Retain the EMIR exemption for risk mitigating derivatives!

Larger non-financial companies using derivatives almost exclusively for risk mitigating purposes must not be obliged to clear centrally

Joint position paper on ESMA's report on the use of derivatives by non-financial companies, 14 September 2015

BDI

BGA Bundesverband Großhandel, Außenhandel, Dienstleistungen e.V.

Deutsches Aktieninstitut

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Introduction

This joint position paper of Bundesverband der Deutschen Industrie (BDI), Bundesverband Großhandel, Außenhandel, Dienstleistungen (BGA), Deutsches Aktieninstitut, Deutscher Industrie- und Handelskammertag (DIHK), European Federation of Energy Traders (EFET) and Verband Deutscher Treasurer (VDT) comments on ESMA's EMIR report no. 1 "Review on the use of OTC derivatives by non-financial counterparties" released on 13 August (ESMA 2015/1251).

After analysing the use of derivatives by non-financial companies ESMA suggests that the clearing thresholds, determining whether a non-financial counterparty is obliged to clear or collateralize bilaterally, should be set "irrespective of their hedging or non-hedging nature". In the opinion of ESMA this proposal is justified, because firstly larger non-financial companies (NFCs) having "substantial" derivative exposures are not captured by the clearing obligation, secondly because the approach to classify derivatives as risk mitigating/non risk mitigating would be challenging to apply especially for smaller companies, and thirdly because supervisory authorities may have difficulties to monitor the respective distinction "risk mitigating/non risk mitigating " carried out by NFCs.

However, the problems described by ESMA are not due to difficulties with the classification of transactions or counterparty status, but mostly due to the complexity and opacity of the current reporting regime. In this regard Deutsches Aktieninstitut made several proposals in its comment on the recent EMIR review launched by the European Commission.[1] Furthermore, so far many Member States have not implemented supervisory processes in order to monitor the adequate application of EMIR compliance. ESMA should support these countries in their efforts to implement efficient supervision processes regarding EMIR compliance of NFCs and should not take these shortcomings as an argument to abolish this crucial relief for corporates provided as a result of an extensive legislative discussion process.

As a consequence of ESMA's proposal, large NFC- would have to collateralise their derivative transactions also in cases where they use these instruments for risk mitigating purposes. According to a study conducted by the Coalition for Derivatives End-Users NFCs would have to set aside 6 per cent of their derivative exposure (measured in notional value) in order to fully collateralise their OTC transactions.[2] This would mean that EUR 204 bn. posted as collateral by European non-financials

1 See the position paper of Deutsches Aktieninstitut "Reduce the regulatory burden for non-financial companies" of 13 August 2015.

2 See Coalition for Derivatives End-Users: The impact of Margin Requirements on Main Street Businesses, 2014.

would no longer be available for investments in growth and employment.[3] This sum is significant compared to e.g. the intention of the European Commission to mobilise EUR 300 bn. in order to promote jobs, growth and investment in Europe. Furthermore, it will prove difficult to finance these amounts of collateral as NFCs – in contrast to financial institutions – do not have access to central banks liquidity facilities. And last but not least, as collateral is typically financed via loans from banks, overall default risks of NFCs will not decline (derivative exposure is exchanged with on-balance exposure from loans) which means that the collateralisation will not work in the intended way of reducing counterparty risks. From a financial markets viewpoint default risk will not be reduced but only be redistributed.

Against this background, we strictly oppose ESMA's proposal to abandon the hedging definition:

1. ***Reopening the debate regarding the risk mitigating definitions is superfluous.*** Risk mitigating derivatives are of strategic importance for non-financial companies irrespective of their size and do not endanger the resilience of the financial system. This is acknowledged by the legislator not only under EMIR, but also by specific exemptions in the revised MiFID II/MiFIR framework, some of which are directly linked to the EMIR definitions and thus also endangered (see section 1).
2. ***Risk mitigating instruments can reliably be identified.*** To distinguish between risk mitigating and other derivatives according to the respective legal definitions is indeed practicable and is well established especially in larger companies (see section 2).
3. ***Monitoring the hedging exemption is possible.*** There are different ways available to solve the problem to monitor a very large number of non-financial companies using derivatives and applying the risk mitigating definition. In Germany this cross-check is performed by external auditors on behalf of the supervisory authority BaFin. Nevertheless, in order to support supervisory authorities in their supervisory capacities the complexity of the reporting regime resulting in a low data quality should be reduced (see section 3).
4. ***The methodological approach chosen by ESMA is questionable.*** ESMA's approach to analyse and evaluate the systemic relevance of derivatives used by non-financial companies is flawed in several aspects. Although in particular larger non-financials, which are in the focus of ESMA, represent only a minor fraction of the total EU derivative market (effectively ca. 0.4 per cent measured by notional value), ESMA constructs some systemic relevance from a very thin line of arguments (see section 4).

3 ESMA reports that the notional value of the derivative exposure of large NFC- amounts to EUR 3,395 bn. (see table 4 on p. 13). If 6 per cent of this exposure has to be posted as collateral, the collateral would be EUR 204 bn.

Our comments in detail

1. Risk mitigating derivatives do not endanger financial stability, but enhance it

The proposal of ESMA, to drop the differentiation between derivatives used for risk mitigating purposes and other derivatives would imply the clearing obligation or the requirement for bilateral collateralisation in particular for larger NFCs, even if they used derivatives almost exclusively for risk mitigating purposes. This would be to the detriment of investment and employment in the respective non-financial companies as the liquidity provided as collateral (initial and variation margins) would be no longer available for operative purposes. Especially when market values of derivatives turn negative the liquidity drain could be significant. Non-financial companies try to match maturities of the hedging instruments with the maturities of the hedged items. Thus, during the lifetime of the hedge, no cash flow would be involved if no collateralisation is necessary. Being obliged to collateralise the market value of derivatives would decouple the cash flow effect of the hedging instrument and the hedged item. As changes in market values of the derivatives and therefore its collateralisation financing needs are not predictable, this might lead to liquidity squeezes of actually healthy companies, with a negative impact on their creditworthiness/rating. In any case, the necessity to block funds for such non-core purposes would reduce the financial flexibility of companies considerably. As mentioned in the introduction this drain of liquidity due to the collateralisation obligation is significant and could amount to EUR 204 bn. for larger European NFCs. Effectively money which is no longer available for investments in growth and employment.

To avoid these damaging effects, the retention of the hedging exemption is of utmost importance. ***This exemption is justified as hedging derivatives are in general risk neutral from a corporate view and do not increase existing non-financial's risk.*** The reason for that is very simple: The market value of the derivative and the underlying business compensate each other. Example: an exporter who sells USD receipts forward via a derivative will a have a negative market value of a FX-derivative when the USD gets stronger, but at the same time the value of the underlying export business rises. In this situation the derivative would be a case of "right-way risk" for the company's counterparty, as the competitive situation of the company's operative business actually increases. As a result of the derivative, fluctuations of the underlying business stemming from currency, interest or commodity price fluctuations are eliminated – which is the main purpose of risk management

with such instruments. Hedging stabilizes cash-flows thus enhancing creditworthiness and ratings of the respective companies.

The mere finding of ESMA that the derivative exposures of NFCs is of considerable size is not surprising, as the turnover of a non-financial group relates to the amount of derivatives employed (in larger companies 50 to 80 per cent of the turnover is hedged). Derivative holdings can be even higher than the yearly turnover, as many projects are stretching over several business years. By general logic, the larger the turnover of a corporate, the larger is also the amount of derivatives used. This fact is well-known among market participants, as most non-financial companies publish the nominal or the market values of their derivative exposures in their annual reports. In addition, large (German) NFCs are already required by corporate law and accounting rules to have efficient risk management systems in place, e.g. limit systems, in order to adequately diversify the risks of their exposure across many financial counterparties (see also our remarks regarding ESMA's methodology in section 4).

Without considering or discussing the above mentioned specifics of risk mitigating derivatives ESMA concludes the systemic relevance of larger NFCs in general. This assumption is plainly wrong as mentioned above.

Furthermore, ESMA's proposal contradicts the overall political consensus not only expressed in the existing EMIR but also in the revised MiFID II/MiFIR[4]. The very important exemptions granted in these directives/regulations are the result of an intensive, constructive and elaborate discussion among the legislator, supervisory authorities and market participants about the use of derivatives by non-financial companies. ***ESMA should not reopen this discussion which does also endanger some of the corporate reliefs to be provided by MiFID II/MiFIR (see footnote 4).***

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4 The following rules in MiFID II/MiFIR are dealing with exemptions for risk mitigating derivatives used by non-financial companies:

- ***Art. 2 para. 4 MiFID II*** which explicitly excludes "transactions in derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity" from the calculation of the so called "ancillary activity exemption", which determines whether a non-financial company has to comply with the strict requirements of an investment firm due to its usage of commodity derivatives, emission allowances or derivatives thereof.
- ***Art. 57 para. 1 MiFID II*** which excludes hedging derivatives from the position limits regime ("Position limits shall not apply to positions held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly relating to the commercial activity of that non-financial entity.").
- ***Art. 8 para. 1 MiFIR*** which excludes hedging derivatives of non-financial companies from the pre-trade transparency regime ("[…] That publication obligation does not apply to those derivative transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group.")

On the contrary, ESMA should be aware that a NFC would be a riskier company if it does not or would not have the opportunity to mitigate business risks appropriately. Income and outgoing cash flows are steadied and can be anticipated in the planning of future operations. This very important feature using risk mitigating derivatives is also acknowledged by bond and equity stakeholders as well as by rating agencies, all of which expect a prudent management of related risks. The latter will inter alia very likely assess the "cash" position from the posted collateral as "restricted" and therefore as not being part of the general liquidity position, whereas the financing of the posted collateral via debt (e.g. commercial paper or credit facilities) is fully reflected in the debt position. Hence, via this "trapped cash" a deterioration of the company's creditworthiness might be the consequence, including potential rating downgrades, breaches of LMA debt covenants, and a general decrease of a companies' debt capacity. A comprehensive rating downgrade in the corporate sector would have also an ultimate impact on the average loan portfolio ratings of the banking sector with direct consequences for the liquidity and loan supply of the European economy. Thus, any regulation that makes the use of risk mitigating derivatives less attractive (which would be the result of mandatory clearing or bilateral collateralisation) will actually increase risks for the economy in total instead of limiting existing risks by spreading them among several market players.

Last but not least, ESMA's approach would distort the global level-playing-field especially regarding the U.S. real economy. As commonly known the U.S. legislator introduced a hedging exemption for NFCs with thresholds more generous than in the EU.[5] To abolish the hedging exemption would seriously harm the competitiveness of the European industry compared with their U.S. counterparts.

2. Classification of risk mitigating derivatives is not a too complex a task

ESMA notes that the abolition of the distinction between risk mitigating and other derivatives would "greatly simplify the process and lower the burden and compliance costs incurred by most NFCs, given that even the smallest ones are currently required to classify all their transactions as hedging or non-hedging" (see p. 28 no. 138 of the ESMA report). That, however, is not of practical relevance due to headroom within the thresholds, as ESMA admits itself (see below).

5 In the U.S. the thresholds to be licensed as Major Swap Participant, the U.S. equivalent to the European NFC+, are less strict than the comparable clearing thresholds under EMIR (between USD 1 and 3 billion for different asset classes, and those calculated in market values, not nominal ones as under EMIR).

Of course, the above mentioned classification is associated with extra costs. However, these extra costs are justified in order to acknowledge the specifics of derivatives used by non NFCs. In particular the ***larger German NFCs*** have already invested a lot of human and financial resources in the implementation of adequate processes to classify the respective derivatives according to the definitions in Article 10, Regulation (EU) No 149/2013.

As an important feature of these processes the group-wide use of derivatives is controlled by internal guidelines defined by the company. These guidelines are part of the annual monitoring process executed by the external auditors in Germany (see a short description of this process below). As far as we know, in most of our member companies these guidelines generally state that the use of derivatives is solely or almost exclusively limited to risk mitigating purposes. Most of our member companies make this transparent via the audited annual report. The finding of ESMA, that especially larger companies display a "hedging ratio" of 100 per cent, is not very surprising (see p. 23 no. 113). ***Therefore, we strictly reject ESMA's remark that "counterparties which classify 100 % of their trades as hedging […] tend to suggest that those counterparties have not developed systems to monitor the hedging […] nature of their transactions" (see p. 27 no. 137).*** We would in turn ask ESMA to provide evidence for that statement. As an example, for German companies the incorrectness of this assumption could easily be proved by auditor's yearly EMIR compliance reports, or by simply looking into the annual reports of publicly traded companies (presumably including most large NFCs).

Although we object ESMA's notion that the classification "hedging/non-hedging" is not feasible or difficult in practice, we support the need to improve the regime for the calculation of the clearing thresholds. This holds especially true for the treatment of intra-group transactions, which do not increase the overall risk of the group but simply redistribute positions between treasury and operative units for the sake of more efficient hedging policies. Hence, these transactions should not be considered for purposes of EMIR at all. We specifically note that ESMA failed to exclude intra-group transactions from their analysis; thereby artificially inflating NFCs positions (please see section 4 of this paper).

In order to avoid an extra burden for ***smaller NFCs***, which are not expected to excess the clearing thresholds due to their small derivative exposure, only smaller changes to EMIR are necessary. NFCs with total derivative positions below the thresholds should be automatically classified as NFC-, because the non-hedging 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 not under EMIR.

The respective proposal of ESMA that counterparties with total positions below the thresholds should report all their positions as "non-hedging" (see p. 24 no. 115) is

not the right way to tackle this problem as this would not appropriately reflect economic realities. Furthermore, companies which would label all of their derivatives incorrectly as “non-hedging” will have to explain the reasons for that to both management and stakeholders, which we assume will further deter treasurers of SME companies from using derivatives at all. In addition, the classification of risk mitigating derivatives is required anyway as companies have to comply with other regulations, in particular with MiFID II/MiFIR, which also obliges them to identify their risk mitigating transactions in order to benefit from certain exemptions (see our remark above and the enumeration of MiFID-rules, dealing with exemptions for hedging derivatives). This is a further reason why this very important feature should not be given up, and our counterproposal above would reduce the administrative load of smaller NFCs.

ESMA introduces further points to eliminate the risk mitigation classification. These are some NFCs which did not correctly label their trades as being “clearing obliged” in their reports submitted to the trade repositories, although exceeding the clearing thresholds (p. 14 no. 73). To note, our member companies experienced also the problem that they reported their trades correctly as “risk mitigating” but the trade repositories did not store this information properly and assigned the trades a “non risk mitigating” label.

The problem that some NFCs have not correctly notified their supervisory authorities as exceeding the clearing thresholds is not a matter of the classification “risk mitigating” and, hence, not an argument for its abandoning. In fact, it should be up to the supervisory authorities to implement efficient monitoring processes instead (see for the German example our remarks below). Furthermore, the data gathered in the trade repositories should help supervisory authorities to detect the correct status of the non-financial company if not correctly notified (which ESMA did also consider in its analysis).

Therefore, what needs to be changed is the complex reporting regime, and not the “Level 1” rules regarding risk mitigating derivatives. Many companies are misreporting due to that circumstance. It is very important to reduce this complexity in order to increase the efficiency of the reporting processes and to enhance data quality which would enable supervisory authorities to use this information in their monitoring processes e.g. to correctly assess the clearing status of the non-financial companies. Deutsches Aktieninstitut made several proposals in its comment on the recent EMIR review as to how the data quality could be enhanced significantly (e.g. a one-sided reporting, reducing the complexity of reporting by evaluating the supervisory benefit of every data field, etc.). Legislator and supervisory authorities should take these proposals into account in order to increase the efficiency of the monitoring process, and also the quality of the reported data.

3. Efficient monitoring of hedging is not rocket science

Although the number of NFCs using derivatives is huge it is feasible for supervisory authorities to monitor the classification "risk mitigating" done by the companies themselves. This is proved by the decentralised approach adopted in Germany, where the external auditor is in charge with the monitoring of EMIR compliance annually on behalf of the supervisory authority BaFin. The monitoring process is based on the legal documents available (EMIR Regulation and Delegated Acts adopted by the European Commission). The conclusion of ESMA, to abolish the definition "risk mitigating" due to the monitoring difficulties, is not a valid solution to accomplish the mandate of EU supervisory authorities.

Of course, other successful forms of decentralized monitoring are also conceivable. As ESMA correctly points out that most NFCs are too small being endangered crossing the thresholds, we would suggest local authorities concentrate on engaging in an open discussion with the larger companies. Like with external auditors in Germany, we trust these are able to explain their risk management concepts to the authorities in a way that erases any doubts about their practices they might have.

ESMA also mentions problems in the context of cross-border supervision of NFCs (see p. 25 no. 126). Although we are convinced that the application of the ***national*** EMIR monitoring process is well established in Germany, we share the perception of ESMA that EMIR supervision lacks efficiency ***EU-wide*** due to differing standards. Deutsches Aktieninstitut addressed this problem in its comment to the EMIR review by proposing a "home regulator approach". A prerequisite for this approach is that the treasury function, in particular the group-wide risk management with derivatives, is centralised in the headquarter or in a separate legal entity, which is already common practice especially among the larger companies we represent. For these companies the group-wide supervisory process should be executed by the supervisory authority the group is domiciled in. This would increase the efficiency of the cross-border supervisory process.

4. Comments on the report's methodology

Besides the conceptual comments, we would like to add some more specific remarks regarding the methodology ESMA applied in its report, in particular on the assumption of ESMA to deem the substantial derivative exposure of larger non-financial companies as systemically relevant. The analysis of ESMA lacks a convincing definition which activity in the derivative market should be regarded as a risk for the financial stability.

- According to ESMA's own analysis, NFCs represent only 7 per cent of trades and only 2 per cent of the total outstanding notional volume within the EU (see p. 8 no. 30). Larger non-financial companies not exceeding the clearing thresholds (NFC-), which are in the focus of ESMA, represent only 1.4 per cent of trades and 0.6 per cent of outstanding nominal value (see table 2 on p. 8 in conjunction with table 4 on p. 13). It has to be noted here that the exclusion of public sector entities from EMIR is resulting in substantial parts of the derivative markets not being reported to trade repositories, especially with regard to interest rate and currency derivatives, which are frequently used by public sector debt vehicles. This means that firstly the market information collected is significantly incomplete, and secondly that the already small market shares of (larger) NFC- given above are overstated. ESMA neither examined the composition of industry sectors of these NFCs, which would have added important information regarding the representative value of the sample drawn.

- ESMA did not eliminate intra-group transactions from the analysis (see p. 36 no. 192). As stated further above, those transactions represent a significant portion of non-financial transactions. For companies with a central treasury function this number should be around 50 per cent, but as not all (especially smaller ones) are structured like that we would estimate, conservatively, an average of 30 per cent. In any case these transactions should not be treated as systemically relevant as they do not increase the risk of the group but re-distribute existing risks between Treasury and the group. ***If these transactions are correctly deducted from the data set, the share of larger NFC- in the derivative market amounts to ca. 0.4 per cent (irrespective of further "sovereign dilution" as explained above). We very much doubt that such a volume is relevant for the stability of the financial system.***

- Besides the size of the derivative exposure ESMA also refers to the interconnectedness of market participants in order to assess the systemic relevance of non-financial companies. Key criteria are the number of counterparties a firm trades with. After analysing these criteria ESMA comes to the conclusion that "the level of exposure of NFC+ and large NFC- is […] concentrated against fewer counterparties than in the case of FCs, with the corresponding impacts, spill over effects and eventually systemic implications in the case of default" (see p. 20 table 5 and p. 21 no. 102). This statement is based on an analysis which is not comprehensive. First of all, we dispute the notion that larger NFC (plus or minus) would trade on average with less than 6 counterparts. In reality that number is much larger and in a 10 to 20 range at least. This is also a consequence of a bank risk limit approach most NCFs use to reduce risk concentration with a single bank counterparty. Irrespective of that, ESMA disregards that, although the number of counterparties of larger NFCs is

much lower compared to those of financial counterparties (5.85 compared to 31.45), this holds also true for the average notional value of the trades (5.384 EUR mn compared to 21.413 EUR mn). This means that NFC- trade with fewer counterparties with an exposure which is also much smaller and, hence, less risky. Furthermore, ESMA does not include in its analysis other factors which are relevant for the risk capacity and the necessity to diversify the derivative portolio among different counterparties, e.g. the equity ratio, which is in general much higher in non-financial companies compared to fincancial companies, or already applied risk reducing measures like exposure limits per counterparty, existing collateralisation on a voluntary basis (see further below) and guarantees. In addition, we reiterate that the business of the "real economy" in terms of using risk mitigating derivatives in order to reduce the impact of price fluctations and to achieve stable planning is different to the business financial companies are dealing with.

- We doubt that the current data quality found in trade repositories is good enough to base such an analysis on. There have been several articles in the press in recent months on this, including notoriously low matching rates, especially where counterparties use different repositories. Furthermore, the complexity and frequently changing rules due to permanent updates of the ESMA Q&A are an obstacle for all market participants to report soundly. In our opinion any result drawn from an unreliable data basis like this should be looked at with a pronounced degree of caution.

- Regarding the asset class commodity derivatives ESMA's analysis should take into account that collateralistion is already a common practice in many companies in particular from the energy sector. In fact, the aim of EMIR to increase collateralisation has been mainly already achieved among utilities. Nevertheless, to require collateralisation for all NFCs is not feasible and would decrease growth and employment of the European economy for the reasons mentioned above.

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Contact

Dr. Norbert Kuhn
Deutsches Aktieninstitut e.V.
Niedenau 13-19
60325 Frankfurt am Main
Phone + 49 69 92915 - 20
Fax + 49 69 92915 - 12
kuhn@dai.de
www.dai.de