

The Association of Corporate Treasurers

Comments in response to
***Consultation Paper: Standardisation and
exchange trading of OTC derivatives***
Issued by: Committee of European Securities
Regulators,
19 July 2010

16 July 2010

The Association of Corporate Treasurers (ACT)

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

Contact details are also 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* and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter. Our comments are made from the standpoint of non financial companies that are users of derivatives.

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We will not rehearse here the arguments against the making of exchange trading or margining of OTC contracts mandatory for non-financial companies principally engaged in hedging activities. However, it is important not, through unduly broad definitions and general provisions drafted to cover the kinds of matter considered in this consultation paper, to undermine the basic principle that such OTC contracts should be allowed to be entirely tailor-made for the circumstances and not affected by standardisation requirements.

Indeed, we would go further and suggest that it is unnecessary to press the standardisation trend by means of new mandatory requirements.

For non financial companies the bulk of their derivative dealings are in FX and interest rate products. As outlined in our response to Q1 we believe that there is already a high degree of standardisation of legal terms through the use of ISDA agreements and a reasonable degree of standardisation in process and even to an extent in some product terms. There is a natural trend for standardisation where there are self evident benefits, but yet flexibility for the end user where this is what the customer wants or needs.

If there is an advantage to be gained from further standardisation, without undue cost, market forces will develop it.

Consultation questions

We make no comment on most questions as we believe others are better placed to answer them. However we do comment on selected questions. For the avoidance of doubt, we do see that exchange trading and central clearing of intra-financial services trades (as distinct from trades involving non-financial companies), done well, can significantly reduce systemic risks.

Q1 Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?

A1 In general we agree with CESR's assessment of the degree of standardisation in FX, interest rate and commodity derivatives. FX and interest rate derivatives and to a lesser extent commodity derivatives are the OTC derivatives most often used by non financial companies. Exchange trading of derivatives is relatively unusual for such companies, with the possible exception of some commodity trades. There is already a high degree of standardisation of legal terms through the use of ISDA agreements and a reasonable degree of standardisation in process and even to an extent in some product terms. Market conventions exist, be they on business days, day counts, frequency of interest, reference rates and so on. Pricing is very transparent with many providers of information or dealing screens available (for example single or multibank portals such as FXAll), and of course the ability for a company to take simultaneous telephone quotes too.

Q3 Do you agree that greater standardisation is desirable? What should the goal of standardisation be?

A3 Standardisation can facilitate greater transparency and liquidity, but only where the product the subject of the transaction is itself standard. Given the nature of the uses of many derivatives contracts, contracts are often

terminated before maturity. Standardisation gives clearer pricing signals for the early termination payments.

We suggest that the goal of standardisation should be to give the opportunity to market participants to share in these benefits by adopting the standardised terms – but, as already mentioned, only where the product is standard. Thus, it should not be so broadly framed that it precludes participants – especially non-financial companies – from entering into bespoke (non-standard) contracts. We think it should be left to the market to form a view of whether those benefits outweigh the costs of reduced flexibility.

Q5 *Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.*

A5 From the point of view of non-financial companies, there are two (potential) obstacles to using standardised derivatives which could be removed or ameliorated by regulatory action.

- First, one of the reasons for using bespoke contracts is to avoid the accounting treatment which can arise in some circumstances through the use of arbitrary tests of effectiveness (required by accounting standards) that can cause distortions. The only test should be the company's economic motive in reasonably using the derivative or combination of derivatives as a hedge or partial hedge, but as yet the accounting rules do not take this course. In the absence of a change to accounting standards to provide this as the sole test, it is necessary for non-financial companies to be able to continue to write bespoke contracts, to avoid these distortions.
- Second, the potentially devastating financing effects for many companies of the need to margin derivative contracts during their life if they are exchange traded/centrally cleared. Providing cash collateral creates a cash flow volatility that undermines the whole rationale for hedging – namely to reduce volatility.

Thus, a commercial risk that management judges it sensible to hedge against might not be hedged, simply because of the unacceptable cost of complying with these requirements.

A third obstacle to note for corporate users of exchange traded derivatives, but one that is not really amenable to regulatory action, is basis risk. A basis risk can arise between a standardised derivative and the certainly non-standardised risk being hedged. For this reason flexibility for customers to use tailored derivatives remains important.

Q7 *CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.*

A7 Electronic confirmation systems are already in use for a number of derivatives trades. We believe that non-financial companies, other than the smallest and

then only if their counterparty does not offer an integrated e-banking suite, will prefer to use electronic confirmation systems where available and integrable with their treasury control systems as this reduces delays and “re-keying” and cost. The user cost of electronic confirmations is vanishingly small, assuming compatible systems. (There must be similar benefits for the financial services counterparty, but we do not know what the investment in systems is on their side.) Mandatory use of electronic systems is therefore not required since there will be a natural commercial tendency to use them where volumes justify it.

- Q8 *Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?*
- A8 Broadly, we agree. The key disadvantage for most non-financial companies of exchange trading are the cash flow implications introduced by a requirement for central clearing with margining during the life of the contract. Funding, assuming it is even available, would need to be kept ready to meet margin calls creating volatility and a potential loss of opportunity. The relative ease with which a price can be agreed OTC for quantities which would be of market-disrupting size on-exchange is another factor to be taken into account.
- Q23 *In your view does the envisaged legislative approach in the US leave scope for regulatory arbitrage with the current EU legislative framework as provided under MiFID? Would regulatory measures taken in the EU to increase ‘exchange trading’ of OTC derivatives help to avoid regulatory arbitrage?*
- A23 The cost to multinationals of siting their central derivatives buying function in the most convenient financial centre is low. While the US East coast is a convenient time zone, other financial centres, particularly in Asia, are available.

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for international treasury, providing the widest scope of benchmark qualifications and continuing development through training, conferences and publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at <http://www.treasurers.org/technical/manifesto>

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