

Non-financial counterparties subject to EMIR

We outline the findings from our latest review on how non-financial counterparties (NFCs) calculate the clearing threshold, and how they are complying with the EU Regulation on derivatives, central counterparties and trade repositories (EMIR).

Why did we do this review?

We wanted to understand how NFCs are defining their hedging activity and monitoring their status against the clearing threshold. We focused on the compliance obligations that now apply to NFCs.

This review, which we conducted during June 2014, focused on energy producers and oil producers, and we agreed follow up actions with NFCs that were not in compliance with EMIR. As a part of our supervisory approach we will in future select other sectors of the economy and meet with relevant NFCs to ensure they are complying with the EMIR regulations.

Findings

NFCs' approach to calculation of the clearing threshold, and identification of hedging and non-hedging transactions

Overall, we found that NFCs were accurately classifying hedging and non-hedging transactions. Here we outline some further findings.

- NFCs had set up internal training to educate staff on the EMIR requirements and ensure consistent interpretation of the EMIR provisions applying to NFCs, including in relation to calculation of OTC derivative contract positions entered into by the NFC or other non-financial entities within the NFC's group which were not for hedging purposes; and in relation to establishing which transactions were not for hedging purposes.
- A significant part of NFC derivatives' trading has migrated from over the counter (OTC) to exchange, allowing the clearing of trades and exclusion from the clearing threshold calculation obligation set out in EMIR Article 10(3).
- Following our statement on the definition of a financial instrument in physically settled gas and power forwards¹, the NFCs we met were either no longer trading on MTFs or had reduced their MTF trading activity. This is more a result of the changes the brokers made to their platforms than a change in behaviour of the NFC.
- Some NFCs were previously using a macro Value at Risk (VaR) approach to identify hedging transactions and calculate against the clearing threshold. However, since OTC Question 10(c) of the ESMA Q&As² was published, NFCs have stopped using this approach. Instead the NFCs have opted for a trade tagging system to ensure that each trade is identifiable as either a hedge or a speculative trade, with the latter counting towards the clearing threshold.
- Persons entering into OTC derivative contracts on behalf of NFCs are governed through controls set by the NFCs such as trading limits to ensure they do not breach their

¹ <http://www.fca.org.uk/news/statement-about-broker-operated-systems-trading-physically-settled-gas-and-power-forwards>

² <http://www.esma.europa.eu/content/QA-IX-EMIR-Implementation>

mandate to enter into hedging transactions and inadvertently enter into speculative positions. NFCs also made reporting to a committee a requirement if a breach in the mandate has occurred.

- NFCs demonstrated that persons entering into OTC derivative contracts on their behalf were aware of the decisions made as part of the trading strategy and, where a trade is entered into as a hedging transaction, how these could be justified, evidenced and linked to an underlying hedging purpose. Persons entering into OTC derivative contracts on behalf of NFCs were aware of the time horizon, net position and nature of their trades, which is in line with the business needs when hedging.

Trade reporting

- Some NFCs are having issues with their legacy data systems, such as retrieving information necessary to meet the requirement to report backloaded trades within the three-year deadline (from 12 February 2014).
- NFCs are experiencing mismatching of fields when trade matching but the current trade repository systems do not inform them why the mismatch has occurred, which makes the problem difficult to correct.

Trade confirmation

- Some trades are only being confirmed manually and there are some NFCs that are pushing the industry to confirm trades electronically. We will do some work in this area to encourage the industry to move to electronic confirmations where this facility is available for the relevant contracts.

Reconciliations

- NFCs have ensured that formal agreements are in place both within their own corporate group and with external counterparties for their portfolio reconciliation arrangements. Appropriate procedures to resolve cases of dispute have also been outlined by the NFCs we reviewed.