POSITION PAPER

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OTC Derivatives

REGULATORY TECHNICAL STANDARDS

Introduction

Non-financial companies use 'over-the-counter' (OTC) derivatives in conjunction with risk mitigation of underlying real economic risks. It is crucial that new technical standards do not undercut the clearing exemption for non-financial companies contained in the European Markets Infrastructure Regulation (EMIR) or discourage end users from entering into OTC derivative transactions. 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.

Definition of 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 or treasury financing activity of the non-financial counterparty concerned as referred to in EMIR.

This term should be defined 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, equity or credit risk related to the commercial activity. All relevant risks stemming from the commercial and treasury activities mitigated by non-financial companies through derivatives should be covered and this should be clearly stated.

This should include derivative instruments used to mitigate risks related to changes in the value of cash flows as both asset values and cash flows are hedged by derivatives. The same applies to fluctuations in commodity prices, credit risk stemming from trade finance assets, and the risk that a business partner defaults before the outstanding obligations (especially trade receivables) are settled.

Corporate actions such as capital decreases or increases, share buy-backs, convertible bonds and employee stock ownership plans should also be covered. These corporate actions are part of the treasury activity and should be accepted as risk mitigating. Moreover, ESMA should also include commonly used risk management practices like macro, portfolio or proxy hedges in the technical standard. These practices are also suitable for the reduction of risk.

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Clearing threshold

Regarding the setting of the clearing threshold, BUSINESSEUROPE believes that the threshold must not be set at a low level (e.g. a one-digit million Euro amount) as this would mean that even the larger SME companies are at risk of falling under the clearing obligation. The value of the threshold should take the systemic relevance of the derivative exposure into account which presupposes a higher level. In comparison, in the US, a similar threshold has been defined in the billion-dollar range. Also, there should be flexibility as there will be certain hedges that may not fall under the final definition of hedging even if they are risk-mitigating from an economic point of view, for example due to uncertainty regarding the interpretation of legal terms or enforcement practices. It is important that there is coherence with the US rules in this area.

Risk mitigating techniques that are applied by non-financial counterparties should be considered in the calculation of the clearing threshold. Thus, the derivative exposure relevant for the calculation of the threshold should be adjusted by bilateral netting agreements and collateral already posted.

The threshold should be calculated at group level and not at the level of every legal entity of the group considering that non-financial companies often centralise their risk management through a financial subsidiary which manages risk on account of other group entities.

Non-financial companies which use derivatives to hedge risks differ in size. This should be reflected by a proportional threshold which takes account of the balance sheet total, the total turnover, or the aggregate derivative exposure of the whole group. A *de minimis* activity defined as a threshold in absolute terms should be set to save SMEs the burden of having to compute the relative threshold.

Notification process

It is very likely that many non-financial companies exceeding the clearing threshold will apply for the group exemption. Therefore, we expect a vast number of notifications which will take time for the supervisory authorities to be thoroughly analysed. For reasons of legal certainty, it is very important that ESMA clarifies that intragroup transactions are not obliged to be bilaterally collateralised until the notification process is finalised. Otherwise, this would lead to the situation that an intra-group transaction has to be collateralised until the exemption becomes valid.

In order to minimize burdens, especially for non-financial companies which have not yet implemented the required reporting structures, the notification procedure should be easy to apply. It should be sufficient that a company aggregates its intragroup transactions per asset class and reports the aggregated volume to the competent authority. Information on intragroup transactions is often confidential because the risk allocation strategy can be revealed by disclosure. In order to limit potential damage, no additional trading data should be publicly disclosed for groups compared to individual companies. If any trading data has to be published, it must be ensured that the figures of intra-group transactions that are to be disclosed shall not allow competitors to gain insights on hedged exposures of subsidiaries.

Trade repositories and CCP requirements

ESMA should also consider the specifics of non-financial companies as regards the risk management and reporting requirements. For example, the obligation for a frequent portfolio compression is not appropriate for derivatives held for hedging purposes. There should be a proportionate reporting regime for derivatives of non-financial companies to avoid unnecessary burdens. It should be allowed that non-financial companies delegate the respective reporting to the financial counterparty without restrictions. Reporting of group transactions which are used for hedging purposes should strictly follow the language provided by EMIR.

Lastly, it is important that non-financial companies can post bank guarantees in addition to cash collateral. Overly strict requirements in this area should not increase non-financial companies' costs of central clearing disproportionally.

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