TREASURY, RISK AND FINANCE PROFESSIONALS

The Association of Corporate Treasurers

Comments in response to

Consultation document: Possible initiatives to enhance the resilience of OTC derivatives markets SEC(2009) 914

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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. 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 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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> *Note: Hedging*
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> *In these comments we frequently refer to non financial companies using derivatives to hedge exposures.*
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> *"Hedging" in this context means the process whereby a firm uses financial instruments (such as forward contracts, futures contracts or options) or other techniques to reduce the impact of fluctuations in the market price of credit, foreign exchange, or commodities on its cash flow, profits or corporate value. Nowadays it extends too to managing inflation and longevity and other risks. Companies usually look for economic effectiveness of hedges and not necessarily for effectiveness for accounting purposes, e.g. under IFRS, which can be somewhat arbitrary.*

We note that the regulatory authorities in the US and Europe are concerned about the systemic risks arising from the build up of positions in OTC derivatives. Accordingly to safeguard financial stability the EU Commission is considering a number of tools[1], namely

(1) promoting further standardisation;
(2) strengthening the bilateral collateral management for non-CCP (Central Counter Party) 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 to private non-financial corporations as end users of derivatives for hedging purposes. It is presumably the threat to financial stability through failure of a financial firm that is the concern. The risk to the system as a whole from failure of a commercial customer of a bank is unlikely to be material.

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, interest rate and commodity swaps, options and 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) 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. Most importantly, in attempting to remove the credit risk between company and bank a liquidity risk is introduced instead.

The liquidity risk introduced is not immaterial. Inspection of the accounts of companies with businesses necessitating long-term hedging, for example Rolls Royce plc., shows the huge amounts of money (in relation to firm size) which might be newly required.

The ACT does not want to stand in the way of improvements to streamline OTC processes and potentially to reduce overall risk[2], but at the same time we do not want to see convenient and flexible hedging instruments for non-financial sector companies banned. The dangers are that, in attempting to reduce systemic risk, ordinary companies

- are put off using derivatives and therefore end up with more commercial risks unhedged or
- have to hedge by more inconvenient or expensive means, affecting the conduct of their businesses or

[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

- face the liquidity risk introduced by margining now, when the hedged cash flows which will offset the derivative position which hedges them occur some (possibly long) time in the future.

It is noteworthy that companies already seem to under-hedge their exposures even where they have no comparative advantage in retaining those exposures and the implied capital they need to hold against the exposures is likely to be inadequately rewarded[3].

Non financial companies tend to make greatest use of foreign exchange, interest rate and commodity derivatives.

They make much less use of equity and credit derivatives. On the latter, note that non-financial companies rarely hold the bonds underlying standard credit default swaps. They may hedge other credit-like exposures to, for example, joint venture partners, key companies in their supply chain or major customers – or even customers of customers if they produce intermediate goods. The bond based CDS might be a reasonable proxy or they may use tailored CDS contracts with the triggering credit event specified exactly to their needs. Importantly, non-financial companies generally deal in large but not systemically significant amounts.

Response to proposals

Principal points

- It is unlikely that a non-financial services sector company using derivatives for hedging will itself represent a systemic risk to the financial services sector.
- Non-financial services sector companies – clients of the regulated sector – use derivative products in their risk management. To restrict this would be damaging and probably mean such companies would need to increase their capital against the unhedged risks and/or change their business behaviour, restricting their activity level and so employment, taxes etc.. To mandate that they must use less convenient or more expensive means of accessing financial hedges would add to their costs and increase their tendency not to hedge, with similar consequences.
- Mandating that non-financial services sector companies only use credit-supported derivatives in their hedging means that such companies would need to hold large undrawn credit lines or cash investments and higher capital accordingly (and this at a time when capital is likely to be scarce and expensive). Such companies would have to treat margins received as "hot money", not available for use in their business pending maturity.
  In attempting to remove the credit risk between company and bank which is not systemically significant, a serious liquidity risk for the firm would introduced instead.

2) Standardisation of derivatives *(numbering follows the consultation document)*

[3] E.g. i. Wharton/CIBC 1998 Survey of Financial Risk Management by U.S. Non-Financial Firms, Gordon M. Bodnar and Richard C. Marston, George Weiss Center for International Financial Research, Wharton School, University of Pennsylvania, and Greg Hayt, CIBC World Markets
ii. CitiFX First Annual Corporate Risk Management Survey, December 2005, Matthew N. Daniel and Didier Hirigoyen, Citigroup.
The article "Companies 'shortsighted when hedging'", Jennifer Hughes, Financial Times, January 26 2006 summarised the survey thus: "Companies' currency hedging horizons are often too short to have any real effect in mitigating adverse trends…"
iii. Guay, W. and Kothari, S. P., How much do firms hedge with derivatives?, *journal of Financial Economics*, Vol. 70, 2003 pp 423061
iv. Robert C. Merton, You Have More Capital than You Think, *Harvard Business Review*, Nov 01, 2005

Questions

1) *What would be a valid reason not to use electronic means as a tool for contracts standardisation?*
2) *Should contracts standardisation be measured by the level of process automation? What other indicators can be used?*
3) *Should non-standardised contracts face higher capital charges for operational risk?*
4) *What other incentives toward standardisation could be used, especially for non-credit institutions?*

Response

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.

Further standardisation is being proposed in order to reduce operational risks from processing and so allow automation of confirmations, central storage, automation of payments and collateral management. Standardisation at the level in 1 above can also reduce legal risk.

We would strongly argue against any standardisation in the sense of only allowing certain fixed amounts, dates or rates to be dealt since this would remove the flexibility a company has to hedge its exact exposures to a particular risk. For a non financial company the ability to tailor a hedge to the exact specification to match the exposure being hedged can be very convenient. If the only hedging instruments available were via standardised contracts, such as an exchange futures contract, many companies with modest treasury resources could be put off hedging at all, leaving volatility and commercial risks.

However some degree of standardisation of contractual form is regarded by the ACT as acceptable and beneficial and could be combined with a degree of standardisation of the fields required to be completed in any transaction. In a cross currency swap requiring certain fields to be completed covering amount, currency A, currency B, rates for currency A and B, term, initial FX rate etc would facilitate electronic processing while leaving commercial flexibility.

Some derivatives however are less suitable for standardisation as to the detailed parameters such as property transactions, tailored CDSs or, of course, the more exotic, highly structured and unusual ones.

Also in this area we see no particular need to be heavy handed with capital charges to incentivise more standardisation. Moves in the direction of standardisation are something which are already in the commercial interests of participants if volumes justify it and the risk and administrative consequences for affected companies don't offset the cost savings. It is already happening and will no doubt continue.

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

Questions

(5) *How could the coverage of collateralised credit exposures be improved?*
(6) *Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.*
(7) *How frequently should multilateral netting be used?*

(8) Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?

Response

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. Taking such credit risks is normally part of the business of a bank.

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 administrative 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 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 by rolling foward 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.

For financial firms that are already subject to regulation and supervision it may be appropriate for regulators to insist on certain steps around bilateral collateral in the interests of financial stability. We understand that reducing the exposures of firms to other firms within the regulated sector is important in reducing the systemic effects of collapse of one firm. For derivatives done between regulated firms and non regulated companies, however, we see no overriding systemic benefit in seeking to remove the freedom of the parties to contract as they feel fit. Banks are in the business of taking financial risks (to a controlled extent) and companies benefit from this service.

Where credit exposures have become particularly large as happened at the end of 2008 and in 2009 normal commercial pressures have come into play with the party at risk

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[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.

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

seeking collateral - the incentive being that without some risk mitigation the parties would no longer be willing to do further business together. It should be remembered that collateral requirements should normally be mutual and following the decline in credit standing of banks many corporates did demand security from their banks.

As regards any margining and collateral arrangements we repeat the crucial point that if a company has to put up cash collateral it turns its hedge transaction into an immediate cashflow which will not match the timing of the counterbalancing commercial cashflow being hedged – perhaps by many years. This introduces a serious cashflow problem, potentially nullifying much of the benefit of the hedge.

In the current economic environment many companies are operating under serious cash constraints with little availability of additional funding to create any cash headroom. For such a company hedging may be commercially essential and were they to have to find additional cash to meet a margin call it could be the final thing that triggers the collapse of the company.

All companies have to be able to demonstrate that they are a "going concern" which involves forecasting cash needs for an least the next 12 months and balancing this against funding availability. A company with significant derivative positions requiring margining would have to hold additional funding headroom to cover the unpredictable amounts that might be demanded. In the current markets, with bank balance sheets under constraints, this is expensive and by no means going to be available to all companies. Derivatives done OTC effectively have this variable funding element automatically built in. Prohibiting OTC derivatives would be equivalent to a withdrawal of credit from the company sector at a time when banks are being urged by governments to continue to advance credit.

Of course, if the mark-to-market favours the company, under a credit support agreement it may receive funds from the counterparty. However, this must be seen as the most volatile of "hot money" and cannot be used in the business pending maturity.

4) Central data repositories

Questions

(9) Are there market segments for which a central data repository is not necessary or desirable?
(10) Which regulatory requirements should central data repositories be subject to?
(11) What information should be disclosed to the public?

Response

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 should not add significantly to the regulated firms costs as these would very likely be passed on the customer, one way or another.

5) Moving clearing of standardised OTC derivatives to CCPs

(12) Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?

(13) What additional benefits should the CCP provide to secure a broader use of its services?
(14) Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?
(15) Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?
(16) Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?
(17) Under which conditions should exemptions be granted and by whom?
(18) What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?
(19) What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?
(20) How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

Response

Conceptually the idea of moving all bilateral credit exposures so that a CCP is interposed between the parties can allow for more extensive netting of exposures. 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] It is likely to add to cost. The CCP is created to be a bankruptcy remote entity 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 above for non-financial-services companies. 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 or at a time of concern about the credit standing of one of the banks.

Note: More than one CCP

We have not emphasised the dangers of multiple CCPs reducing the efficiency of margin moneys and increasing counterparty risk by restricting netting opportunities in the total derivatives space[2 above]. This is for two reasons:

- We do not believe that non-financial sector companies should be required to use CCPs for the reasons we give and
- We believe that regulators can easily eliminate the disadvantages of multiple CCPs by insisting on agreements between CCPs for information interchange so that an identified counterparty can make all daily margin payments to and from one nominated CCP and the CCPs settle daily between themselves accordingly and transmit notices of any failures to receive expected margins so that affected CCPs can take the appropriate actions.

6) Increasing transparency of prices, transactions and positions

Questions

(21) Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

(22) How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

(23) How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

Response

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 and commodities where liquid and transparent markets generally exist. We are not convinced that additional pricing transparency is required. As regards position reporting 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 (but see section 3) (9),(10), and (11) above).

7) Moving trading to more public trading venues

Questions

(24) How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

Response

The ACT regards this and mandatory margin requirements as the most extreme and most contentious ideas. The Commission recognises 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 you end up regarding the stability and transparency of markets as the overriding consideration, to the detriment of end users. We do not think that individual end users are systemically significant.

It is noteworthy 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. As discussed elsewhere the reasons are likely to be avoidance of the liquidity risk introduced by margining, convenience of administration, ability to match exposures exactly or pricing of combinations of all of these. 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.

An exchange traded contract will rarely match the exact risk to be hedged and thus the company will end up under or over hedging, in both cases leaving it with a risk that, under a flexible regime, can be eliminated. A standard contract might be an additional reason that the company may not meet the hedge effectiveness tests required under accounting standards. In this case the company will not be able to get hedge accounting resulting in confusing accounts that could mislead the users.

On the other hand for many reasonably straightforward financial risks such as relatively short term FX and interest rate risks, fully standardised exchange traded contracts can be used to give a good hedge. This is relatively unusual for companies but a few of the larger companies have deliberately chosen to run the bulk of their hedging through exchange contracts and have found the process to be entirely satisfactory. Other companies regard the changes necessary to accommodate for example the standard monthly settlement dates for exchange traded contracts as unacceptably increasing their operational risks and will, where possible, not use exchange traded contracts for this reason.

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

Conclusion

If there is perceived to be an excessive risk arising from derivative contracts between financial counterparties and that 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.

We believe than non-financial companies using derivatives for hedging are not systemically significant. 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 companies facing material cash flow risks or more commercial risks being left unhedged and to companies requiring more capital and restricting their operations with negative consequences for employment, taxation, etc..

We do not regard the opportunity for non financial sector companies to hedge their activities through other group companies in jurisdictions which do not introduce undesirable restrictions on use of derivatives as in any way justifying poorly adapted legislation in Europe.

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The ACT is an 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 treasury, providing benchmark qualifications and continuing development through training, conferences, 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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