TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

ACT background information on the proposals for regulation of OTC derivatives
July 2009

The regulatory authorities in the US and Europe are concerned about the systemic risks arising from the build up of positions in OTC derivatives. They are worried that the huge volumes of outstandings and the lack of transparency could mean that in the event of the collapse of a large market participant there could be catastrophic chain of defaults and the withdrawal of liquidity from the markets.

To safeguard financial stability the EU is considering a number of tools[1], namely

(1) promoting further standardisation;
(2) strengthening the bilateral collateral management for non-CCP (Central counterparty and see glossary) eligible contracts
(3) enhancing the use of central data repositories;
(4) moving clearing of standardised OTC derivatives to CCPs;
(5) increasing transparency of prices, transactions and positions; and
(6) moving (part or all of) trading to public trading venues.

Some of the ideas may have merit in reducing credit risk and improving transparency, but seem to be most applicable to the dealers and financial participants in the OTC markets rather than corporates as end users of derivatives for hedging purposes.

The ACT is concerned that either intentionally or accidentally legislation will prohibit companies from using tailored OTC derivatives including many straightforward transactions such as FX forwards, currency and interest rate swaps, options and commodity forwards. Even if this is a fairly unlikely and extreme outcome there are other elements that could complicate treasury hedging, for instance the possibility that any derivative dealt bilaterally would have to be novated to a Central Counterparty (CCP)[2] for clearing and netting. There would then be formal requirements to put up margin (collateral) based on daily mark to market valuations. For those with large exposures this might be regarded as a beneficial risk mitigation measure, but for others it could increase the complexity and cost of dealing.

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[1] EU Commission consultation - "Possible initiatives to enhance the resilience of OTC Derivatives Markets" http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/derivatives_consultation.pdf

[2] The conditions under which a CCP may reduce counterparty risk or increase it are discussed in *Does a Central Clearing Counterparty Reduce Counterparty Risk*, Darrell Duffie and Haoxiang Zhu, Stanford University, July 2009, http://www.stanford.edu/~duffie/DuffieZhu.pdf

The ACT does not want to stand in the way of improvements to streamline OTC processes and reduce overall risk, but at the same time we do not want to see convenient and flexible hedging instruments for non-financial sector companies banned. The danger is that, in attempting to reduce systemic risk, ordinary companies are put off using derivatives and therefore end up with more commercial risks unhedged or hedged by more inconvenient or expensive means affecting the conduct of business . There is in any case strong evidence that companies greatly under-hedge their financial price risks[3].

The issues for corporates

1) Standardisation of derivatives

Standardisation can be at two levels:

1. Standardisation of the contractual framework by use of a standard template like the ISDA master agreement.
   This, generally speaking, can be helpful for certainty and efficiency of processing.

2. Standardisation of the parameters such as rates, dates and amounts which if mandated would remove a valuable flexibility.
   Quite apart from perhaps making the company unable to get the commercial match that it needed, this could also complicate the accounting if hedge effectiveness can no longer be demonstrated.

2) Strengthening the bilateral collateral management for non-CCP eligible contracts

As an alternative to subjecting derivative contracts to the rigours of a CCP the proposal from the EU is to strengthen the processes between the parties in a bilateral deal, centred on having more deals and exposures collateralised with frequent revaluations of positions and posting of collateral.

The ACT would encourage good house-keeping such as prompt exchange and agreement of confirmations, but sees no reason to interfere with whatever commercial agreement the parties care to make as to giving each other collateral. For a non-financial company, a major advantage of OTC dealing with its relationship banks is that the banks are prepared to take a credit risk on the company. In some cases, cash margining or provision of collateral – not necessarily cash[4] – is agreed. If collateral/margining were to be required, quite apart from the admin complication, the company often may need to use valuable credit lines to drawdown the cash needed. Systemically in such a case, nothing has changed. Instead of a credit exposure to a currency swap, say, the banking sector would have a credit exposure on a loan.

For the company you have the very real problem that a mark to market loss on a derivative contract hedging a long term risk or cash flow becomes an immediate cash flow. Even if the underlying

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[3] Companies 'short-sighted when hedging', By Jennifer Hughes in New York, Financial Times, January 26 2006: "Companies' currency hedging horizons are often too short to have any real effect in mitigating adverse trends, Citigroup has said after a survey of corporate clients and their foreign exchange hedging practices."

[4] For example, some Registered Social Landlords in the UK provide collateral by security over a parcel of real estate rather than by providing cash margining.

position being hedged is showing a gain the timings would become mismatched. Best practice in treasury has always warned against hedging a longer term cash flow with a short term contract that generates short term cash flows.

Where, unusually, a bank or the company[5] does ask for margining, if it is agreed, it is usual for this to be mutual – each providing margin to the other when either has a mark to market loss on the derivative. For most companies, in order to reduce the administrative burden, margining usually is calculated periodically (perhaps weekly) and only provided where the aggregate mark to market loss is material: for a large company perhaps £20 to £50 million; for a small company, less.

3) Enhancing the use of central data repositories

We assume any reporting requirements for deals done with non regulated firms would be looked after by the financial counterparty, so we make no comment on this aspect except that it is important that the reporting mechanism not add to the regulated firms costs as these would very likely be passed on the customer, one way or another.

4) Moving clearing of standardised OTC derivatives to CCPs

Conceptually the idea of moving all bilateral credit exposures so that a CCP is interposed between the parties does allow for extensive netting of exposures and for parties to the transaction and the system as a whole this may be beneficial. However there can be circumstances, particularly if there are multiple CCPs when it may add to overall margin requirements and counterparty risk[2]. Certainly, it would add to cost. The CCP is created to be an undoubted credit risk with all CCP members having to put up a deposit to the "default fund" and then through the initial margin and daily margin adjustments on transactions. As for the comments above on bilateral margining, the CCP margin process would turn a hedge into an immediate cashflow and potential further cash flows if mark-to-market losses occur, with all the complications mentioned. In addition there is the question of how a non-financial company gains access to the CCP. If this has to be indirect through an existing general clearing member there is a potential extra exposure to that member and, perhaps, further cost.

As an alternative to using a CCP to facilitate clearing and netting, companies that have done one deal with bank A and closed off that hedge with identical parameters with bank B have always been able to ask one bank to novate the deal to the other, but this is administration intensive and probably only worthwhile for large transactions with large mark to market valuations.

5) Increasing transparency of prices, transactions and positions

Because non-financial companies do not usually use equity or credit derivatives, for most of the transactions that are regularly done by companies the pricing is already reasonably transparent. The majority of dealing is typically in FX rates and interest rates where liquid and transparent markets exist. We are not convinced that additional pricing transparency is required. As regards

[5] While a bank has a business of providing credit, non-financial companies usually do not and they have only a small credit portfolio. Accordingly, the credit limit a company marks for a bank is normally much smaller than the bank marks for the company.

positions and the risks to financial stability, we assume that would be handled at the financial counterparty end of a transactions, so the ACT makes no comment.

6) Moving (part or all of) trading to public trading venues

The ACT regards this as the most extreme and most contentious idea. The authorities recognise that requiring all derivatives to be exchange traded would limit the range of derivatives available to meet the exact risk management needs of users, but the concern is that they end up regarding the stability and transparency of markets as the overriding consideration, to the detriment of end users.

It is significant that at present few treasurers in Europe use exchange traded markets or other public trading venues for FX or interest rate hedging although for commodity hedging it is more normal. The implication is that OTC trades are more attractive to companies be that for convenience of administration, ability to match exposures exactly or pricing. Administrative issues and costs are a major consideration here. Even if the exchanges eliminate some of the turn taken by OTC dealers it is apparent that any pricing benefit cannot be sufficient to offset the other benefits of OTC trading.

Moving trading to public venues would generate all the downsides of standardisation and use of a CCP that have already been mentioned and add materially to companies' costs.

Conclusion

If there is perceived to be an excessive risk between financial counterparties that poses a risk to financial stability any new measures would be best directed at those financial counterparties. We have not seen any mention that financial stability is threatened by credit risk on non-financial companies, in which case there should be no need to include OTC deals with the non-regulated sector in any new processes and regulation. Furthermore removing OTC dealing flexibility from non-financial companies would potentially give rise to more commercial risks being left unhedged within that sector.

Glossary

Central counterparty (CCP): An entity that interposes itself between the counterparties to the contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

Clearing: The process of establishing settlement positions, including the calculation of net positions, and the process of checking that securities, cash or both are available. In other words it is the process used for managing the risk of open positions.

Novation: The replacement of a contract between two initial counterparties to a contract (the transferor, who steps out of the deal, and the remaining party) with a new contract between the remaining party and a third party (the transferee).

Settlement: The completion of a transaction, wherein the seller transfers securities or financial instruments to the buyer and the buyer transfers money to the seller.