SO EMIR, SO FAR...

DID THE EUROPEAN MARKET INFRASTRUCTURE REGULATION MAKE YOU WANT TO SCREAM? A YEAR AFTER THE GO-LIVE, MARK RULE REVIEWS HOW IT WENT

ILLUSTRATION: NLSHOP/SHUTTERSTOCK

On 12 February 1994, two men broke into the National Gallery of Norway and, in less than a minute, they had stolen Edvard Munch's masterpiece *The Scream*. Twenty years later, on 12 February 2014, the go-live of the European Market Infrastructure Regulation's (EMIR's) trade reporting requirement caused many a corporate treasurer to resemble that iconic painting. Just over 12 months on, are they more like Da Vinci's *Mona Lisa* or Picasso's *Weeping Woman*?

Background

The financial crisis of 2007/8 and the failure or near failure of large participants in the derivatives market such as Bear Stearns, Lehman Brothers and AIG highlighted to regulators the opaque nature of the OTC derivatives market and the difficulty in determining the true risk position of a given firm at any point in time. The European regulatory response to this was EMIR, which came into force across the EU on 16 August 2012.

What does EMIR require?

- EMIR is designed to catch every EU entity that enters into any form of a derivatives contract. This covers financial counterparties (FCs) and non-financial counterparties (NFCs).
- The more sophisticated the counterparty, the more stringent the reporting requirements.
- From 12 February 2014, each entity must, on a next-business-day basis, report (or arrange to have reported) details of the derivatives contract to a registered trade repository (TR).
- This applies to trades that have been freshly entered into, modified or terminated.
- The reporting process can be outsourced either to the FC or to an independent third party.
- The legal responsibility to report cannot be outsourced.
- All market participants must ensure that they have appropriate risk management procedures to deal with non-cleared OTC derivatives.

Where are we now?

Two key issues to be addressed in the first stages of EMIR reporting were the quantum of trades that had to be reconciled and the consistency of the underlying data.

- Due to the volume of collateral and valuation data that had to be submitted and reconciled, an extension of the reporting start date was required; it was extended 180 days from 12 February 2014 to 12 August 2014.
- Initially, the six recognised TRs used their own standardised data set for trade reporting. Each counterparty to a trade populated a long list of data fields and reported that to a TR of their choosing. The TRs searched the various TR databases for the other side of the trade by using the unique trade identifier, then compared the other data fields until all fields were matched.

As a result of the lack of consistency in populating the

different data fields, there was a very low reconciliation rate, especially between one TR and another. The European Securities and Markets Authority addressed this issue by bringing in its Level 1 Validations directive for all TRs as of 1 December 2014 to update its guidance on reportable fields and proposing changes to its Technical Standards.

Reporting to trade repositories: To delegate or not to delegate

For many NFC entities, it is an attractive and easy option to delegate reporting such that the more experienced party to the derivatives trade (usually the FC) performs the trade reporting requirements on their behalf – especially when such a service is offered on a complimentary basis. But there are some issues that an NFC should consider before opting for this solution:

- NFCs who have intergroup derivative trades are unlikely to be able to delegate the reporting of such trades to an FC.
- Not all FCs offer a delegated reporting service.
- NFCs have certain obligations under EMIR in relation to risk management, which includes the need to have procedures for:
  - Portfolio reconciliation;
  - Trade valuation; and
  - Dispute resolution.

These housekeeping procedures can be of real benefit to a company in that they reduce the operational risk of holding derivative positions. In practice, however, NFC counterparties are rarely in control of the documentation and reporting process, so they rely entirely on their FC to produce derivative contract notes and periodic valuation reports.

An alternative to delegating reporting to an FC is therefore to appoint an independent third party with relevant expertise in derivatives. This provides the NFC with much more control over the reporting process, particularly with regard to independence of valuations and dispute resolution.

CASE STUDIES: MANAGING THE PROCESS

1. Large European utility company with derivative dealings with multiple banks.

- The project started in 2013 with an information-gathering exercise from banks and trade bodies that was managed within treasury.
- It was initially felt that EMIR would be a big headache to introduce and the company didn't understand why what was considered a bank problem should be imposed upon corporates.
- The company became aware of the option to delegate reporting and most concerns disappeared since the majority of swap activity was directly with FCs.
- For its small number of internal swaps, the company decided to use the Depository Trust & Clearing Corporation's (DTCC's) OTC Lite product as the reporting medium.
- At the outset, there were some issues getting the reporting format correct and DTCC seemed to be overwhelmed with the volume of reports.
- Due to the small number of internal trades, the company did not feel it worthwhile to upgrade its treasury management system to one that provided EMIR capabilities.
- Existing headcount was used to manage the reporting requirements.
- The in-house derivative reconciliation process is straightforward, with basic rules to catch large moves in valuations so that the company relies on the banks to get things right.
- Overall, EMIR's bark was worse than its bite and so long as delegated reporting is a free option, then EMIR will remain quite manageable.

"The experience has taught us that for projects like this, it's important to start early, get the right people involved and to use existing relationships – particularly with banks – to your advantage. They are incentivised to make EMIR as painless as possible."
TREASURY MANAGER

2. SME leasing company with few derivative dealings with its bank.

- The company only became aware of the EMIR requirements when seeking new financing via a ring-fenced financing vehicle (RFFV).
- Due to regulatory rules, the costs for the RFFV entering into an interest rate swap directly with an FC were prohibitive.
- It was therefore necessary for the FC to trade with the company and the company to enter into a back-to-back trade with the RFFV.
- Both transactions were captured under EMIR, but the company did not have the necessary infrastructure, nor the in-house market knowledge, to manage the requirements.
- The FC offered the company delegated TR reporting, but it would still be necessary for the transaction with the RFFV to be reported (both by the company and the RFFV).
- During deal negotiations, legal counsel pointed out that the legal responsibility for reporting resided with the company, even with delegated reporting to its FC.
- After careful consideration and clearly driven by the requirement to report the back-to-back trade, the company decided to engage an independent firm to manage its EMIR obligations.

"Once we became aware of the EMIR reporting requirements, we were pleased to find an independent third party that could assist us. This was a one-off transaction that needed ongoing monitoring and we had neither the expertise nor the experience to manage it. So the ability to outsource that capability provided us with a perfect solution."
FINANCE DIRECTOR

Conclusion

The regulator's goal of establishing a warehouse of derivatives trade data has largely been achieved. The success of data submission to these warehouses is mostly due to delegating trade reporting to sophisticated derivative players. Some work still needs to be done to ensure trade matching across TRs, but it is likely this should be resolved with adherence to the Level 1 Validation rules and revised Technical Standards.

More sophisticated derivative users have used EMIR to improve their internal processes and workflows, but, not surprisingly, it is the occasional users of the derivatives market that do not have the time, money or in-house expertise to fully benefit from the discipline needed to comply with the EMIR requirements.

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