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POSITION PAPER ON EMIR REVIEW

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SUMMARY

EuropeanIssuers welcomes the forthcoming review of the European Market Infrastructure Regulation (EMIR) [1] which offers an opportunity to fine-tune the current rules. By leveraging on the experience of our members, we would like to contribute to the political and technical debate with several proposals seeking to improve efficiency and effectiveness of EMIR, while keeping in mind other regulatory objectives of reducing systemic risk and increasing market transparency. To achieve this, we propose to:

1. **MAINTAIN THE CORPORATE HEDGING EXEMPTION FOR CALIBRATING THE CLEARING AND BILATERAL MARGINING REQUIREMENTS**

Non-financial companies (referred to in EMIR as Non-Financial Counterparties[2] or 'NFCs') that are below the current clearing threshold should **maintain their current exemption from clearing and bilateral margining obligations**. This exemption prevents the entities that do not generate systemic risk from unnecessary liquidity and credit risks, as well as markets from a significant level of systemic risk.

Deleting the hedging exemption for NFCs would result in:

- **disproportionate costs** for cash collateral funding and cash flow management;
- **undermining EMIR's objective of systemic risk reduction**, by de facto increasing liquidity and credit risks faced by NFCs;
- **regulatory inconsistency** as hedging and "risk mitigating" are internationally recognised references that have become standard categories in other financial legislation, such as MiFID II and new accounting standards (e.g. IFRS 9).

2. **REDUCE BURDENS AND COSTS OF REPORTING FOR CORPORATES & IMPROVE THE QUALITY OF DATA**

Transparency could be enhanced if the focus of EMIR reporting shifted towards the **quality of reported information,** as opposed to the current bias towards the quantity and timing of reported information**.**

This can be achieved by:

- **Simplification of data flows** by:

[1] The European Market Infrastructure Regulation (EMIR) lays down rules on OTC derivatives, central counterparties and trade repositories.
[2] Non-financial counterparty (NFC) under the EMIR Regulation (art. 2 par 9) is an undertaking established in the European Union other than a financial counterparty (FC) or a CCP

- Eliminating **the double-sided reporting and move towards single-sided reporting** for both exchange traded and OTC traded derivatives. A fall-back solution could be a **mandatory delegation with a full transfer of responsibility to the Financial Counterparty**.
- **Exemption of intra-group transactions**;
- **Ending the practice of backloading**, as it has marginal benefits for transparency but is very difficult to carry out particularly with regard to very old transactions given the often poor quality of data.

- **Streamlining of reporting timing**

Reporting of already confirmed deals would reduce mistakes, eliminate correction flows and ultimately significantly improve the quality of data. Therefore, we recommend to **shift the timing of the reporting obligation from the day following contract trading to the day following the confirmation between the two counterparties.**

3. IMPROVE REGULATORY COHERENCE AND LIMIT PROCYCLICALITY

Considering that the forthcoming MiFIR/MiFID II ancillary tests for commodity derivatives might fully replace the EMIR threshold, we suggest to simplify calculations for NFCs and to eliminate the NFC+ category which we consider to be redundant.

By the second quarter of 2017, **clear deadlines should be set for the Trade Repositories (TRs) to provide reliable statistics to the Market Participants (MPs)** on financial markets, both on aggregated basis and on individual positions to single counterparties. Lack of these statistics would discourage efforts and investments by MPs in EMIR compliant reporting and would jeopardise the possibility of new ancillary activity tests required by MiFIR/MiFID II.

To limit procyclicality, **EuropeanIssuers supports ESMA's suggestion to increase the transparency of CCPs' margining calculations** (see EMIR Review Report no.2 - Review on the efficiency of margining requirements to limit procyclicality), through a mandatory disclosure of data necessary for risk management and of Initial/Variation Margin models and methodologies. Moreover, EuropeanIssuers believes that this should not be limited to clearing members but extended to all market participants.

POSITION

Almost four years after their entry into force, EMIR requirements have proven to be well designed to cope with the main challenges faced by G20 in response to the financial crisis: systemic risk reduction on financial derivatives' markets and increasing their transparency. Leveraging on the experience gained by market participants in implementing EMIR, we recommend to:

- Maintain the hedging exemption in clearing threshold calculations;
- Reduce burdens and costs of reporting and improve the quality of data for market transparency.

We believe this would help to better achieve the aforementioned objectives.

1. MAINTAINING HEDGING EXEMPTION FOR CALIBRATING THE CLEARING AND BILATERAL MARGINING REQUIREMENTS

Systemic risk on financial derivatives markets has been addressed substantially by reducing credit exposures related to financial derivatives via cash collateralisation. The rationale behind the introduction of a gradual cash collateralisation, either via central clearing or bilateral margining, is to mitigate credit exposure deriving from financial derivatives. Such a mechanism requires a large amount of cash or cash equivalents and robust processes/IT systems to manage on a continuous basis the daily cash flows bilaterally and with Central Clearing Counterparties (CCPs). It is justified only for counterparties representing systemic risk for financial markets.

Non-Financial Counterparties (NFCs) are generally recognised as not contributing to systemic risk, considering both their low market shares of financial derivatives (i.e. the actual "size" of their potential contribution to credit risk) and their low levels of interconnectedness (i.e. their limited contribution to potential contagion effects).

NFCs using financial derivatives for hedging purposes are not creating systemic risks because the underlying hedged item is per se implicit collateral of hedging financial derivatives, gain/loss being compensated by the offsetting loss/gain related to the underlying asset. On the contrary, a counterparty trading a financial derivative for speculation is creating a "naked" credit exposure proportional to market movements. The larger the market movement the bigger the potential credit exposure deriving from a speculative derivative.

The obligation to clearing/bilateral margining financial derivatives used by NFCs for hedging purposes would therefore impose disproportionate costs in terms of cash funding and processes on NFCs that are not contributing to systemic risk.

It is also important to underline that **cash collateralisation of hedging derivatives increases the level of systemic risk by NFCs to financial markets, rather than reduces it**.

The obligation of clearing/bilateral margining derivatives used for hedging their budgets, would ultimately result in NFCs anticipating to Financial Counterparties (FCs) the cash flows of financial derivatives that NFCs would recover only once they sell / buy their physical goods. Such **cash anticipation is a relevant source of potential liquidity risk for NFCs**, that could be squeezed by markets movements, and of credit risk, since, after anticipating cash to FCs, NFCs would remain exposed to credit risk vis-à-vis their commercial counterparties for their physical goods.

A short **practical example** of a normal hedging process can easily clarify liquidity and credit risks for NFCs deriving from Clearing/Bilateral Margining obligation.

During the budget process in November 2016 a utility NFC, selling gas to commercial customers, hedges out 100% of its 2017 revenues, structuring financial derivatives on its gas sales with a FC. From November to December 2016 gas price increases by 25%, therefore, in case of clearing/bilateral margining obligation, by end of 2016 the utility NFC must anticipate cash to FC for an amount equal to 25% of its global revenues plus the amount initially posted for the so-called Initial Margin. The revenues of physical gas to be sold in 2017 will only be cashed-in gradually during the following year and for each customer defaulting the utility NFC will face a net credit loss.

In the example, cash collateralisation is reducing to zero the credit risk between the NFC and FC on their financial derivatives, but leaves the NFC with a large level of liquidity risk and credit risk.

The exemption of non-systemic relevant NFCs from the obligation of Clearing/Bilateral Margining should definitively be preserved.

Nevertheless, there are a few NFCs that, given the size of their non-hedging activities in financial derivatives, might constitute a non-negligible source of systemic risk. However, current EMIR thresholds for the different asset classes, which exclude hedging derivatives from the calculation, are well aimed to spot this category of NFCs ("NFCs+"), and to impose the cost of cash collateralisation only to the ones generating systemic risk.

The current hedging exemption should not be replaced with an absolute threshold based on financial derivatives' gross notional. As a matter of fact, this threshold would not be an effective way of capturing systemically relevant NFCs, since a NFC trading a smaller number of speculative derivatives is likely to cause more systemic risk than a NFC trading a larger notional of pure hedging derivatives.

Moreover, these concepts have informed accounting standard evolution. The original IAS 39 hedging definition for balance sheet purposes was quite far from actual business processes and was recently revised with the introduction of new IFRS 9 accounting standard, which is much more aligned with EMIR hedging definition.

Preserving the hedging exemption in EMIR is also important to maintain consistency between EMIR, other regulations (e.g. MiFIR/MiFID II, new accounting standards, such as IFRS 9) and with NFCs' internal control processes. Since EMIR introduced the concepts of hedging and "risk reducing", they became an internationally recognised standard applied in NFCs internal portfolio management processes.

2. REDUCE BURDENS AND COSTS OF REPORTING FOR CORPORATES & IMPROVE THE QUALITY OF DATA

Before the introduction of EMIR, any assessment of OTC derivatives markets statistics was very difficult and analysis was ultimately unreliable due to the lack of public transparent information. In this regard, the EMIR reporting obligation was meant to solve the problem of reliable sources of information both for Regulators and for Markets Participants (MPs) through Trade Repositories (TRs).

After almost four years of reporting, and despite the big efforts requested from MPs in terms of processes, IT systems and data flows, the results in terms of reliable statistics are still far away from expectations. **Practical experience gained so far suggests that better results could be achieved if the**

focus of EMIR reporting, biased towards quantity and timing of reported information, was shifted towards quality of reported information. EMIR reporting entails huge information flows from MPs to TRs and from TRs back to Regulators and MPs which results in complexity and mismatches in the reconciliation process. It is important to notice that, besides reporting, EMIR is imposing to MPs a complete set of compliance requirements, so-called risk management techniques, which are meant to reduce financial trading operational risk by guaranteeing standardisation, electronic processing and quality of financial derivatives data. MPs invested a significant amount of resources to implement said risk management techniques: **timely confirmation, reconciliation, disputes resolution, mark to market and compression** are all EMIR requirements well established in MPs processes. These investments **should be leveraged to achieve a better quality of data for EMIR reporting.**

EuropeanIssuers consider that **a significant improvement of data quality could be achieved by eliminating some information flows of reported data with little added value in terms of transparency and by leveraging investments made in the other EMIR requirements for confirmation, reconciliation, dispute resolution and compression.**

A first example of information flow adding huge amount of data to EMIR reporting without any relevant corresponding benefit, is **double sided reporting**. Currently EMIR, differently from other international regulations recognised as equivalent, requires reporting to both MPs of a derivative contract. This obligation implies a duplication of information flows and a duplication of reconciliation processes, i.e. a huge impact on processes and IT systems.

The second example is the "**timing**". Currently, the EMIR reporting obligation is set on a (t+1) timing, where "t" is the trading day of a financial contract, not the day of its confirmation between MPs. Therefore, currently both counterparties of a derivative contract are requested to report said contract to their TR (that could be different) before having mutually confirmed it between themselves.

TRs' fundamental role is to gather data, make them available in disaggregated and aggregated forms to Regulators and Market Participants and produce market statistics, not to reconcile data. Full reconciliation, starting with confirmation and ending with disputes resolution, is a compliance already requested from MPs, and should be leveraged.

There is a **delegation mechanism,** but it leaves the delegating party fully liable for completeness and correctness of reported information, so it is not legally and operationally viable, since it obliges the delegating party to invest in its own controlling processes.

A solution for reducing the burdens and costs of EMIR reporting and improving the quality of data could be found by:

- **eliminating double sided reporting and moving towards single sided reporting for both exchange traded and OTC traded derivatives**; if single sided reporting is adopted, certain information fields, may need to be modified to fit the new reporting model, ensuring completeness of information;
- if a move to single sided reporting is not viable, a fall-back solution might be **mandatory delegation with full transfer of responsibility** to the Financial Counterparty (in case of two NFCs, delegated NFC will be agreed upon on the contract), whereby delegating party can transfer full reporting responsibility;

- both proposals should be associated by the **deletion of the requirement to report intragroup trades (IGT)**. Otherwise, NFCs could not benefit from a one-sided reporting regime or an effective delegation mechanism as they must implement a reporting regime for their IGT (see below);
- **setting reporting timing obligation to the day following the confirmation between the two counterparties instead of the day following contract trading.**

With such modifications, information flows would be cut by half, all information flows amongst MPs and TRs for communicating corrections after confirmation would be eliminated, all information flows amongst TRs for reconciling the same financial contract reported to them by different counterparties would be eliminated and only contracts already confirmed would be reported, with a clear improvement in term of data reliability and an actual leverage of investments already made by MPs for confirmation processes and IT systems.

With respect to EMIR reporting it is important to consider the effects of the entry into force of MiFIR/MiFID II. With the introduction of MTFs and OTFs besides RMs (definition that includes current EMIR Exchanges), MiFIR/MiFID II will define a complete set of Trading Venues (TVs) that will be subject to relevant compliances, including specific reporting obligations. TVs will be in the best position to cover also EMIR reporting obligations with arguably the best level of data quality. **Therefore it is advisable to progressively involve TVs in the EMIR reporting obligation, in a first phase allowing participants of current Exchanges to delegate reporting of Exchange Traded Derivatives (ETDs) to said Exchanges with full transfer of responsibility, then in a second phase, when MiFIR/MIFID II will be in force, transferring single side reporting obligation on TVs (Regulated Markets, MTFs and OTFs) for all derivatives electronically traded on their platforms** or, as a second best solution, allowing Market Participants to delegate reporting to said TVs with full transfer of responsibilities.

Involving TVs in reporting obligations would also avoid reporting duplication of a large amount of commodity contracts currently reported to ACER per the REMIT regulation, that could soon become financial derivatives due to the new broader definition of financial derivative entering into force with MiFIR/MiFID II. Such contracts called "physical forwards" represent a relevant share of REMIT reporting and are normally reported via so-called Organised Market Places (OMPs), that are basically included in MiFIR/MiFID II TVs definition. Allowing MPs to fully delegate EMIR reporting to TVs will become the logical and most reliable solution for reporting all standardised and electronically traded financial derivatives, reducing data flows and increasing data quality, since the required information is already present on TVs, electronically confirmed and with the possibility to enrich market statistics with additional information, e.g. TVs official market prices.

Another requirement with little added value is the "**reporting of intragroup transactions**". NFCs use financial derivatives via centralised business units and/or legal entities to achieve significant benefits in term of risk management and portfolio optimisation, cost reduction and centralisation of internal financial services such as centralised treasuries departments for cash pooling. Thus an external derivative transaction might correspond to several intra-group deals that are not adding any systemic risk to financial markets. Centralised **management of intra-group transactions is an effective way for reducing transactions volumes through an internal compression and netting activity, like external compression requested by EMIR compliance, within the list of compulsory**

risk management techniques. Compression is a mandatory activity requested to simplify the large amount of redundant financial trades resulting from gross flows of buy and sell volumes amongst the same counterparties. EMIR compression requires to net out and cancel all unnecessary offsetting financial trades amongst external counterparties, leaving only the trades that represent a net exposure. In this way volumes and costs for EMIR compliance can be optimised without losing any relevant information in terms of systemic risk. The same netting and compression functions are performed internally to NFCs and large groups via the centralisation of financial derivatives and/or treasury activities: central business units and/or legal entities are processing intra-group transactions by netting and offsetting opposite or redundant internal requests for financial derivatives, reducing the number of contracts traded with external counterparties. Therefore, the intra-group reporting obligation imposes a burdensome reporting of internal transactions with no significant systemic risk for financial markets. Moreover, one could expect such intra-group transactions to have a negative impact on data quality, since control processes are normally simplified for internal transactions with respects to control processes on external deals.

Eliminating reporting obligation for intra-group transactions would therefore be in line with the simplification objectives pursued by EMIR, without affecting systemic risk and transparency, also given that counterparties already have an obligation of regularly assessing the opportunity of executing the compression of their deals.

Finally, another source of great burden, costs and potential negative impact on data quality without adding any perceivable benefit in term of transparency is **backloading**. Backloading requires reporting transactions that were traded before the start date for EMIR reporting in February 2013. Recently the deadline for backloading has been postponed by two additional years until 2019. MPs will then have to report trades closed more than six years ago, when standard fields required for EMIR reporting were not mandatory and EMIR risk management techniques were not necessarily implemented and standardised. **EuropeanIssuers' opinion is that backloading should be abandoned considering the extreme difficulty for MPs to retrieve information not normally recorded at the time of trading and the potential negative impact that such information could have on overall EMIR reporting reliability, due to their expected poor quality.**

A focus shift from quantity and timing of reporting to quality of reporting is needed not only in view of regulatory targets but **also to guarantee MPs a return in term of market statistics of their large investments for processes and IT systems.** The current lack of reliable market statistics is undermining the possibility for MPs to understand their market share on financial markets. This information has become crucial for assessing NFCs market share, through ancillary tests introduced by MiFIR/MiFID II.

In this regard, EuropeanIssuers urges to set clear deadlines by Q2 2017 for TRs to make available to MPs reliable statistics on financial markets, both on aggregated basis and on individual positions to single counterparties. Lacking such market statistics by TRs should imply a postponement of ancillary tests calculation deadline, given the crucial role played by market shares information.

3. OTHER SUGGESTIONS TO IMPROVE REGULATORY COHERENCE AND LIMIT PROCYCLICALITY

- **EMIR threshold/MIFID II "ancillary test"**

Considering that MiFIR/MiFID II new ancillary tests for commodity will inherit from EMIR objectives, hedging exemption and compliance consequences, it is important to **better define relationships between EMIR thresholds and MiFIR/MiFID II tests on commodity**, to eventually simplify thresholds and to avoid redundancy of categories for commodity traders. In the end when MiFIR/MiFID II will enter into force the two ancillary tests will spot NFCs with a systemic relevance on commodity financial markets and such NFCs will have a perimeter of compliance which will include all EMIR requirements (including clearing/bilateral margining) plus MiFIR/MiFID II specific requirements. Thus NFCs+, i.e. NFCs exceeding EMIR clearing thresholds for commodity, will be left as a "hybrid" category of NFCs with systemic relevance on commodity markets but with a perimeter of compliance limited to EMIR. It is questionable whether NFC+ category will still be relevant for regulatory purposes after MiFIR/MiFID II will be in force.

Hence, there is probably scope for a simplification for commodity financial trading, whereby once MiFIR/MiFID II will be in place, only ancillary tests will remain for commodity traders and EMIR threshold calculation together with NFCs+ category will have no further application for commodity traders.

- **Increase transparency of margin calculation**

In view of limiting procyclicality, **EuropeanIssuers supports ESMA's proposal of increasing transparency of CCPs margining calculations, including mandatory disclosure of data necessary for risk management and of Initial/Variation Margin models and methodologies.** Moreover, EuropeanIssuers believes that this should not be limited to clearing members but **extended to all market participants**. In fact, all clearing stakeholders should be provided with the information required for predicting margin requirements and for managing their risk. In this regard, the most effective solution would be for CCPs to make available margin simulation models that can be run directly by clearing members and market participants, with full disclosure of methodologies and assumptions.

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