Goodbye to the light touch

Executive summary

- **The EU is trying to greatly reduce the risk for counterparties in over-the-counter derivatives by netting off exposures to a central counterparty. In response, the ACT has made headway in influencing the EU juggernaut against undermining the ability of non-financial companies to use derivatives as a way of transferring risk.**

In late October, the European Commission outlined the measures it is planning to introduce to "strengthen the safety of derivatives markets". The proposals, which the Commission wants the EU states to turn into national legislation from 2010 onwards, focus particularly on the over-the-counter (OTC) market, which until now has enjoyed relatively light-touch regulation. They also address collateralisation, which forms the basis of around 70% of OTC derivative transactions.

The market in OTC derivatives, of which interest rate contracts are the most common, has thrived over the past decade. By the end of 2008 its estimated worth had grown to $592 trillion, according to data from the Bank of International Settlements. It's a rate of growth that has helped convince the regulators that the OTC derivatives market needs more checks and balances.

This apparent need became more urgent in the wake of Lehman Brothers' collapse and the US government-backed rescue of insurer American International Group in autumn 2008. The ensuing financial crisis intensified the concerns of regulatory authorities on both sides of the Atlantic over the systemic risks associated with the build-up of positions in derivatives.

Most recently this has been emphasised by the filing by CIT Group for Chapter 11 bankruptcy protection in the US, after failing to successfully negotiate a restructuring of its $30bn-plus debt. The bankruptcy has triggered payments on credit default swaps covering the business lender.

The European Commission believes that derivatives played a central role in the crisis and that OTC traders were far too optimistic when estimating the risk of default by their counterparties. According to reports, the EU's internal market commissioner, Charlie McCreevy, previously a supporter of light-touch regulation, admitted that the proposals marked a break from the view that derivatives were financial instruments for professional use that did not require close regulation. Indeed, reports suggest that he and others were taken aback by the exposure of many French and German banks to the fortunes of AIG, which would have triggered a crisis in the EU had AIG had been abandoned to its fate in the same way as Lehman Brothers was.

The new thinking was reflected in the European Commission's draft statement, which acknowledged that derivatives play a "useful role" in the economy.

"IT WOULD BE ALMOST IMPOSSIBLE FOR NON-FINANCIAL COMPANIES TO FIND THE FUNDING TO COLLATERALISE ALL THEIR DERIVATIVE POSITIONS WITHOUT SIGNIFICANT DAMAGE TO ECONOMIC ACTIVITY AND PROSPERITY GENERALLY."

GRAHAM BUCK EXAMINES THE EUROPEAN COMMISSION'S LATEST PROPOSALS FOR TOUGHER REGULATION OF THE DERIVATIVES MARKET.

CURRENT COLLATERAL LEVELS ARE TOO LOW AND DO NOT REFLECT THE RISK THAT BILATERALLY CLEARED DERIVATIVES POSE TO THE FINANCIAL SYSTEM WHEN THEY REACH A CERTAIN CRITICAL MASS. FINANCIAL FIRMS NEED TO HOLD A LARGER AMOUNT OF COLLATERAL TO COVER THEIR CREDIT EXPOSURE.

"However, they also contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants, a fact which went unnoticed because of lack of market transparency," it went on. As a result, it said, derivatives "should be appropriately priced in relation to the systemic risk they entail in order to avoid these risks being passed on to the taxpayers".

A particular worry, intensified by the onset of the crisis, is the potential for a chain of defaults and a widespread withdrawal of liquidity in the wake of a major market participant collapsing, due largely to the huge volumes of outstandings and lack of transparency.

SEARCH FOR CONSENSUS Over the past year the European Commission has consulted with the industry in an attempt to win consensus on how extensive the move to greater standardisation should be. Its proposals (set out in a communication entitled Ensuring Efficient, Safe and Sound Derivatives Markets: future policy actions) confirm that the new legislation planned by the Commission would impose regulatory and operational standards for Europe's trading exchanges and other central counterparties (CCPs).

The Commission's proposals include the statement: "Current collateral levels are too low and do not reflect the risk that bilaterally cleared derivatives pose to the financial system when they reach a certain critical mass. Financial firms need to hold a larger amount of collateral to cover their credit exposure."

Under bilateral collateralisation, a trader posts funds with the opposite party in a trade. Should the other party subsequently default on the deal, the trader retains the collateral funds that were posted by the counterparty. In clearing, these funds are paid to the clearing house or CCP to enable the deal to be completed should either party default.

If adopted, these proposals would require the "standardised" products currently traded off-exchange to clear through CCPs. The result would be a widened gap between capital charges for centrally and bilaterally cleared contracts in the EU's Capital Requirements Directive, which would make non-standardised contracts significantly more costly.

However, the Commission also concedes that it has not yet determined how far the term "standardised" should extend. It has assured the business world that it is not seeking to eliminate tailor-made contracts.

Regulation of the derivatives market will pass in 2010 to the Paris-based European Securities and Markets Authority (ESMA), one of three organisations that are being set up next year to oversee markets. National regulators such as the UK's Financial Services Authority will continue to perform "ongoing supervision", but subject to the requirement that they implement any "specific requests or instructions" issued by ESMA.

CORPORATE CONCERNS While the intent behind the proposals is to minimise the risk of default, it has also raised various concerns among corporate users of OTC derivatives that the legislation could – whether intentionally or accidentally – hamper their ability to hedge many of their normal financial risks through using tailored OTC derivatives. These risks include FX forwards, currency and interest rate swaps, property derivatives and commodity forwards.

The ACT has been active in recent months in conveying the concerns of corporate treasurers over the impact of the new regulations. These were set out in a summary position paper, prepared in conjunction with the European Associations of Corporate Treasurers (EACT) and available on the ACT website.

The ACT pointed out that the provision of capital by non-financial institutions is not the best route to de-risking the system, although it would help for transactions between financial firms. ACT chief executive Stuart Siddall says: "It would be almost impossible for non-financial companies to find the funding to collateralise all their derivative positions without significant damage to economic activity and prosperity generally."

This lobbying has had some effect. The revised proposals issued in late October offered a few concessions to corporates, with the European Commission conceding that the use of derivatives by non-financial companies does not create systemic risk. As the ACT noted, the revisions have gone some way to reducing the negative implications for companies but still leaves "considerable problems yet to be resolved".

In its response to the latest proposals, the ACT warned of a "long

legislative process ahead: "Treasury associations and individual companies will need to continue to monitor developments to ensure there is no unnecessary and unintended harm to customers of the financial services sector."

EARLY DAYS The EU decision-making process is outlined in Box 1 and is still at a relatively early stage as regards OTC derivatives. The Commission has issued a consultation paper followed by a communication, reflecting how its views have evolved. The ACT formally responded to the consultation and has participated in follow-up meetings with Commission officials.

Since any eventual draft European legislation will require approval from all the commissioners – and not just the internal market commissioner – the ACT and Europe's other national treasury associations have briefed their national commissioners on the corporate use of OTC derivatives.

Within the European Parliament, the Economic and Monetary Affairs committee will be drafting its own report and, in due course, considering the eventual legislation drafting from the Commission.

Approval of any new regulations will also need the agreement of the Council of the EU, and both Parliament and HM Treasury will have responsibility for arguing the UK's position in the Council and the working groups. HM Treasury has already started discussions with interested parties, including the ACT, to consider the respective benefits and impacts of any changes in the markets.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org

Box 1: Calling the EU shots

THE ACT'S MARTIN O'DONOVAN EXPLAINS HOW THE VARIOUS EU BODIES DECIDE POLICY AND LEGISLATION.

THE EUROPEAN COMMISSION
The European Commission proposes new laws for the European Parliament and the Council of the EU to consider. Legislation starts at the Commission in the form of a green paper or discussion and consultation document, leading to draft legislation and further public consultations. Each member state has one commissioner, responsible for a different functional area. The Directorate for Internal Market and Services is the section most heavily involved in the financial markets.

THE EUROPEAN PARLIAMENT
The European Parliament passes laws together with the Council, based on proposals from the Commission. Twenty permanent parliamentary committees, divided into subject areas such as foreign affairs or the budget, consider the Commission's proposals. The Economic and Monetary Affairs Committee covers most matters affecting treasury, banking and finance. Normally, "co-decisions" are required, with legislation only passing if the Council of the EU accepts the European Parliament's amendments to the legislation proposed by the Commission.

COUNCIL WORKING GROUPS
Working groups and committees of the Council of the EU are responsible for preparing all issues before they are referred to Coreper (see next section) and then ministers. There are around 160 working groups and committees, which are made up of senior officials from the member states.

Source: EU

COREPER
The EU Committee of Permanent Representatives (Coreper) prepares for Council meetings. The UK's permanent representatives carry out much of the daily business that goes on between the UK government and the European institutions. On financial matters the UK representatives will work closely with HM Treasury to present the UK position on a subject. All issues must pass through Coreper before they can be included on the agenda for a Council meeting.

THE COUNCIL OF THE EUROPEAN UNION
After legislation has received a first reading in the European Parliament it is passed to the Council of the EU. Each member state has a single representative on the Council, which votes on proposals for EU legislation. The role of president of the Council passes from the minister of one member state to another every six months, rotating through the entire EU membership; the minister who holds the presidency sets the Council agenda. Although a single entity, in practice the Council is divided into several councils, each dealing with a different functional area; for example, the Economic and Financial Affairs Council is composed of the economics and finance ministers of the member states.

Once a majority has been reached in the Council, legislation is returned to the European Parliament for a second reading. Following that, it returns to the Council, at which point a reconciliation process may be required to allow both the European Parliament and the Council to agree on legislation.