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The Association of Corporate Treasurers

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Comments in response to:
ESMA discussion paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine* and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this discussion paper, but has restricted its comments to those sections on non-financial companies.

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In formulating the detailed level 2 technical standards it is important always to have in mind the purpose of the EMIR legislation which was to reduce the systemic risk arising from the web of connectedness that derivative exposures can create. In the drafting of EMIR it was recognised that the derivative activity of non financial companies is a relatively small proportion of outstandings and not a significant contributor to systemic risk. The granularity of companies and the much reduced correlation between them as compared to financial companies means that even large exposures in a single company are unlikely to be of systemic relevance. There are vastly more individual non financial companies in existence as compared to the much smaller number of financial institutions.

The ACT believes that the technical standards should be set with the aim that the vast majority of companies must be totally outside the EMIR provisions so that the burdens of administration and any enforced procedures on the real economy are minimised.

The recent extension of the date for finalising the technical standards to 30 September appears sensible given the volume of work to be completed by ESMA, but this obviously reduces the period for implementation of the standards to three months. The number of questions and the level of detail seen in the three discussion documents released to date indicate that there are still a number of conceptual, as well as technical issues to finalise. We wonder if even the new timetable will give you enough time to consider all the issues.

As regards implementation, is there any consideration being given to an extension to the implementation date? We would in any case suggest at least an observation period of say 12 months prior to full implementation to allow companies a reasonable period to ensure compliance with all aspects of the regulations once the technical rules are finalised? This is a particular concern to non-financial entities. The regulations have of course, and rightly, been drafted primarily with the financial services industry in mind. Non-financials will almost certainly be required to make amendments to existing systems and processes. These were almost certainly not designed with end-user clearing, margining or reporting requirements in mind, or the need to track activity against categories of thresholds as considered in EMIR. In addition end users may need to put in place or amend legal agreements with financial counterparties that take account of the final technical standards. This at a time when companies are generally seeking to reduce their exposure to banks (which, for many companies, will be of lower credit standing than the company itself) which overlays another layer of complication.

Regulation of derivatives is progressing in the US as well as in Europe, so there remains a danger of conflict in the absence of agreement between US and EU authorities and potentially those elsewhere too eventually. Companies need to be able to in apply some very simple rules setting out a clear decision tree as to which regime applies for any particular transaction – including external transactions of US and other third country group members and transactions between those companies and group members within Europe.

Comments on specific questions

Non-financial counterparties (Article 5/7)

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

For convenience we refer to EMIR hedges or counting as hedges for EMIR purposes and by that mean "contracts [that] are objectively measurable as reducing risk directly related to the commercial activity or treasury financing" as clarified in the draft technical standards.

Summary points:

- Companies largely hedge cashflows yet this sort of hedge is not clearly defined as "…. reducing risk…." for EMIR purposes
- It is important that
    - hedges of hedges and transactions for the purpose of unwinding or partially unwinding existing hedges,
    - longer term, strategic hedges and

    - proxy hedges should, even if effectiveness is not perfect but at a commercially acceptable level

  still count as hedges for EMIR purposes and if there is any ambiguity in drafting this should be made clear
- Provision should be made for elimination in estimating volumes for threshold purposes of "double counting" of hedges
- The proposed caveat that EMIR hedges must be "in the ordinary course of its business" should be deleted unless it is defined very widely
- The list of EMIR hedgeable risks (interest rates, inflation rates or foreign exchange rates) is too restricted and, in any case, not future proof, and should be deleted, there being no benefit from restriction.

For non financial companies their use of derivatives is driven largely by the need to hedge. For that reason we provide below some extended discussion of how a typical company might be using derivatives.

Most non financial companies will have a treasury policy which says that the company may only engage in derivatives for hedging purposes and that speculation is prohibited. While these sorts of policies are not always tightly defined the intent can generally be interpreted as meaning that any transactions must be related to some genuine need within the business and that the amounts transacted must keep the derivative exposures within the envelope of current and expected business needs. In simplistic terms a company with no exposure to gold would regard dealing in gold futures as speculative (though gold derivatives might be used as a proxy to hedge some other risk in the company's business - see below) and a company with £100m of borrowings that was expected to grow to £200m would not enter into net interest rate derivatives in excess of £200m nominal.

However, in the latter case the *gross* derivatives could exceed £200m and still be hedging. For example the company might raise borrowings of £200m from a fixed rate bond ahead of the final decision to make a new investment. Pending that investment it would be less risky to swap the bond proceeds into floating rates. At the time of making the new investment and undertaking the investment appraisal the then market interest rate might be used in the appraisal and for that reason it be decided to lock into that rate by swapping back into fixed, meaning that there were £400m of gross swaps on the books. (The business operating cashflows may themselves have a strong linkage to interest rates which warrant some further interest rate hedging but this is ignored in this simple example. The ability of a housebuilder, for example, to make sales is very dependent on the level of mortgage interest rates which generates a further interest rate exposure which the company may decide to manage.)

The ESMA proposed definitions in para 29 probably covers this circumstance where there is a hedge of a hedge but for clarity it would be helpful to replicate some of the US wordings to make it clear that use of a derivative to hedge or mitigate the risk of another derivative which itself is used to hedge or mitigate a business risk is still "hedging".

The definitions proposed by ESMA in para 29 focus very much on changes in "values" of assets and liabilities and so on. This orientation is perhaps to be expected in legislation aimed at the financial markets. However non-financial companies are far more concerned with hedging cashflows contracted for and also cashflows that are merely expected. To the extent that a cash inflow is a future asset the definition clearly covers changes in values of that asset but in the case of a cash outflow it is less clear that the definition caters for it. A cash outflow is not itself really a liability: it is extinguishing a liability. Some additional clarity around the definitions is required here.

The definition in 29a includes changes in the values of services and inputs. With these a company can be said to "buy" or "use" them. It would be helpful to add the verb "uses" to the list in this paragraph.

Companies hedge cashflows from future sales or purchases where there is a foreign exchange risk or where the flows are dependent on, say, interest rates. These cashflows may be contracted for or may simply be expected. Forecast exposures might be regarded as speculative especially if they are very far into the distant future as the future is inherently uncertain. However we believe the definitions in para 29 which cover exposures which the company "reasonably anticipates" are adequate to cater for this. Again for clarity one might add "having regard to the nature and circumstance of the non financial counterparty's current or forecast business". For some businesses hedging expected transactions 20 years forward would be speculative whereas for a utility-like business (including, for example, the maintenance of long-life equipment) this might be perfectly valid.

The "reasonably anticipates" wording is clearly intended to cater for those future forecast of expected transactions, assets or cashflows, but we have concern as to whether some ambiguity could arise. One meaning of anticipate requires some action to have been taken in respect of the future expectations; in which case the wording is too narrow. A company may expect to sell its product abroad in three years time and want to hedge the FX risk, but it might have taken no actions to anticipate that sale, it has not yet ordered the raw materials it has not yet run its marketing campaign etc and therefore it might be said that that sale is not "anticipated" even though it is expected. The FX forward transaction to hedge that sale is nonetheless still a reasonable hedge and not a speculation. Of course, building a factory with an expected 20-year life might be seen as action taken to "anticipate" sale demand for the product over that period.

Normally a company's derivatives are reasonably linked to an actual or specific expected exposure, but on other occasions a company may wish to take a more strategic hedge where the linkage is more general – though still directly with the business. An example might be to a company which buys various metals as raw materials. You could conceive that some specific metals might not be readily hedged in which case the company uses some sort of basket of metals or metals index as its proxy strategic hedge. Or, a company planning an acquisition may take out hedges on a sector rather than an actual company name. A transport company or a buyer of plastic mouldings with a significant fuel cost/oil component to its business may take out a hedge on crude oil rather than petrol or aviation fuel or plastic and this properly counts as a hedge for EMIR purposes.

Political/country risk may be important for some businesses but not be directly hedgeable so that, instead, a position is taken in the relevant government bonds or CDS as a proxy. Given that the para 29 definition refers to the company having its "objective [is] to reduce the following risks", clearly the *objective*, even if an imperfect hedge, is still sufficient to count as a hedge for EMIR purposes.

One of our members had a further example of proxy hedging. It operates in a regulated industry for which price rises were allowed by reference to inflation as measured by the RPI index. It took out an RPI hedge. Subsequently, its regulatory formula was changed to be indexed off an alternative inflation measure – the CPI index. Nonetheless because of the correlation between RPI and CPI it decided to keep its RPI hedge in place. This should still count as an EMIR hedge, and indeed it does because its *objective* is still validly covered.

The EMIR includes the wording "objectively measurable as reducing risk directly related to the commercial activity or treasury financing". In the context of managing interest rate

risk one could debate which of fixed rate, floating rate or index-linked is least risky. One treasury approach is to reduce risk through diversifying risk and in this example by including a mix of rate characteristics. We believe that diversifying risk would count as a valid EMIR hedge and would meet the objective test but if there is any ambiguity clarification will be essential.

Within para 29a there is an over-riding caveat that the changes in value referred to are "in the ordinary course of its business". Assuming that this applies to the entire list of sources of change in value this would exclude a material amount of hedging activity carried on by most companies. We have in mind acquisition and disposal activity of businesses, companies, or groups or substantial assets and liabilities where the transactions are not in the ordinary course of business (as sometimes defined) but yet are intimately related to the business and what might be major step changes in the business. Given that acquisitions and disposals etc. can be time consuming to complete or are planned long ahead as part of a strategic plan the need to pre hedge value or exchange rates or financing costs etc can be crucial to success.

Another example might be the hedging of dividend flows. Dividend payments are often regarded by lawyers as not in the ordinary course of business, and likewise various capital reorganisations or reconstructions and intra group transactions are not regarded as in the ordinary course of business. Nonetheless we regard this sort of hedging as perfectly valid and not speculative. Income from trade investments should also not fall outside the ordinary course of business restriction

We recommend that the proposed caveat that EMIR hedges must be "in the ordinary course of its business" should be deleted. If not deleted then, to avoid possible narrow interpretations by national courts, the definition of ordinary course of business should be specified as including dividends paid and received, capital reorganisations , mergers acquisitions and disposals, significant capital and property (including real and moveable property and intellectual property, not confined to patents and registered intellectual property) acquisitions and disposals, income from trade investments and licences etc

In para 29b the additional triggers for a change in value to be 'hedgeable' for EMIR purposes are stated to be "resulting from fluctuation of interest rates, inflation rates or foreign exchange rates". This is a very narrow range of drivers of value. Hedges already exist and are used in connection with property values, commodities, weather, longevity, credit risk, energy, carbon pollution permits and political risk to name but a few. The financial markets have developed products that can hedge all manner of risks arising in a business and there is no reason to doubt that they might develop further as the world changes and needs arise or are recognised - perhaps GDP hedges, hedges on values of licences or other rights, catastrophe impacts or whatever.

In some respects para 29b is not really required since a company may validly hedge *any* drivers of value or cashflow change. It might be more helpful as a non exclusive list of examples.

Para 30 helpfully adds that transactions qualifying as hedging for IFRS purposes are certainly hedges for EMIR purposes. Our reading of paras 29 and 30 are that para 30 is an additional case of an EMIR hedge rather than a proviso that the transactions in para 29 must **also** qualify under IFRS to achieve the EMIR exemption, but it would be helpful to clarify this. It is important for non financial companies that the EMIR definition is not restricted to the IFRS definition since many companies choose to avoid the administrative burden of demonstrating IFRS effectiveness and do not claim hedge accounting even though the objectives of the transactions are truly hedging. Hedge

accounting for inflation risk, for example, can be difficult to achieve but as the ESMA paper already mentions inflation is a valid risk to hedge.

In the same vein we note that para 29 starts with the wording "by reference to European accounting rules". For reasons explained immediately above hedging is concerned with the commercial impact and not usually with the accounting effects[1]. We recommend the words "by reference to European accounting rules" be removed.

To the extent that a reference is made to accounting standard this should also refer to any subsequent amendments or revisions to the standard, particularly since IFRS 9 on hedge accounting is currently in the process of coming into being.

As a general principle we do not believe that regulations should be drafted around accounting standards.

Clearing Threshold

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

Given that EMIR is being created to reduce systemic risk the ACT firmly believes that its implementation should not impact on businesses whose activity is clearly not going to be systemic. There will certainly be some level of non-hedging and non-cleared deals that are immaterial to the "system" and these could be very large given the huge volumes outstanding in the derivative markets overall.

Certainly for smaller or medium sized companies there should be no question of their being brought into the rigours of mandatory clearing – it would be a totally unnecessary burden and of no benefit to the "system". It would also ease the overall cost to the economy of implementing EMIR if a large number of non-risky sized companies could be excluded from even having to go through the procedures to demonstrate that their transactions are hedging for EMIR purposes.

In the US FX spots and forwards are excluded completely from mandatory clearing. We ask that in reviewing asset classes to be covered by EMIR, ESMA should consider whether an equivalent carve out for FX spot and forwards would be appropriate in Europe too.

The US threshold for the substantial position test for becoming a Major Swap Participant would be a daily average current uncollateralized exposure of $1 billion in each of the three applicable major category of swaps(credit, equity and commodity), except that the threshold for the rate swap category(interest rates and FX rates – here FX swaps not spots and forwards) would be $3 billion. There is a second test taking in future potential exposure arising from positions with doubled limits.

These limits cumulate to $6bn (plus, of course, unlimited FX spots and forwards). At June 2011 the BIS data for OTC derivatives (all categories) was $707,569bn which puts a threshold of this order of magnitude into perspective, as still being immaterial. And for

[1] One would only hedge accounting effects in special circumstances – for example if it were necessary to be

non-financial companies where the inter-connectedness is much less than within the financial sector the limit could safely be set much higher.

These comments on thresholds have been based on notional amounts of swaps, however the credit risk is dependent on the mark to market valuation of those swaps plus possibly an allowance for future movements (value at risk) so “exposure” would be a better measure. Typically the exposure on a swap will largely depend on the volatility of the underlying and on the maturity and could easily fall into a huge range from 0% to say 40% of notional so it would be fair for exposure limits to be much lower than notional limits. For ease of application, and assuming that the thresholds are reasonably set, notional limits would be easier to operate with and would be less prone to breach of limits due to market moves rather than derivatives activity. We therefore accept that use of notional would be more straight forward and should be acceptable assuming the limits are set accordingly high.

Notional limits do have drawbacks from the grossing up of many short time period transactions as compared to doing a single long period transaction. An example here might be a company that chooses to manage its interest rate exposure by entering into a series of three monthly FRAs (forward rate agreements) rather than executing a single 5 year swap. Equally a swap may be broken into time periods in order to deal different time periods with different banks, so to add up the notionals is to multiple-count. Or what could be a single cross currency interest rate swap could be broken into a currency swap with a separate interest rate swaps. This sort of effect can be easily dealt with by allowing elimination of double counting in the technical standards.

Para 34 debates whether limits should apply separately to separate asset classes. Given the risk of any credit scares and systemic risks transferring across asset classes we accept it is reasonably to apply limits across all asset classes.

Para 35 debates whether limits should apply per legal entity or by group. The more correct approach may be to recognise the independence of legal entities and the limited liability concept in groups. However for many non-financial groups there is a common purpose and interdependency between group companies in practice. Taking the pragmatic point of view, we accept that limits should apply to groups.

However if limits are set too low there is a danger of inadvertently tripping a group limit through a subsidiary dealing and perhaps forgetting to claim hedging status. Taking the group approach with one limit would only work if the limit is not set low. Likewise there is the downside that a group that exceeded the limit would then trigger the need for every subsidiary, however small to clear and margin its derivatives.

Certain large groups may have a regulated financial party within the group which will be subject to clearing but may also have many other non-financial group companies. In defining the thresholds we would, politely, remind ESMA to ensure that the definition is clearly applicable only to the transactions of the non-financials.

Risk mitigation for non-CCP cleared contracts (Article 6/8)

Timely confirmation

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

The ACT endorses the NIPS Code (Non investment products code) issued by the Bank of England[2] and recommends that its members aim to operate within its guidelines. For straightforward deals the electronic confirmation timescales set are to exchange and process confirmations within two hours of the deal being struck and by the end of the day (trade date) at the latest, while recognising that lack of access to SWIFT could make these deadlines difficult to meet.

The ACT agrees that electronically executed, processed or confirmed transactions can generally be confirmed more quickly and that therefore the timescales proposed for financial counterparties and non financial counterparties above the clearing threshold are at an appropriate level.

In para 39 slightly extended timescales are being proposed for transactions executed with counterparties other than financial counterparties and non financial counterparties above the clearing threshold. In our view the next business day for electronically executed or processed deals is reasonable and for transactions not executed electronically we would suggest a further day is allowed i.e. no later than the second business day after execution.

In referring to “confirmations” we would ask that ESMA makes it clear that it interprets that term fairly widely to take in any equivalent messages and processes having the effect of confirming. For instance non financial companies may check and acknowledge bank generated confirmations received by them, which is sometimes referred to as an affirmation. Likewise foreign exchange deals settling through CLS Bank may be subject to “confirmation” within CLS rather than via externally exchanged confirmations.

There is a further complication that even if the transaction is confirmed promptly there can still be some legal details or parameters of the deal that take longer to be set. The concept of a confirmation should allow that not all the details will be available at time of dealing, e.g. a derivative priced by reference to an index at some future date so the initial fixing is not yet fully determined.

Q13: What period of time should we consider for reporting [by financial counterparties] unconfirmed OTC derivatives to the competent authorities?

A key control and risk mitigation arising from confirmations is to have a good follow up procedure to investigate and resolve unconfirmed transactions as soon as possible, and this is the responsibility of the parties involved. Although reporting by the financial counterparty to its competent authority may impose a powerful incentive we regard this as very much a backstop and would therefore consider that the period for outstanding to warrant reporting should be fairly extended, certainly no shorter than 30 days for reports about non-financial counterparties.

Reconciliation of non-cleared OTC derivative contracts

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

In proposing daily reconciliations ESMA is probably adopting a financial services sector mindset. For the financial sector dealing is a core part of their business. For a non

[2] http://www.bankofengland.co.uk/markets/Documents/forex/fxjsc/nipscode1111.pdf

financial company dealing is merely ancillary to their prime business. Even if a significant number of deals are outstanding they are not likely to change materially from day to day. Irrespective of size of portfolio anything more frequent than monthly would represent a significant burden for most non-financials - and remember that this element of the risk mitigation measures is set to apply to all companies with uncleared transactions. It is not limited to those who have exceeded clearing thresholds. There are millions of small, medium and mid-sized businesses in Europe. We ask that ESMA considers carefully the cost / benefit trade off of imposing provisions that are too onerous

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