POSITION PAPER

16 February 2011

OTC Derivatives

PROPOSAL FOR A REGULATION

Introduction
BUSINESSEUROPE is in favour of smart regulation for financial services in response to the regulatory failures that led to the financial crisis and to address the risk of similar events occurring in the future. In this context, we support the subject matter and scope of the proposal and especially the proposed exemption for non-financial companies which use derivatives in conjunction with risk mitigation of underlying real economic risks is of crucial importance.

Article 2 – Defining hedging
It is important that it is more clear which derivative transactions are considered to be objectively measurable as reducing risks directly related to the commercial activity of the non-financial counterparty concerned as referred to in Article 7. Article 2 should therefore define the term "reducing risks directly related to the commercial activity" from a principal perspective, stipulating method and intend, so that it would include any derivative entered into to mitigate risk, such as from foreign exchange, interest rates, commodities prices, or credit risk related to the commercial activity.

The definition of a hedging contract should not be based on hedge accounting standards. Determining what constitutes a hedging contract should be based on a concrete analysis of the contract which is carried out by the company itself and certified by a reviewable self-commitment of the company subject to sample inspection of relevant authorities.

Transferring risk intra-group
The Regulation should make it clear that transactions with affiliates are exempt from clearing and reporting obligations so that it will be possible to transfer commercial risk intra-group. Often the underlying commercial risk that is being mitigated by hedging does not lie in the same entity that contracts the hedge externally. The proposed Regulation is based on the assumption that it applies on a legal entity basis. This will create problems for large international European companies as they will often manage their risk on a group basis reducing the risk which is taken by the group as a whole. It should therefore be clear that the threshold should only count derivatives which do not reduce risk directly related to the commercial activity of the group.

Article 3 - Clearing obligation
It should be explicitly specified in Article 3 that a non-financial counterparty which does not exceed the clearing threshold should not be required to clear its OTC derivative contracts also when the counterparty is a financial institution or a non-financial counterparty which is exceeding the threshold. To avoid regulatory arbitrage, it should

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be similarly clarified that the clearing obligation equally applies to counterparties which enter into eligible transactions with third country entities that would be subject to the clearing obligation if they were established in the EU.

Clearing shock

It should be avoided that a non-financial counterparty has to clear all of its OTC derivative contracts once the clearing threshold is breached including the contracts which were previously exempt. This will force companies to post margins for all these trades requiring them to raise such liquidity which might be difficult and expensive in the currently prevailing market conditions. The liquidity posted will also not be available for much needed investments in the operative business of corporations which could slow down the recovery of the EU economy.

Providing intra-day cash collateral is not feasible for market participants that have no access to Central Bank liquidity. Consequently, to avoid the risk of illiquidity under extreme circumstances, non-financial companies would need substantial additional credit lines to cover tail-risks which would be hard and costly to obtain. This would lead to corporations stop hedging risks, increasing not only the risk for the single corporation concerned but also for the economy as a whole. Reduced hedging will also lead to a different risk assessment of the non-financial companies concerned by capital markets which will negatively affect the cost of equity and financing. Collateralisation would not resolve this and might even increase the default probability in times of financial distress as non-financial companies have an incentive to significantly reduce their hedging activity to stay within the clearing threshold especially when indeed the entire OTC derivative portfolio has to be cleared once the threshold is breached. The use of a clearing agent does in principle not significantly reduce the amount of counterparty risk for a corporate. As it needs to secure additional liquidity for collateral, counterparty risk only moves over to the provider of such lines.

The clearing obligation should thus only apply to derivative contracts entered into and after the date from which the obligation takes effect so that non-financial counterparties are not forced to clear contracts that were previously exempted. Clearing obligations should be determined on the basis of net positions and exposures over an appropriate time period that is adequate to allow the application of the clearing obligation by the non-financial counterparty. The Regulation should include appropriate transitional provisions to ensure that non-financial businesses are not forced to close long standing positions before implementation to avoid breaching the threshold. Otherwise, this could result in substantial losses for businesses on positions entered into in good faith.

Determining the thresholds

The regulation should contain the main criteria for determining the thresholds. The systemic relevance of the sum of net positions and exposures of OTC derivatives should be assessed on the basis of appropriate quantitative and qualitative criteria per class of OTC derivatives over a specified time period, in particular on the credit risk exposures to systemically relevant financial institutions. The reporting obligation should also be limited to the information on the OTC position and it should be possible that reporting can be delegated, for example to the financial counterparty.

Not cleared OTC derivative contracts

Higher capital requirements for financial institutions for non-standardised contracts under Basel III will have an impact on access to finance, also in conjunction with the proposed margin posting requirements. It is important that countries work cooperatively on the implementation and calibration of Basel III – especially across the Atlantic – to ensure that access to finance and the competitiveness of European companies will not be unduly affected. The central role in Europe of bank intermediation in the financing of the economy and the diversity of banking models in the EU should be duly considered. A thorough, consistent and credible impact assessment looking at the cumulative effect of financial market reforms on access to finance and growth should be undertaken.

In this context, it is of utmost importance that Article 8 is not amended in any way that would require non-financial companies to post collateral in circumstances where they satisfy the exemption test as this would undermine the very purpose of the exemption set out in Article 7.

Institutions for occupational pension schemes

The inclusion in Article 2 para 6 of institutions for occupational pension schemes should be deleted. Corporate and non-corporate pension funds should not be covered by the reporting and clearing requirements laid down in Article 7. The use of derivatives by annuity providers is similar to that of non-financial companies which use these contracts in conjunction with risk mitigation of underlying real economic risks. These institutions should thus not be discouraged to hedge the risks they face such as interest rate and longevity risk.

The inclusion of these institutions in the Regulation would also force them to hold a larger proportion of government bonds to use as collateral reducing investment in corporate bonds. A similar effect is caused by the implementation of Basel III and Solvency II rules which discourage investments in long-term bonds. As demand for capital intensifies, companies will thus find it increasingly difficult to obtain the finance they need for investment. It is crucial that financial reforms do not harm market liquidity and make it more difficult for businesses to access debt and equity funding through financial markets.