



The European Association of Corporate Treasurers

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Comments in response to ESMA discussion paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

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The European Association of Corporate Treasurers (EACT)

The EACT is a grouping of national associations representing treasury and finance professionals in 17 countries of the European Union. We bring together about 8,100 members representing 4,600 groups/companies located in the EU. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe. We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

Our contact details are provided on the final page of this document.

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Introductory comment

We are limiting our responses to those questions most specifically related to the use of derivatives by non-financial counterparties; we therefore address only Questions 10, 11, 12 and 21.

The drafting of EMIR recognised that the use of OTC derivatives by non-financial counterparties accounts for a very small proportion of the total outstandings; it was widely accepted that these transactions did not give rise to systemic risk in the recent financial crisis and are highly unlikely to do so in the future. The EACT and non-financial counterparties in general welcomed the principles established in EMIR, which included setting out to ensure that the use of OTC derivatives to mitigate underlying risk outside the financial sector can continue so far as possible without a requirement for central clearing.

The EACT therefore considers it of fundamental importance that in ESMA's work on EMIR's Level 2 technical standards, the key questions around the definition of "contracts [that] are objectively measurable as reducing risk" and of the clearing threshold are addressed in a way that does nothing to dilute the intent behind EMIR's 'exemption' for non-financial counterparties.

It is the EACT's hope that the standards defined by ESMA will ensure that the overwhelming majority of non-financial counterparties will be able to continue to use OTC derivatives without introducing the threat to financial and economic instability and the liquidity risk that would be associated with any requirement to enter such transactions into central clearing.

Comments in response to specific questions

1 **Criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to the commercial activity or treasury financing**

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

There are complex issues raised both by the interpretation and the scope of ESMA's discussion of this topic. We want to focus attention on three issues: the governance context in which non-financial counterparties can be assumed to be using OTC derivatives; the range of exposures (risks) for which hedging is routinely used to mitigate business risk; and the role of IFRS in relation to the standards to be defined by ESMA.

1) The governance context: non-financial counterparties must be expected to operate within policy frameworks that are both rigorous in prohibiting any treasury activity that is speculative and broad in recognising that good treasury management requires taking a forward-looking view of the evolution of financial risks within the business.

This view of both the known and the expected future risks relies on the ability of treasury management to put in place hedges that minimise the risk of any mismatch between the risk and the hedge. Because these risks are for the most part not 'standard' judgement and flexibility is required. It is important therefore that ESMA's standards do not restrict risk mitigation through too narrow an interpretation of 'objectively measurable'.

The EACT therefore supports this wording change to paragraph 29, as proposed by another of the respondents to ESMA's discussion paper:

By reference to European accounting rules, ESMA considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks ~~directly related to~~ arising from the commercial activity or treasury financing activity of that non-financial counterparty.....

2) The range of exposures requiring to be hedged: paragraph 29 (a) concludes with an all-encompassing reference to risks that are "in the ordinary course of [a non-financial counterparty's] business". This reference is unhelpful because it substantially narrows the understanding of what such a non-financial counterparty will do routinely (and prudently) to mitigate the financial risk arising from its normal activities. Practitioner respondents will provide ESMA with extensive instances of such activities; at a high level these can be assumed for example to include hedging associated with merger and acquisition activity, with dividend flows and with income from trade investments.

The EACT therefore encourages ESMA to consider the following amendment to paragraph 29 (a):

The potential change in the value of assets, service, inputs, products, commodities, liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring ~~in the ordinary course of its business; or~~

3) The role of IFRS: although we understand that this may not have been ESMA's intention, paragraph 30 appears to suggest that a transaction *qualifying under IFRS principles as a hedging contract* is not just a sufficient but also **a necessary condition** for the OTC derivative to be deemed "objectively measurable as reducing risks".

The EACT considers it essential that this is unequivocally clarified by ESMA, so that there is no suggestion that IFRS hedge accounting treatment is mandatory for the underlying OTC derivative to qualify for the exemption from central clearing. The reasons why this is important can be summarised as:

- as a matter of principle financial regulation should not be built around (transitory) accounting standards;
- many non-financial counterparties find it difficult to achieve hedge accounting under IFRS because of the complexity and non-standardised nature of their underlying risks; and

- demonstrating 'hedge effectiveness' under IFRS can pose an administrative burden on many companies and for this reason is not regarded as worthwhile.

2 *Setting the clearing threshold*

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

The EACT considers that an overriding objective in setting the clearing threshold should be to ensure that the great majority of non-financial counterparties, that cannot be considered to have any systemic risk significance, should not be inadvertently caught by a threshold that has not been appropriately defined. We recognise the argument for setting a low threshold but suggest that this could be short-sighted, if the inadvertent consequence (for whatever reason) is to force non-financial counterparties into central clearing despite the integrity (risk mitigation) of their actions.

We agree with ESMA's recommendation that the clearing threshold should be simple to implement. We therefore agree with the approach of using the notional value of OTC derivatives subject to the clearing obligation, provided that the threshold levels are set at an appropriate level. Whilst in theory it may be possible to use a more complex process such as looking at a Potential Future Exposure on each specific type of derivative in order to recognise their different risk characteristics, this would seem unnecessarily complex to administer, would introduce a degree of subjectivity into the process, could lead to a breach of the clearing threshold due to market movements and is likely to be pro-cyclical.

Paragraph 35 discusses whether limits should apply per legal entity or by group. The more correct approach would be to recognise the independence of legal entities and the limited liability concept in groups. However for many non-financial groups there is a common purpose and interdependency between group companies in practice if not strictly on a legal basis. Taking the pragmatic point of view we accept that limits should apply to groups. However if limits are set too low there is a danger of inadvertently tripping a group limit through hedging actions within a downstream subsidiary.

If the clearing threshold is to be defined on a group basis this provides further reinforcement for the argument that the monetary amount should not be set at too low a level.

3 *Timely confirmation*

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

Treasury associations across Europe are expected to encourage their members to conform to guidelines published at national level (for instance, in the United Kingdom the NIPS Code (Non Investment Products code) issued by the Bank of England). In the case of the NIPS Code this means that for electronic confirmation the timescales are to exchange and process confirmations within two hours of the deal being struck and by the end of the day (trade date) at the latest, while recognising that lack of access to SWIFT could make these deadlines difficult to meet.

The EACT agrees that electronically executed, processed or confirmed transactions can generally be handled more quickly and that therefore the timescales proposed for financial counterparties and non-financial counterparties above the clearing threshold are at an appropriate level.

In paragraph 39 slightly extended timescales are being proposed for transactions executed with counterparties other than financial counterparties and non-financial counterparties above the clearing threshold. In the EACT's view next business day for electronically executed or processed deals is reasonable and for transactions not executed electronically we would suggest a further day is allowed, ie no later than the second business day after execution.

In referring to “confirmations” the EACT supports the request from the ACT in the UK that ESMA interprets that term fairly widely, to take in any equivalent messages and processes having the effect of confirming. As the ACT states, non-financial counterparties may check and acknowledge bank generated confirmations received by them, which is sometimes referred to as an affirmation. Likewise foreign exchange deals settling through CLS Bank may be subject to “confirmation” within CLS rather than via externally exchanged confirmations.

4 *Intra-group exemptions*

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

For the purposes of these comments we accept that ESMA appreciates that non-financial counterparties tend to centralise treasury activities within their group and this carries a number of advantages, which can be summarised as:

- central oversight, monitoring and reporting of consolidated financial risks;
- a stronger control environment; and
- dealing and netting efficiencies in mitigating those risk with hedges.

The EACT wishes to express its concern over the requirement to notify the competent authority details of exempt intragroup transactions. By definition intra-group transactions of non-financial counterparties do not pose a systemic risk to the financial system. We also express concern over the lack of clarity around how a competent authority may exercise its discretion in granting an exemption.

If the requirement to notify a competent authority to make use of the exemption is to be included in ESMA’s rules the EACT strongly urges that the information to be provided should be relatively simple and not create a heavy administrative burden. The type of minimalist data provision that might be implemented could be limited to:

- Names of the two counterparties
- Purpose or type of the derivative transactions
- Confirmation that appropriate risk management procedures are in place

The EACT understands that there may be a requirement for intragroup transactions to be collateralised until the relevant exemption has been approved by the competent authorities in each Member State. This raises the threat of a significant practical problem for non-financial counterparties.

Such entities would have to set up a temporary collateralisation structure, which is challenging in itself for businesses in the ‘real economy’, such as manufacturers and service providers, whose management teams are wholly unfamiliar with a process that is fundamentally designed for the financial sector.

A further problem would arise where the subsidiary within a non-financial counterparty does not have enough assets to post as collateral and would have to borrow money internally from the group treasury in order to post it back to the group treasury as collateral. The operational risks as well as the inherent economic inefficiency of this will be evident to ESMA.

The EACT stresses overall that intragroup collateralisation, whether temporary or permanent, is completely impractical for the majority of non-financial counterparties to implement. It would require a significant investment in new systems and processes, with an associated increase in cost and personnel, for little obvious benefit in terms of reducing systemic risk and contributing to the European Union’s financial stability and economic growth.

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