The Association of Corporate Treasurers

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Comments in response to

CALL FOR EVIDENCE
EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

November 2015

29 January 2016

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. It is established by Royal Charter in the public interest. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details and a link to our approach regarding policy submissions can also be found at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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INTRODUCTION

The ACT has been active in supporting its members with the implementation of the regulatory changes made since the 2008 financial crisis.

We applaud all efforts to bring stability to financial markets.

We are concerned about:

- the continuing changes in regulation which generate uncertainty; and
- the extension of financial services regulation to non-financial services businesses; and
- the adverse effect on banking activity including lending, market making, and pricing; and
- the intent of EU agencies to undo elements of Level 1 legislation passed by the EU Parliament; and
- the adverse effect on competitiveness of EU domiciled businesses.

Our response below comprises a summary of our concerns and detailed responses to each of the four main headings:

- Rules affecting the ability of the economy to finance itself and grow
- Unnecessary regulatory burdens
- Interactions of individual rules, inconsistencies and gaps
- Rules giving rise to possible other unintended consequences

A Glossary of abbreviations used in this response appears at the end of the written response.

SUMMARY OF CONCERNS

We represent Treasury professionals working in non-financial businesses which make investment decisions in order to generate revenue and hence deliver economic growth and employment. Many of these businesses are making regular medium to long term capital investment decisions using capital raised as debt and equity. It is essential to the investment process that businesses operate in an environment of legal certainty and economic stability.

We applaud efforts to bring stability to the financial services industry which proved ill equipped to withstand adverse economic conditions.

The focus of regulators on avoiding further public expenditure in support of failing banks is reasonable but we are concerned that their efforts have reduced the ability of banks to engage in their traditional banking activities.

The banks' traditional roles have been to act as intermediaries between:

- holders of funds and those requiring capital to invest,
- natural holders of differing currencies, and in more recent times
- bank and non-bank parties who seek to change their interest and forex risk profile through the use of derivative transactions.

We believe that the body of regulation as implemented and envisaged has gone beyond addressing the initial objective of protecting the taxpayer and now constrains commercial activity, and increasingly burdens non-financial businesses with the cost and distraction of engaging with the regulation of the financial services sector. Increased capital requirements and heavy compliance costs on traditional banks are making them uncompetitive and leading to the emergence of new forms of Financial Institution. For example: P2P lending and challenger banks operating in specific markets which may create more risk for consumers and businesses in the long run.

RULES AFFECTING THE ABILITY OF THE ECONOMY TO FINANCE ITSELF AND GROW

1) Unnecessary regulatory constraints on financing

'The Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.'

No response

2) Market liquidity

'Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.'

Directives/Regulations referred to: MiFID II, CSDR

Multiple regulatory pressures are being placed on market makers and the securities markets. Dame Clara Furse in her February 2015

speech[1] noted the material decline in trading inventories at investment banks as seen in BoE statistics.

Capital requirements have taken their toll. Changes in Repo trading required by CSDR[2] will put market makers at risk under the mandatory buy-in rules, and now these MiFID II transparency rules as proposed will further increase their risk. Market makers can respond by either further withdrawing from markets or by increasing spreads to protect their trading margin.

The mandatory buy-in requirement of CSDR and the transparency requirements of MiFID II[3] are expected to have an adverse effect on pricing by market makers with consequential impact on market liquidity and impact secondary market pricing on which new issuance pricing is based.

Our concern is that the transparency requirements of the draft Regulatory Technical and Implementing Standards Annex[4] are likely to cause market makers to widen secondary spreads to protect against investors demanding trades at published prices which is the degree of price visibility which is key to MiFID.

New issuance spreads will be affected by secondary market spreads at a point of regulatory development at which the EU is encouraging increased funding of corporates through issuance of tradeable securities.

To summarise, the risk to corporate issuance margins is real although difficult to quantify and is not restricted to MiFID II which would exacerbate an increase in secondary market prices and affect new issuance rates.

Suggested Remedy:

Regulators need to consider cumulative impact of existing and proposed regulation on liquidity where liquidity is desired.

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1 http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech796.pdf

2 Article 7 (3), central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012

3 MiFID II / MiFIR: Regulatory technical and implementing standards – Annex I

4 http://www.esma.europa.eu/system/files/2015-esma-1464_annex_i_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf

3) Investor and consumer protection

‘Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence.’

No response

4) Proportionality / preserving diversity in the EU financial sector

‘Are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non- financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how? ‘

Directive/regulation referred to: MiFID / MiFIR II Article 2(1)(d)(ii)

The new MiFID / MiFIR II rules concerning trading on electronic trading platforms are disproportionate for non-financial companies.

European authorities have recognised the economic importance of non-financial companies’ use of derivatives for hedging and therefore these transactions have been subject to important exemptions in the legislative framework for OTC derivatives. Non-financial companies regularly use the services (with direct or indirect access) of various platforms, such as FXall or 360T, that could be qualified as Organised Trading Facilities (OTFs) and Multilateral Trading Facilities (MTFs). These platforms bring clear benefits, such as increased efficiency and liquidity, error reduction and automatic generation and transmission of UTIs where required for input into TRs. Non-financial companies transact on these platforms when hedging their commercial and financial exposures.

In addition, NFC transacting on OTFs are dealing with banks that are already regulated.

Under MiFID I rules non-financial companies have been able to rely on the exemption for dealing on own account (Article 2(1)(b)) which currently exempts them from MiFID obligations when directly accessing trading platforms. However, in MiFID II the exemption has been considerably narrowed and the new exemption under (Article 2(1)(d)(ii)) will not include “*members of or participants in a regulated market or an MTF or have direct electronic access to a trading venue.*” We understand the exemption has been narrowed in order to capture high frequency traders into the scope of MiFID, which we fully agree with. However this wording has a serious unintended consequence as this would bring non-financial companies using the above-mentioned platforms into the scope of full MiFID.

A consequence of this would be to discourage non-financial companies from using these platforms, which would lead to increased pricing, higher operational risk and inefficiencies for non-financial companies. A shift away from trading on electronic platforms would also be in serious contradiction with the authorities' general objectives which seeks to push more trading onto electronic platforms. Electronic platforms provide more transparent pricing, a full audit trail of transactions and are in our view far superior to all alternatives.

Evidence:

Automated trading systems are widely used across corporate treasury functions and are being integrated into EMIR reporting processes to increase accuracy and improve timing of data submitted to TRs.

We have received direct feedback from our members about their concerns about the potential effect of implementation of MiFID II Article 2(d).

Suggested Remedy:

The Regulatory Technical Standards for MiFID/MiFIR should be amended to clarify the definition of direct electronic access so that it does not apply to end-users who access electronic execution platforms using an access system provided by the trading venue (e.g. a website).

UNNECESSARY REGULATORY BURDENS

5) Excessive compliance costs and complexity

'In response to some of the practices seen in the run-up to the crisis, EU rules have necessarily become more prescriptive. This will help to ensure that firms are held to account, but it can also increase costs and complexity, and weaken a sense of individual responsibility. Please identify and justify such burdens that, in your view, do not meet the objectives set out above efficiently and effectively. Please provide quantitative estimates to support your assessment and distinguish between direct and indirect impacts, and between one-off and recurring costs. Please identify areas where they could be simplified, to achieve more efficiently the intended regulatory objective.'

Example 1

Directive/Regulation: EMIR

Non-financial companies have invested and continue to invest considerable funds in the implementation of and on-going compliance with EMIR, particularly in reporting. In our view such expenditure is not justified

by the overarching objective of EMIR, which is to preserve financial stability, as NFCs' OTC derivative transactions are not systemically relevant.

Non-financial companies' transactions represent only about 2 per cent of the notional value of outstanding transactions, yet almost 80 per cent of the reporting entities are non-financial companies, which represents over 100,000 non-financial reporting entities against around 28,000 financial entities[5]. Therefore we believe the current legal framework poses an undue burden on non-financial companies.

NFCs use derivatives to manage risks of underlying commercial and industrial operations. They do not enter such derivatives for speculative purposes and do not pose systemic risks by their derivative transactions. Corporate treasurers are not compensated to take risk, on the contrary. Furthermore, the use of derivatives for hedging does not only reduce operational risks for non-financial companies themselves; it also reduces risks for the banks which lend to these companies and hence contributes to the global stability of the financial system. At the level of the European economy the total compliance cost represents a significant investment by companies in money, IT resources, and distraction of finance staff. However, we are convinced that this investment does not contribute to greater financial stability but it drains funds from more productive investment.

Evidence:

In particular the following aspects of EMIR pose undue burden on non-financial companies:

- Dual-sided reporting: we see no added value in reporting the same transaction twice, both by the financial and the non-financial counterparty. Dual-sided reporting is both inefficient and costly. Single-sided reporting would enable supervisors to better access information on potential systemic risks without such inefficient expenditure and allocation of resources by non-financial companies.

- Reporting of intra-group transactions: we consider the reporting of these transaction is irrelevant from the perspective of maintaining financial stability. Non-financial companies centralise risk management for the purposes of efficiency and cost saving. External derivative transactions (usually of net but sometimes of gross exposures) are often undertaken by a central unit and these are then mirrored appropriately as intra-group transactions with the part of the group where the underlying business risk has arisen. While it significantly increases the reporting burden on companies, reporting

[5] https://www.esma.europa.eu/system/files/esma-2015-1251_-_emir_review_report_no.1_on_non_financial_firms.pdf

the intra-group transactions does not bring any additional value to the supervisor, as the related external trades have already indirectly been reported (twice in fact, due to the dual reporting requirement). Whilst we understand that intra-group exemptions are available for clearing and margining requirements, in practice these are likely to be complex and administratively burdensome to obtain for NFC+ corporates. It significantly increases the administrative burden on companies to submit notifications to obtain exemptions for transactions that are not systemically risky. We propose that for NFC+s, intra-group exemptions are automatically granted without having to adhere to the notification process. Alternatively, as a minimum, a single-sided notification process should be adopted where a centralised risk management function is counterparty to the intra-group derivative transaction to ease the administrative burden for corporates and competent authorities.

Suggested Remedy:

EMIR should be amended and the obligation for dual-sided reporting and the reporting of intragroup transactions should be removed.

Example 2:

Directive/Regulation: SFTR

Similarly to EMIR, the SFTR extends the reporting obligation to non-financial counterparties entering into securities financing transactions. Non-financial counterparties enter into reverse repo transactions for placing their excess cash reserves.

Recent developments such as banks' increased credit risk, new regulatory liquidity rules and regulatory focus on other short-term investment products such as Money Market Funds have contributed to an increased interest in this cash management product by non-financial companies, as it helps to diversify risk and offer the additional advantage of being secured by collateral. Typically reverse repos entered into by non-financial counterparties are secured by high quality instruments, are for relatively short time periods and are not systemically risky.

Based on the experiences with EMIR reporting, we believe that the requirement of dual-sided transaction reporting for non-financial counterparties will be costly, burdensome and inefficient for non-financial companies, without adding value for supervisors or contributing to financial stability. SFTR Article 4(3) provides for an exemption from the reporting requirement for certain non-financial entities but we believe such a provision is redundant as it applies only to the smallest non-financial companies, which would typically not enter into securities financing transactions.

Suggested Remedy:

The exemption from the reporting obligation in Article 4(3) in SFTR should be extended to all non-financial counterparties.

Example 3:

Directive: EMIR

Cross Contamination of Asset Classes Affects Competitiveness of EU Domiciled NFC+

A multi-national commodity group's funding hedging activities are likely to be subject to clearing and margining/collateralisation under EMIR on account of the business's worldwide commodity trading activity being in excess of the commodity clearing threshold. The group will therefore be classified as NFC+ under EMIR.

We expressed a concern in our response to the 2015 EMIR consultation that the funding hedging activities of EU commodities businesses will be subject to clearing and margining/collateralisation under EMIR on account of that NFC+ status although they are hedging activities.

This is in contrast to treatment of US domiciled commodities groups because the application of Dodd Frank does not have a similar cross contamination of asset classes. That is, the funding hedges will not lose their end user exemption because the commodities hedges exceed the trading threshold.

This:

- seems disproportionate in that they only engage in group funding hedging activity to minimise risks to their business as a whole and the Treasury functions of similarly sized/larger corporates without commodity trading activities will not be subject to central clearing and bilateral collateralisation obligations; and

- will increase cash flow volatility and liquidity risks at the group funding level as a result of the EMIR requirements; and

- will disincentivise prudent risk management for the business as a whole to reduce costs; and

- may require the business to consider alternative methods of reducing the cost burden, for example, balancing against the potentially greater cost of restricting bond issuance to only one currency or conducting capital market activities in other regions; and

- the EU commodity sector could face a disadvantaged cost of capital relative to other sectors, and relative to commodity sectors in other regions; and

- funds set aside for central clearing and margin requirements will not be available to invest in Exploration and Extraction and Production or Refining and Marketing.

The scale of the possible cash call in current market conditions, which we expect to be several billion Euros, would either require the business to borrow with the resultant additional funding cost, or to set aside capital which would otherwise be used to deliver value for shareholders.

On a sector-wide basis the overall reduction in investment would be considerable and likely to lead to negative consumer and employment outcomes.

Allowing an exclusion from central clearing and bilateral collateralisation requirements for group funding activities which do not fall under Article 10.3 of EMIR (see above) and are hedging will:

- achieve regulation of credit risk on OTC derivatives activity that is not entered into for hedging purposes; and

- avoid creation of liquidity and cash volatility risks at the group funding level;

- promote best practice, i.e. most efficient, Treasury risk management in large EU commodity businesses;

- safeguard investment in the EU commodity sector; and

- encourage commodity businesses worldwide to continue to view the EU as an attractive region for corporate funding

Suggested Remedy:

We recommend amendment of the Directive or associated Regulations to remove the "cross contamination" of derivative asset classes so that NFCs are only providing margin for those classes of derivative which are non-hedging, or exceed clearing thresholds.

Example 4:

Directive: Proposal for a Regulation on Money Market Funds (COM) 2013/615

Proposed constraints on Money Market Funds (MMFs) will reduce their effectiveness for corporate cash management, and reduce

liquidity in financial securities which underpins EU initiatives such as CMU.

Corporate have increased their holdings of cash as banks have withdrawn from, and priced higher committed bank facilities. This trend is expected to increase as Basel III ratios are imposed and tightened, and as Bail In rules make committed bank facilities less valuable as “back-up” liquidity. The cost of carry of holding cash has been estimated as 2% per annum for large corporates and will be increasingly expensive as a corporate credit rating reduces.

Corporate treasurers have used MMFs as part of their cash management for years. The funds provide a convenient and cost efficient means of diversifying counterparty exposure.

Otherwise most corporate treasuries rely on placing bank deposits with relationship banks. These banks now offer only sub optimal yields due to the imposition of Basel III ratios which make. Bail in rules will also have some adverse impact on investor appetite for bank counterparty risk.

Some larger corporates have started using the Repo markets as a means to enhance yield and diversify risk by accepting financial securities in addition to counterparty liability, but many mid to small corporate treasuries cannot justify the cost of the commercial infrastructure to participate in the Repo market.

A viable alternative for the mid to small corporate sector is the use of MMFs which in turn could manage and diversify risk by, amongst other investments, using the Repo market where their funds can stimulate demand for securitisation and support increased debt issuance by mid and smaller cap corporates emerges under the Capital Markets Union proposals.

The proposed Money Markets Funds Regulations (MMFR) would place restrictions on the investment content of, and impose Net Asset Value (NAV) related capital buffers on MMFs with the intent of improving risk but in fact limiting the MMFs ability to enter the MMF markets and making returns less valuable.

Suggested Remedy:

We support the trend of revisions being made to the MMFR proposals. We recommend these consider the credit risk enhancing nature of Repo transactions to enable MMFs to enter these markets to stimulate further trade in financial securities while minimising reduction in yield through NAV buffers.

6) Reporting and disclosure obligations

‘The EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.

Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals.

Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value.’

We challenge the assertion that “rules [are] designed to increase transparency”. The volume of regulation and data can only be considered to possibly aid transparency if sufficient resource is available at EU and member state level to monitor, interpret, and react.

Example 1: EMIR Reporting

Directive/Regulation: EMIR

The current EMIR reporting regime is inefficient and over-burdening to non-financial counterparties. As stated in our response to Issue 5, the same information is reported twice due to the dual-sided reporting requirement, which in our view is not needed for the purposes of effective oversight subject to reporting parties meeting reporting standards which remain suspect: we draw your attention to the remarkably high level of NFC- trades reported as non-hedging (ESMA EMIR Review Report no. 1, Section 4.4).

Furthermore, the reporting requirements are too complex and subject to interpretation to ensure that consistent and reconcilable data is reported by counterparties.

Non-financial counterparties are experiencing the following issues with the current reporting requirements:

- Currently still a high number of unmatched transactions and considerable efforts and resources spent on fixing mismatches. In most cases these mismatches are not due to a real mismatch in data content but rather due to a format difference or incorrect matching rules applied by the trade repository
- The rules and guidance provided by ESMA remain unclear, incomplete and subject to interpretation, and are themselves derived from BSI rules which are similarly unclear. A singular issue is the lack of finite field specifications both in meaning and format.
- The lack of truly standardised reporting format is a major problem that needs to be tackled – currently reporting formats differ depending on the TR, counterparty etc. **Example:** UTI fields of 34 characters can variously contain blank characters or require packing depending on the TR and the FC.
- The number of reported fields is excessive and the level of detail is of very little value in our view. **Example:** the need to report exact time (including seconds) for execution and confirmation timestamp. We therefore believe that all parties would benefit if the number of reconcilable fields would be decreased and concentrated on fields that contain information necessary for reconciliation. ESMA should furthermore clarify that counterparties to a transaction should not require any specific content on non-mandatory fields. **Example:** non-financial counterparties are often faced with a mismatch due to financial counterparties expecting a specific content for non-mandatory fields and the required content differing from one financial counterparty to another.

Example 2: Prospectus Directive developments

Directive: PD 3

The current draft of PD 3 seeks to remove the existing differentiation between wholesale and retail investors and this is achieved in the main by removal of the €100,000 threshold above which distribution is only to wholesale investors.

Removal of the €100,000 is a logical step in a traded debt market where corporate debt is often held in managed funds where wholesale purchases are allocated across large numbers of retail investors by expert fund managers.

However, we are concerned by the accompanying disclosure requirements. We appreciate that an objective is to make Prospectus' more easily readable for retail investors but do not believe that limiting the number of risks to be disclosed in the Summary is appropriate.

The Summary is the part of the Prospectus most likely to be read by retail investors. We support the widespread belief that retail investors are unlikely to read the full document.

The concern for Prospectus issuers is that retail investors, now to have access to all securities issued by Prospectus, would be poorly informed of risk, and that the issuers could be held responsible for which risks they include in the limited number permitted.

Debt and equity issued under a Prospectus could be either to large complex businesses or new areas of investment, for example novel renewable energy technology. We believe that the issuers and their advisers must be free to decide what risks are appropriate for disclosure in the Summary. Those investors who find a risk analysis too complex to grasp would thereby appreciate the investment risk is beyond their competence to grasp.

Suggested Remedy:

The limitation on the number of Risks to be disclosed in the Prospectus Summary be removed.

7) Contractual documentation

'Standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/ investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.'

Anti-Money Laundering Measures and their Impact on Know Your Customer Practices

Non-financial institutions share with private individuals the burden of proof of identification when opening bank accounts or seeking financial services. The information requirements are non-standardised, are often required by differing parts of single financial institutions, and may be required at different stages of related transactions.

This is creating cost and time inefficiency as large organisations have been required to increase staff, and the time required to bring new banking services into operation is now often reported as "up to a year".

The problem is exacerbated: when entities with existing banking services want to operate through their existing bank but in a different country; and in

smaller entities controlled by small groups of people where each must prove their existence.

This is in addition to the documentation, and reporting requirements which businesses suffer under other regulations such as EMIR and FATCA and becomes a barrier to market entrants. We are aware that start up Fintechs in particular find difficult opening bank accounts.

Suggested Remedy:

Standardised KYC format for information required to be provided by private and corporate customers, and the creation of a central repository where the information could be shared, or transportability of KYC data between financial institutions. Digital standards for approvals could be solutions imposed by EU, international, or member state regulators regulator (with the support of Corporate Treasurers associations).

8) Rules outdated due to technological change

'Please specify where the effectiveness of rules could be enhanced to respond to increasingly online-based services and the development of financial technology solutions for the financial services sector.'

No response

9) Barriers to entry

'Please document barriers to market entry arising from regulation that the EU should help address. Have the new rules given rise to any new barriers to entry for new market players to challenge incumbents or address hitherto unmet customer needs?'

No response

INTERACTIONS OF INDIVIDUAL RULES, INCONSISTENCIES AND GAPS

10) Links between individual rules and overall cumulative impact

'Given the interconnections within the financial sector, it is important to understand whether the rules on banking, insurance, asset management and other areas are interacting as intended. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-sectoral rules (for

example with regard to financial conglomerates). Please explain in what way and provide concrete examples.'

Directive/Regulation: CRR

In terms of the impact of CRD IV, we would highlight not only the impact on the availability of financing but also the impact on banks' deposit taking, and availability and pricing of certain important services. CRD IV imposes multiple layers of capital, liquidity and leverage ratio requirements, and the combined impacts of these is expected to bear profound consequences on how banks look at and behave towards their corporate customers. At this stage it is of course impossible to have a view on the full impact of these requirements, as implementation has only started and some elements (like the Net Stable Funding Ratio) still need to be defined by the EU legislator.

The most obvious impact is the extraordinary spread between deposit yields and cost of short term borrowing for retail customers and wholesale customers which include non-financial corporates of all sizes. This spread for large corporates can be 2%[6], and greater for SMEs and individuals. The risk to financial services entities being erosion of their depositor base as natural cash holders seek alternative investments for their cash.

The forthcoming tightening of bank ratios required by Basel III will increase the cost of bank facilities to non-financial borrowers while continuing to keep deposit rates low. Non-financial businesses will have the unenviable choice of paying for expensive committed facilities or suffering a high cost of carry for holding cash. Current evidence is that non-financial businesses are continuing to prefer to hold cash due to perceived uncertainty over the reliability of bank lines (see: http://bankunderground.co.uk/2015/07/24/are-firms-ever-going-to-empty-their-war-chests/), aggravated by recent "bail-in" regulations[7].

Suggested Remedy:

We recommend regulation consider the risk of material amounts of cash in short term, economically inefficient wholesale deposits.

11) Definitions

'Different pieces of financial services legislation contain similar definitions, but the definitions sometimes vary (for example, the definition of SMEs). Please indicate specific areas of financial services legislation where further clarification and/or consistency of definitions would be beneficial.'

[6] http://www.bankofengland.co.uk/statistics/Documents/efr/2015/mar/effectiverates.pdf

[7] See: http://www.ft.com/cms/s/0/f32f555e-b3c5-11e5-8358-9a82b43f6b2f.html#axzz3xzg26icO for discussion on the nature of the problem).

Directives/Regulations: MiFID / MiFIR II, EMIR

The term 'financial instrument' is defined in MiFID and cross-referenced in several other legislative texts, such as EMIR. Member States have however translated MiFID I in different ways, leading to different interpretations within the EU specifically concerning the definition of FX forward / spot and whether FX forward contracts concluded for commercial purposes are to be considered as financial instruments. This has caused asymmetric reporting requirements linked to EMIR for instance.

MIFID II seeks to remedy this by stating that a contract relating to a currency is not a financial instrument if it is a spot contract or a means of payment that must be settled physically, and is effected to facilitate payment for goods, services or direct investment. However, we believe that this definition may be interpreted inconsistently and would not be useful for non-financial companies as it is too restrictive. Therefore the definition should be extended to specifically exempt FX instruments used in treasury financing activities. This can be addressed by amending the definition as follows:

"A contract relating to a currency is not a financial instrument if it is a spot contract or a means of payment that must be settled physically otherwise than by reason of a default or other termination event, and is effected to facilitate payment or receipt of payment for goods, services, direct investment or treasury financing activities by a non-financial counterparty (NFC), or by other NFC entities within the group to which the NFC belongs."

We believe that this approach would help to harmonise EU requirements with other jurisdictions outside the EU which generally have exempted FX forwards and/or non-financial end users from the scope of their OTC derivative regulations.

12) Overlaps, duplications and inconsistencies

Please indicate specific areas of financial services legislation where there are overlapping, duplicative or inconsistent requirements.

Example 1

Directive/Regulation: EMIR

The start date of EMIR variation margin requirements is currently set for 2017, which is significantly earlier than the start date of the central clearing obligation (December 2018 for Category 4 counterparties) and the obligation to post initial margin (2019 or 2020 for NFC+s). The fact that the RTSs for variation margin have been drafted to reflect the BCBS/IOSCO

recommendations and their implementation timeline and has not been adapted to ensure a consistent implementation timeline at EU level is problematic for EU non-financial counterparties subject to these rules. The BCBS/IOSCO recommendations do not include the concept of a 'non-financial counterparty' subject to mandatory central clearing (NFC+ in EMIR) and currently NFC+s are grouped in the category of 'All other covered entities', which is a category for all but the largest banks. The current timeline does not give corporates sufficient time to raise working capital, implement new systems and processes to adhere to the requirements.

Suggested Remedy:

The Regulatory Technical Standards should be amended to align the start of the obligation to post variation margin for non-centrally cleared transactions with the start date of the central clearing obligation.

Example 2

Unintended Effect of Multilateral Interchange Fees Regulation

EU wide caps on card interchange fees have been imposed. These fees are those chargeable by card networks (for example: VISA) for clearing transaction within and between themselves, and are ultimately payable by consumers.

We were surprised that debit card interchange fees are to be regulated on an ad valorem basis. UK practice has to date recognised the essential difference between credit and debit cards: the former being a credit transaction where risk is based on value uncollected at point of use; and the latter a transaction charge for moving cash between two bank accounts. Levying an ad valorem charge on debit cards would be akin to applying one to BACS and SEPA payments.

The result has been to lower interchange fees for transaction less than £30 and to increase them for larger transaction. The effect for a UK utility is generally an increase in costs of about £100,000 per annum. There will be an adverse impact on many retailers of higher value goods and services, such as whitegoods, travel, and capital goods such as motor vehicles where debit cards had provided a safe, and immediate means of payment.

Suggested Remedy:

Regulators must ensure they have a representative response to any consultation. We understand that responses to a consultation an interchange fee cap on debit card transactions may have been biased towards high volume, low value retailers who would support the ad valorem process.

13) Gaps:

'While the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether they are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.'

No response

RULES GIVING RISE TO POSSIBLE OTHER UNINTENDED CONSEQUENCES

14) Risk

'EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.'

Directives/Regulations: EMIR, CRR, Bank structural separation, FTT

We believe risk is shifting within the financial sector towards CCPs and otherwise towards the non-financial sector as a consequence of the continued pressure on the use of risk mitigating OTC derivatives by non-financial companies.

Despite the exemption from central clearing and margining in EMIR and the read-across exemption from the CVA risk capital charge under CRR, there is continued pressure on the ability of non-financial companies to manage their risk through the use of non-centrally cleared OTC derivative products:

- **CCPs** may not be able to manage a material default by one or more counterparties although increasingly important as custodians of initial and variation margin.
- **EBA's** planned guidelines on the treatment of CVA risks under SREP, which would impose additional capital requirements on banks for their non-centrally cleared OTC derivatives transactions with non-financial companies. This would largely eliminate the benefit to NFCs of the exemption from CVA risk capital charge in CRR.
- **Bank Structural Separation**: may further limit the availability of OTC derivatives and impact their pricing; and is leading to inconsistent national level reaction which could lead to competitive issues across borders.
- **Financial Transaction Tax** will penalise risk mitigation, either directly by considering non-financial companies with centralised risk management

function as a financial institution and/or indirectly via the additional costs imposed by banks. This cost may be multi-level as transactions pass through the market as financial services entities seek to match counterparties risk management requirements.

Regulation needs to recognise that risk is rarely eliminated and is mitigated by being passed to the party most capable of managing it.

The combined effect of CVA on NFC-, FTT, banking separation, and margining through CCPs will be to increase costs of risk management while concentrating liquidity risk in CCPs.

Suggested Remedy:

We strongly recommend an holistic view of financial transactions and the risk they create be put in place of regulation which has conflicting objectives (commercial growth for jobs against protecting taxpayer exposure) and concentrates liquidity risk in CCPs where failure of one or a few financial institutions could impact through the CCP to many others.

15) Procyclicality:

'EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how.'

Directive/Regulation: EMIR

EMIR and its regulations require that businesses classified as NFC+ be required to post initial and variation margin for OTC derivatives. We believe this exposes financial markets to procyclical movements when under stress and expressed this concern in our response to the 2015 EMIR consultation of DG-FISMA.

Market volatility during the period since the last financial crisis has been high (for example: interest rate falling from 5.5% to 0.5%) and greater movements have been suffered in post war period. Procyclicality is the essential by-product of margining: counterparties can only react to adverse price movements by closing out their contracts, and thereby further aggravate the market movements, or by lodging margin generally in the form of cash.

The problem is the use of margining which had previously been the mechanism of a few discreet markets, those in which only marginal price movements were expected, and those in which counterparties tended to be of a consistent and high credit quality but is now being used to push the risk

elsewhere: most likely back into the banking system of the margin payer's domicile.

Suggested Remedy:

Regulation needs to recognise this essential weakness either by dismissing margining, and similarly the efforts by the EBA to create de facto margining for NFC- through CVA, and/or using market circuit breakers set by regulators, and coordinated across the G20 members, to stop movements beyond thresholds at which margining is feasible without creating material risk.

GLOSSARY

BCBS	Basel Committee on Banking Supervision: the agency which sets Basle III rules
CCP	Central Counterparty: used to clear margin for derivative contracts
CRD IV	Capital Requirements Directive 2013/36/EU
CRR	Capital Requirements Regulation (EU) No 575/2013
CSDR	REGULATION (EU) No 909/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012
CVA	Credit Value Adjustments: risk weighting charge to recognise the credit risk of a counterparty to an Financial entity
EBA	European Banking Authority: the EU Agency which oversees banking within the EU
EMIR	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
ESMA	European Securities and Markets Authority: the EU Agency which administers financial directives such as EMIR
FC	Financial Counterparty for the purpose of EMIR
FTT	Financial Transaction Tax: an ad valorem tax on financial transactions currently proposed by 10 member states
IOSCO	International Organization of Securities Commissions
MiFID II	DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
MiFIR	See above
NFC	Non-Financial Counterparty for the purpose of EMIR
OTC	“Over the Counter” derivative transaction: that negotiated between two parties and not in a form traded on exchanges
PD 3	The draft of the Prospectus Directive currently under development.
RTS	Regulatory Technical Standards: Level 2 legislation issued by an EU Agency
SFTR	Securities Financing Transactions Regulation: Repos are SFTs
SREP	Supervisory Risk and Evaluation Process of the EBA (EBA/GL/2014/13 of 19 December 2014)
TR	Trade Repository: where OTC and Repo transactions are or are to be recorded for the purpose of EMIR and SFTR

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