The Association of Corporate Treasurers

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Comments in response to:

Public Consultation on Derivatives and Market Infrastructures

Issued by the Internal Market and Services Directorate General of the European Commission

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Markt-consultations-otc-derivatives@ec.europa.eu

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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. We are registered with the European Commission as an interest representative. 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*, 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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The OTC derivative markets provide a valuable service to non financial companies, allowing them to manage or transfer a range of their business risks in a cost effective and efficient manner. We therefore welcome the Commission's overall objective of creating safe, robust and systemically stable markets.

The ACT has on previous occasions made its position on proposals for reform of the OTC derivative markets known to the Commission, for example in response to the Commission's *Consultation document: Possible initiatives to enhance the resilience of OTC derivatives markets SEC(2009) 914 of 3 July 2009*[1] and through meetings of the Commission with the European Association of Corporate Treasurers and formal submissions by them.

The ACT comments on a variety of regulatory initiatives emanating from a range of different authorities and it would be fair to say that the proposals on OTC derivatives have excited more comments and expressions of concern from our members than any other topic for many years. There is a strong belief that there is little real justification for regulating non financial companies and that therefore any new regulations should be crafted to have minimal impact on the vast majority of non financial companies.

Your current proposals for controlling risk in the derivatives markets depend on the use of central clearing and collateral. This is fundamentally the wrong method of managing the risk that non financial companies pose to the financial sector. One role of banks is to take just such risks, another example being the credit risk banks take on their lending portfolios, and to control this they are subject to various regulations on capital requirements, large exposures etc. Proportionate capital requirements on financial firms transacting derivatives with non financial end users are the most relevant risk control mechanism.

Continuing the comparison with lending, there are no proposals to create mandatory requirements for companies to put up, pound for pound, cash collateral for any large loans they have taken from the banking sector. Clearly that would be a nonsense. Equally cash collateral on all derivatives would be a nonsense. It should be sufficient for banks to take a commercial view on their credit risks and to hold sufficient capital buffers against this.

In summary: there is no evidence that the derivative positions of non financial companies are a likely cause of systemic risk so that in designing any rules for mandatory central clearing the Commission should have as its objective that of ensuring that the vast majority of non financial companies are not impacted.

4. Non-financial undertakings

Question: Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

The ACT reiterates that non financial companies and the exposures on OTC derivatives generated by them do not constitute a systemic risk to the financial systems and therefore should be totally outside of any new regulation of OTC derivatives. The proposals to improve the derivatives and markets infrastructures arose from concerns over the stability of financial systems and their ability to cope with severe stresses. Derivative transactions and positions between financial institutions create a vast web of interconnectedness with a lack of real transparency. Failure at certain critical nodes could easily give rise to network instability and failure.

[1] http://www.treasurers.org/otcderivatives/euproposals/actresponse

For non financial companies on the other hand there will be a lack of correlation between them and a significant granularity of risk such that they are unlikely to be a systemic risk. The derivative transactions they undertake will mainly be for hedging purposes so that there is automatically a limit to the size of derivative position that they will individually build up. Furthermore if a derivative position done as a hedge is out of the money for the company there will be a positive balancing position within its business or on borrowings being hedged, so that at just the time when the derivative markets have a risk on the company the company's business should itself be flourishing or its borrowings reducing and thus the risk of default is either lower or neutral.

The Langen report from the ECON Committee[2] has recognised that the non financial end users create limited systemic risk and have good reasons to engage in derivatives for hedging real transactions.

The Basel Committee on Banking Supervision has said[3]:
"Large financial institutions were more interconnected than currently reflected in the capital framework. As a result, when markets entered the downturn, banks' counterparty exposure to other financial firms also increased. The evidence suggests that the asset values of financial firms are, on a relative basis, more correlated than those of non-financial firms."

Imposing a requirement for central clearing and margin payments on the derivative positions of all companies would create a new requirement for funding and liquidity and would potentially tie up large amounts of cash. The cash drain and liquidity risk for companies would make it essential for them to raise new capital to counter-balance the changed riskiness of their businesses. For some companies this would just not be possible causing them to fail while others would avoid this liquidity risk by changing their hedging activities leaving them with other equally unattractive risks that would otherwise have been hedged, such as currency or interest rate risks. Either way the consequences would feed through to become a major drag on the productive capacity of the real business economy. It would be a totally disproportionate response to what is in reality a negligible threat to financial systems and stability.

Within the USA the Dodd-Frank legislation includes an exemption for non financial companies provided that their transactions are for hedging purposes or for non hedge related positions that the counterparty exposure will not have serious adverse effects on the financial stability of the United States banking system or financial markets . It would be good if the eventual EU drafting of regulations could work in a similar manner.

Thresholds

Although the ACT believes that non financial companies pose a negligible systemic risk we recognise that it is possible for a few large organisations to run significant positions or to accumulate large speculative positions. Alternatively companies that are really part of the interconnected financial system may attempt to route

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[2] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2010-0187+0+DOC+PDF+V0//EN&language=EN

[3] Consultative Document; Strengthening the resilience of the banking sector, issued December 2009, para 114 http://www.bis.org/publ/bcbs164.pdf?noframes=1

transactions through an apparently non financial business For these reasons we can support your concept of an "information threshold".

It could be designed so that once non hedge positions exceed some limit the company will need to start reporting to the authorities. We see no need for a hard second (clearing) threshold, but rather we would propose giving the regulator the discretion to take further steps which could include the right to call for further information and regular reporting, to make an assessment of risk, and ultimately to require some transactions to be collateralised or go through central clearing.

Within a framework established for the EU and with detailed rules devised by ESMA (European Securities and Markets Authority) we would recommend that the monitoring and review of companies would be the responsibility of the national regulators, who would be in the best position to assess the real risk from un-margined positions and the appropriate actions required.

Measurement of thresholds

One of the reasons for granting some discretion is to allow for the practical difficulties in creating a hard and fast rule / limit and the inconsistencies it could create. There are complications in defining what method or basis of measurement is appropriate for measuring positions, defining what large is and in the practicalities and processes required.

It is widely accepted that for a derivative the nominal amount or notional principal amount of the transaction is not the sole measure, rather it is the mark to market (MTM) value at any one time that better represents the risk to the parties. However in practical terms this will be changing continuously so that a threshold could be exceeded or not exceeded from day to day.

A more representative measure of risk over time is to take a future MTM measure such as Value at Risk (VaR), but this is subject to difficulties in standardising the definition and indeed doing the calculations. Does one use the 95% or 99% or some other confidence levels; is the daily VaR used or monthly or annual?

VaR does have the advantage of bringing in the effects of duration of the contracts and an indication of the volatility of the derivative reference commodity. However it is widely acknowledged that VaR has major shortcomings as a risk measure.

For most companies measures such as VaR are not commonly used and to require this sort of assessment across the board would introduce a huge bureaucratic burden on business.

There is then the question of taking net or gross positions and whether across instruments or not. Where a legal right of offset exists then netting down of positions would be reasonable. Where offsetting pluses and minuses exist but with different counterparties netting would not be logical. Transactions that are already collateralised on a bilateral basis would clearly need to be excluded from the threshold amounts.

None of this includes a measure of likelihood of default, i.e. the credit worthiness of the party. In a rigorous assessment this should be allowed for but in the context of systemic risk the worry is not over the frequency of a significant default it is over any occurrence of any significant default that impacts the system as a whole. However a regulator with discretion could, if clearly appropriate, make allowance for this.

Hedging criteria

While hedging transactions do have characteristics that make them less systemically risky by and large the significance of a derivative position for financial stability will depend on its size, the degree of interconnectedness of that party within the financial system and the probability of default or some measure of the party's credit risk.

However we consider that if attempting to define some companies as out of scope the use of a hedging criterion may be a useful shorthand way to create a definition. If a company were in some way able to register as a non financial user of derivatives and so be out of scope of the regulations by making some testimony as to the nature of its derivative transactions then a statement that predominantly all its derivatives are done for hedging purposes could be part of that advance categorisation of a company. (Many companies already state something akin to this as part of their statement on treasury and risk policies in their annual report and accounts.)

Gaining hedging treatment for IAS 39 purposes is notoriously complicated so that certain transactions which a corporate would enter into as a clearly defined economic hedge may not satisfy the rules of IAS39. In many cases the decision as to whether a transaction qualifies is hotly contested between auditors and companies. At the time of dealing it could well be uncertain if a transaction will eventually qualify as fully effective, so is such a deal to be exempt or not? Even where the rules are clear cut a transaction that at first qualifies can subsequently cease to qualify or vice versa. Any definition of hedging should be wider than that used in IAS 39 and should encompass all derivatives done with the intention of mitigating or managing a business risk.

Crossing thresholds

Moving from out of scope to in scope for central clearing as a company crosses a threshold could have the unintended side effect of introducing a step change in credit risk and indeed triggering the very default that the system is trying to insulate itself from. If there were to be a hard clearing threshold the sudden need to collateralise **all** its positions could well cause a liquidity crisis for the company and failure. A process of allowing time to move to CCP margining or a system of early warnings to allow the company time to arrange new finance should be built in. Any transition to clearing could be phased by applying to new transactions only or to positions identified as riskier.

The need for adequate funding for margin calls has a serious knock on impact on a company's need to be able to make a going concern statement that it has adequate cashflows or funding facilities to cover its cash needs for the next 12 months. This must be taken into account in any new regulations.

Once again we point out that non financial companies are different from financial firms who might well have existing portfolios of suitable instruments that can be used to secure positions at the CCP.

Transition rules

Appropriate transition rules at the start of any new regulation will be essential.

Intra-group derivatives

We assume the intention is to keep any intra-group derivatives outside the scope of any regulations since any risks or gains and losses are purely internal to that group and do not impact the wider financial systems. For clarity it would be good if this can be specifically stated .

5 Risk mitigation techniques for non-cleared contracts

Question: Do stakeholders share the principle requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

We welcome the Commission's emphasis on the need for electronic confirmations wherever possible. Timely and accurate exchange of confirmations plus reconciliations are a key first step in reducing systemic risk in a market where the administrative processes have not always been as efficient and effective as one might have hoped for.

5(b) calls for timely and accurate exchange of collateral **and** appropriate and proportionate holding of capital. These concepts can be an important risk control mechanism but it would be wrong to insist on a blanket catch-all requirement here. The parties may decide the risks do not justify collateral or the size of exposures are not material. They may wish to work on, say, monthly adjustments to collateral to ease the administrative burden, or collateralisation may be designed only to apply when the exposure exceeds a pre-agreed threshold size. And importantly we would expect that capital requirements fall only on the financial counterparty to a transaction.

7. Segregation and portability

Question: Do stakeholders share the approach set out above on segregation and portability?

We hope that because of the exemptions most non financial companies will not need to pass their transactions via a CCP. However if this is not the case then since most non financial companies will not themselves be clearing members they will instead need to have access to a CCP via an existing clearing member. We therefore welcome the Commission's recognition of the need for segregation of client assets from those of the clearing member itself. There will also need to be proper segregation of one client's assets from another client's assets. Furthermore each client will need to have its own positions separated so that each can benefit from the netting of its exposures within the CCP.

The need for portability of assets and positions from one CCP to another (subject to agreement) is flagged as a requirement on a clearing member acting for clients and we welcome that. In fact interoperability between CCPs will be an important factor in reducing the systemic risk that could develop from a multitude of CCPs coming into being.

8. Prudential requirements

In section A. Initial capital paragraph a) you propose that a CCP should have a minimum capital of a set Euro amount. We question the point of this since any minimum would need to be set very small so as to allow for the possibility of a smaller specialised CCP set up to cover a niche form of derivative. Far more relevant is the formulation for initial capital in paragraph b) which relates capital need to scale of activities. This requirement should be sufficient without paragraph a).

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

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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