Deutsches Aktieninstitut

Reduce the regulatory burden for non-financial companies

Review of EMIR should adequately take into account that non-financial companies using derivatives for hedging purposes are not of systemic relevance

Position paper of Deutsches Aktieninstitut, 13 August 2015

Introduction

Deutsches Aktieninstitut[1] welcomes the opportunity to comment on the European Commission's public consultation on Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories. Our answers represent the view of non-financial companies (NFCs) using derivatives almost exclusively to mitigate risks related to their commercial or treasury financing activities ("hedging").

We followed the legislative procedure on EMIR and the subsequent measures on level 2 very closely constantly stating that the exemptions from the clearing obligation should adequately reflect common risk management practices in non-financial companies. Accordingly, we do appreciate the definitions of derivatives which are objectively measurable as reducing risks directly relating to the commercial or treasury financing activity and the clearing thresholds as being appropriate. Both elements – the hedging definitions including the definition for macro-, portfolio- and proxy-hedging and the clearing thresholds – proved well in practice and should be maintained.

Nevertheless, the burden to comply with the different EMIR requirements is considerable although our member companies are classified as non-financial companies not exceeding the clearing thresholds (NFC-) and are therefore not regarded as being systemically relevant. Taking this into account, the EU legislator should include substantial reliefs in EMIR especially for NFC-. This was e.g. also stated by the German government in its recent report on the review of financial markets regulation which expresses the will to work towards (size-specific) alleviations for non-financial counterparties regarding the EMIR reporting obligation.[2]

Our comment focuses in particular on the following aspects of the consultation paper:

- Retain the existing hedging definition and the clearing thresholds in their current format;
- Exempt intra-group transactions, at least those concluded by NFC-, from EMIR requirements, especially the calculation of the clearing thresholds and the reporting regime;

1 Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and Berlin.

2 See Bundesministerium der Finanzen: Überprüfung von Regulierungsmaßnahmen im Finanzmarkt, Bericht an den Finanzausschuss des Deutschen Bundestags, June 2015, p. 35.

- Introduce a one-sided reporting regime or, at least, reduce the complexity of the reporting regime;
- Substitute parts of the ESMA Q&A by an instrument which allows for appropriate consultation of market participants, sufficient transitional implementation phase to comply with changes and which provides sufficient democratic legitimacy;
- Provide coherence in the EU-wide EMIR compliance processes by introducing a “home regulator” approach;
- Allow for more flexibility in the timely confirmation process and clarify that market values are not covered by the reconciliation requirement.

Answers to selected questions

Q 1.2a

i. Are the clearing thresholds for non-hedging transactions (Article 11, Regulation (EU) No 149/2013) and the corresponding definition of contracts objectively measurable as reducing risks directly relating the commercial activity or treasury financing activity (Article 10, Regulation (EU) No 149/2013) adequately defined to capture those non- financial counterparties that should be deemed as systemically important?

Yes with regard to the issues hedging definition and clearing thresholds. ***No*** with regard to the treatment of intra-group transactions which should not be considered in the calculation of the clearing thresholds at all (to the latter see our answer to Q 1.2a ii. below).

The clearing thresholds and the corresponding hedging definition are justified in order to appropriately reflect the risk management practice of non-financial companies using derivatives for risk mitigating purposes. This definition, which also adequately includes instruments not covered by IFRS hedge accounting, and the level of the clearing thresholds should not be changed. This holds also true for the inclusion of hedging techniques like macro-, portfolio- or proxy-hedging not allowing establishing a one-to-one link to the commercial or treasury financing activities. ***The latter should be clearly stated in the respective definition; otherwise, companies are endangered that risk management instruments like macro-hedging etc. are no longer available.***

Furthermore, we would like to reiterate our point already addressed in several position papers that appropriate clearing thresholds are important even for those companies using derivatives exclusively for risk mitigating purposes:

- The clearing thresholds should provide companies sufficient leeway for ***cases of doubt***. This applies, e. g., for derivatives which cannot be subjected to IFRS hedge accounting or to national GAAP. Although we very much appreciate that the definition "hedging" is not only restricted to the above mentioned accounting rules (see Art. 10(1)(a) and (b) Regulation (EU) No 149/2013), for some of these instruments the proof "risk mitigating" is technically complicated. This might lead to lengthy discussions with external auditors (who are in charge to monitor whether the non-financial company complies with the EMIR requirement in Germany), for which sometimes the time is not available as hedges have to be booked on short notice. To avoid these efforts, companies classify these "cases of doubt" as

non-hedging – provided that the clearing thresholds are leaving room for this option.

- Generally, IFRS hedge accounting rules (and also its national equivalents) are driven by accounting/auditing and not necessarily by financial logic. Among others, the substantial changes to IAS 39 intended by the new IFRS 9 proposal underline this. IFRS 9 will show major improvements but will – nonetheless – not heal this topic. This fact is generally reflected in the EMIR hedging definitions which, for the reasons mentioned above, goes beyond this accounting rules.

  Therefore, it is very important to preserve the existing definition of hedging which includes derivatives not accounted under IFRS. Due to complexity reasons many companies only use IFRS for parts of their derivative exposure. In addition, IFRS is difficult to apply for certain derivatives. One example are collar structures which show a risk profile that is in between forwards and plain vanilla options. For non-financial companies such structures can be very important to hedge risks (mainly foreign exchange) from forecasted/planned cash flows, among others because they are commercially attractive compared to a plain vanilla option (lower/no premium). While forwards and plain vanilla options do qualify for hedge accounting a complete IFRS recognition of a collar structure is at least complicated and in certain cases hardly possible. ***Clearing thresholds can be seen in this context as a – low administrative burden – instrument to close the gap between hedge accounting rules and the EMIR hedging definitions.***

- ***Wind down superfluous derivatives:*** Unlike to the banking industry non-financial companies do hedge risks resulting from forecasted/planned operative cash flows (e.g. delivery contract, future turnover, future supplier payments). It is in the nature of the risk management of non-financial companies that a derivative contract which was entered into for a risk-mitigating purpose might become superfluous before its expiry, e.g. because business plans do not evolve as originally expected. However, it is technically impossible and commercially disadvantageous to timely react on each change in realization probability of each individual contract. Furthermore, if an unwinding of existing positions is indeed appropriate this may take some time especially for more exotic or large hedges. As there is legal uncertainty among market participants as regards the period in which the derivatives have to be closed out companies sometimes calculate the respective instruments against its threshold to not endanger their EMIR compliance. Sufficient clearing thresholds are the prerequisite for this procedure.

- ***Market making*** should be allowed within appropriate clearing threshold in order to preserve liquidity in the markets. This is especially relevant for

companies stemming from the energy sector. Otherwise, to avoid the additional burden to comply with the clearing obligation, non-financial market makers would leave the market or restrict their activities to the detriment of liquidity and with the result of increasing transaction costs for all non-financial companies using derivatives for hedging purposes.

- ***No systemic relevance:*** The given thresholds proved to be justified and did not endanger the resilience of the financial system.
- A ***competitive level-playing-field*** especially with U.S. companies should be ensured. In the U.S. the thresholds to be licensed as Major Swap Participant, the U.S. equivalent to the European non-financial exceeding the clearing thresholds (NFC+), are less strict than the comparable clearing thresholds under EMIR (between USD 1 and 3 billion for different asset classes, and those calculated in market values, not nominal ones as under EMIR).[3]

ii. If your answer to question i. is no, what alternative methodology or thresholds could be considered to ensure that only systemically important non-financial counterparties are captured by higher requirements under EMIR?

Although the clearing thresholds and the hedging definition proved to be appropriate (see our answer to Q 1.2a i.) the treatment of ***intra-group transactions*** should be rethought. The legislator should be aware that these transactions solely redistribute risks within the group but do not create new risks or increase the risk on a group level basis. Potential losses of one group member are potential gains of another. ***In fact, intra-group transactions within NFCs are risk neutral. They should, therefore, be exempted from EMIR requirements.***

Furthermore, the stated characteristics of intra-group transactions are acknowledged by the legislator, e.g. in Art. 2(1)(j) MiFID II which states that the respective transactions are "privileged" and excluded from the calculation of the thresholds regarding the ancillary activity. Hence, to provide coherence with MiFID II, EMIR should also provide exemptions for intra-group transactions, at the very least for NFC-.

3 See CFTC/SEC: Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'', Federal Register, May 2012, p. 30671.

Q 1.2b

Please explain your views on any elements of EMIR that you believe have created unintended consequences for non-financial counterparties? How could these be addressed?

The administrative burden to implement the respective processes to comply with EMIR has become more difficult due to permanent updates of the ***ESMA Q&A***, combined with their classification by some local regulators, who see them as binding part of the regulatory framework instead of an explanatory tool. For example, ESMA released a clarification in its Q&A regarding the application of the unique trade identifier (UTI) two days before the obligation itself came into force to assign an UTI to every trade. At this point in time, market participants had already implemented processes for their EMIR compliance and thus were facing the task to adapt the updated requirements within only two days. This was a very short time span, in fact too short for many.

We understand that requests for clarification of certain EMIR rules coming from market participants were a key aspect for the permanent updates of the Q&A. Nevertheless, as today the clarification needs are settled to a large extend the Q&A should at least partially be substituted by other instruments for the following reasons:

- It is one of the main problems that the legal character of the Q&A is so far ambiguous. While many market participants and regulators regard the Q&A – correctly, in our opinion – as not legally binding explanations providing guidance for the coherent compliance of EMIR, others take them as equal part of the regulation. Due to this diverging perceptions the Q&A are applied differently within the EU which forestalls a level-playing-field.

- In addition, if regarded as legally binding, ESMA's Q&A are lacking democratic legitimacy as neither the European Council nor the European Parliament are scheduled to provide input or to reject certain content. Last but not least, market participants have no possibility to comment on the ESMA Q&A with regard to their practical feasibility.

- As the implementation periods for the Q&A changes are not adequately defined it is very challenging for market participants to apply the updates immediately lacking other timing information.

Therefore, at least the parts of EMIR-Q&A deemed to be strictly binding should be replaced by regulatory instruments (e.g. Delegated Acts adopted by the European Commission) with appropriate time lines for consultations and the right to reject for the European legislators.

As a complementary step, the legislator should clarify that the instrument Q&A are not a legally binding instruments but explanations / guidance, and leave companies enough time to implement the respective adjustments following the updates (e.g. 6 months after the publication of the update).

Q 1.5b

[…] i. Is the spectrum of eligible collateral appropriate to strike the right balance between the liquidity needs of the CCP and its participants?

Other than financial counterparties non-financial counterparties do not have access to central bank money. Thus, their cash reserves are much more limited. Although most of the non-financial companies use the clearing exemption, some clear (parts) of their derivatives voluntary. The duty to provide cash-collateral in the clearing process would overstretch liquidity reserves with negative effects to the investment and employment decisions of non-financials. This would lower the incentive to use clearing voluntary. ***Therefore, we very much appreciate the possibility granted in Art. 46(1) EMIR that non-financial companies are allowed to post bank guarantees as collateral which should be preserved.***

Furthermore, non-financial counterparties should still be able to use bank guarantees which are not fully backed by liquid assets also beyond March 2016.

Q 2.3

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

Yes.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Most companies we are representing (larger companies) do the reporting themselves as they have to report intra-group transactions anyway. They have, in general, made the experience that both the implementation of and the day-to-day compliance with EMIR reporting requirements have caused a massive additional administrative burden. These unintended consequences should be addressed by decreasing the workload for the reporting entities wherever possible without putting at risk the regulatory rationale behind EMIR.

The extensive reporting requirements also contribute to the fact that matching of reports delivered separately by both counterparties is extremely difficult leading to low matching quotas. This contradicts the aim of the regulator to increase data quality in trade repositories.

A main driver of the additional administrative burden is the enormous ***complexity*** of the reporting process. It is also unclear, whether the excessive amount of data required to be reported is really needed for supervisory purposes. This applies especially for the following examples:

- ***Execution* and *confirmation time stamps:*** It is close to impossible that both counterparties will agree on a common execution time stamp for trades bilaterally agreed via phone, e-mail etc. as the trade is recorded in the systems of the respective counterparties at different times. Therefore, time stamps assigned by the counterparties will hardly ever be matching. The same holds true for the confirmation time stamp as it is common practice among non-financial companies to exchange confirmation forms. Each counterparty reconciles the documents regarding the agreed trade details after receipt. As the confirmation documents are not sent out at the same time, it is impossible to agree on a common time stamp without massive additional coordination efforts. In sum, the additional administrative burden to agree on a "fictional" execution and confirmation time stamp is not reasonable. It further does not add meaningful information for supervisory purposes, as the agreed time stamps will – by logic – not reflect the exact date of the confirmation or the execution for the reasons described above. Neither is this information of any regulatory value, as such non-standard transactions will not be used in any heavy trading strategies exactly because of the slow settlement processes involved (especially the case in transactions with non-financial companies). In order to match information regarding one and the same trade delivered by both counterparties, the time stamp is not even necessary as the UTI is created to solve this identification problem. Therefore, time stamps are of no benefit in this regard and should be abolished. At the very least, it should be sufficient that both counterparties report the day of the execution/confirmation instead of agreeing on the exact second.

- There are other examples for ***superfluous reporting*** fields like the "master agreement version", which provides little information value but is difficult to reconcile due to the fact it is an unformatted text field.

- The ***reporting period*** of t+1 is very ambitious for derivatives not executed on electronic platforms like Currenex or 360T as many details of the paper confirmations will in fact be reconciled at a later stage (e.g. UTI – see our remarks below). Therefore, reconciliation time periods and reporting time

frames, especially for "traditional" OTC trades, should be aligned with market standards.

- ***Legal entity identifier (LEI):*** ESMA determines in its Q&A that every transaction partner, in case of intra-group transactions every subsidiary of a group, has to be assigned a legal entity identifier (LEI), no matter if it is domiciled in or outside the EU. As entities from third countries are not required to report under EMIR they should not be obliged to obtain a LEI. The application process to get a LEI is associated with costs which can add up to a significant amount especially for those companies which are active in many countries all over the world.

  Furthermore, each LEI registration needs to be re-certificated yearly involving a fee. This requirement is not comprehensible as changes of the LEI data are not common and if they occur they are required to be notified anyway. Therefore, the yearly re-certification frequency should be abandoned and should be appropriately prolonged (e.g. 5 years).

- ***Interim UTI:*** In many cases the unique trade identifier (UTI) is exchanged via the trade confirmation (t+2 at the latest). In order to comply with the obligation to report within t+1 the non-financial counterparty generates an "interim UTI". This interim solution is replaced after receiving the final UTI included in the confirmation. Following its submission the non-financial counterparty forwards the UTI to the trade repository which is matched subsequently with the interim UTI already delivered. According to recent discussions within ESMA it is planned to abandon the possibility to provide an "interim UTI" after the beginning of next year. This would cause an additional burden for non-financial companies as processes have to be changed again, and could ultimately result in rule violation where UTIs are not provided on time in the confirmation process. Therefore, the possibility to report transactions with an "interim UTI" should be preserved.

- In order to solve the problem of different understandings of the reporting requirements ***trade repositories provide their own clarifications***. The result is that details of the required reports differ by trade repositories. E.g. regarding the reporting field "action type" trade repositories like DTCC require market participants to fill in three different fields. In addition, DTCC requires FX swaps to be reported as two trades (FX spot and FX forward or FX forward and FX forward) while others, e.g. REGIS-TR, provide the possibility to report FX swaps as one trade. Other examples are differences in the handling of the product ID, the price notation or the delivery type. Therefore, matching reports from different trade repositories is at least a challenging task, or – as the case of the different swap reporting shows – sometimes a "mission impossible".

These examples clearly show the complexities that especially non-financial companies are facing while complying with the reporting requirements.

Therefore, the following should be done to solve the problem of unintended consequences:

- ***One-sided reporting:*** Counterparties should be allowed to agree that only one counterparty reports the trade data. This should not be misunderstood as or be confused with the possibility of delegation under the current legislation. The delegation does not help very much because both counterparties are still liable for the correctness of the data. Liability should be limited to the reporting counterparty, though. One-sided reporting does also reduce the duplication of reports and the risk of mismatches. This is the main reason why counterparties have to determine *one* responsible reporting entity under the U.S. Dodd-Frank-Act.[4] This is also the case in Switzerland where only one counterparty is required to report – in particular the financial counterparty within transactions with non-financial counterparties.[5]

- ***Exempt intra-group transactions:*** Delegation is not used by many corporates as they are obliged to report intra-group transactions anyway. These transactions between the parent company and its subsidiaries do not involve an external counterparty which could be mandated to report. Therefore, as the respective infrastructure is available, especially larger companies do not make use of the right of delegation for external transactions but report by themselves. Nevertheless, as mentioned above, the legislator and supervisory authorities should be aware that intra-group transactions simply redistribute positions internally and do not increase the overall risk of the group as the risks are compensating each other at group level. Due to this "risk neutrality" the information gathered by the reporting regarding intra-group transactions is of no benefit for supervisory purposes. Even worse, to make sure risk positions are adequately mapped, regulators would need to remove these transactions from their analysis. ***Therefore, reporting of intra-group transactions should be abandoned, at least for intra-group transactions executed by NFC- as these transactions cannot be regarded as systemically relevant anyway.*** This would also provide a level playing field with corporates in

4 See the hierarchy regarding the designation of the responsible reporting counterparty in CFTC: Swap Data Recordkeeping and Reporting Requirements, January 2012, p. 2138ff.

5 See Art. 104(2) Bundesgesetz über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel, June 2015.

the U.S. because their regulator does not require the reporting of intra-group transactions.[6]

- ***Reduce complexity:*** Complexity of reporting requirements should be decreased in general. Every reporting field should be carefully evaluated whether it is needed to execute supervisory powers. This applies especially for the above mentioned critical points like the time stamps etc.

- ***Requirement to report expired trades should be removed:*** According to Art. 9(1) EMIR, the reporting obligation includes trades that were both outstanding on or entered into after the entry into force of EMIR. This means all trades that were outstanding, but that had expired before the reporting start date in February 2014, will have to be reported to a trade repository. According to Regulation EU 1247/2012, those derivative contracts which were entered into on or after 16 August 2012, that are not outstanding on or after the reporting start date shall be reported to a trade repository within 3 years. While significant effort to retrieve and source such data will be required, the value of these data sets will be minimal as many trades will be unmatched as they will be reported without UTIs, which were not used at the time of execution. Moreover, many reports will be single-sided, as the counterparty to the trade may no longer exist. Thus, this requirement should be removed from EMIR.

Q 2.4

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting risk mitigation obligations in accordance with Articles 11(1) and (2) of EMIR?

Yes.

ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

It turned out that some risk mitigating techniques are very onerous and difficult to implement for non-financial companies. This applies especially for the following aspects:

- ***Timely confirmation:*** While NFCs are able to confirm especially those trades executed on electronic platforms very quickly, the length of the

6 See the "No-Action Relief for Swaps Between Affiliated Counterparties That Are Neither Swap Dealers Nor Major Swap Participants from Certain Swap Data Reporting Requirements Under Parts 45, 46, and Regulation 50.50(b) of the Commission's Regulations" released by the CFTC in April 2013.

confirmation process varies with the specifics of the transaction. This applies especially for more complex transactions which are, in general, not executed on electronic platforms but traded OTC via phone etc. There are certain reasons for the longer confirmation period, e.g. additional (not yet defined) legal terms included in the confirmation or the involvement of different departments within a company. ***Therefore, the period for the timely confirmation should be adjusted for non-standardized transactions, i.e. those not executed on platforms. This period should be extended from t+2 to t+10.*** A possible alternative might be to amend the rules such that confirmations regarding transactions with NFCs should be submitted within t+2 (rather than to reach formal agreement).

- ***Portfolio Reconciliation***

    - *Frequency:* A quarterly reconciliation process, which is required for NFC- when the counterparties have more than 100 OTC derivative contracts outstanding with each other (Art. 13(3)(b) Regulation (EU) No 149/2013), implies significant investments in additional back office resources. Even though a technology carries out the matching of portfolios in some companies, resources are required to analyze the results which often involve different areas of the counterparty (e.g. credit and market risk, back office, etc.) Sometimes the data quality and delivery timing from counterparties is not appropriate. NFCs employ significant additional resources to perform a portfolio reconciliation on a quarterly basis which is also not of benefit when the confirmation process is adequately implemented as, in general, the terms of the contract do not change within the maturity of the derivative. ***Therefore, the frequency of the portfolio reconciliation requirement for NFC- should be restricted to once a year irrespective of the number of contracts concluded with the respective counterparty.*** This is also required as part of the annual external audit and should be sufficient.

    - *Market values:* “NFC-“ are not required to calculate market values for their transactions according to EMIR. Nevertheless, ESMA states in its Q&A that market values should be part of the portfolio reconciliation. To reconcile market values is a necessary exercise for those companies obliged to exchange collateral (variation margins) in order to ensure a common understanding of the amount of collateral. It is of no use for those companies exempted from the margining requirements like NFC-.

      Furthermore, especially SMEs do not calculate market values. For

those companies ESMA states that NFCs "can rely on the valuation of their counterparties or on other means". This relief is not a feasible option for larger companies, which are calculating market values for sound risk management procedures, as e.g. certain accounting rules would forbid to simply replace calculated values with those given by a bank. To reconcile these market values with their counterparty is no option either, as this process is very costly without adding a benefit for the reasons mentioned above. ***Therefore, it should be clearly stated that NFC- are not required to reconcile market values.***

Q 2.6

(a) i. With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

Yes.

ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

We refer to cross-border problems involving counterparties within the EU. It is in the core of the European regulatory framework that EMIR requirements are implemented coherently across the EU. This should apply especially for the enforcement regime.

The status quo is far away from this "vision". In some cases EU-affiliates of non-financial groups domiciled in Germany are faced with queries from the respective competent authorities regarding the compliance with EMIR. This is e.g. the case in Ireland, where the Central Bank of Ireland intends to introduce an annual EMIR Regulatory Return[7], and also in countries like Portugal or Croatia. To answer these queries or to comply with specific national requirements is burdensome and would contradict the approach to allow for a coherent EU-wide implementation of EMIR processes.

In order to avoid cross-border frictions and to keep the administrative burden as low as possible it is important to implement a coherent enforcement regime across the EU. ***To achieve this goal a "home regulator approach" should be introduced.*** As the administrative processes concerning the compliance with EMIR are central-

7 See Central Bank of Ireland: Feedback Statement to Consultation on the Supervision of Non-Financial Counterparties under EMIR, 2015.

ized on group level, the enforcement process should be restricted to the group entity which is responsible for these processes. In most cases this task is executed by a specific legal entity or via the holding company of the group. This entity should be the one determining which supervisory process is relevant for the group as a whole. The supervision of the group should be solely up to the competent authority of the country where this entity is domiciled. Hence, for purposes of local supervision of group subsidiaries in other member states it should suffice to refer to this "home regulator" process to fulfill EMIR compliance.

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