Commodity Markets Council - Europe

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European Commission EMIR REFIT proposal

Members of the Commodity Markets Council – Europe (CMC Europe) welcome the Commission proposal to amend the European market infrastructure regulation (EMIR)[1] as a step towards making its requirements more proportionate for non-financial companies which use derivatives to manage their commercial and financing risks.

CMC Europe Members in particular welcome the proposal to ease the application of the **clearing obligation for non-financial counterparties** (NFC) by only requiring that NFCs that exceed one or more clearing thresholds (NFC+) clear the contracts subject to the clearing obligation in the asset class in which the threshold is exceeded (Article 10(1). At the same time, we are concerned that by maintaining the requirement for NFCs to exchange collateral for contracts across all asset classes, the proposal fails to meaningfully ease the burden of the EMIR framework on NFCs.

Members welcome the fact that the **hedging exemption** in Article 10(3) EMIR has not been modified in the proposal. This is important to ensure legal certainty and consistency for market participants, given that the EMIR hedging exemption has been included in the revised Markets in Financial Instruments Directive (MiFID II)[2] which is now being implemented by market participants. We believe it would be premature to reassess and potentially revise the exemption while MiFID II has not been fully applied, and doing so would also lead to inconsistency in the requirements applied to non-financial commodity market participants.

CMC Europe Members also welcome the Commission's proposal to ease the **reporting obligation for NFCs**, notably by stipulating that where an OTC derivative contract is entered into by a NFC- and a financial counterparty (FC), the FC is responsible and legally liable for reporting the transaction (Article 1(7)(b) EMIR REFIT); and by removing the reporting obligation on intra-group transactions involving an NFC (Article 1(7)(a) EMIR REFIT). In this respect, we are concerned about some of the compromise proposals currently discussed in the Council. In particular, we believe that the proposal to leave an option for NFC- to choose to retain the reporting obligation risks bringing confusion to the question of who has legal liability to report. To respect the objective of easing the reporting obligation on NFCs, we believe it should be clear that the obligation and liability for reporting rests with the FC. We are equally concerned about the proposal to limit the exemption for intra-group transactions to contracts where both of the counterparties are NFCs.

[1] Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories, 4 May 2017

[2] The hedging exemption is included in point (b) of the fifth paragraph of Article 2(4) MiFID II as well as Article 5 of RTS 20 and Article 8 of RTS 21

Risk mitigation and collateral requirements for uncleared OTC derivative transactions

As mentioned, CMC Europe members welcome the easing of the clearing obligation for NFC+ to only require clearing for contracts in the asset classes where the clearing thresholds are breached. CMC Europe members believe that the same approach should be taken with regards to the risk-mitigation requirements for uncleared contracts in Article 11, so that NFCs would only need to comply with the requirement to exchange collateral for contracts in the asset classes where they have breached the clearing obligation.

Maintaining this requirement would mostly impact on **FX and interest rate swaps** that are largely transacted OTC. It is important to note that NFCs use these contracts almost exclusively for **hedging purposes** to protect against price risks related to the financing of their physical operations. The requirement to hold collateral against these positions impacts on the cost of financing these physical operations, thereby implicitly **penalising the hedging activity**, and potentially having the effect of disincentivising prudent risk management activity. It may also translate into lost benefits for the broader economy if investments in physical operations are re-evaluated as a consequence.

We believe that the portion of the OTC derivative markets in FX and interest rate instruments that are traded with NFC+ is **not of systemic relevance** within the broader markets, and the removal of the margin requirement would therefore not pose significant additional risks to the market. According to the Bank for International Settlement, non-financial customers accounted for under 3% of the global OTC interest rate derivatives market and for approximately 12% of the foreign exchange markets in the second half of 2016[3]. Considering that the vast majority of NFC activity is conducted by NFC-, **only a small portion of these trades are transacted by non-financial counterparties that have breached the clearing threshold**. The section of the market that would be impacted by a removal of the collateral requirement is therefore of no systemic relevance. Removing the collateral requirement for these contracts would also be in line with the BCBS / IOSCO framework that recommends excluding non-systemically important non-financial entities from the margin requirements for non-cleared OTC derivative trades.

The collateral requirement will also increase the potential of multi-national groups **relocating** their affected central treasury functions or relevant hedging and financing activities to other jurisdictions where that activity would not be subject to margin requirements for uncleared OTC derivative contracts.

From 3 January 2018 onwards, the situation will be exacerbated by the application of variation margin requirements to physically settled FX forwards under the EMIR regulatory technical standards on risk mitigation techniques for uncleared OTC trades[4] in the EU, while in other jurisdictions, such as the United States, these contracts have been excluded from margin requirements.

We understand the Commission's objective to encourage central clearing by maintaining the risk mitigation requirements for NFC+ across all asset classes, but would like to highlight that the FX and interest rate contracts that would be predominantly impacted are customised to the needs of each NFC and given their bespoke nature **will not have the level of standardisation required for central clearing** in any event.

[3] The calculations are based on notional amounts outstanding in the second half of 2016, BIS semi-annual OTC derivatives market statistics on the global OTC derivatives market, 17 September 2017 (see http://www.bis.org/statistics/d5_1.pdf)

[4] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty

CMC Europe suggested amendments:

Recital 7 EMIR REFIT: "Non-financial counterparties are less interconnected than financial counterparties. They are also often active in only one class of OTC derivative. Their activity therefore poses less of a systemic risk to the financial system than the activity of financial counterparties. The scope of the clearing obligation for non-financial counterparties should therefore be narrowed, so that those non-financial counterparties are subject to the clearing obligation only with regard to the asset class or asset classes that exceed the clearing threshold~~,~~ ~~**while retaining their requirement to exchange collateral when any of the clearing thresholds is exceeded**~~.

Article 11 (3) EMIR: "Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after 16 August 2012. ~~Non-financial counterparties referred to in Article 10 shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the clearing threshold is exceeded."~~

Paragraphs 7 and 9 of Article 11: ***Deleted***

Methodology for calculating positions against the clearing thresholds for NFCs

CMC Europe members welcome that the Commission's proposal amending Article 10(1) moves away from the burdensome daily calculation of positions against the clearing thresholds and proposes that the calculation of positions be performed on the basis of an aggregate month-end average position over three months.

However, CMC Europe members are concerned about the inflexibility of the procedure proposed under the revised Article 10(2) EMIR for demonstrating that a NFC+ no longer exceeds the clearing threshold. The Commission proposal would oblige the NFC+ to wait for at least a full year before it can have the clearing obligation dis-applied. This is problematic and could lead to situations where an entity will have to comply with both the clearing obligation and the collateral requirement for uncleared trades for a full year because of temporarily having come above the clearing threshold in one asset class.

We would therefore suggest that the proposed framework be amended to provide for the calculation of positions against the clearing thresholds on the basis of an aggregate month-end average position over the last three months that could be performed at any time during the year. The same approach should be applied for an NFC+ to deregister from the clearing obligation.

CMC Europe suggested amendments:

Article 10 (1) and (2) EMIR:

"1. A non-financial counterparty taking positions in OTC derivative contracts shall calculate, ~~annually,~~ its aggregate month-end average position **over the preceding three-month period** ~~for the months March, April and May~~ in accordance with paragraph 3.

Where the result of that calculation exceeds the clearing thresholds specified pursuant to paragraph 4(b), that non-financial counterparty shall:

(a) immediately notify ESMA and the authority designated in accordance with paragraph 5 thereof;

(b) be subject to the clearing obligation referred to in Article 4 for future OTC derivative contracts in the asset class or asset classes for which the clearing threshold has been exceeded;

(c) clear the contracts referred to in point (b) within four months of becoming subject to the clearing obligation.

2. A non-financial counterparty that has become subject to the clearing obligation in accordance with the second subparagraph of paragraph 1 and subsequently demonstrates to the authority designated in accordance with paragraph 5 that its aggregate month-end average position for the **preceding three-month period** ~~months March, April and May of a given year~~ no longer exceeds the clearing threshold referred to in paragraph 1 shall no longer be subject to the clearing obligation set out in Article 4.";

About CMC Europe

CMC Europe is an industry association bringing together agriculture, energy, metals and other commodity market participants, price reporting agencies, and trading venues established and/or operating in the European Union (EU), the European Economic Area (EEA), Switzerland and neighbouring countries. Our members trade large volumes of agricultural and energy commodity derivative contracts on European, US and other trading venues every day predominantly to hedge risks related to their commercial activities. CMC Europe members are therefore directly impacted by EMIR provisions on non-financial counterparties generally and on commodity derivatives in particular. For more information, visit www.commoditymkts.org/cmc-europe/.