PERSPECTIVE

The EMIR has no clothes!

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The banking crisis of 2007–2009 demonstrated to the G20 finance ministers that the derivatives market was potentially beyond their control. The European Market Infrastructure Regulation (EMIR) is intended to fulfil Europe's commitment to the G20 to increase transparency and to supervise the derivatives market. It requires three things of derivative users, including users of commodity derivatives – reporting of risk, clearing of risk and mitigation of risk. Although commodities were innocent by-standers in the banking crisis, commodities have been caught, in my opinion, wrongly, in the EMIR net.

Reporting

EMIR applies to futures, forwards, swaps and options, whether traded over-the-counter (OTC) or on a regulated exchange. A typical EMIR deal report contains 60 data points. Given the fragmented nature of the commodity market the European Securities and Markets Authority (ESMA) will require an army of analysts to make sense of all the information it receives.

Each deal is reported to a trade repository, which aggregates it and passes it on to a national competent authority (NCA), which in turn passes it on to ESMA who analyse it for signs of international systemic risk. It seems likely that by the time ESMA receives the data all it will be able to analyse is what went wrong in the past, rather than anticipate and head off any systemic risk before it spirals out of control.

Each commodity market has its own idiosyncrasies. So, in the commodity sector, ESMA will need the services of analysts familiar with oil, gas, power, coal, not to mention agricultural commodities.

More data does not mean more transparency as the European Commission found out when it raided the offices of Platts, BP, Statoil and Shell in May 2013 in order to look for evidence of price collusion. Two years later we are all still waiting for their findings.

FC or not FC? That is the question

The extent to which EMIR applies depends on whether the company concerned is a financial counterparty (FC), a non-financial counterparty above a dealing threshold (NFC+), or a non-financial counterparty below a dealing threshold (NFC–).

Whether the company is NFC+ or NFC– depends on whether the size of its notional position over a rolling 30-day average period is greater or less than a threshold of €3bn. This suggests that a company would have to have traded the equivalent of 50mn–55mn barrels in a 30-day period to qualify as NFC+. Hence, this category is only likely to apply to major oil and gas companies, mining companies, utilities and large trading houses.

FCs and NFC+ companies have to do more than simply report deals.

Clearing and risk mitigation

The clearing requirement of EMIR applies to OTC derivatives and requires FC and NFC+ parties to give up the trade to a central counterparty (CCP) for clearing. If one of the counterparties is NFC–, the deal need not be given up for clearing.

The risk mitigation requirement of EMIR applies to OTC derivatives and requires parties to deal responsibly by:

- Confirming trades promptly.
- Marking trades to market on a daily basis.
- Having a dispute resolution procedure in place.
- Performing portfolio reconciliation at regular intervals.
- Performing portfolio compression, ie netting off long and short positions held with the same counterparty.
- Exchanging collateral to secure trades.
- Applying higher capital adequacy obligations on FCs.

The hedging get out

Hedge transactions are exempt from the need to clear and mitigate risk, but the hedger is still bound by the reporting requirements of EMIR. Relieving hedgers of the need to give up trades for clearing or to post collateral is crucial. Small companies often avoid regulated markets because they do not have the cash capacity to deal with margin calls.

But to assess accurately whether a company is hedging or speculating requires a detailed analysis of the company's risk profile, risk appetite and market price view. FC and NFC companies that are otherwise required to clear or collateralise deals are likely to err on the safe side and assume that a counterparty that claims to be hedger may in fact be speculating. It is safest to deny counterparties the hedging get out.

EMIR avoidance

There is a way that NFC– companies can still manage price risk but not engage with EMIR at all – by building 'optionality' in the formula pricing of physical contracts.

Most physical contracts are based on formula prices rather than fixed prices. Larger companies who may also be NFC– companies, but who already use the derivatives market, are in a position to offer price flexibility inside the terms of the physical contract. Physical contracts do not fall within the scope of EMIR. Since the company that is offering optionality in the price clause is taking on price risk in the physical contract, when it comes to lay it off with a derivative, it can claim the hedging exclusion of EMIR.

So, with a single bound, the small producer or end-user can be free of EMIR's reporting requirements while still having the ability to manage price risk.

So much for transparency and control. ●