

# EUROPEAN SYSTEMIC RISK BOARD

## ADVICE OF THE EUROPEAN SYSTEMIC RISK BOARD

of 31 July 2012

submitted to the European Securities and Markets Authority in accordance with Article 10(4) of Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories concerning the use of OTC derivatives by non-financial corporations

(ESRB/2012/2)

(2012/C 286/09)

### 1. Legal background

- 1.1. Article 10(4) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories <sup>(1)</sup> provides that the European Securities and Markets Authority (ESMA) has to consult the European Systemic Risk Board (ESRB) and other relevant authorities on the development of draft regulatory technical standards specifying: (a) criteria for establishing which over-the-counter (OTC) derivative contracts are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity referred to in Article 10(3); and (b) values of the clearing thresholds above which non-financial corporations have to clear their future derivative contracts through central counterparties (CCPs), which are determined taking into account the systemic relevance of the sum of net positions and exposures per counterparty and per class of OTC derivatives.
- 1.2. On 26 June 2012 the ESRB received from ESMA a request for its advice on the above issues, referring to the ESMA consultation document published on 25 June 2012 <sup>(2)</sup>.
- 1.3. In accordance with Articles 3(2)(b) and (g) and 4(2) of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board <sup>(3)</sup>, the General Board of the ESRB has adopted this Advice, which is published in accordance with Article 30 of Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board <sup>(4)</sup>.

### 2. Economic background

- 2.1. OTC derivative contracts are used by non-financial corporations mainly for the purpose of hedging commercial and treasury financing activities. Any definition of a clearing threshold should as a matter of principle ensure that the following policy goals are achieved:
  - (a) The integrity of the market must be defended and its transparency ensured. Legislators might start from the assumption that they need to ensure — from a macro-prudential angle — that a maximum percentage of overall non-financial derivative transactions need to be centrally cleared, to reduce counterparty risk in the market. Legislators might also wish to ensure that all corporations which are exposed to derivative activities at a given proportion of their overall balance sheet are treated equally, whatever their size.

<sup>(1)</sup> OJ L 201, 27.7.2012, p. 21.

<sup>(2)</sup> ESMA consultation document, 'Draft technical standards for the Regulation on OTC derivatives, CCPs and trade repositories', published on ESMA's website at: <http://www.esma.europa.eu>

<sup>(3)</sup> OJ L 331, 15.12.2010, p. 1.

<sup>(4)</sup> OJ C 58, 24.2.2011, p. 4.

- (b) The total amount of derivatives held by a non-financial corporation, irrespective of their intended use, should be appropriately reflected in the basis of the calculation. From a financial stability perspective, risk is generated by the (relative) size of the derivative positions, regardless of the purpose of the derivatives.
- 2.2. In a number of market segments, such as commodities markets, which were previously mainly accessed by non-financial corporations, the use of OTC derivatives for speculative, investment or trading purposes has become predominant. This is partly a response to the entry of financial institutions into these markets, the so-called financialisation process. This calls for a prudent approach to the risks posed by the use of derivatives by non-financial corporations.
- 2.3. The definitions of commercial and treasury financing activities should be as detailed and objective as possible, leaving no leeway for different interpretations or arbitrage, since the consequences of meeting the definition or not might be significant.
- 2.4. Following a detailed analysis <sup>(1)</sup>, the ESRB is proposing calculating thresholds using a two-step approach aimed at defending the integrity of the market and ensuring market transparency, and not at protecting the interests of the single market participants. The aim is also to make sure that the risks arising from the holding of derivatives by non-financial corporations are appropriately considered.
- 2.5. Derivatives held in the context of commercial and treasury financing activities are not risk free because, in cases where they are not appropriately priced in, they may lead to an inefficiently large level of hedging, which may have systemic consequences.
- 2.6. From a macro-prudential stance, it is preferable that non-financial corporations clear their derivatives through CCPs by paying margins rather than obtaining similar services from banks in exchange for a fee. There is the risk that banking fees, which are essentially resources and which leave the non-financial corporations, will not adequately price the risk, from the point of view of both the banks and the non-financial corporations.

### 3. Definitions

#### *Definition of commercial and treasury financing activities*

- 3.1. The ESRB welcomes the work carried out by ESMA in the definition of commercial and treasury financing activities and broadly agrees with the results of this work subject to the following:
- 3.2. Commercial activities of non-financial corporations should refer to specific items in the balance sheet and, more specifically, to the core business of the non-financial corporation, namely, stocks, payables, receivables, property, plant and equipment. The concepts of 'capital expenditure' and 'operational expenditure' should be introduced in the definition of commercial activities, as a reference to International Financial Reporting Standards for the definition of commercial activities may prove not to be optimal. The maximum level of derivatives linked to the commercial activities of the non-financial corporation should be the carrying amount of the stocks, payables, receivables, property, plant and equipment in the balance sheet.
- 3.3. Treasury financing activities should be defined using the cash flow statement of the non-financial corporation, establishing that such activities should be limited to the cash flows from the financing activities of the non-financial corporation generated during the year.

#### *Definition of the clearing thresholds*

- 3.4. The ESRB welcomes the work carried out by ESMA in the definition of the clearing thresholds subject to the following:
- 3.5. Initial low clearing thresholds for non-financial corporations should be based on clear macro-prudential principles with the possibility of increasing them in further reviews if deemed necessary.
- 3.6. A balance between the complexity of the calculation of the clearing threshold and the mitigation of risks arising from the holdings of OTC derivatives by non-financial corporations should be found.

<sup>(1)</sup> See the ESRB's response, 'Macro-prudential stance on the use of OTC derivatives by non-financial corporations in response to a consultation by ESMA based on Article 10 of the EMIR Regulation', published on the ESRB's website at: <http://www.esrb.europa.eu>

- 3.7. A limited number of classes of OTC derivatives should be defined, which should be subject to different requirements in terms of clearing thresholds.
- 3.8. Clearing thresholds should not be defined per counterparty, as that would increase the complexity of the regime without bringing substantial benefits.
- 3.9. Gross market values for the definition of clearing thresholds should be preferred to notional values as this would provide a more accurate picture of the market value of the derivatives held by non-financial corporations and hence a more accurate approach to the risk posed by those derivatives to the system. The calculation of the clearing thresholds should be conducted with a fixed frequency, with the possibility for competent authorities to increase this frequency in times of financial crisis.
- 3.10. The clearing threshold per class of OTC derivatives, subject to the calibration of the clearing threshold as a two-step approach in Section 4, should be defined as follows:
- (a) The non-financial corporations which should be subject to the clearing thresholds will be assigned to two subsets according to the following criteria:

$$\frac{TD(x)}{CR(x)} > \delta \text{ and } \frac{TD(x)}{CR(x)} \leq \delta$$

where:

- TD (x) is the gross market value of all the derivatives held by the non-financial corporation x,
- CR (x) is the carrying amount of the capital and reserves of the non-financial corporation x.

- (b) For non-financial corporations for which the value as defined in (a) exceeds the value  $\delta$  the clearing threshold should be defined as:

$$\frac{NCNTFD(x)}{GMVCD} > \varepsilon \text{ or } NCNTFD(x) > \varepsilon'$$

where:

- NCNTFD (x) is the gross market value of the non-commercial or non-treasury financing derivatives held by the non-financial corporation x,
- GMVCD is the gross market value, per class of OTC derivatives, for all counterparts reported on a global basis in the Bank for International Settlements database on OTC derivative markets statistics.

- (c) For non-financial corporations for which the value as defined in (a) does not exceed the value  $\delta$  the clearing threshold should be defined as:

$$\frac{NCNTFD(x)}{GMVCD} > \gamma \text{ or } NCNTFD(x) > \gamma'$$

#### 4. Calibration of the clearing threshold as a two-step approach

The two-step approach should be conducted as follows:

- (a) Non-financial corporations should be assigned to two subsets according to the following criteria:

$$\frac{TD(x)}{CR(x)} > 0,03 \text{ and } \frac{TD(x)}{CR(x)} \leq 0,03$$

- (b) For non-financial corporations for which the value as defined in (a) exceeds 0,03, the following thresholds for each class of OTC derivatives should apply:

$$\frac{\text{NCNTFD (x)}}{\text{GMVCD}} \times 1\,000\,000 > \varepsilon$$

- (i) Clearing threshold for credit derivative contracts,  $\varepsilon_A = 8,4$ .
  - (ii) Clearing threshold for equity derivative contracts,  $\varepsilon_B = 9,4$ .
  - (iii) Clearing threshold for interest rate derivative contracts,  $\varepsilon_C = 12,4$ .
  - (iv) Clearing threshold for foreign exchange derivative contracts,  $\varepsilon_D = 13,4$ .
  - (v) Clearing threshold for commodities and other OTC derivative contracts,  $\varepsilon_E = \beta_E = 9,4$ .
- (c) For non-financial corporations for which the value as defined in (a) does not exceed 0,03, the following thresholds for each class of OTC derivatives should apply:

$$\frac{\text{NCNTFD (x)}}{\text{GMVCD}} \times 1\,000\,000 > \gamma$$

- (i) Clearing threshold for credit derivative contracts,  $\gamma_A = 25,2$ .
  - (ii) Clearing threshold for equity derivative contracts,  $\gamma_B = 28,2$ .
  - (iii) Clearing threshold for interest rate derivative contracts,  $\gamma_C = 37,2$ .
  - (iv) Clearing threshold for foreign exchange derivative contracts,  $\gamma_D = 40,2$ .
  - (v) Clearing threshold for commodities and other OTC derivative contracts,  $\gamma_E = 28,2$ .
- (d) For non-financial corporations for which the value as defined in (a) exceeds 0,03, the following thresholds derived as absolute amounts should apply:

$$\text{NCNTFD (x)} > \varepsilon'$$

- (i) Clearing threshold for credit derivative contracts,  $\varepsilon'_A = \text{EUR } 13 \text{ million}$ .
  - (ii) Clearing threshold for equity derivative contracts,  $\varepsilon'_B = \text{EUR } 7 \text{ million}$ .
  - (iii) Clearing threshold for interest rate derivative contracts,  $\varepsilon'_C = \text{EUR } 151 \text{ million}$ .
  - (iv) Clearing threshold for foreign exchange derivative contracts,  $\varepsilon'_D = \text{EUR } 31 \text{ million}$ .
  - (v) Clearing threshold for commodities and other OTC derivative contracts,  $\varepsilon'_E = \text{EUR } 16 \text{ million}$ .
- (e) For non-financial corporations for which the value as defined in (a) does not exceed 0,03, the following thresholds derived as absolute amounts should apply:

$$\text{NCNTFD (x)} > \gamma'$$

- (i) Clearing threshold for credit derivative contracts,  $\gamma'_A = \text{EUR } 39 \text{ million}$ .
- (ii) Clearing threshold for equity derivative contracts,  $\gamma'_B = \text{EUR } 20 \text{ million}$ .
- (iii) Clearing threshold for interest rate derivative contracts,  $\gamma'_C = \text{EUR } 453 \text{ million}$ .
- (iv) Clearing threshold for foreign exchange derivative contracts,  $\gamma'_D = \text{EUR } 92 \text{ million}$ .
- (v) Clearing threshold for commodities and other OTC derivative contracts,  $\gamma'_E = \text{EUR } 48 \text{ million}$ .

Done in Frankfurt am Main, 31 July 2012.

*The Chair of the ESRB*  
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