Response to the Call for Technical Advice (no. 5) launched by the Committee of European Banking Supervisors (CEBS) of November 28, 2005

I. Introduction

We are representing a group of German energy trading firms which established a joint working and discussion group for the exchange of experiences in financial and physical energy trading and for the co-ordination of the communication with German and European authorities (in the following "Energy Commodity Traders Group"/"ECT-Group"). We would like to respond to the Committee of European Banking Supervisors' industry consultation to be carried out in the course of the European Commission's Call for Technical Advice no. 5 of November 28, 2005 (hereinafter referred to as "Call for Technical Advice").

The ECT-Group consists of entities active in the energy trading sector; several of them pursue also banking activities or render financial services related to energy derivative products. Entities which pursue banking activities or render financial services related to commodity derivatives are according to the German Banking Act (Kreditwesengesetz/KWG)[1] investment firms which have to apply for a license in order to carry out the banking activities or financial services related to commodity derivatives and which are supervised by the German Financial Supervisory Authority Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin") The ECT-Group serves as a platform for such firms in order to develop common positions with respect to the financial supervision and to communicate them to BaFin and other legislative and administrative bodies. There has been a steady and successful cooperation between BaFin and the ECT-Group in order to develop an adequate supervisory regime for investment firms rendering financial services related to energy derivative products because the provisions of the Banking Act, designed for the banking and investment services sector are not appropriate for entities active in the commodity trading and commodity derivatives business, in particular not for the energy related commodity business.

An industry consultation with respect to the monitoring, treatment and reporting of large exposures of firms shall be undertaken according to no.2 lit. (b) of the Committee of European Banking Supervisors` Call for Technical Advice. In response the ECT-Group avails itself of the possibility to describe how energy trading entities monitor, report and treat large exposures against the background of the current financial regulatory framework in Germany and the supervisory practice of BaFin.

[1] Gesetz über das Kreditwesen (Kreditwesengesetz – KWG) in der Fassung und Bekanntmachung vom 9. September 1998 (BGBl. I S. 2776), zuletzt geändert durch Art. 3 Mineralölsteueränderungsgesetz vom 23. Juli 2002.

II. Large Exposure treatment under German law

1. Scope of Application of the German Banking Act

The German legislative authorities adopted a more extensive approach with respect to the supervision of the financial market as the Investment Services Directive 93/22/EC ("ISD-Directive"), the forerunner of Directive 2004/39/EC on markets for financial instruments (MiFID), has foreseen. Accordingly, the German Banking Act stipulates that entities which render financial services or banking activities such as commission trading, portfolio management, brokering, agency or own account trading with respect to commodity derivatives - which include also energy derivatives – are investment firms and must apply for a banking license in order to be entitled to render these services. Upon granting of a banking license the respective commodity investment firms have to comply with the requirements stipulated in the German Banking Act and concretizing regulations thereto. This embraces in particular the own funds requirements for banks, credit institutions and investment firms according to Section 10 ff. German Banking Act and the Regulation on the ascertainment, measurement, weighting and notification of loans in the area of the large and million loan provisions of the German Banking Act (GroMiKV).[2] The rules on own funds requirements and large and million loan exposures in the German Banking Act and the GroMiKV have been implemented upon transposition of the Directive 2000/12/EC relating to the taking up and the pursuit of credit institutions of 20 March 2000 ("Banking Directive").

2. Large and Million Loan Exposures under German Banking Act

a) Consequences of the Large and Million Loan Exposure rules for energy firms

Large loan exposures are pursuant to Section 19 para. 1 no. 4 German Banking Act inter alia also payment claims for commodity deliveries. Thus, the large loan exposure rules apply also to payment claims arising from commodity deliveries. This extensive approach caused serious problems for energy trading entities which carry out financial services related to energy derivatives but pursue also physical energy supplies. These entities exceed the large loan exposure limits frequently - a situation followed by duties to notify the overstepping of the large loan limits immediately to BaFin and to secure the exceeding amount by additional own funds.

The frequent overstepping of the large loan limits of Sections 13, 13 a, 19 German Banking Act occurs due to the common invoicing practice in the energy market. It has been a long established practice to invoice energy deliveries monthly. This means suppliers render deliveries for one month in advance without demanding payment. The invoice for the deliveries of

[2] Verordnung über die Erfassung, Bemessung, Gewichtung und Anzeige von Krediten im Bereich der Großkredit- und Millionenkreditvorschriften des Gesetzes über das Kreditwesen (Großkredit- und Millionenkreditverordnung – GroMiKV) vom 29. Dezember 1997, BGBl. I, S. 3418, zuletzt geändert durch Artikel 9 des Gesetzes vom 15. August 2003, BGBl. I, S. 1657.

a month will be rendered in the following month. Generally, payment claims for energy deliveries are due on the 20th day of the month following the delivery month. Thus, in the meantime between energy delivery and payment the large exposure limits are frequently exceeded. The mentioned invoicing practice was especially awkward for purchase co-operations, meaning utilities which set up a common subsidiary for the carrying out of the energy purchases for its shareholders. If the subsidiary renders alongside also financial services and thus comes under the financial supervision it has to obey the own funds and large loan exposure requirements of the German Banking Act and the GroMiKV. If such a subsidiary has only a few utilities as shareholder to whom it delivers energy the large loan exposure limits of the German Banking Act and the GroMiKV will be exceeded in regular turns. The same applies in the insofar similar situation in which an entity subsidiarizes its energy trading whereby the subsidiary purchases also the energy for the parent company.

In addition, large Exposures arising from market value changes of forward rate agreements (pre-settlement risk) cause similar problems with respect to the overstepping of the large exposure limits. This is due to the industry structure in energy markets which is characterized by few very large customers and counterparties on the wholesale level.

b) BaFin´s position on the applicability of the Large and Million Loan Exposure rules to energy firms

The aforementioned licensed energy trading entities face serious economic disadvantages compared with entities which do not have to comply with the own funds regime and large loan exposure regime of the German Banking Act because they do not render financial services but pursue only energy supplies to end users. This consequence was factually a contradiction to the envisaged and politically much desired fast development of a liquid energy trading market. The ECT-Group made its concerns about the unmodified application of the own funds regime and large loan exposure requirements of the German Banking Act and the GroMiKV to licensed energy trading entities known to BaFin. The objective was to obtain in particular an exemption from the unmodified application of the large loan exposure requirements for a period of one month plus 20 days (the common invoicing period in the energy market). Meaning, the obligations to notify an overstepping of the large loan exposure limits to BaFin and to secure the exceeding amounts by own funds should be deferred until the period of one month plus 20 days expires. This solution was to serve both interests, the energy suppliers could keep their invoicing schedule and the counterparty risks were sufficiently secured through the obligation to secure the exceeding large loan amounts with own funds upon the date they are due.

Eventually, in its circular dated February 3, 2004, Annex 1, page 7,[3] BaFin permitted an exemption from the unmodified application of the large exposure requirements if a licensed company's transactions are restricted to energy and/or energy based derivatives and not conducted with retail clients. Such a company may exceed the large loan limits of the German Banking Act with respect to payment claims resulting from the delivery of electricity for a period of 50 days without having to provide extra amounts of own funds. Moreover, according to this BaFin circular, the overstepping of large exposure limits resulting from calculating credit equivalent amounts from forward contracts relating to electricity has been tolerated since too. The prerequisite for these exemptions is that the respective licensed firm has a risk management system in place which makes sure that concentration risks can be managed in a way that makes possible to react adequately and in a sufficiently timely manner to solvency degradation of the debtor. The application of the aforementioned exemptions to licensed energy trading entities has been the situation since for energy trading undertakings in Germany being supervised by BaFin.

Against the aforementioned background the ECT Group welcomed the interim exemption provisions which have been introduced upon inter alia its initiative by the European Parliament and Council into Article 45a and 45 d of the Recast Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions and Directive 93/6/EC on the capital adequacy of investment firms and credit institutions (hereinafter called “Recast CRD-Directive”). The ECT-Group proposes strongly to adopt the Articles 45 a and 45 d of the Recast CRD-Directive exemption as permanent provisions. In the following we wish to explain why we are in favour of the permanent exemption from the capital requirements of the Recast CRD-Directive.

3. Justification for an Exemption

a) Features of the Energy Market

An exemption from the own funds requirements is justified because activities in commodity, especially in energy trading are not associated with risks comparable with the risks associated with activities in the traditional financial market sector. The operability of the ("energy"-) financial market is much less at risk, thereby justifying lower capital requirements.

aa) No need for Investors` Protection

Regulation makes sense certainly with respect to the objective of investor protection. The failure of an individual firm may cause loss to clients or counterparties of the firm and those clients or counterparties ought to be protected against that loss because they are not readily able to judge the safety and soundness of the firm and are thus incapable of protecting their

[3] Circular of February 3, 2004, Annex I, page 7, see under www.bafin.de, => legal foundations and announcements, => circulations, => circulations 2004.

own interests. However, these arguments carry little weight in the case of energy trading firms that participate in wholesale markets. These firms do not take deposits from the public. Nor is there any protection scheme or lender of last resort providing a safety net against failure which needs the protection of a regulatory capital regime.

The energy trading firms trade in energy derivatives with wholesale market participants who should be in a position to assess the credit-worthiness of their counterparties.

bb) No systemic instability

Regulation may also make sense in some markets because the failure of an individual firm may have adverse effects on systemic stability. However, there is little evidence that the failure of an energy trading firm is likely to have that effect. Some of the market participants may be part of larger groups of a significant size (e.g. large power generators). It is unrealistic to expect the securities or banking regulator to seek to monitor or control the risks in such a group as a whole, even if it were desirable. Indeed, the most significant recent failure, Enron, did not have systemic impact, notwithstanding its scale.

To the extent that these entities participate in energy storage or transmission networks, the banking or securities regulator is likely to be ill-equipped to supervise the activities of market participants. The relevant energy market regulator is likely to be better placed to do this.

In any event, there is little to indicate that these markets have the characteristics of other markets where the risk of systemic damage is so significant to justify intervention. The energy market participants do not have the unique balance sheet structure of banks or the pivotal role that banks have in the payments system, which could serve as a means to transmit the consequences of a collapse into other market segments. Indeed, in markets such as power or energy markets, a generator or producer that becomes insolvent is likely to continue to operate, and to fulfil its core supply obligations, under protection from its creditors, thus further weakening any possible link between firm default and systemic consequences.

b) Unintended Consequences

The introduction of regulatory capital requirements may have significant unintended consequences:

Any regulatory capital regime is likely to impose significant costs on an ordinary commercial or industrial enterprise with assets and liabilities. So the imposition of such a regime is liable to lead to the "push out" of regulated activities into a separate regulated trading subsidiary. For many producers, users, manufacturers, generators, etc. of energy, their activities in physical markets are a natural offset to their commodity derivatives business. Forcing such firms to subsidiarise their commodity derivatives business may in fact make it more difficult

for them to manage risk, particularly if the regulated subsidiary is limited in the extent to which it can lay off risks with its other group companies by limits on intra-group large exposures.

Similarly, it is likely to lead to those groups seeking to carry out activities in non-EU markets from outside the EU on the basis that this is cheaper and less burdensome.

In addition, if there are significant regulatory capital rules, on top of licensing requirements, this is likely to create additional obstacles to non-EU entities wishing to participate in EU markets, thus reducing competition in those markets. While non-EU groups can make use of EU booking vehicles to trade in EU markets, laying off those risks through back-to-back or similar contracts or arrangements may be made more difficult by regulatory capital rules.

c) No need for regulation to try to create "level playing field"

Moreover, the mere fact that some banks and securities firms which trade in these markets are the subject of comprehensive regulatory supervision does not justify the introduction of comparable rules for commodity firms which pose very different risks to the system, have essentially wholesale counterparties/customers and carry on a very different underlying business.

The ECT-Group considers that proportionate and risk-based regulation should give full recognition to the matters set out above, the very different nature of commodity markets (and their economic purpose) and the significant differences in the quantum and type of risks faced by members of those markets, as compared with retail investors and savers. These fundamental differences have led the ECT-Group to question whether it is necessary or desirable to impose a prudential or regulatory capital regime on commodity firms.

III. Treatment of Large Exposures

Investment firms trading energy commodities avail themselves of several methodologies to monitor concentration risks and exposures.

Whereas funded credit protection such as cash, debt securities from banks and issuers rated by an external rating agency, treasury bills and gold are commonly used forms of credit risk mitigation and protection against default in the financial sector these forms of credit risk protection are not of major importance for the energy trading sector. The energy trading entities use some types of collateral such as cash, securityships, letters of awareness in context with profit and loss transfer agreements or guarantees. In the field of commodity and energy trading, however, collateral is more frequently provided in the form of assets (commodity stock). Open positions are normally closed through corresponding transactions at exchanges or over the counter (OTC) and are thus hedged by countervailing selling or purchase positions.

Other widely used forms of counter party risk mitigation are Payment and Close Out Netting. Payment Netting will be carried out by setting up mutually due payment claims of the parties daily so that only one payment claim of a party remains to be paid. Close Out Netting occurs if an agreement is terminated for cause. In that case the market value of all open positions under the agreement will be calculated and the mutual claims will be set off leading to just one remaining payment claim for one of the parties.

A major part of large exposure risk mitigation is the constant evaluation of the counter party. This is carried out by review of the annual reports, annual balance sheets and constant monitoring of the energy trading market. Further, many trading firms apply trading limits to certain counter parties which shall not be exceeded so that no major risk concentration appears.

We would be very pleased to obtain the opportunity to discuss this topic further with representatives of CEBS may it be in person, per mail or telephone. If you have questions or comments, please, feel free to contact the representatives of the ECT-Group whose contact details are given below. For further information about the ECT-Group and its activities you may also refer to its website under www.ect-g.de.

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