RULES AND REGULATIONS

As I celebrate my two-year anniversary of working with the ACT, I am reminded not only of the economic challenges and market scandals, but also the numerous regulations proposed as a result. EMIR, Basel III, the CRD IV capital requirements framework, the International Organization of Securities Commissions' margin requirements... the list goes on. The latest update on ESMA's rules, Erkki Liikanen's proposals and Martin Wheatley's recommendations, I have summarised below.

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{ IN DEPTH }

ESMA ISSUES FINAL DRAFT TECHNICAL STANDARD

The European Securities and Markets Authority (ESMA) has published its final draft technical standard on OTC derivatives, central counterparties and trade repositories. This details how the European market infrastructure regulation's (EMIR) requirements are to be implemented.

HEDGING DEFINITION

EMIR recognises that non-financial counterparties (NFCs) use OTC derivatives as hedges. As a result, OTC derivative contracts that do not exceed the clearing thresholds are not subject to clearing, but if a threshold is exceeded, all future OTC derivatives must be centrally cleared, no matter whether or not they are hedges. The clearing thresholds remain at the levels set in the consultation paper, ie €1bn gross notional value for credit and equity derivatives and €3bn gross notional value each for interest rate, FX and commodity derivatives.

When calculating if the clearing threshold has been exceeded, only OTC derivative contracts that are not hedges are included.

ESMA defines hedging as "objectively measurable as reducing risks directly related to its commercial activity or treasury financing activity or that of its group". Proxy hedging is allowed and a recent amendment now clarifies that portfolio hedging is permitted and OTC derivatives that offset hedging contracts would also qualify as hedging. This avoids having to include in the threshold calculation derivatives entered into to offset redundant hedging contracts. ESMA has also clarified that employee benefits, such as stock options and acquisitions, would be covered by the hedging definition. Derivatives that are hedge accounted under IFRS are deemed to be hedges.

RISK MITIGATION FOR OTC DERIVATIVES NOT CLEARED BY A CENTRAL COUNTERPARTY (CCP)

The requirement for timely trade confirmation will now be phased in with the end goal timing as the business day following executions for NFCs above the clearing threshold, and the second business day following execution for NFCs below. Trade confirmation execution may be delegated, but this does not remove responsibility for compliance.

ESMA has also agreed to differentiate the frequency of reconciliation of non-cleared OTC derivatives for NFCs below the clearing threshold. For portfolios of 50 or fewer OTC derivatives with any one counterparty, the monthly reconciliation has been replaced by a quarterly one.

EMIR reporting requirements are designed to improve transparency and supervision

REPORTING OF DERIVATIVES TO TRADE REPOSITORIES

EMIR reporting requirements are designed to improve transparency and supervision. It is ESMA that has responsibility for defining the details of derivatives that need to be reported to trade repositories. All derivative transactions must be reported and it is expected that this will include intra-group derivatives. Banks could potentially report external derivatives on behalf of NFCs, but they won't have the visibility to a group's intra-group transactions to be able to report these. ESMA has also clarified the reporting of mark-to-market values is not applicable to NFCs that are under the clearing threshold.

YOUR SHOUT

How are market and regulatory developments affecting corporate appetite for derivatives? Has your organisation changed how it uses derivatives to manage risk due to increased pricing? Tell the ACT policy and technical team. Email: modonovan@treasurers.org or mprice@treasurers.org

{ INTERNATIONAL }

EU BANKING SECTOR REPORT

In November 2011, Erkki Liikanen, the governor of the Bank of Finland, was appointed chair of a high-level expert group set up by the European Commission to examine possible reforms to the EU's banking sector. His report, published last month, makes five recommendations:

- In a proposal similar to the Vickers report, proprietary trading and other significant trading activities should be ring-fenced in a separate legal entity, separating it from the less risky, deposit-taking activities of the bank. This would apply if a bank's assets held for trading and available for sale exceed a threshold of 15-25% or €100bn.
- Effective and realistic recovery and resolution plans must be drawn up and maintained by the banks.
- 'Bail-inable' instruments are strongly supported and banks should build up a sufficiently large layer of such debt. But the position of bail-in instruments within the debt hierarchy must be clear so investors know their treatment in case of resolution.
- More robust risk weights should be applied in the determination of minimum capital standards and more consistent treatment of risk in internal models. Also, given the role that property bubbles have played in historical crises, the capital requirements for real estate lending should be reconsidered, as well as maximum loan-to-value and/or loan-to-income ratios applied.
- Existing corporate governance reforms should be enhanced, including a share of bankers' bonuses to be in the form of bail-in bonds, and an assessment of the impact of restricting bonus levels is recommended.

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

ACT response to setting the strategy for UK payments

ACT input into European Parliament's consultation on market manipulation post Libor

ACT response to banking reform white paper

ACT response to proposed General Anti-Abuse Rule (GAAR)

{ WATCH THIS SPACE }

THE ACT SUPPORTS THE WHEATLEY REPORT

The Wheatley report on the future of the London Interbank Offered Rate (Libor) was published in late September. The ACT and European Association of Corporate Treasurers (EACT) submitted responses and we are pleased that the report's conclusions are very much in line with our representations. Wheatley suggests a balance between banks submitting actual trade data and using judgement by having to verify submissions against transaction data, but also recognising that in the absence of transaction data relating to a specific Libor benchmark, expert judgement should be used to determine a submission. To reduce reliance on judgement, Wheatley also recommends, and the ACT supports, a widening of the Libor definition to reflect the rates banks pay on their funding from the wider wholesale money markets and reducing the number of Libor published benchmarks from 150 to 20. It remains to be seen how contributor banks will be encouraged to make Libor submissions given that this is to become a regulated activity with the potential for criminal sanctions.

{ TECHNICAL ROUND-UP }

HEDGING, EUROBONDS AND GOVERNANCE

A staff draft on the general hedge accounting section of IFRS 9, *Financial Instruments*, has been published by the IASB. It is based on the proposal in the December 2010 exposure draft, with key changes being the increased eligibility of both hedged items and hedging instruments, and the removal of the 80-125% 'bright lines' in hedge effectiveness testing. When finalised, the intended effective date is financial years beginning on or after 1 January 2015. For more on hedge accounting, see page 28.

HMRC has backed down on its proposals to abolish yearly interest and restrict the interest on eurobonds exemptions following input by the ACT. These proposals were outlined in its consultation on possible changes to the income tax rules (March 2012), but following feedback, they will not be taken forward. The ACT's response can be found at www.treasurers.org/node/7985

The Financial Reporting Council has announced changes to the *UK Corporate Governance Code*. These include mandatory tendering of external audit contracts for the FTSE 350, and audit committees having to explain how they have carried out their responsibilities, including how they have assessed the effectiveness of the external audit process. See www.tinyurl.com/9dy7h5y

Changes to the method of calculating the retail prices index (RPI) are being considered by the Office for National Statistics (ONS). These could reduce the RPI so that it comes in closer to the consumer prices index. For regulated industries, their allowed price rises could be down as much as ¾% and the repercussions could flow through to any contracts referencing RPI. Provide feedback to the ONS before the consultation closes on 30 November.

A report of the Financial Reporting Lab's 'Net debt reconciliations' project has been published by the Financial Reporting Council. The report shows how some companies are defining net debt and disclosing various cash and non-cash movements in net debt that may not otherwise be apparent from the financial reports. See www.tinyurl.com/8z73kuv