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»» Response to the Second Consultative Document of the BCBS and the IOSCO
"Margin requirements for non-centrally-cleared derivatives"

Date: : 06/03/2013

Dear Madam or Sir,

We are submitting this comment letter in response to the February 2013 Second Consultative Document entitled Margin Requirements for Non-Centrally-Cleared Derivatives (the "**Consultative Document**"), issued by the Working Group on Margining Requirements (the "**WGMR**") of the Basel Committee on Banking Supervision (the "**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). We appreciate the opportunity to comment on the near-final policy proposals of the WGMR on establishing minimum standards for margin requirements on derivatives not cleared through a central clearing organization.

KfW is one of the largest issuers of bonds and notes worldwide issuing annually 70 to 80 billion Euro equivalent of debt securities in the capital markets under a statutory guarantee of the Federal Republic of Germany (the "**Federal Republic**"). KfW uses derivatives primarily to hedge interest rate and foreign exchange risk arising from its funding and lending business as the Federal Republic's promotional bank. In terms of size and status in the capital markets, KfW thus closely resembles sovereign issuers on the one hand and the large multilateral development banks on the other.

When reviewing the near-final policy proposals we noted that the WGMR suggests exemptions for central banks, sovereigns, multilateral development banks, the Bank for International Settlements, and non-systemic, non-financial firms. However, no explicit exemption is being proposed for public

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sector entities ("PSEs") like KfW which represent the same credit risk as the sovereign in whose jurisdiction the PSE is established, the Federal Republic in KfW's particular case. Based on the arguments presented in the following herein, we think that this is neither justified nor acceptable for entities like KfW.

In this context, we note that, in accordance with Paragraph 58 of the Basel II Framework, claims on domestic PSEs may be treated in the same way as claims on the sovereign in whose jurisdiction the PSEs are established. This is the case for KfW. We therefore respectfully request that either KfW individually or PSEs which satisfy the requirements of Paragraph 58 of the Basel II Framework should explicitly be added to the list of entities exempted from the margin requirements.

1. Background on KfW

KfW was established in 1948 by the Administration of the Combined Economic Area, the immediate predecessor of the Federal Republic. KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organised under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau*, or the "KfW Law"). The Federal Republic holds 80% of KfW's equity capital and the German federal states hold the remaining 20%.

As a German state-owned promotional bank, KfW serves domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities. KfW's lending activities include domestic financing, primarily made through commercial banks, including, in particular, loans to small and medium-sized enterprises and housing-related loans, export and project finance through KfW's wholly-owned subsidiary KfW IPEX-Bank GmbH and development finance for developing and transition countries.

The KfW Law expressly provides that the Federal Republic guarantees all existing and future obligations of KfW in respect of money borrowed, bonds and notes issued and derivative transactions entered into by KfW (Article 1a of the KfW Law¹). Under this statutory guarantee, if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW's obligations mentioned above, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable. The Federal Republic's obligation under the Guarantee of the Federal Republic ranks equally, without any preference, with all of its other present and future unsecured and unsubordinated indebtedness.

Because of the Federal Republic's guarantee and the affirmative decision by the German supervisory authority *Bundesanstalt für Finanzdienstleistungs-*

¹ The KfW Law is available in German language under http://www.kfw.de/kfw/de/I/II/Download_Center/KfW-Gesetz_und_Satzung/KfW_Gesetz_D.pdf and in a non-binding English translation under http://www.kfw.de/kfw/en/I/II/Download_Center/Law_concerning_KfW_and_KfW_By-laws/KfW_Gesetz_E.pdf. In the non-binding English translation, § 1a KfW Law reads as follows: "The Federal Republic guarantees all obligations of the Institution [i.e. KfW] in respect of loans extended to and debt securities issued by the Institution, fixed forward transactions or options entered into by the Institution and other credits extended to the Institution as well as credits extended to third parties inasmuch as they are expressly guaranteed by the Institution."

aufsicht ("BaFin"), as described in more detail in the following paragraph, KfW is a PSE within the meaning of Paragraph 58 of the Basel II Framework.



Under European legislation implementing the Basel II Framework, KfW is a PSE as defined in Article 4 Point 18 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions ("Directive 2006/48/EC"). In a letter dated August 16, 2006, BaFin confirmed that KfW is a PSE in accordance with Article 4 Point 18 of Directive 2006/48/EC and that exposures to KfW, due to the Federal Republic's guarantee, may be treated in the same way as exposures to the Federal Republic in accordance with Annex VI Part I Paragraph 15 of Directive 2006/48/EC relating to the standardised approach. In this context, please note that with respect to the internal ratings-based approach Article 86 Paragraph 2 of Directive 2006/48/EC says that exposures to PSEs which are treated as exposures to central governments under the standardised approach shall be treated as exposures to the central government.

Therefore, both under the Basel II Framework and Directive 2006/48/EC exposures to KfW resulting from derivative transactions entered into with KfW as counterparty may be treated as exposures to the Federal Republic. The risk weight for these exposures is thus zero percent under the standardised approach and may be as low as zero percent under the internal ratings based approach given the ECA risk scores of the Federal Republic.

With respect to the treatment of KfW under Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructure Regulation or "EMIR"), please note that, with the exception of the reporting obligation in Article 9, EMIR does not apply to PSEs as defined in Article 4 Point 18 of Directive 2006/48/EC where they are owned by central governments and have explicit guarantee arrangements provided by central governments in accordance with Article 1 Paragraph 5 *lit. b*) of EMIR. KfW is thus neither subject to the clearing requirement for certain standardised derivatives laid down in Article 4 of EMIR nor to certain risk mitigation techniques - including, but not limited to, the exchange of collateral - required to be applied by Article 11 of EMIR.

Finally, the Commodity Futures Trading Commission ("CFTC"), in its final rule on the End-User Exception to the Clearing Requirement for Swaps², gave guidance to the effect that it does not believe that foreign governments, foreign central banks, or international financial institutions should be subject to the clearing requirement established by section 2(h)(7) of the Commodity Exchange Act³. In this context, the CFTC expressly considered KfW to be included in the term "foreign government" based on - *inter alia* - KfW's status as PSE and the statutory guarantee of the Federal Republic⁴. Therefore, KfW would not be required to clear standardised derivatives through a registered Derivatives Clearing Organization when concluding transactions with U.S. counterparties in accordance with section 2(h)(7) of the Commodity Exchange Act.

² 77 Federal Register 42,560

³ 77 Federal Register 42,562

⁴ 77 Federal Register 42,561, footnote 12

2. Comments on Element 2: Scope of coverage – scope of applicability



No. 2 of the proposed key principles and requirements of the Consultative Document deals with the scope of applicability of the margin requirements. For these purposes, “covered entities” are proposed to be “all financial firms and systemically important non-financial entities.”

We fully agree with the WGMR's approach that the margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempt from central clearing mandates under most national regimes. In fact, (ii) is the natural consequence of (i) in our view.

As mentioned in our response dated September 24, 2012 to the WGMR's first consultative document, we also fully agree with the view taken by the WGMR in its first consultative document that ensuring consistency between entities that are subject to the central clearing obligation for standardised derivatives and those entities that are subject to margin requirements for non-centrally-cleared derivatives is desirable. Requiring entities which are not subject to the central clearing obligation for standardised derivatives to post margin for non-centrally cleared derivatives in order to promote central clearing would not be consistent in itself.

Likewise, we think it would not be consistent with the Basel II Framework if entities the uncollateralised exposure to which may be assigned a zero risk weighting under the Basel II Framework would need to collateralise their counterparties' exposure to them under the margin requirements.

Based on these arguments, we proposed in our response to the WGMR's first consultative document to define “covered entities” to be “all entities that are subject to the central clearing obligation for standardised derivatives”. This wording would have directly taken up in the definition of “covered entities” the underlying rationale of providing an exemption from the margin requirements for entities which are not subject to the clearing obligation for standardised derivatives because they are deemed to not pose systemic risk.

We understand that the WGMR prefers an enumerative list of exempted entities rather than a generic, principle-based definition of “covered entities” as described in the preceding paragraph. For that purpose, we agree with the BCBS and the IOSCO that central banks, sovereigns, multilateral development banks and the Bank for International Settlements should not be subject to the margin requirements for the reasons outlined above.

However, we do think that the list of exempted entities proposed by the WGMR - central banks, sovereigns, multilateral development banks, the Bank for International Settlements, and non-systemic, non-financial firms - falls short in acknowledging that there are a limited number of entities that should be explicitly treated like sovereigns in the context of the margin requirements, namely those PSEs the claims on which may be treated in the same way as claims on the sovereign in whose jurisdiction the PSEs are established in accordance with Paragraph 58 of the Basel II Framework - which is exactly the case of KfW. To not include these PSEs in the list of entities exempted from the margin requirements would result in an

inconsistency of the margin requirements with the Basel II Framework in two respects:



- Firstly, exposures to these PSEs arising from derivative transactions would be treated differently from non-derivative exposures to these PSEs, even though the counterparty is the same. While derivative exposures to these PSEs would be implicitly deemed to be risky for being subject to the margin requirements, a risk weight of zero percent would apply to non-derivative exposures to these PSEs provided that the sovereign carries an ECA risk score of 0 to 1 under the Basel II Framework. The latter would be the case for exposures from investments in bonds and notes issued by KfW, for example.
- Secondly, it directly follows from the aforesaid that the treatment of exposures to these PSEs compared with the treatment of exposures to the respective sovereign, would be inconsistent, too. While PSEs would be subject to the margin requirements, the sovereigns would not. Therefore, PSEs and their sovereigns would be treated differently under the margin requirements, although there is no difference in risk. However, non-derivative exposures to PSEs would continue to be treated in the same way as if they were exposures to the respective sovereigns, in the case of KfW, a zero percent risk weight would apply.

We therefore kindly request the WGMR to reconsider the list of entities proposed to be exempted from the margin requirements and add to this list either KfW individually or PSEs the claims on which may be treated in the same way as claims on the sovereign in whose jurisdiction the PSEs are established in accordance with Paragraph 58, Part II of the Basel II Framework collectively. The latter may be achieved by the following insertions (underlined) to Paragraph 2.4 and footnote 11 of the final policy framework on margin requirements:

Paragraph 2.4:

“Covered entities include all financial firms and systemically important non-financial firms. Central banks, sovereigns, public sector entities, multilateral development banks, the Bank of International Settlements, and non-systemic, non-financial firms are not covered entities.¹¹”

Footnote 11:

“Public sector entities exempted from these requirements are those public sector entities the claims on which, subject to national discretion, may also be treated as claims on the sovereigns in whose jurisdiction the public sector entities are established in accordance with the Basel capital framework (at the time this margin framework is published, see paragraph 58, part 2, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework, <http://www.bis.org/publ/bcbs128b.pdf>). Multilateral development banks (MDB) exempted from this requirement are those MDBs that are eligible for a zero risk-weight under the Basel capital framework (at the time this margin framework is published, see footnote 24 of paragraph 54, part 2, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework, <http://www.bis.org/publ/bcbs128b.pdf>).”

We thank you again for taking our comments and proposals into due consideration.



Sincerely,

KfW

A handwritten signature in black ink, appearing to read 'L. Funke', written over a horizontal line.

Name: Dr. Lutz-Christian Funke
Title: Senior Vice President

A handwritten signature in black ink, appearing to read 'M. Schulze', written over a horizontal line.

Name: Dr. Michael Schulze
Title: Head of Treasury