MORE ON DERIVATIVES

These pages tend to concentrate on aspects of treasury that are changing – sometimes imminently, such as the regulation of derivatives; at other times further in the future, such as the financial transaction tax. Those who put these changes into practice can find the dilemma is assigning priorities. The near-term urgent issues just have to be dealt with now, but perhaps the longer-term changes and needs are actually more important? Recall the 'Five Ps': Proper Planning Prevents Poor Performance.

Martin O'Donovan is ACT deputy policy and technical director @MartinODonovan1

{ IN DEPTH }

EMIR TRIGGERS ISDA CHANGES

All companies, except those with sizable financial trading activity, will probably escape the legal obligation to pass derivatives through a central counterparty as required by the European Market Infrastructure Regulation (EMIR). Even so, all companies transacting in derivatives must urgently prepare for the other, more procedural, requirements that are already coming into force. Documentation will need to be updated and processes agreed for reporting all derivatives to a central trade repository.

In the first instance, banks will want to amend International Swaps and Derivatives Association (ISDA) agreements with companies to include representations from non-financial counterparties (NFCs) as to their status under EMIR. In other words, are you an NFC or are you over the clearing threshold and thus categorised as an NFC+? For those active enough to fall into the NFC+ group, the ISDA agreement will need to add in provisions covering the obligation to submit deals for central clearing, and, potentially, whether any pricing adjustment is needed if a non-cleared deal has to be cleared. ISDA has published the *ISDA 2013 EMIR NFC Representation Protocol*, which provides the mechanism to amend all existing agreements. The protocol is drafted so that if any misrepresentations as to status occur, then they are treated as 'additional termination events', and not as 'events of default'.

ISDA has also prepared a *Timely Confirmation Amendment Agreement*. This is needed because EMIR imposes an obligation for the parties to a derivative to exchange confirmations within certain timescales (the five-day deadline for credit default and interest rate swaps has been in force since 15 March 2013), but to complete any confirmation, each party is dependent on the timely action of the other party. Of particular note is the option within the agreement to allow for negative affirmation, meaning that the bank can take a confirmation as agreed if it hears nothing back from the customer after a certain time. Negative affirmation is not a good control process, so companies will have to decide if this is acceptable.

Yet more paperwork will be required by September 2013, when the obligation arises to have written procedures covering reconciliations and disputes agreed between the parties. At the same time, the reporting requirements for credit and interest rate derivatives are also expected to start, even though many of the arrangements needed to make this happen are scarcely in place.

Further confusion exists around exactly what counts as a derivative subject to EMIR. The Financial Conduct Authority (previously the Financial Services Authority) has a web page entitled 'EMIR – what you need to know', which explains that FX forwards are not in scope unless caught by the Regulated Activities Order, namely done for investment purposes rather than commercial purposes. This definition of a derivative is taken from the Markets in Financial Instruments Directive, which has been implemented and interpreted slightly differently across European member states. At the time of writing, it is the Financial Conduct Authority's additional perimeter guidance that takes FX forwards out of scope, and similar guidance does not exist in other countries.

YOUR SHOUT

Watch out for proposals to move money market funds to a variable net asset basis, which are expected from the European Commission in early May. Please share your views with us by emailing technical@treasurers.org

{ INTERNATIONAL }

FINANCIAL TRANSACTION TAX

The proposed financial transaction tax (FTT) applies to financial transactions to which a financial institution (FI) is a party if at least one of the principals is established in the FTT zone (ie the 11 EU member states that have opted in, including France and Germany) with each financial party to the transaction suffering the tax. Note the Netherlands may also opt in if pension funds are exempt, so this could increase to 12.

Financial institutions include the obvious banks and insurers, but also comprise pension funds, leasing companies and any other entity if more than half of its turnover consists of financial activities – hence a finance/ treasury subsidiary set up in Belgium, or potentially the Netherlands, could itself be liable to pay FTT on its transactions, both with FIs and its own group companies.

The amount of FTT tax that a treasury subsidiary will be liable for should not be underestimated. Any back-to-back hedge between a Belgium treasury company and its UK-headquartered company will result in a minimum FTT charge of 0.02% of the notional amount. For example, a €100m FX forward between a FTT-zoned bank and a Belgian treasury subsidiary that is passed through to the UK group company will require the treasury subsidiary to pay FTT of €20,000 (0.01% of notional for each transaction) at inception and every time it is rolled forward. And this ignores the 'cascade effect' of additional FTT tax paid by the counterparty bank and other intermediaries in the transaction. Some of this will no doubt be passed on to the corporate end user.

View the following technical updates, blogs and policy submissions at www.treasurers.org

Loan documentation – change to 'Screen Rate' definition

ESMA, March 2013: Q&As on OTC regulation implementation

Blog – wholesale bank deposits made hot money

{ WATCH THIS SPACE }

DON'T NEGLECT LONG-TERM FINANCE

"Many decisions taken in today's stressed environment are likely to be focused on responding to short-term pressures rather than adapting to long-running challenges." These wise words, which were taken from the Financial Conduct Authority *Risk Outlook 2013*, have been somewhat redressed by recent papers from the European Commission and the International Financial Stability Board, each of which are reviewing long-term financing for business investment.

It is no surprise that the Commission recognises as important the question as to whether Europe's historically heavy dependence on bank intermediation in financing long-term investment will give way to a more diversified system with significantly higher capital markets contribution. The Commission is also interested in knowing whether businesses share its concern that investment projects need access to more equity rather than debt. Further important questions are raised on the cumulative negative effects of regulatory reforms, on availability of SME finance, and on the role of taxation and government initiatives.

{ TECHNICAL ROUND-UP }

PENSIONS, PAYMENTS AND BASEL III

Following the UK Budget in 2013, the Pensions Regulator will be given a new duty. The Regulator will need to provide support to 'scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer and fully consistent with the 2004 funding legislation'. The precise wording of this new objective will be set out in legislation that the Department for Work and Pensions will publish later this year, but quite how different this approach will be compared with existing practice remains to be seen.

The governance of UK payments is under review by HM Treasury. In summer 2012, the government was proposing to move away from the existing industry-run strategy set up by the Payments Council and instead to introduce a new public body, the Payments Strategy Board. Self-regulatory failures elsewhere have now led the government to conclude that this option would not deliver its aims, and that these would be best achieved by bringing payment systems under a new regime of economic regulation with a new competition-focused, utility-style regulator for retail payment systems. Past failures to give proper weight to end-users' views are to be addressed.

CRD IV, the Capital Requirements Directive and Regulation, which implements Basel III in Europe, has been agreed between the European Parliament and Council. Subject to certain formal approvals, the text is expected to be published in the *Official Journal* by 30 June 2013, so that the new rules will apply from 1 January 2014. The agreed text includes an exemption from the 'own funds' requirement for credit value adjustment risk for transactions with non-financials as defined in EMIR and for non-financial companies outside the EU whose transactions do not exceed the clearing threshold in EMIR. The ACT, which had earlier made representations to the Economic and Monetary Affairs Committee of Parliament and through the UK representation on Council, welcomes this change since it removes an additional capital cost on derivatives.