OTC Derivatives Reform

On 25th June, the European Securities and Markets Authority (ESMA) published its draft proposals for improving the functioning of the derivatives markets in the European Union. The European Markets Infrastructure Regulations (EMIR) aim to reduce risk through the use of sound and resilient central clearing firms, increase transparency through mandatory trade notification mechanisms and reduce counterparty risk through appropriate risk mitigation techniques.

The principals contained in the proposal document operate under three pillars

- **Reduction of counterparty** risks by defining when central clearing must be used, and defining the risk mitigation techniques for OTC derivatives not centrally cleared. It also lays down the requirements for the application of exemptions to non-financial (i.e. corporate) counterparties and intragroup transactions.

- Establishment and supervision of a robust group of **central clearing firms** for OTC derivatives. A comprehensive set of organisational, conduct of business and prudential requirements for these central clearing firms are set out in the draft proposals including how they should calculate margin, types of acceptable collateral and liquidity requirements.

- **Provision of increased transparency** in the OTC market by specifying the details of derivatives transactions that need to be reported to trade repositories and defining when and how the trade repositories' data is to be made available to relevant authorities and regulators

WHAT IT MEANS FOR CORPORATE TREASURIES

The main provisions impacting corporate treasuries (referred to as non financial counterparties) include

Classes of derivatives to be subject to clearing. These are expected to be defined by reference to

- the degree of standardization of the contractual terms and operational processes for the relevant class of OTC derivatives,
- the volume and the liquidity of the relevant contracts within the relevant class of OTC derivatives and
- the availability of fair, reliable and generally accepted pricing information.

Clearing Thresholds. The proposals set the clearing thresholds per asset class. Five asset classes are considered i.e. credit derivatives, equity derivatives, interest rate, foreign exchange and, finally, commodity and others. <u>When one of the clearing thresholds for an asset class is reached, the counterparty is considered as exceeding the clearing thresholds and therefore is subject to the relevant EMIR requirement for all classes of OTC derivative contracts.</u>

Hedging Activities. OTC derivative contracts that protect against risks directly related to commercial activities and/or treasury financing activities as well as those that do not exceed the clearing thresholds (see below) <u>are not subject to the clearing obligation</u>.

At the point where the clearing thresholds would be exceeded, the clearing obligation would apply to all future OTC derivatives. In order to calculate whether it exceeds the clearing thresholds, a non-financial counterparty does not include derivatives that reduce risk. An OTC derivative contract is deemed to be objectively measurable as reducing risk, when it reduces the potential change in value of assets that it owns, sells or leases in the ordinary course of its business, <u>*or*</u> mitigates potential changes resulting from fluctuation of interest rates, inflation <u>*or*</u> foreign exchange rates or when the accounting treatment of the derivative contract is that of a hedging contract pursuant to IFRS.

An OTC derivative contract which is used for a purpose in the nature of speculation, investing, or trading will not meet this definition.

Risk Mitigation – The proposals include provisions for the establishment of "appropriate risk mitigation and management techniques" and include

- *Timely confirmation.*Financial counterparties and non-financials exceeding the clearing thresholds would confirm their OTC derivative contracts as soon as possible and at the latest by the end of the day when they entered into the contract.

  Non-financial counterparties would have to confirm their OTC derivative contracts as soon as possible and at the latest, by the second business day following the trade day.

- *Unconfirmed Trades.* Financial counterparties are required to report on a monthly basis derivative contracts that remain unconfirmed for more than 5 business days. This requirement is not expected to apply to non financial counterparties.

- *Portfolio reconciliation.* In order to quickly identify any disagreement, timely portfolio reconciliations should be completed. It is proposed that portfolio reconciliation be performed at least each business day when the counterparties have 500 or more derivative contracts with each other, at least once per week for a portfolio between 300 and 500 derivative contracts with a counterparty and once per month for a portfolio of less than 300 derivative contracts with a counterparty. Arrangements to resolve any discrepancy in a material term of a contract or in its valuation are expected to be set out.

- *Portfolio compression.* Financial entities or non-financial entities having a portfolio of at least 500 or more non- centrally cleared derivative transactions, should have procedures to regularly, and at least twice a year, analyse the possibility of conducting a portfolio compression exercise. The aim of the exercise is to reduce their counterparty credit risk.

  As a result of the portfolio compression exercise, the offset OTC derivative contracts should be terminated no later than the day following the execution of the fully offsetting derivative contract.

Dispute resolution - Counterparties should have the dispute resolution procedures agreed upon when they enter into OTC derivative contracts. The draft technical standards specify matters and topics to be included in the procedures and processes but do not determine their details that are to be agreed upon by the counterparties: it is up to them to decide whether they want to set them up by reference to existing industry standards or to specific contractual arrangements. The purpose of the provision is not to mandate resolution of a dispute within a given timing but to ensure appropriate procedures are in place to manage it.

Marking-to-model .In situations where market conditions would prevent marking-to-market, financials and non-financials exceeding the clearing thresholds shall use reliable and prudent marking-to-model. The mark-to-model valuation technique should incorporate all factors that counterparties would consider in setting a price, be consistent with accepted economic methodologies for pricing financial instruments, be calibrated and tested for validity by a unit independent from the risk taking unit, and be duly documented and approved by the board as frequently as necessary and at least annually.

Intra-group exemptions – Three requirements are included here.

- details on the practical and legal impediments to the prompt transfer of own funds or repayment of liabilities between counterparties,
- details of the intragroup derivatives to be included in the notifications to a regulator and
- how the use of the intragroup exemption to be publicly disclosed.

It is agreed that disclosure should not provide sensitive confidential information such as revealing the risk allocation strategy of the counterparty.

Regulatory Arbitrage - Discussions are ongoing on the most appropriate way to ensure that possible overlaps with other third country legislations do not result in a disruption of the global nature of the OTC derivatives market or in the impossibility for certain counterparties to enter into OTC derivatives transactions with each other.

As further work is required on this topic, a separate set of proposals, will be released in the near future to address the issue of the possible scope of application of EMIR to transactions between non-European counterparties that have a direct, substantial and foreseeable effect within the EU or to prevent avoidance of EMIR provisions.

TIMELINE

Feedback on the proposals is requested by 5 August 2012 with final binding rules expected by 30 September 2012. Implementation dates for the various provisions are to be specified as part of the final rulemaking.

CONCLUSION

As the most far reaching series of proposals in the derivatives market for decades, the impact of the ESMA consultation process is likely to have a pervasive impact on how, where and when Corporate Treasuries engage in the OTC market. Commercially, the provisions dealing with central clearing and margining bring additional complexities and demands on the most valued of resources, liquid cash.

For those impacted by its full range of provisions, the investment in people and systems is likely to be considerable. Even for those who are not subject to all the proposals, the requirements in relation to confirmations, trade notification and dispute resolution are likely to increase the operational burden on what are often already stretched back-office functions.

Note – The proposed clearing thresholds are

- *EUR1 bn in notional for credit derivatives*
- *EUR1 bn in notional for equity derivatives*
- *EUR3 bn in notional for interest rate derivatives*
- *EUR3 bn in notional for foreign exchange derivatives*
- *EUR3 bn in notional for commodity and other derivatives*

For further information

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