Deutsches Aktieninstitut

Corporate data regarding EMIR: Likely liquidity drain because of the clearing obligation – administrative burden of EMIR-reporting

Retain the hedging exemption for non-financial counterparties – decrease the reporting costs

Data provided for the European Commission's Impact Assessment on EMIR,
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Introduction

This paper refers to the European Commission Report on the EMIR review. We are very concerned that the European Commission discusses the possibility of imposing clearing and margin requirements for non-financial companies (NFC) based simply on the volume of transactions, i.e. to abandon the differentiation between hedging and non-hedging transactions. We re-enter into discussions we had in the beginning of EMIR in 2010, now based on the ESMA report we had already commented.[1]

We once again strongly oppose the view that hedging and speculation cannot be differentiated and strictly oppose the approach to abolish the hedging definition as this would force larger NFCs in the clearing and margining obligation. Therefore, we would like to provide figures which demonstrate that for that case the resulting liquidity needs for NFCs would be nothing but extreme. The figures base on risk management activities of **nine DAX companies**, **two companies from the German mid-cap stock index MDAX** and **one family owned company**.

We welcome that the discussion is moving towards a single-sided reporting which would reduce NFCs' current reporting burdens. However, such a reporting model would need to be combined with an exemption for intragroup transactions and the possibility to transfer liability for data correctness. Otherwise, NFCs would not be able to benefit from relevant cost savings. We provide figures for the ongoing costs of the reporting obligations and the relation between external and internal transactions of eight companies (**six DAX companies, one MDAX company and one familiy owned company**) in order to show that the administrative burden of reporting is significant.

[1] For a comprehensive overview of our arguments please see Deutsches Aktieninstitut's paper "Retain the EMIR exemption for risk mitigating derivatives!" (14.9.2015) co-signed by other important German associations, https://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/2015-09-14%20ESMA%20report%20non-financial%20EMIR%20position%20paper.pdf.

1 Retain the hedging exemption for risk mitigating derivatives

1.1 Abandoning the hedging exemption…

…would lead to significant liquidity needs

The proposal to drop the differentiation between derivatives used for risk mitigating purposes and other derivatives would imply clearing and margining obligations in particular for larger NFCs although they use derivatives almost exclusively for risk mitigating purposes.

The margining obligations will result in a drastic additional need of liquidity which is objectively neither necessary from a risk perspective nor available. Non-financial companies try to match maturities of the hedging instruments with the maturities of the hedged items, i.e. the sale of goods or the purchase of pre-products or raw materials. Thus, during the lifetime of the hedge, no cash flow is involved which would have a negative impact on the corporates' risk profiles. Therefore, collateralisation is not necessary from the perspective of the company.

However, the liquidity drain from possible margin calls would deteriorate a firm's financial position. The following estimates underline the concerns of non-financial companies regarding the proposal to abandon the hedging exemption. They illustrate the amount of potential variation margins which would have to be posted by major German NFCs. Initial margins are not included in the estimates as FX instruments – the "main" derivative used by these companies – are currently exempted from the initial margin obligation. Nevertheless, companies apply also interest, commodity and credit derivatives, which would have to be collateralised with initial margins. The numbers provided below would be much higher as initial margins add up to 15 per cent of nominal values in some transactions (depending on the asset class).

According to a quick survey conducted by Deutsches Aktieninstitut in its working group on corporate finance/treasury the liquidity to be set aside for potential variation margins calls in the smaller stock listed companies would be in the three digit million Euro range if the hedging exemption was dropped. While many larger companies estimate the cash needed for collateral purposes between two and ten billion Euro, the liquidity drain for collateral purposes in one company could even amount up to 14 billion Euro. In total the liquidity needs of the eleven companies participating in our survey add up for **48.9 bn. Euro**, on average more than 4 bn. Euro per company.

In five companies the liquidity needs could be more than 100 per cent and – worst case – up to six times of the **annual earnings**. In many companies this counts for between 5 and 100 per cent of the annual earnings. The ability of companies to finance collateral could also be expressed in relation to the **operating cash flow**, meaning the cash flow available from their operational business activities. In six companies this relation is more than 50 per cent.

This data clearly shows that financing of collateral would overstretch liquidity reserves. Therefore, collateral would be typically financed through bank loans. To safeguard potential collateral needs companies would have to extend their **credit lines** significantly. Many companies would have to double lines, one would have to agree on new lines nearly five times as high as the existing ones.

Also, additional credit facilities would trigger extra costs like commitment fees for NFCs. Needless to mention, that NFCs do not have access to central bank credit facilities and are dependent on commercial banks. Accordingly, mandatory clearing/margining has the potential to convert long-term credit risk into short-term liquidity risk and ultimately direct insolvency risk for corporate end-users.

As a result, the liquidity maintained simply for collateral purposes would no longer be available for operative purposes. This would be detrimental to investment and employment in the respective NFC. To leave activities above the "new" thresholds unhedged is also no valid alternative as this would increase the corporate risk significantly. To avoid such a situation it would be necessary to increase existing clearing thresholds roughly 100-fold, which sounds not like a realistic assumption for those familiar with EU legislative processes.

…would contradict definitions already adopted in other EU-rules

The proposal to abandon the hedging definition also contradicts the overall political consensus not only expressed in the existing EMIR but also in the revised MiFID II/MiFIR (e.g. Art. 57(1) MiFID II) to be enacted 2018. The very important exemptions provided in these directives/regulations are the result of an intensive, constructive and elaborate dialogue among the legislator, supervisory authorities and market participants about the use of derivatives by NFCs.

…would weaken the level-playing-field to the detriment of EU-corporates

Exemptions from the clearing and margining obligations for NFCs are standard also in other jurisdictions, e.g. in the U.S., Japan, Canada, Australia, Hong Kong, Republic of Korea, Singapore. To abolish the hedging exemption would seriously harm the competitiveness of the European industry compared with their counterparts in other jurisdictions.

…would not reduce systemic risks in the intended way

As above mentioned, collateral that would be used by NFCs is typically financed via loans from banks. Overall default risks of NFCs will not decline (derivative exposure is exchanged with on-balance expo-sure from loans) which means that the collateralisation will not work in the in-tended way of reducing counterparty risks. From a financial markets viewpoint default risk will not be reduced but only be redistributed.

1.2 Monitoring and application of the hedging exemption is possible

It is argued that the hedging exemption is difficult to monitor for supervisory authorities and difficult to apply especially for smaller companies. Both concerns are not valid from our point of view.

Regarding the monitoring issue there are different ways available to solve this problem. We are in fact irritated by the idea to overcome any supervisory issues some jurisdictions might have by simply deleting the exemption. In Germany the respective cross-check is performed by external auditors on behalf of the supervisory authority BaFin. While this might be a very formalistic way it should be up to the supervisory authorities also in other jurisdictions to implement efficient monitoring processes.

In order to avoid an extra burden for smaller NFCs, which are not expected to exceed the clearing thresholds due to their relatively small derivative exposure, only minor changes to EMIR would be necessary. NFCs with total derivative positions below the clearing thresholds could be automatically classified as not clearing obliged (NFC-) because the derivative portfolio will never exceed the thresholds in this case. This approach would relieve these smaller NFCs from monitoring and classifying their derivatives as risk mitigating or non-hedging under EMIR. This is, to note, not a question of being unable to classify own derivatives, but it could reduce administrative burden for the implementation of the respective processes can be especially in smaller companies a substantial issue.

2 Alleviate reporting burdens for NFCs – single-sided reporting combined with an exemption of intra-group reporting

In our comment on the EMIR-review we asked the legislator to introduce a single-sided reporting regime.[2] This is necessary in order to improve data quality and to decrease the reporting burden especially for NFCs. As NFCs with a centralised treasury unit have to report intra-group transactions anyway, they would still have to retain the respective reporting infrastructure. Consequently, the single-sided reporting should be combined with an exemption for NFCs regarding the reporting of intra-group transactions.

The burden for NFCs to report their trades is indeed significant. Our member companies estimate the **compliance costs for the ongoing reporting obligation** up to 500,000 Euro a year per company. Even for smaller companies the annual costs for the reporting ranges from 20,000 Euro p.a. upwards.

In addition, depending on the risk management procedures of the companies the **internal transactions amount up to 100 per cent of the external transactions** executed with banks. As intra-group transactions require reports from both counterparties, e.g. the central treasury unit and the subsidiary, inclusion of intra-group transactions can increase the transactions to be reported up to three times.

[2] Please refer to our paper "Reduce the regulatory burden for non-financial companies" (13.8.2016), https://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/2015-08-13%20EMIR%20review%20position%20paper%20DAI.pdf.

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