Spotlight Quiz
August 2013

EMIR: European Markets and Infrastructure Regulation

Question 1
European Regulation of OTC Derivatives
The European Markets and Infrastructure Regulation (EMIR) became law within the EU on 16th August 2012. The objective of the regulation is to reduce the systemic risk posed by OTC derivatives and the consequent large credit exposures that could accumulate unseen by regulators. The G20 summit in Pittsburgh held in the aftermath of the 2008 crisis discussed how to ensure that the crisis could not be repeated. Those discussions resulted the Dodd Frank Act in the US and EMIR in the EU – both intended to reduce drastically the systemic risk of the derivatives market.
However, in its first version, it seemed that non-financial companies would be caught up in the fall out by having to post collateral for each derivative entered – effectively margin calls. Fortunately the ACT, among others, successfully made representations for exemption from the requirement for derivatives used as hedges.

However, all companies must report details of all of their derivative transactions after the start date for the Regulation and must comply with the requirement for timely confirmations despite this exemption from posting margin collateral. The start date for the regulation was 16th August 2012, so details of all derivative transactions since then must be retained to be reported .

Question
Although transactions backdated to 16th August 2012 will eventually need to be reported what is the expected start date for submission of reporting data on interest rate derivatives
(a) 23rd September 2013
(b) 30th November 2013
(c) 1 January 2014
(d) 15th January 2014
(e) 31th March 2014
(f) Don't know

Answer
The right answer is (c) 1 January 2014

The start date for reporting of interest rate and credit derivatives was originally set as 23 September 2013 or 90 days after the registration of a trade Repository if later. Based on expected dates of that registration the date that ESMA (European Securities and markets Authority) was predicting for the reporting start date were initially September, was deferred until November and currently (August 2013) the prediction is 1 January 2014 see http://www.esma.europa.eu/page/European-Market-

Infrastructure-Regulation-EMIR. Even this is regarded by most as a challenging timetable so it may yet be deferred further.

The data fields to be reported are extensive and cover 2 sections: the details of the counterparties, and the details of the derivative itself. This may sounds straightforward, and it may come to be so but at present there are added steps to be organised ahead of time. For example every company needs to apply for a Legal Entity Identifier (LEI) and the system for allocating these is only just being set up. (See "Derivative reporting muddle", The Treasurer July/August 2013 http://www.treasurers.org/node/9216)

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies. The ACT website: http://www.treasurers.org/otc or in print, paragraphs 40 - 51.

Question 2

Clearing Threshold for NFCs

The very largest NFCs (Non Financial Counterparties) will not be able to use the exemption from central clearing and therefore from margin calls. These large NFCs are referred to as NFC+.
The threshold is set as a total volume of deals, i.e. the sum of the notional amounts of all OTC derivatives of the NFC and any other NFCs within the worldwide group to which the NFC belongs *excluding* any risk-reducing derivatives. All non-hedging intra group derivatives must be included and because the gross notional amount is required, equal and opposite derivative deals will both be counted. In economic terms they may net off but in threshold terms they count twice. Once the threshold is passed then the central clearing obligation will apply to all categories of OTC derivative, whether risk-reducing or not. This will also apply to other group NFCs in the EU (or EEA) – effectively they all become NFC+. This also applies to intra-group derivatives although some exemptions may be available.

The clearing threshold is split into categories: credit derivatives, equity derivatives, interest rate derivatives and 'commodity and other' derivatives.

Question

What is the clearing threshold, as a gross notional amount, for interest rate derivatives?

(a) €500million
(b) €1,000 million
(c) €2,000 million
(d) €3,000 million
(e) Don't know

Answer

The right answer is (d) €3,000 million

This figure is used as the threshold for each of interest rate derivatives, FX derivatives and commodity and other derivatives. A lower figure of €1,000 million gross notional amount is used as the threshold for each of credit derivatives and equity derivatives.
The consequence of passing the threshold is that, when passed, the clearing obligation applies to all categories of OTC derivatives, irrespective of whether they are risk-reducing or not. So, if the threshold is passed in credit derivatives, then all other derivatives, interest rate, FX, commodity derivatives, will be required to be centrally cleared with consequent margin calls.

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies.
The ACT website: http://www.treasurers.org/otc or in print.
Para 25 to 28.

Question 3
Intra Group Clearing Exemption
If a company exceeds the clearing threshold then all companies in the group become NFC+ and subject to the clearing requirements, even on intra group transaction unless they meet certain requirements

For legal entities in the same EU member state there is no requirement for central clearing and collateral so long as there is no legal or practical impediment to payments between the two entities.

Question
Which of the following must be demonstrated to gain similar intra-group exemption when the two counterparties are in different EU member states?

A both parties are part of the same group
B both parties are included in the same set of consolidated accounts
C both parties are included in the same consolidated accounts *on a full basis*
D both parties have cross guarantees in place
E both parties are subject to a centralised risk evaluation, measurement and control procedures
F both parties are established in the EU, or a 'Commission-acceptable' third country

(a) A only
(b) A and B only
(c) A and C only
(d) A, B and D only
(e) A, C and E only
(f) A, B, D and F only
(g) A, C, E and F only
(h) Don't know

Answer
The right answer is (g) A, C E and F only

The two counterparties must be in the same group and have their accounts consolidated on a full basis in the same accounts, have common centralised risk management and both be in the EU, or an 'acceptable' third country. The acceptability is defined by the Commission having adopted an implementing act under Article 13(2). This effectively declares that the third country has a legal and supervisory system equivalent to that in the EU.

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies.
The ACT website: http://www.treasurers.org/otc or in print.
Para 37 and 38.

Question 4
Derivatives used for Hedging
Although 'hedging' is not a term that is used in EMIR, the concept is entrenched in the regulation. The term used is 'objectively measurable as reducing risks'. The realisation that corporate use of derivatives is mostly about reducing risk was an important factor in allowing the exemption from central clearing. It is interesting to theorise about whether overall system risk is increased or reduced by discouraging corporates from using OTC derivatives; on the one hand the systemic risk is reduced by a lower derivative volume, but on the other hand the underlying corporate risks that were being reduced would then be left unhedged.
Having granted the exemption to Non-Financial Counterparties (NFC) for derivatives used for hedging, EMIR must define a hedging OTC derivative. This necessity covers only OTC derivatives, because other derivatives already trade on an exchange and are subject to clearing and margin calls. The core of the definition is that an OTC derivative that objectively reduces risks that relate to the commercial or treasury activity of the NFC and either on its own or in combination with other derivatives, it meets one of three conditions.

Question
Which of the following most closely describes the three conditions, at least one of which must be satisfied, for qualification as a risk reducing derivative?

A It is between two EU-based counterparties, of which one is a NFC
B It covers risks from change in value of assets or liabilities that the NFC owns, sells or purchases
C It covers risks in the fluctuation of prices of commodities to which the NFC is exposed
D It covers risks from the indirect impact of assets, liabilities or other inputs resulting from changes in interest, inflation or exchange rates or credit risk
E It qualifies under IFRS for hedge accounting

(a) A, B and C
(b) A,B and D
(c) B, D and E
(d) B, C and D
(e) B, C and E
(f) Don't know

Answer

The right answer is (c) B, D and E

To qualify as risk reducing the derivative must meet any one of the three conditions, so if the hedge qualifies for hedge accounting, then EMIR qualification follows. Surprisingly, condition C is not one of the three – the fluctuation of commodities prices might have been included in D, along with interest rates, inflation rates, exchange rates and credit risk, but it was not. In practice this is unlikely to be problematic because condition B would clearly cover any hedge to cover the change in something to be purchased or sold.

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies.
The ACT website: http://www.treasurers.org/otc or in print.
Para 22 to 24.

Question 5
Confirmations

The term confirmation refers to the documentary evidence that both counterparties to an agreement accept and agree all of the terms of the transaction. Compliance with EMIR's requirements means that the confirmation must be legally binding on both counterparties. In practice, the banking counterparty has typically sent out a confirmation to the NFC but sometimes the NFC has not sent a confirmation the other way. Banks often work on the assumption of negative affirmation – in other words the NFC responds only if there is a disagreement. Otherwise affirmation is assumed. Further, there has often been a time limit of, say, 48 hours for the NFC to raise objection. This may be inadequate under EMIR. EMIR can only be satisfied if the process is two way or that both counterparties have agreed in advance to confirm using negative affirmation. Best practice is that confirmations should be two way or ideally carried out electronically.
EMIR imposes an obligation for counterparties to exchange confirmations within a maximum time. That maximum time is already in force (since 15th March 2013) but is relatively extended for NFCs below the clearing threshold until 31st August 2013. After 1st September 2013 and until 31st August 2014 the timescale is shortened until after 1st September 2014 the target maximum time is achieved.

Question

What is the target maximum time permitted for a NFC below the clearing threshold to confirm an interest rate swap, after 1st September 2014?

(a) 4 hours
(b) 1 business day
(c) 2 business days
(d) 3 business days
(e) Don't know

Answer

The right answer is (c) 2 business days

At present (August 2013) the permitted time allowed for confirmation is 5 business days. This falls to 3 business days after the end of August 2013 and finally 2 business days after 1st September 2014.

This timescale also applies to NFCs below the threshold for credit default swaps. Equity swaps, FX swaps and commodity swaps are currently 7 business days, reducing to 4 business days after 1st September 2013 and then 2 business days after 1st September 2014.

For FCs and NFCs above the threshold all of these times are shorter, ending at 1 business day in 2014.

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies.
The ACT website: http://www.treasurers.org/otc or in print.
Para 52 to 57.

Question 6

Reporting and Reporting Bodies

One of the shortcomings that the 2008 crash revealed was that the supervisory and regulatory authorities did not have adequate information to fulfil their roles. EMIR proposes to address this by creating Trade Repositories to whom all derivative transactions must be reported. This will then allow an overall view to be taken of the market and its systemic risk. The Trade Repository organisations will then aggregate derivative information and make these aggregate positions available to the public. It is argued that this will enable ESMA (European Securities and Markets Authority) and national authorities to do their jobs.
As already noted, these Trade Repositories are yet (August 2013) to be officially registered by ESMA. It is planned that 90 days after registration the reporting requirement will start. That reporting must take place by the day following the creation or modification of a derivative deal. This will apply to *all* derivative deals from any entity, intra-group and external.

One requirement to be reported is the LEI (Legal Entity Identifier), the unique reference number for each individual company. The system for creating these LEIs must be co-ordinated internationally and this is the responsibility of the Financial Stability Board. Companies will have to apply for a Legal Entity Identifier(LEI) , but as yet the final system for creating these reference numbers does not exist. Instead pre-LEIs are being generated by pre-Local Operating Units such as the Irish Stock Exchange, the London Stock Exchange, WM Datenservice based in Germany and the established CICI in the US (cf www.leiroc.org).

Question

Derivatives must be reported to a Trade Repository. Which of the following are true?

A. Exchange traded as well as OTC derivatives must be reported
B. Intra group derivatives need not be reported if between companies in the same group and which are included in the same accounts consolidation on a full basis
C. An NFC below the clearing threshold need not report
D. For an NFC dealing with an FC it may delegate its reporting to the FC and the FC will take legal responsibility.

E. For an NFC dealing with an FC it may delegate its reporting to a third party but the NFC retains responsibility for the reporting

(a) All of the above
(b) A, B, D, E
(c) A, B, E
(d) D, E
(e) A, E

Answer

The right answer is (e) All derivatives including exchange traded and OTC and intra-group must be reported by both sides to the transaction. However the actual submission of reports can be delegated even to a third party, but when delegated the transacting parties each remain responsible and liable for the reports. On 8th August 2013 ESMA proposed that the reporting start date for exchange traded derivatives be postponed by one year. The European Commission has three months to decide whether to endorse this change.

Briefing note: European Regulation of OTC Derivatives, Implications for Non-financial companies.
The ACT website: http://www.treasurers.org/otc or in print.
Para 40 to 49.