European Energy Exchanges (Europex) in writing a letter⁷ calling for access to short-term liquidity or guarantees provided by public entities and extension of eligible collateral to fully committed on demand bank guarantees and EU Emission Allowances. EACH and the various associations representing energy market participants agreed on the need of allowing CCPs to accept non-cash collateral. This will enable market participants to post these assets as collateral to cover at least an appropriate portion of the margin requirements held by the CCP. This removes part of the pressure on liquidity management and, therefore, mitigates the risk that some firms might not be able to meet additional margin calls.

1.4. Fully committed on demand bank guarantees in light of the key EMIR requirements towards collaterals

Similarly to any other form of collateral, fully committed on demand bank guarantees must be subject to a robust risk management framework that addresses the potential risks of this form of collateral as described below.

⁷ https://eachccp.eu/wp-content/uploads/2022/05/20220419_Joint-associations-position-on-support-for-well-functioning-energy-markets_Executed.pdf

1.4.1. Collateralisation

We propose that bank guarantees are exempted from being fully collateralised. Any measures or limits to guarantees considered acceptable can be managed directly by specific requirements dictated by the CCPs, adapting requirements to the particularities and risk conditions of the products and clients. Bank guarantees are an acceptable and tested means of guaranteeing payments, guarantor would not be related to the guaranteed.

As already mentioned, any underlying collateral behind the bank guarantees gives in reality no further comfort to the CCPs, but makes the whole bank guarantee acceptance difficult and too regulated, because:

- This secondary “backed” collateral is only good for the CCPs if the CCP has direct access to it, if for any reason the bank also bankrupts at the same time as the clearing member. We discussed above, that in case of direct clearing members / mostly energy market participants / where these bank guarantees are relevant, the correlation / contagion effect of bankruptcy in the energy sector AND banking sector at the same time is very low. If the collateral can not be used directly by the CCP in case of the bank’s default, it has no real value to CCPs.
- These kind of “general” collateral requirements for bank guarantees should be considered by the issuing banks themselves (if they want at all), who are taking the risk of the issuance (in respect of the beneficiary). It is not the CCP’s area of influence.

Any such additional regulatory requirement would make the whole acceptance complicated and might not reach the aim of supporting the liquidity challenge, which is in the spotlight of the initiative.

It is important to note that the aim of the CCPs is to be able to manage their risks adequately, in compliance with the regulatory requirements and ensuring the safe operation. From a CCP risk management point of view, accepting fully committed on demand bank guarantees as an eligible collateral could be an adequate risk management tool as part of its well-established risk management system.

Taking into account the market needs, this collateral asset would support the non-financial energy market clearing members as well, with supporting the continuous participation on the transparent and safe energy markets and increasing their available liquidity resources.

In common with any other form of collateral, CCPs will take account of the credit risk of the counterparty (for instance accepting only letters of credit guaranteed by certain banks of good credit risk which is independently monitored), and CCP users will be subject to a maximum reliance on bank guarantees to ensure that the CCP can rely on a diversified mix of collateral.

1.4.2. Limited liquidity risk

The characteristics of bank guarantees as unconditional, irrevocable and on first demand, make them “highly liquid”. On first demand, bank guarantees create a non-accessorial 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. 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, within the limit of the line of credit, if there is a subsequent indebtedness.

1.4.3. Minimal market risk

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

1.4.4. Managed and highly monitored credit risk

The credit risk of bank guarantees shall be managed and constantly monitored by the CCPs. CCPs have a sophisticated risk management framework, where the “credit risk” of banking partners from whom they accept bank guarantees can be integrated.

CCPs shall be able and authorised to use their risk management frameworks to manage, monitor, limit and mitigate the credit risk of the banks they accept guarantees from.

The acceptance of bank guarantees is possible by banks and financial institutions, who are also highly supervised institutions. Bank guarantee-provision by banks to each other is a commonly used guarantee and risk management tool in the banking industry, for which banks have developed in-depth risk management framework.

Within the risk management framework of CCPs, apart from the already mentioned strong framework for maintaining appropriate rating and limit management as well as operating systematic monitoring system, CCPs can use a wide range of risk mitigating and management tools for the mitigation and limitation of risk, such as limits to be granted only to banks with appropriate rating, maximising exposure based on country-risk and other portfolio limits, other restrictions based on the valuations using an internal limit-system etc.

The regular review of limits, exposures and development of the issuers’ counterparty rating can ensure the adequate coverage all the time.

CCPs shall be and would be able to initiate actions if needed when the situation evolves as a result of for example a deterioration of a bank guarantee issuer’s credit worthiness, the

country-rating or other circumstances. These will have implications on the limits available for certain banks, on the applied haircuts and/or overall eligibility of the bank guarantees issued by the relevant bank or banks in a country, etc.

1.4.5. Adequate haircut

Although “haircut” in the traditional meaning is not applicable in case of bank guarantees, the maximum acceptance level of the guarantees would be defined by the limit management system as well as by specific “concentration limits”. CCPs would be able to apply certain maximum thresholds to bank guarantee acceptances, e.g. given percentage of the margin requirement of a Clearing Member could be fulfilled with bank guarantees (the remaining with cash or other EMIR eligible collateral assets), and/or the total accepted bank guarantee stock must be diversified from CCP perspective with the use of concentration limits on issuing banks.

1.4.6. Low correlation between financial and energy sector

The correlation of defaults in the energy sector and the financial sector has been historically low. The participants in the market for financial derivatives on energy are primarily the suppliers and users of energy (i.e. the producers and wholesale consumers). In this aspect the energy markets differ from financial markets in general, as participants in other financial markets to a large extent are banks, dealers and other financial institutions. Current regulation already makes a distinction between eligible collateral for financial and non-financial firms, in that financial firms may not post bank guarantees as collateral.

Financial firms must provide collateral in the form of cash or securities deemed eligible by the clearing house and compliant with regulation. Financial firms typically have a balance sheet consisting of various types of financial assets, and are actively engaged in hedging of risks stemming from these assets.

Many of the non-financial firms do not hold excess financial assets eligible as collateral. For this reason, non-financial firms need other types of collateral as bank guarantees to cover large parts of their margin requirements.

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.

1.4.7. Logistical risks

In the context of a default management process, legally the execution of a bank guarantee states that it is unconditional, irrevocable and on first demand. A CCP having a bank guarantee to execute and “cash in” is in a comfortable position given that the collateral does not need to be valued or sold in a market. There is no price risk of that collateral, as the price is known.

In addition, a default event shall be managed in line with the Art. 45 of EMIR. CCPs shall use the margins (i.e. collaterals, including cash, financial instruments, bank guarantees), posted by the defaulting clearing member prior to other financial resources covering losses. This means that the bank guarantee as an eligible collateral, provided by the defaulting clearing member shall be drawn down immediately (in line with the procedure laid down in the bank guarantee's terms). In parallel, CCP shall immediately execute the default management action in line with the default waterfall; the defaulted amount (covered by the bank guarantee) shall be performed from its own liquidity resources, until the issuing bank performs.

Furthermore, CCPs shall be liable to accept only such bank guarantees which meet the conditions defined by the CCPs approval / risk management framework, including the drawdown terms and deadlines which has liquidity risk on the CCPs' side.

1.4.8. Prudential risks

Banks manage and use bank guarantees for numerous activities and monitor these tools as part of the credit facilities they offer. The institution of bank guarantee is a regular and widely used product in the banking sector, granted within dedicated frameworks as per the risk and liquidity management of the issuing banks and the relevant legislation governing the banking sector.

The CCP is by definition responsible for risk management and may accept only such bank guarantee which meets the conditions determined by its risk management framework. The pricing policy of the issuing bank – which is relevant for the clients of the bank (non-financial clearing member) – shall not be considered by the CCP from risk management aspects.

1.5. Comparison with other jurisdictions and compliance with the PFMI

EACH notes that in other jurisdictions such as Canada or the US, fully committed on demand bank guarantees are normally accepted. This is the case for ICE NGX and CME based in those jurisdictions. These jurisdictions normally refer to bank guarantees as "letters of credit".

Below we provide some details of this comparison noting that we include it as an illustration of the variation at international level and that we are not suggesting the Canadian or US model should be copied in Europe.

As an example, collateral posted with ICE NGX may take the form of letters of credit and may be denominated in either CAD or USD. The characteristics are the following:

- It is an irrevocable standby letter of credit issued by a bank that is acceptable to ICE NGX (i.e., financial institution with a rating of A or better);
- The risk lies with the issuing bank rather than the clearing member who post the letter of credit;

- The issuing bank works with the clearing member directly to have an asset as a security against the letter of credit, e.g. cash or machinery (some energy companies are asset heavy) ;
- ICE NGX does monitor the internal credit rating of financial institutions issuing letters of credit on behalf of NGX's clearing members in order to detect changes in their respective credit profiles and ensures aggregate exposure from each bank remains within specified limits.

In this context, on 6 July 2022 ICE Futures US submitted a document⁸ to the CFTC self-certifying amendments to the Exchange's Canola Rules, allowing Merchants to use of letters of credit in the delivery process to satisfy all or part of the Indemnification Amount required under the Canola Rules.

Furthermore, concerning CME, letters of credit are accepted⁹ as collateral provided that they are issued by a CME-approved bank. In addition, they are capped at \$500 million USD across the clearing member and affiliates and capped at 25% of margin requirement.

We note that US and Canada jurisdictions currently and the EU until 2016¹⁰ allowed the use of fully committed on demand bank guarantees while **the Principles for Financial Market Infrastructures (PFMIs)**¹¹ where already in place. We therefore interpret the PFMIs as allowing the use of fully committed on demand bank guarantees as part of a range of eligible collateral for CCPs, subject to the appropriate risk management framework that accompanies all collateral treatment by CCPs.

⁸ https://www.theice.com/publicdocs/regulatory_filings/22-122-Amendments_to_Canola_Rules.pdf

⁹ <https://www.cmegroup.com/clearing/financial-and-collateral-management/acceptable-collateral-for-letters-of-credit.html>

¹⁰ https://www.esma.europa.eu/sites/default/files/library/2015-1750_emir_statement_re_bank_guarantees_energy_market.pdf

¹¹ <https://www.bis.org/cpmi/publ/d101a.pdf>

2. EU Emission Allowances

2.1 What are EU Emission Allowances?

General Allowance (EUA) and Aviation Allowance (EUAA), allowance to emit one tonne of carbon dioxide equivalent during a specified period, which shall be valid only for the purposes of meeting the requirements of Directive 2003/87 EC¹² and shall be transferable in accordance with the provisions of this Directive, as defined respectively in Articles 3(7) and (8) of Commission Regulation (EU) No 389/2013 in its respective valid version, collectively referred to as “allowances”. Allowances are kept in the Union Registry and can be transferred at the respective delivery day (Spot market Primary auction and secondary trading: General Allowances (EUA), Aviation Allowances (EUAA); Derivatives market secondary trading: EUA Futures, EUAA Futures).

Allowances that may not be used to fulfil the requirements of Directive 2003/87/EG due to legislative measures or regulatory decisions and which are explicitly identifiable as such, may not be used for fulfilment of delivery obligations arising from secondary market spot transactions in EUA and EUAA or EUA Futures and EUAA Futures.

We see benefit in adding EU Emission Allowances or other accredited carbon allowances (“Emission Allowances”) to the definition of eligible collateral. We observe a growing interest from market participants in using Emission Allowances as an eligible financial collateral for the purpose of central clearing. The main reason for this is that these markets have seen a steady increase in liquidity and could be considered as relatively mature by now. Accepting Emission Allowances under Article 46(1) EMIR as collateral would allow market participants to make use of their allowances more productively and economically. This could lead to substantial cost savings for market participants, especially for compliance users, by avoiding the costs of raising other collateral and by freeing up capital for investments into their main business.

However, today, possibilities for clearing houses to accept Emission Allowances are limited mainly for legal reasons. According to Article 46(1) EMIR, a clearing house shall only accept highly liquid collateral with minimal credit and market risk to cover its initial and ongoing exposure to its clearing members. Without the explicit recognition of Emission Allowances as an eligible type of collateral, we believe that the market participants cannot efficiently use their Emission Allowances as collateral for central clearing. We believe that Emission Allowances are indeed sufficiently liquid financial instruments to qualify as eligible collateral under Article 46(1) EMIR. We also believe that, given Emission Allowances are securely stored in the EU registry¹³ rather than a securities settlement system, the EU EUA registry should be taken to mean a securities settlement system under Article 44 of RTS 153/2013.

¹² <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003L0087&from=EN>

¹³ https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets/union-registry_en

2.2 Do they meet the requirements of Article 46(1) of EMIR ?

2.2.1 Liquidity risk/Highly liquid

Emission markets have seen a consistent and sustainable market liquidity in recent years, especially in the secondary market liquidity increased lately as shown in the table below :

	Primary Auction	Secondary¹	Total
2016	724,776,500	308,087,000	1,032,863,500
2017	955,926,000	386,330,500	1,342,256,500
2018	925,089,000	758,971,225	1,684,060,225
2019	594,042,500	502,462,000	1,096,504,500
2020	786,008,000	689,080,000	1,475,088,000
2021	586,738,000	685,647,000	1,272,385,000
2022 (until June)	249,655,500	386,783,000	636,438,500

¹ EEX, ICE, Nasdaq

Developments

- EEX primary auctions consistently deliver volume into the market with an averaged cover ratio of 1.84 since January 2019.
- EEX EUA secondary market volumes have been slightly declining since the start of 2019.
 - Since the start of 2021 average monthly volumes have been just under 5,000 lots.
 - The number of trades has been steadily increasing and is now averaging over 500 trades a month.
- ICE spot volumes have been significantly increasing over the past three years. This year trading almost around 55,000 lots a month.

2.2.2 Minimal credit risk

There is no credit risk for EUAs as there is no counterparty involved (unlike bonds).

2.2.3 Minimal market risk (e.g. Volatility of value)

The ESMA Final Report on Emission Allowances and associated derivatives¹⁴ finds that "*the historical volatility of EUA prices since January 2019 (computed using standard deviation of daily returns) was 2.9%, compared with 1.2% for equities and less than 0.3% for bonds*", as illustrated in the table below. The higher volatility compared to securities (bonds/equities)

¹⁴ https://www.esma.europa.eu/sites/default/files/library/esma70-445-38_final_report_on_emission_allowances_and_associated_derivatives.pdf

should be addressed with an appropriate haircut when used EUA as a collateral. However, respective risk haircuts can take this higher volatility into account as they are also calculated with regard to stressed market conditions and an adequate liquidation period.

Table: Historical volatility from 1 January 2019 to 31 December 2021

EUAs	Equities	Corporate bonds	Government bonds	Crude oil	Natural gas	Coal
2.9%	1.2%	0.2%	0.3%	4.3%	5.1%	2.7%

2.2.4 Adequate haircut

In line with all collateral, CCPs would apply the appropriate risk management approaches to Emission Allowances and consequently they would apply an appropriate haircut to the value of Emission Allowances to establish the eligible collateral value.

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