# The Association of Corporate Treasurers

Interest Representative Register ID: 64617562334-37

## Comments in response to
## *Commission Services Staff Working Document: Possible Further Changes to the Capital Requirements Directive,*
## European Commission
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.

This document is on the record and may be freely quoted or reproduced with acknowledgement.

**General**

We confine ourselves to comment on a very few issues.

We attach the ACT's response to the Basel Committee's consultation – Strengthening the resilience of the banking sector, as an Appendix to this response.

**Section I Liquidity standards for credit institutions and investment firms**

Questions 2 and 3

> *2. In particular views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex 1) and whether central bank eligibility should be mandatory for the buffer assets?*
> *3.Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex 1) for the primary and secondary markets in which these products are traded and their participants.*

Response

We consider these questions to be of high importance.

Most significantly, the recent crisis has highlighted the chilling effect on liquidity of assets arising from fear about the credit standing of financial intermediaries (the potential counterparties to sales/purchases) irrespective of the credit quality of the obligor on the asset the subject of the potential trade. This was subject to a multiplier effect: if a party found a bank it was willing to deal with, the bank itself might be reluctant to trade or would load the price because it feared it would be unable to find a counterparty (another bank) it was happy to take the counterparty risk on in selling the trade on.

What liquidity there was became concentrated in assets with at least some central bank eligibility.

**In order to avoid a spiral of diminishing liquidity of assets, and so of access to finance by obligors, we think it vital to include some corporate obligations among assets regarded as having some liquidity and eligibility for sale to or use as collateral with central banks, subject to appropriate limits and "haircuts".**

We recognise that market liquidity of corporate obligations (after the period after issue) is likely to be less than that of sovereign obligations, particularly due to the relatively small size of long-term issues and the "buy and hold" nature of investors. This would be a factor in setting limits and "haircuts".

However, we think that the recent activity of the Bank of England (following precedents of other central banks) in acting as a "market maker of last resort" for some corporate obligations, as set out in Paul Fisher's speech earlier this year[1], is useful recognition of the need to do more than exclude corporate obligations on illiquidity grounds.

See also comment on Annex 1 and Annex 2.

**Intra group liquidity management**

Question 12

> *Comments are sought on the different options and in particular for how they would operate for the treatment of intra-group loans and deposits and for intra group commitments, respectively. Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio.*

Response

Your paper considers various options for the treatment of internal liquidity in order to take account of possible difficulties between different legal systems in stressed circumstances. We appreciate that some form of symmetrical treatment is helpful in avoiding inconsistencies and excessive conservatism at a consolidated level, but we

[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

have some concerns that ignoring any internal liquidity inflows and outflows could increase costs still further for external customers. Non financial companies operating internationally will often have global pooling arrangements with their banks and would not want the benefits and practicalities of these arrangements to be eroded by the rules on internal liquidity for their banks.

We believe that it is important to allow internal liquidity to be recognised where it is enforceable and where there is no legal impediment to such intra group liquidity even under reasonably foreseeable stressed conditions. A process whereby waivers, if justified, can be readily obtained, will be needed.

In the longer term we would hope that the national authorities can work together towards the elimination of enforcement difficulties between legal systems.

**Section IV Counterparty credit risk**

Key problems identified
Paragraph 109(iii)
We think that the observation in this sub-paragraph of the higher correlation of risk among financial institutions relative to non-financial firms is very important. This is not surprising however as one would expect increasing correlation of risk of firms in any one industrial sector against that of firms in all other sectors.

Subject to usual concentration risk issues, we think the advantageous granularity aspects of risk in dealing with the much larger number of smaller relationships with non-financial firms as against financial institutions further reduces the risk of financial institutions' exposures to non-financial companies. These factors deserve wide recognition.

Section IV generally
The ACT is concerned that following the Basel Committee proposals the capital requirement imposed on derivative transactions done with end users by firms and which are not cleared centrally will be excessive, not truly proportionate to the (systemic) risk and indeed could act as a significant disincentive for companies to undertake sensible commercial hedging transactions with their banks.

We understand that the Commission in its draft discussion paper for the 16th April meeting of the Derivatives and Market Infrastructures Members States Working group comments that "in principle, non-financial institutions could be exempt from the clearing obligation". If the Commission finally concludes that this should be implemented, it would be perverse if the CRD proposals were to negate the conclusions being reached on the importance of preserving the ability of non-financial companies to undertake derivative transactions readily and cost effectively. If non centrally cleared derivatives were to become excessively expensive due to punitive capital requirements the knock on effects would be negative for business activity by those companies, their customers and suppliers, affecting economic activity levels generally, employment and tax receipts too.

**Section V Countercyclical measures**

Capital treatment
Para 151 ff.

We strongly agree with “The suggestion [which] is to exclude general provisions from regulatory capital”. In the absence of such a rule, companies, clients of the financial sector, suffer greatly from the effects on bank behaviour of the diminution of regulatory capital in the transition from the excessive build up of such capital in an economic up-phase to its amplified diminution in the down phase.

Counter-cyclical buffer
Para 162

We think it will be important to preserve the action jurisdiction by jurisdiction. It is a great advantage to overall stability if Member State’s economies do not move in lock-step but follow their own cycles with smoothing effects on other Member States at different stages of their cycles.

**Section VI Systemically important financial institutions**

Para. 169
We recognise that the CRD is concerned with the institutional level.
However, it is important to acknowledge that one is concerned with systemically important financial institutions because of system level effects and this may mean action at the institutional level justified only because of the latter.

Accordingly, we are disturbed to read the comment that “Applying a restriction on the size of a SIFI without regard to whether it had and was abusing a dominant market position would not be consistent with the EU approach.” This seems to be fundamentally ill conceived and extremely dangerous were it true.

It is perfectly possible that an institution may be so large/interconnected etc. as to pose a threat to financial stability at the system level even if it poses no competition problems.

It may be that CRD is not the place to deal with such risks, but in principle we believe that systemic risk requirements should be seen as fundamental and separate from, additional to and over-riding competition issues institutional level risk issues. System level issues, financial stability, should be seen as a basic necessity.

**Section VII Single rule book**

Areas where more stringent requirements are necessary:
On Pillar 2 we wonder if it is well suited to handling the effect at institutional level of system level/network issues and think that careful drafting generally is needed to interpret it so as to make it more effective/less of an obstruction here.

**Annex 1 and Annex 2**

Regarding corporate obligations:
We believe a certain pragmatism is needed here. The paper refers to “... corporate ... bonds ... traded in large, deep and active markets...”. After the first couple of years, corporate bonds tend to settle with buy-and-hold investors and are infrequently traded. Market makers/exchanges may list prices but if you want actually to buy or sell in any material volume you talk to the intermediary who will make you a price which may have more or less relationship to the listed price. At times of crisis, a party may be more worried by the credit risk on the intermediary bank for the trade than on the underlying credit risk on the bond and this makes a “large, deep and active market” impossible. The Bank of England’s recently assumed role as market

maker of last resort for some corporate debt (as some other central banks have done)[1] is very important as an example.

Careful wording is required here not to exclude corporate obligations as a class. See also comments on Section I above.

**Annex IX Possible contours of changes to the counterparty credit risk framework – further details**

We note the preferred use of CDS spreads in discounting the bond-equivalent of counterparty risks which follows Basel proposals. We generally deprecate the use of CDS spreads where actual bond spreads of the obligor are available due both to CDS spread volatility and to its introduction of other factors, for example associated with the writer of the CDS and its expected counterparties as it lays off risk acquired.

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/resources/manifestoMay2007.pdf .


| | |
|---|---|
| Contacts:<br>Stuart Siddall, Chief Executive<br>(020 7847 2542 ssiddall@treasurers.org)<br>John Grout, Policy and Technical Director<br>(020 7847 2575; jgrout@treasurers.org )<br>Martin O'Donovan, Assistant Director, Policy and Technical<br>(020 7847 2577; modonovan@treasurers.org) | The Association of Corporate Treasurers<br>51 Moorgate<br>London EC2R 6BH, UK<br><br>Telephone: 020 7847 2540<br>Fax: 020 7374 8744<br>Website: http://www.treasurers.org |

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

# 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.

This document is on the record and may be freely quoted or reproduced with acknowledgement.

## 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"[2]. 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.

2 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 .


| Contacts: | |
|---|---|
| Stuart Siddall, Chief Executive<br>(020 7847 2542 ssiddall@treasurers.org)<br>John Grout, Policy and Technical Director<br>(020 7847 2575; jgrout@treasurers.org )<br>Martin O'Donovan, Assistant Director, Policy and Technical<br>(020 7847 2577; modonovan@treasurers.org) | The Association of Corporate Treasurers<br>51 Moorgate<br>London EC2R 6BH, UK<br><br>Telephone: 020 7847 2540<br>Fax: 020 7374 8744<br>Website: http://www.treasurers.org |