EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

EACT Position on ESMA Review on the use of OTC derivatives by non-financial counterparties

6 October 2015

On 13 August 2015, the European Securities and Markets Authority (ESMA) published four reports focused on how the European Markets Infrastructure Regulation (EMIR) framework has been functioning and providing input and recommendations to the European Commission's EMIR Review. Report no. 1 deals with non-financial counterparties' (NFC) use of OTC derivatives[1]. We welcome the data provided by ESMA but we contest some of the analysis and recommendations made in this report and we urge EU policy-makers to reflect on the economic impacts of ESMA's recommendations.

We are in particular concerned by ESMA's recommendation that the clearing thresholds, determining whether a non-financial counterparty is obliged to clear or collateralise bilaterally, should be set "irrespective of their hedging or non-hedging nature". ESMA justifies this recommendation mainly by the fact that some NFCs appear to have large portfolios of derivatives but remain below the clearing thresholds; the high number of NFCs that classify all of their transactions as hedging; and the practical difficulties faced by supervisors in verifying the hedging nature of transactions.

We would like to highlight that the exemption to centrally clear or to post bilateral margin for hedging transactions serves an important economic purpose. It was acknowledged by the legislator in EMIR and CRD IV. We believe ESMA's analysis has several shortcomings (see Annex I) and therefore the recommendations made by ESMA are not appropriate. Firstly, as ESMA details in the report, NFCs represent only two percent of notional volume of outstanding OTC derivative transactions (even less if intragroup transactions are excluded as they should), which raises doubts as to the potential systemic nature of any individual NFC. Secondly, hedging transactions represent less systemic risk than non-hedging transactions, because the mark-to-market of hedging transactions will be offset at NFC level by an underlying exposure related to their core activity. Therefore large price moves in an asset class will have little impact on the results of corporate NFCs and are unlikely to cause default of that NFC, let alone cause a financial crisis. Thirdly, unlike ESMA claims, the risk mitigating nature of transactions is being monitored and documented by NFCs and easily verifiable by auditors and/or supervisors. Therefore there is no basis for removing this crucial exemption for the EU real economy.

[1] http://www.esma.europa.eu/system/files/esma-2015-1251_-_emir_review_report_no.1_on_non_financial_firms.pdf

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Furthermore, a 2014 study (Coalition for Derivatives Users) shows that margining requirements would lead corporate NFCs to set aside 6% of the notional of their derivatives portfolio. The 6% collateral amount is consistent with the standard model proposed by the 3 ESAs (ESMA / EBA / EIOPA) in their second consultation paper on the risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP[2] published in June 2015. ESMA reports shows (table 4) that large NFC- have a notional portfolio of EUR 3 395 397 mn. Therefore if the hedging exemption would be removed, large NFC- would have to collateralise their hedging transactions. Should large NFC- have to mobilize 6% of that amount, it would remove EUR 203 billion of investment in the real economy. This represents approximately three times the 2014 funding activity of the European Investment Bank and two-thirds of the intended investments to be made through the 'Juncker Plan'.

Unlike stated by ESMA, abandoning the hedging criteria would not meaningfully lower the regulatory burden for NFC-s as the current reporting regime and its complexity is the main source of compliance burden to NFCs. Therefore, the reporting regime should be amended to single-sided reporting, without reporting of intragroup transactions – these would be the only useful amendments from NFCs' perspective.

[2] https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

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Annex I – detailed comments on ESMA report:

General:

- ESMA fails to present relevant criteria for defining the systemic importance of NFCs to the financial system. There is a fundamental problem in applying the criteria that is used for analysing banks' systemic importance (paragraph 76: size, substitutability and interconnectedness) to non-financial companies. ESMA makes no attempt to understand the different nature of NFCs as counterparties in the financial markets:

    - NFCs' business and default risks are much less correlated and therefore less systemically important than those of financial institutions; therefore counterparty risk due to non-financial counterparties cannot be treated in the same way as that of financial counterparties. The sector diversification of NFCs means that correlation is low and due to the high number of counterparties, the individual NFC risk is not a threat to the financial system. Also, hedging transactions are generally matched in the NFCs by equal and opposite business flows, which further reduces the riskiness of their transactions.

    - Hedging improves the overall risk profile and credit worthiness of companies, which in turn improves financial stability by making NFCs less risky as counterparties to financial institutions.

    - The volume of transactions is not always a relevant measure for measuring the systemic importance of NFCs as often large companies have sizeable portfolios due to the scale of their business activities, not due to speculative actions. A single underlying business transaction, for example a bond issuance, can lead to multiple derivatives transactions to mitigate financial risks. Therefore the initial bond amount may lead to multiple amounts of derivatives.

- EMIR Article 85 (1) b calls upon ESMA to assist the Commission in assessing '*the systemic importance of the transactions of non-financial firms in OTC derivatives and, in particular, the impact of this Regulation on the use of OTC derivatives by non-financial firms'* therefore we question the basis for ESMA making recommendations on changing a fundamental feature of EMIR without any further analysis or impact assessment. Furthermore, ESMA's report does not analyse the impact that EMIR has had on NFCs' use of OTC derivatives, which is nevertheless required by EMIR Article 85.

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Hedging / non-hedging transactions:

- According to ESMA the fact that a large part of NFCs declare all their OTC derivative transactions as risk mitigating means that NFCs have not developed sufficient means to monitor their hedging and non-hedging transactions. ESMA provides no further analysis or basis for such a statement. We find it perfectly logical that most NFCs would qualify all their transactions as hedging as most NFCs are using OTC derivatives solely for risk mitigating purposes and not for speculating on financial markets. This information is included (at least for the biggest NFCs) in their audit reports or published annual reports. It is simply untrue to state that NFCs do not have tools to monitor their transaction. NFCs apply best practice risk management procedures to record and monitor derivatives transactions. NFCs' OTC derivatives transactions are documented either to qualify as hedges under IAS39 or by other internal procedures to link the P&L to the underlying businesses. In case of control by a supervisor or an auditor, NFCs will be able to demonstrate the hedging character of their transactions.
- As to certain companies declaring all their transactions as non-hedging, we believe they are likely to do so cautiously because of the existing basis risk in commodity markets.
- Abandoning the hedging criteria would not meaningfully lower the regulatory burden for NFC-s as the current reporting regime and its complexity is the main source of compliance burden to NFCs. In a survey conducted earlier this year by the EACT[3], none of the respondents singled out the hedging/non-hedging criteria as a source of regulatory burden. On the contrary, reporting of both external and internal OTC derivative transactions is a major regulatory burden and represents significant costs to treasuries.

Data quality:

- Many of our members have consistently reported of problems with transaction reporting to TRs. Therefore we believe some issues identified by ESMA are simply due to the shortcomings of the current data reporting and validation, for instance the fact that some counterparties are classified inconsistently (the fact that some counterparties sometimes seem to report their transactions as financial counterparties and other times as non-financial counterparties): our members have reported that many times the data validated by TRs does not correspond to the reports that have been sent. Furthermore, if reporting is delegated, it is sometimes difficult for NFCs to view and to control how the data is being reported and validated.

Methodology:

- ESMA has included intragroup transactions in its analysis, which distorts the data by inflating the volume of NFCs' transactions. Intragroup transactions represent a large proportion of

[3] available at: http://www.eact.eu/docs/EACT-Survey-Report-EMIR-Cost-Compliance-Aug15.pdf

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NFCs' OTC derivatives transactions but are not a source of systemic risk to the financial system. Non-financial companies centralise risk management for the purposes of efficiency and cost saving. External derivative transactions are undertaken by a central unit and these are then mirrored appropriately as intra-group transactions with the part of the group where the underlying business risk has arisen. The related external trades are being reported to the TRs and are therefore captured by the regulatory regime. Including intragroup transactions is therefore not appropriate, as the data obtained as a result does not provide accurate figures of NFCs' importance in the OTC derivatives market. Including intra group transactions leads to triple the amount of actual economic transactions (two intra group, one external). Excluding them from the analysis would have shown that the percentage of NFC transactions is even smaller than the two percent of notional value established by ESMA.

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