

Third Country Equivalence According to the EU Benchmark Regulation

German Non-financial Companies are Concerned
about Negative Consequences for Risk Management

Background

As explained in the general position paper¹ of Deutsches Aktieninstitut² in more detail benchmarks from third countries play an important role for non-financial companies. Therefore, it is important that benchmarks, which are calculated outside the EU, will still be available in the European Union. Non-financial companies are, thus, concerned that Art. 20 which defines an equivalence test for these benchmarks will be too strict so that the use of benchmarks from third countries will seriously be hampered.

This note briefly summarizes where benchmarks from third countries may be used in financial contracts/instruments provided by EU financial institutions.

Risk Management with Non Deliverable Forwards

Benchmarks from third countries are an important element of Non-Deliverable Forwards (NDFs) und Non-Deliverable Swaps (NDSs). NDFs and NDSs are used by non-financial companies in order to hedge foreign exchange risks in countries with currencies that are not freely convertible. This is typically the case in a number of Latin American and Asian emerging markets such as China, India or Brazil where many European corporates have significant operations.³ The respective foreign exchange risks may result from business relations in the foreign country or from internal financial relations in the foreign currency.

A non-deliverable forward/swap differs from a “normal” foreign currency forward/swap contract. The counterparties agree to buy, sell or exchange a currency at a pre-determined exchange rate and on a pre-determined future date. Unlike “normal” foreign exchange derivatives NDFs/NDSs cannot be settled physically because the convertibility restrictions do not allow for the foreign currency to be delivered physically. Instead, they are settled in cash which typically means in US dollar or euro. Cash settlement means that the price difference

¹ Deutsches Aktieninstitut, Benchmark Regulation and Non-Financial Companies, Position Paper, 23 October 2014, <http://www.dai.de>.

² Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and Berlin. This position paper is based on discussions in the working committee on corporate treasury/corporate finance consisting of representatives of the treasury departments of German non-financial companies.

³ The BIS lists the following currencies with an active NDF market: Brazilian real, Chinese renminbi, Indonesian rupiah, Indian rupee, Korean won, Malaysian ringgit, Philippine peso, Russian rouble, New Taiwan dollar. See McCauley, Shu, Ma, Non deliverable forwards: 2013 and beyond, BIS Quarterly Review, April 2014

between the agreed exchange rate and the market exchange rate at the termination date of the contract is paid out.

In order to determine the US dollar cash equivalent the counterparties have to refer to a fixing of the foreign currency. In practice, the respective fixings are either provided by the central bank of the country with the non-deliverable currency or private companies such as WM Company or Thomson Reuters. In addition, fixings stemming from industry organizations like the Emerging Markets Trade Association (EMTA) or industry surveys may be used.

It is our understanding that these fixings will be regarded as a benchmark according to the regulation. As a consequence, non-financial companies will no longer be able to hedge against currency risks in the respective countries with a European bank unless the respective benchmark passes the equivalence test of Art. 20 or will be exempted according to Art. 2 of the regulation.

As there is no comparable regulation on benchmarks in the respective countries the equivalence test will most likely not be met for the respective benchmarks. Obviously, this will limit the non-financial companies' options to hedge against risk in a number of important markets. We do not believe that this negative consequence is intended by the legislator as it would set European companies (and banks) in a competitive disadvantage to their peers in other areas of the world. Even worse, this negative effect would arise as of the day the new regulation comes into force because the transitional provisions of Art. 39 prohibit any new financial contract/instrument with a reference to an index/benchmark that does not meet the duties of the regulation until the equivalence decision has been taken.

Other References to Third Country Benchmarks

In addition to the management of currency risks non-financial companies use financial contracts/instruments referencing to third country benchmarks in a number of additional circumstances. A limitation of their use due to Art. 20 may, therefore, have additional negative consequences.

Pension funds or other pension vehicles typically hold a portfolio of different assets from all over the world. In order to manage the risks of these assets they typically enter into derivative contracts that may refer to third country benchmarks. An equity derivative instrument on the MSCI World may, for example, be used to reduce fluctuations in the prices of a global equity portfolio. Also here Art. 20 may interfere with hedging needs of non-financial companies if not properly adjusted. Non-financial companies also typically hedge against fluctuations in the price of commodities in order to shield their operative business against such risks. The relevant bench-marks are often provided by agencies, organizations or private companies from outside the EU so that no comparable regulation is in place. A

good example is the Platts Steel Index which serves as a benchmark for the price of steel in the global markets; another is the Henry Hub Natural Gas Index which serves as a benchmark for the price of gas. EU banks would, therefore, be stopped from offering hedging services for the relevant commodities.

And finally, credit agreements may reference interest rate benchmarks administered outside the EU such as the US Prime Lending Rate calculated by the Wall Street Journal on the basis of a poll among US banks.

Position of Deutsches Aktieninstitut

Overall, the third country provision according to Art. 20 of the proposed EU benchmark regulation will have a number of negative consequences for the non-financial companies. As long as the home countries of the relevant benchmark providers do not enact a similar regulation it is highly likely that a number of important benchmarks will not be available anymore for European banks and thus their customers from the non-financial sector.

It is also worth noting that the proposed amendments to the regulation by the ECON's draft report and the latest compromise proposal of the Council will not limit the risk of reduced availability significantly. Although the recognition process of Art. 21a does not refer to the equivalence of the legal framework of the third country but rather to "equivalent behavior" of the administrator from third countries, the compliance duties for the respective administrator will still be very strict. As a consequence, in particular smaller administrators are likely to turn away from the European market. In addition, no recognition can be granted unless there is appropriate cooperation between ESMA and the third country authority which brings back the issue of equivalent legislation and supervision.

In the same way, although the new Art. 20 para. 2a (only ECON draft report, amendment no. 162) provides for additional flexibility regarding the provision of third country benchmarks in the EU for at least some benchmarks, it is not certain that the EU Commission will use its discretionary power. In addition, in contrast to Art. 21a the equivalence test of Art. 20 para. 2a still refers to "specific rules or requirements in a third country" so that a reference is made to the legislation rather than to the behavior of a single administrator.

➔ *Against this background, Deutsches Aktieninstitut suggests to drop the third country equivalence test completely and replace it with another rule: Concretely, the index providers (from third countries) should disclose whether they comply with the requirements of the EU Regulation or not.*

This would be similar to the rule the ECON proposes for regulated data benchmark providers and would be less disruptive to the market. Users of a financial instrument or a financial contract could then decide for themselves how important the compliance with all of the requirements of the proposed regulation is to them. It would also be the end user's decision whether he wishes to continue to use the financial instrument/financial contract in question. Non-financial companies as professional users/clients are certainly able to make the respective judgment.

The advantage of this proposal is clear: The risk that third country benchmarks cannot be used anymore in the EU will be minimized. On the other hand, transparency will be increased and market control on benchmark providers will be encouraged.

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