THE ROAD TO REFORM

HOW WILL STRUCTURAL TRANSFORMATION OF THE FINANCIAL MARKETS AFFECT CORPORATES? NICK BURGE EXPLAINS

The financial market regulatory reforms coming into effect over the next 12-24 months are far-reaching structural changes. While most of these reforms are targeted at the banking industry and financial institutions generally, there will be a knock-on effect on all users of financial products. What impact should corporate treasurers expect?

The rationale

Changes to the structure of financial markets are typically driven by a mix of four factors: technology; macroeconomic events; the political and broader social climate; and the regulatory framework (the last factor usually being framed by the third).

In the three decades leading up to the watershed of the 2008 financial crisis, changes in market structure were predominantly being driven by huge technological development – both in terms of product sophistication and the scalability of delivery systems. Combined with a relatively lighter-touch regulatory environment, this resulted in broad globalisation of markets along with massive innovation in, and significant growth of, the use of financial products.

But the events of 2008 triggered a turnaround in the factors driving structural change in the markets, and a recalibration of regulation. The G20 leaders' response to the financial crisis – clarified at the Pittsburgh summit in September 2009 – was to make markets safer, more transparent and better regulated, setting the context for subsequent reforms. These goals are supported politically and socially, with the result that technology, while important, is no longer in the driving seat. Instead, it plays a supporting role in reshaping how the markets operate and fulfilling the objectives of the regulations that are now determining structural change.

The core elements of the major regulatory reforms across the markets – despite being implemented under different sets of national and regional legislation and at differing speeds – contain some or all of the following elements:

- **Increase in banks' (and some other institutions') capital requirements and imposition of liquidity coverage ratios;**
- **Structural change to banks;**
- **OTC derivatives market reform;**
- **General reforms of markets for other traded products;**
- **Possible financial transaction taxes in certain jurisdictions; and**
- **Other industry-specific reforms (for example, insurance and alternative funds).**

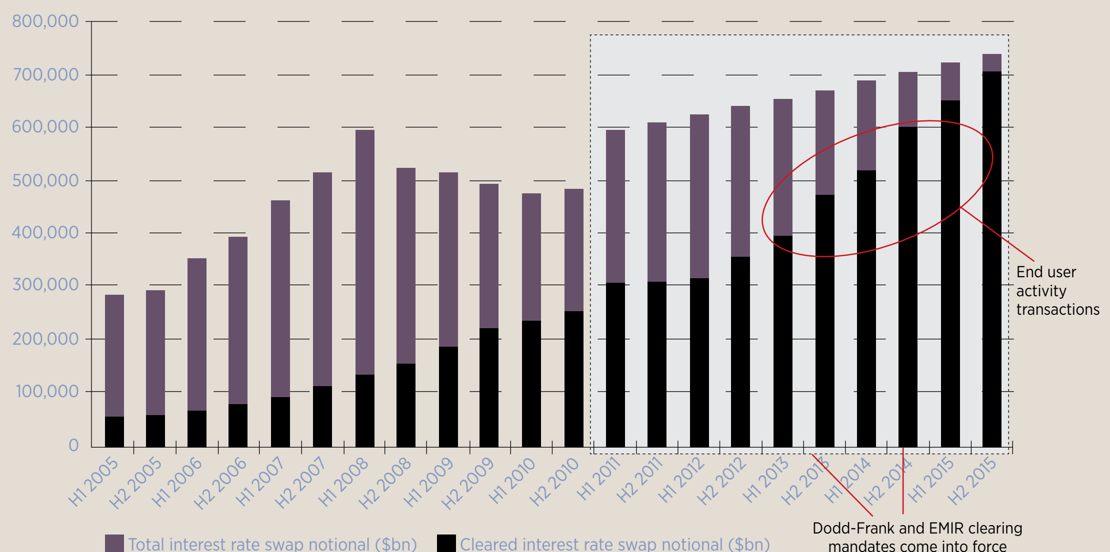
In the US, for instance, market and financial industry reforms are wrapped up in the all-encompassing Dodd-Frank Act of 2010. Some elements of this Act began to take effect from October 2012, and more will follow, having a cumulative impact through 2013 and 2014.

A European lens

In Europe, which the rest of the article will focus on, the changes are coming through a series of regulations and directives, the key ones being the Capital Requirements Directive IV (Basel III); the European Market Infrastructure Regulation

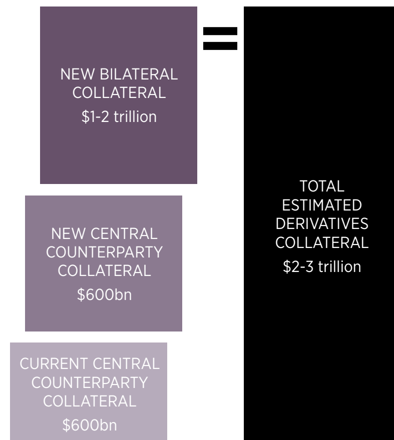
VOLUME MIGRATION – GROWTH OF CLEARED VS NON-CLEARED VOLUMES (LLOYDS BANKING GROUP ESTIMATES FROM H1 2011)

(SOURCE: LLOYDS BANK, 2013)



INCREASING DEMAND FOR COLLATERAL COVERING OTC DERIVATIVES

There will be a huge increase in demand for eligible collateral driven by central clearing and mandatory bilateral margining of non-cleared derivatives, which will be incremental to existing demand for collateral securing central bank financing schemes, etc.



(SOURCE: LLOYDS BANK, 2013)

(EMIR); the Markets in Financial Instruments Regulation and Directive (MiFIR/MiFID II); Solvency II; and the Alternative Investment Fund Managers Directive (AIFMD). In addition, there is a growing set of national and regional initiatives, including ring-fencing proposals put forward by the UK's Independent Commission on Banking (ICB) and Erkki Liikanen in Europe, as well as various countries' plans for new financial transaction taxes.

While some of the details of these regulations are still to be finalised, the direction of travel is clear and change is beginning to take effect. Corporates will see (and already are seeing) the imposition of higher capital requirements and liquidity coverage ratios on banks impacting the pricing of some loans and other credit products – including derivatives – as well as the availability of long-duration financing/exposure products. At present, this impact may be partially masked by both the high cash balances held by corporates and low economic growth, leading to reduced demand for financing. Also, the enhanced supply of funding in the form of various central bank special lending schemes, such as the UK's Funding for Lending programme, as well as the broader effect of quantitative easing in its various guises, may be helping to conceal the repercussions.

Many corporates are focused on the reforms to the OTC derivatives market, which take effect this year under EMIR. They are then looking ahead to the reforms of the broader operating structure of bilateral markets in 2015 with MiFIR/MiFID II, which will impact all users of derivatives. EMIR requires (as does Dodd-Frank Title VII) that all eligible OTC derivatives are cleared, where a clearing capacity exists, through a regulated clearing house or central counterparty unless a specific exemption applies. The European Securities and Markets Authority will determine which specific derivative contracts are mandated for clearing that is expected to begin in summer 2014. There are some specific products exempt from the clearing requirement – most importantly cash FX. But in practice, most derivatives, in volume terms, will migrate to central clearing, with interest rate products in the first wave.

Under EMIR, corporates – known as non-financial counterparties (NFCs) – are exempt from the clearing requirement if they can demonstrate that their derivative use is to hedge commercial exposures (ie it covers the risk arising from the normal course of business; it covers indirect risks; or it is consistent with the IFRS hedging definition).

If this is not the case, there are simple aggregate notional limits (for example, €3bn for interest rate and FX derivative contracts), which corporate treasurers ought to be aware of. If breached, these limits move the corporate (NFC) into a so-called 'NFC+' category. What this means is that the corporate will be subject to mandatory clearing in line with financial counterparties. Recent estimates suggest that there are between 150-200 corporates in Europe that will be deemed NFC+.

What is more, NFC+ entities will also be subject to the mandatory bilateral margining regimes that are currently being finalised for non-clearable derivatives. As with cleared derivatives, these will require initial as well as variation margin to cover the potential future risk and realised valuation changes on derivative positions.

As such, NFC+ corporates subject to clearing and/or bilateral margining will join the queue of market participants demanding high-grade eligible collateral. While the absolute size of this demand is a matter of hot debate, the scale is not disputed – it runs into the trillions.

Clearing and bilateral margining come with cash management consequences, as well as significant operational and technical demands. But higher operational and technical requirements to access and use financial markets products will be a theme for all corporates, even those exempt from clearing and/or margining.

During 2013, EMIR will require all derivative users to start reporting transaction details to central regulated trade repositories. Reporting of interest rate and credit derivatives is slated to begin in September. Most corporates will look to their banks to provide this, and related, services for them.

In addition, there are other operational risk mitigation requirements under EMIR for all contracts. These include reduced timelines for finalising trade confirmations and regular schedules for portfolio reconciliation with counterparties (geared to entity type and size of portfolio).

It is currently anticipated that from 2015, MiFIR/MiFID II will bring in reporting requirements for a broader range of activities and products. There will also be greater prescription around the regulation of trading venues and the structures that trading markets operate under. This includes the requirement that cleared derivatives are traded on organised trading facilities rather than bilaterally.

Conclusion

All corporates, if they haven't already begun, need to consider how they will achieve compliance with the regulatory reforms that directly affect them and what the cost of compliance is likely to be – both for their organisation and their banking partners. The compound impact of these regulatory initiatives will affect both the pricing of financial services for corporates, as well as the structural and operational mechanisms through which various financial services are delivered. Those that haven't yet focused on the coming changes should find their bank a first port of call for guidance.

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