TREASURY, RISK AND FINANCE PROFESSIONALS

The Association of Corporate Treasurers

Comments in response to
Consultative Document - Strengthening the resilience of the banking sector, Basel Committee on Banking Supervision, Bank for International Settlements
December 2009

April 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 our Policy and Technical Committee.

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General

In general the ACT welcomes the proposals in the Consultative Document. We confine our comments to certain limited points.

The primary reason for the financial sector is service to the non-financial sector – the economy in general. Important parts of the non-financial sector are, of course, governments and private non-financial companies (PNFCs). Our members are mostly drawn from the latter.

In addressing stability of the financial services system, it is important to leave it fit for purpose in serving the other sectors. The services most important to PNFCs are those of money transmission, provision of funding and provision of risk management products. All three are vital for the continued satisfactory operation of companies and real economy activity in general. It is important that regulation not make provision of these services excessively difficult or unreasonably costly.

Finally, if major changes in the cost or availability of services is contemplated, it is important to ensure that the pace of change is such that it can be absorbed without shock bearing in mind the rate at which adaptation can be effected. Appropriate transitional arrangements or grandfathering will be required.

Counterparty credit risk

Private non-financial companies (PNFCs)

- **Credit characteristics**

  We note the Document's proposal to raise the risk weights on exposures to financial institutions relative to the non-financial corporate sector due to higher correlation.

  We would add that other characteristics of PNFCs also tend to reduce their systemic risk significance (in the absence of sectoral or other concentration risk taken by a systemically significant financial institution). Two examples.
  First, the granularity and diversity of PNFCs. Put simply, there are more non-financial than financial corporations and most companies are relatively small.
  Second, medium and large PNFCs tend to decline in credit quality relatively slowly. They take years to fail and informed creditors usually adjust their positions in the course of the decline.

- **Over the counter derivatives (OTC derivatives)**

  We are supportive of the objectives of the mooted regulatory changes.
  PNFCs use derivatives usually for one of two purposes: cash flow hedging or as part of their financing. All companies, whatever their size, are affected directly or indirectly by this.

  In either of the two main uses of derivatives, for PNFCs the exact tailoring of hedging derivatives to the particular exposure being hedged is often important for risk management and for accounting purposes. Standardisation can make this impossible to achieve.

We can provide complete background of the need for PNFCs to manage cash flow risks arising from financial price risks – interest rates, exchange rates and commodity prices, inflation, etc. – and examples of the need in large and small companies if required.

  The use of derivatives in funding arises both in relation to the interest rate risks associated with funding and with the need for PNFCs to have access to large and deep pools of capital to invest in their obligations. At a time when bank balance sheets are likely to be under pressure and institutional funding will be competed for by banks, governments and local governments and PNFCs, at various times in many jurisdictions local capital availability will be inadequate to meet demands. By accessing pools of capital in other jurisdictions, PNFCs can more likely achieve their funding needs. But funds raised in other currency jurisdictions will need to be swapped into the currency of use and the fixed or floating or index linked nature of the coupon will need to be swapped into the form that the company seeks. Cash flow risk arising from margined derivatives in achieving this can make the finance very unattractive or even require the raising of capital in order to be able to manage the introduced cash flow risks.

  Some companies with large exposures, including derivative exposures, to particular banks have in recent years asked those banks to credit support a proportion of their derivative exposures. Two way margining is usually agreed (obviously with no initial margin) with a large threshold and fortnightly or monthly adjustments. Some companies have moved some of their derivative activity onto exchanges with central clearing. The vast majority of investment grade corporate derivative activity is however OTC and not margined. (Sub-investment grade companies usually have limited arrangements with banks for derivative dealing or may have to provide security for all their banking business.)

There is a very good reason for PNFCs to wish to avoid mandatory margining of derivative contracts. A requirement for margining of all derivatives by PNFCs would introduce cash-flow volatility which would require companies to hold much more capital or to curtail their business activity in view of the extra risks it would bring. This applies to the companies' use of derivatives in cash-flow hedging and in their financing.

We also highlight the use of derivatives by pensions funds. The long term nature of pension fund liabilities and the need to manage overall risks of the fund mean that such funds will very often make extensive use of derivatives often with long maturities. Margining requirements would introduce a whole new short term liquidity problem for pension funds and in any case, as explained for PNFCs, pension funds are unlikely to present a systemic risk.

We acknowledge the encouragement of use of central clearing for standardised derivatives. However, we are hopeful that PNFCs and pension funds will benefit from exemption or some exemption from mooted requirements for on-exchange dealing or central clearing (with margining) of their derivative contracts, at least those used for hedging purposes (including those associated with fund raising). Accordingly, we are most concerned that banking sector resilience measures are proportional and that capital requirements for non-centrally cleared or margined derivatives are set on prudential grounds and not in order arbitrarily to encourage or discourage particular behaviour.

We understand that the extra capital requirements for banks in providing un-margined OTC derivatives are likely to increase spreads materially. We can accept that banks may have attributed too little counterparty risk to derivatives in the past and that some increase will be required. However, the proposals in the Document seem rather arbitrary and designed to increase the costs punitively rather than prudently.

Of course banks' charging of clients for products are only indirectly related to the regulatory capital cost of providing the service – especially where the bank's internal prudential assessment takes a different view. And banks seek to earn an appropriate return on the economic capital they see as tied up in a relationship across the whole spectrum of business with that client. But we think that the scale of capital increase mooted will lead to material price changes.

Introduction of the changes as proposed would lead to material behavioural changes in PNFCs with significant effects on growth.

Liquidity coverage

One of the learnings from the recent crisis is the importance that the financial sector will put on the potential liquidity of their holdings. This is very material in looking at the future supply of funds to PNFCs.

For term obligations, liquidity comes from the ability to sell the asset or to use it as collateral for borrowing. Corporate obligations, with very few exceptions, if any, will tend to be illiquid in that while there may in principle be a market for them, there is not continuous trading in the obligation or even continuous effective two-way price making. After the period after issue, even the largest corporate bond issues tend to have moved to buy and hold investors. Intermediaries will make a price on request (even if they are displaying a nominal price) for small volumes and may take time to quote for any significant amount.

The inherent illiquidity of corporate obligations was, we presume, behind the Bank of England's actions during the crisis to act as "market maker of last resort for eligible corporate obligations"[1]. We think this is a behaviourally important activity directly in times of market stress and as background at all times.

Use of corporate obligations as collateral, even with central banks, is an important alternative source of liquidity. We think it very important that at least investment grade corporate obligations, with appropriate haircuts, be eligible with central banks. While it is important not to get too complicated, it is desirable to have at least some discrimination in the haircuts between higher and lower credit grade obligations. With this background, we think it appropriate that eligible corporate obligations count, with appropriate limits and haircuts, toward meeting the liquidity obligations of financial institutions. Without this , we see aggravation of capital scarcity for PNFCs, putting pressure on levels of real economy activity levels with consequential implications for tax receipts and employment.

[1] Paul Fisher, Executive Director Markets, Bank of England, and Member of the Monetary Policy Committee "The Corporate Sector and the Bank of England's Asset Purchases", paper to The Association of Corporate Treasurers, 18 February 2010 http://www.bankofengland.co.uk/publications/news/2010/014.htm

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/resources/manifestoMay2007.pdf .

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