

29th January, 2010

**House of Lords
EUROPEAN UNION COMMITTEE
Sub-Committee A (Economic and Financial Affairs and International Trade)
Commission communications on ensuring safe and sound derivatives markets
Call for Evidence**

The Association of Corporate Treasurers (ACT)

1. 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.
2. We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine* and our Policy and Technical Committee. The evidence herein is submitted by the ACT as author acting as a professional body taking the point of view of the non financial companies who use derivatives.

Summary

3. The ACT accepts that there are certain features of derivatives that can generate substantial contingent credit exposures between major market participants. In the event of the failure of a significant market participant there could be a threat to the stability of financial systems. However that risk arises within the activities of financial firms. Non financial companies and their activities in the derivative markets are very unlikely to create any systemic risk.
4. Non financial companies generally do not use some of the more risky credit derivatives and the derivatives that they do use are for hedging purposes. The ACT is strongly of the view that any requirements for mandatory margining should not apply to non financial companies. This is partly because such companies pose no material risk. But most importantly because any such requirement would introduce new and significant cash flow risks during the life of the contract – a contract used to protect cash flow on ultimate maturity when matching the underlying business risk. This would be damaging to individual companies and the wider economy as companies responded to the new risk.
5. Attachments:
Letter from the EACT to the European Union Commissioners dated 6th January 2010
A summary position paper from the European Association of Corporate Treasurers – September 2009

General

6. The ACT accepts that derivatives can be inherently highly leveraged so that as markets move very large exposures can build up and these exposures are not particularly visible to the market and analysts. By its nature, derivative trading can be carried out with no initial payments between the parties. Then as market prices move one party can become “out of the money” and effectively owe money to the other party. Were a major, systemically significant firm to fail or get into financial difficulties there could be a loss of confidence spread rapidly through the market because of the large and interconnected, but invisible counterparty credit exposures. There could be concern about excessive risk between financial counterparties that could pose a risk to financial stability.
7. It is therefore reasonable for the European Commission to be considering proposals to help reduce this potential for systemic risk. The systemic risk arises from the network of interconnections between financial firms and the large positions they build up.
8. For non financial companies the positions in derivatives are much smaller and less concentrated so that any failures in such companies are unlikely to create a threat to the financial system as a whole or even to the derivatives markets themselves. BIS semiannual OTC derivatives statistics at end-June 2009 show that in the OTC FX derivatives markets, for instance, non financials (companies and governments) accounted for 17% of outstanding notional amounts and 21% of outstanding gross market values.¹
9. The ACT has considered the proposals from the point of view of the non financial companies who use derivatives. There has been a very significant and widespread concern from these companies that the proposals could, whether intentionally or unintentionally, make the use of derivatives difficult or totally impractical. The ACT does not want to stand in the way of improvements to streamline OTC processes and reduce overall risk, but at the same time we do not want to see convenient and flexible hedging instruments made inaccessible for non-financial sector companies.

The danger is that, in attempting to reduce systemic risk, ordinary companies are put off using derivatives and therefore end up with more commercial risks unhedged or hedged by more inconvenient or expensive means and so negatively affecting the wider business and economy. Alternatively they continue to use derivatives and although counterparty credit risk is minimised through margining and use of a Central Clearing Counter Party (CCP) whereby those end users are exposed to a funding and liquidity risk during contract life which again could negatively affect the wider business and economy. This would be counterproductive, as it would decrease counterparty credit risk, but actually increase overall credit risk in the system due to the associated cash flow volatility.
10. Conceptually the idea of moving all bilateral credit exposures so that a CCP is interposed between the parties does allow for collateral security to be put in place and for extensive netting of exposures. For the parties to the transaction and for 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 risk².

¹ Bank for International Settlements -Semiannual OTC derivatives statistics at end-June 2009:

<http://www.bis.org/statistics/otcder/dt1920a.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>

11. The proposals requiring mandatory collateralisation of contracts, either bilaterally or via a CCP, if applied to non financial companies, would be the part of the proposals of most concern to companies. Non-financial companies mostly use derivatives for hedging – the objective being to remove variability from some future business cash flow – so that:
- movement in *value* of the derivative over its life compensates for the opposite movement in *value* of the future business cash flow and
 - the *cash flow* associated with the derivative on maturity is available to match the (opposite) *cash flow* on the underlying business cash flow.
12. If, however, the derivative is subject to daily cash margining, a totally new cash flow volatility is introduced during the life of the derivative. From that point of view the company is in some ways in a worse position than were it not to hedge: it has to keep liquidity available every day for any size of movement in required margin and there is no matching of these potential daily cash flows with the underlying business cash flow.
13. Any cash requirements for margin calls will have to come from cash or from borrowing facilities or from new bond issues or equity issues. For some companies this can be problematic. Even where new borrowing facilities can be arranged it would be using up valuable borrowing capacity in an unproductive way with knock on effects on economic activity. Furthermore many existing company borrowing agreements include a negative pledge which precludes the giving of security to any creditor. Providing margin would come within this and be forbidden, in which case existing lenders will have to be approached to negotiate an exception to this clause, which would not necessarily be granted or might entail payment of an additional fee.
14. A non-financial company's derivative position is directly related to its underlying business exposures and so the outstandings are limited by that. Financial institutions (defined widely), however, are more highly geared and can take proprietary, speculative, positions limited only by prudence and regulatory capital requirements.
15. Of course the variation in value of the derivative during its life can put the user company “in the money” – with a contingent receivable from the counterparty (bank). The size of this can represent a significant sum for the company. With the company's small, concentrated and undiversified credit portfolio, the sum can exceed the amount the company is happy with having outstanding from the bank. Companies can ask the bank for margin in such cases. And, of course if a bank is unhappy about a contingent sum due from the company it can ask for margin too (though banks with their large, diversified credit portfolios usually mark a much larger limit for companies than the companies can mark for the bank). And, to ease administration in such cases, margin may be recalculated only every so often (fortnightly, monthly, etc.) and be paid only when above a materiality threshold. Some companies, for some trades, will use exchange traded contracts where daily margining and central clearing is a requirement where they feel able to manage the attendant cash flow risks – but this is only a small minority of companies and even then usually for only part of their activity.
16. The ACT has concluded that while there may be merits in introducing more extensive use of CCPs for financial parties dealing between themselves. However, making it mandatory in dealings with non-financials would be damaging for them (and the wider economy) and

unnecessary, since non-financials are not likely to pose a significant risk to the stability of the financial system.

17. The extent of concern across Europe over the current OTC derivative proposals was reflected in the number and range of companies that were keen to add their names to a letter from the European Association of Corporate Treasurers to the European Union Commissioners³. Over 160 companies have publically put their name to this letter as did the ACT and other National Treasury Associations across Europe. It is appended to this response.
18. On behalf of the Treasury Associations in Europe the EACT has issued a position paper on the EU proposals for OTC derivatives and this is fully endorsed by the ACT. It is appended to this response.⁴

Particular questions:

Derivatives

What economic benefits do derivatives bring?

19. Derivatives do offer a convenient mechanism whereby certain risks can be transferred to the parties best able to bear those risks or to manage them to the mutual benefit of the parties and to the economy as a whole. In a simplified example a sterling based company with a business exposure to the receipt of \$ can sell its \$ forward to a bank to achieve certainty. The bank can lay off its risk by selling those \$ forward to another of its customers that happens to have a short position in \$ and wants to buy \$ as a hedge.
20. Non financial companies use derivatives to hedge risks that exist in their main business. They will have in place a strategy to assess those risks, both actual and forecast and to manage those risks so as to reduce volatility in the performance of the business. For example, a company exposed to foreign exchange risks in the form of sales made or contracted for, may decide to achieve complete certainty now by selling the foreign currency forward. For forecast sales it may decide on a strategy of partial hedging depending on the certainty of the forecasts. The aim is to remove some of the volatility in the value of those sales while buying the company time to adjust its cost base or take other business measures to address changes in exchange rates.
21. As a further example a company with a continuous hedging strategy – i.e. it hedges to a pre-determined rolling maturity on a regular basis – having to post margin in respect of out-of-the-money (OTM) hedges of forecast FX cash flows may restrict its ability to continue its hedging program at the very time when, in fact, underlying achievable rates on new and additional hedging are very attractive (hence why previous hedges are out of the money). Capacity to continue to hedge (e.g. due to cash flow constraints) may only become available when underlying achievable rates have deteriorated such that previous hedges require less cash collateral. The very requirement of cash collateral therefore makes the hedging process very inefficient from a cash flow and financial performance perspective. There is clear evidence that this requirement would be especially onerous for high value manufacturing/engineering

³ Available at <http://www.treasurers.org/otcderivatives/eactresponse/201001>

⁴ Available at <http://www.treasurers.org/otcderivatives/euproposals/eactresponse>

firms who would have to more than double their debt capacity to accommodate new legislation. This could have profound effects for their business models.

22. Other risks where companies commonly want to hedge using derivatives include, interest rate risk, commodity price risk, including energy prices, inflation risk, property values risk and so on. A company can use outright derivative contracts (forward contracts, futures, etc.) or options (which are also derivatives).
23. A corporate could use its own balance sheet to create a form of hedge rather than using derivatives. For example, in place of a foreign exchange forward it could buy currency now and place it on deposit; in place of oil futures it could borrow cash and buy oil now and store it to cover its forecast needs; but grossing up the balance sheet is an inefficient approach which would mean proportionately more funding and equity is needed. A far better solution is to rent a part of a bank's balance sheet since they can operate with higher gearing and can benefit from the portfolio effect of aggregating counterbalancing risks.
24. There is a further reason why companies use derivatives to hedge financial exposures. That is that borrowing agreements may contain financial covenants which constrain the firm. For example then may limit debt and leases outstanding as a multiple of cash flow or interest expense (and the interest-like cost of financial leases) as a fraction of profit before interest and tax. Financial price movements which could change those ratios unfavourably (irrespective of what is happening to the underlying business) must be avoided, managed or laid off.
25. For a company, having equity is the ultimate form of risk protection buffer for those dealing with it. If a company has a risky business model it needs to hold more equity. But companies seek to use their capital in activities where they have comparative advantages and avoid those activities where they have none. That is they usually seek to lay off those risks which do not contribute an appropriate return. Some of those risks can be avoided by changing the business model. But some are unavoidable in this way if the core business is to flourish. Most companies in the real economy therefore carry and manage the operational risks of their core business but will try to shed or share other risks (such as financial price risks) via insurance and hedging and be very prudent about the risks they retain. Using derivatives to cover certain financial risks is key in this process.

What risks are associated with derivatives and derivatives markets?

26. Derivatives are a geared instrument in that for a (usually) nil initial investment large contingent gains or losses can build up during the life of the instrument. If used for speculative purposes there is a price/value risk. For a company using a derivative for hedging purposes this price risk is what they are seeking in order to match against a business risk, so that "risk" is rather a misleading term to describe it.
27. To the extent that one party to a derivative finds that its derivative value is positive there will be a contingent credit risk on the counterparty to the deal to the extent of that mark to market value. This is crystallised as a certain sum payable from one party to the other on maturity, or by each party settling its respective delivery obligations.

28. It should be noted that Bank counterparties consider the credit risk from customer derivative contracts along with the credit risk of lending to their clients. This risk is therefore firmly on the radar. In addition, the discipline that the onerous documentation and effectiveness testing requirements of International Accounting Standards (IAS 39) have brought to the corporate hedging process has significantly reduced the risk of a corporate counterparty entering into derivatives with speculative characteristics. These factors should be viewed as mitigating the credit risk associated with derivatives dealt by corporates in the normal course of business. This process has functioned successfully for decades and cannot reasonably be viewed as having contributed in any significant way to the financial crisis.
29. If the derivative has run to its maturity, there will then be a settlement risk on the settlement day in that one side to the bargain may deliver its obligation before the other party performs its side of the deal. It often is the full amount of the transaction that is exposed to default during this short time – in a forward foreign exchange deal, for example to sell US\$1m for €700,035 (at a rate of USD1.4285 the full amounts are paid each way).
30. This settlement risk can be reduced by simultaneous payments when received by a third party (as in CLS bank in foreign exchange), or by agreeing that the only cash flow on maturity will be the net value of the flows at the price on maturity- a non deliverable forward. (So, in our example if the rate was US\$1.4 = €1, the amount to be settled is only US\$19,951 – a much smaller settlement risk.

What role did derivatives play in the recent financial crisis?

31. The ACT does not have sufficient information to comment extensively on this question. However we would like to make the observation that the fear that certain financial institutions were suffering large losses on their dealings in credit derivatives did trigger wider worries and withdrawal of liquidity in several other financial markets. Before rushing to condemn all derivatives as excessively risky it is worth remembering that credit default swaps (CDS) have very different characteristics from other derivatives. Their market value will move gradually as the credit standing of the reference entity changes but will normally move very rapidly and significantly when the reference entity defaults or is near default. Most other derivatives do not normally exhibit this sudden discontinuity in value.
32. In addition, the notional value of the credit derivatives market is many times the size of the underlying asset markets. Therefore, there could be situations where the high likelihood of default (and the requirement to liquidate positions) causes a dramatic disruption in the market for the underlying assets due to short term supply/demand factors. FX and interest rate derivatives, which are the most common instruments used by non financial companies, do not exhibit this characteristic to the same extent.
33. Credit derivatives are not used at all extensively by non-financial companies⁵.

Clearing Directive

⁵ They can be used to protect against credit-like exposures – not just a supplier's credit exposures but also the risk of a major supplier or joint-venturer collapsing, etc.

The Commission intends to produce legislation regulating the activities of central counterparties (CCPs) with the objective of eliminating national regulatory discrepancies, improving risk management and creating a single European market for CCPs.

Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?

What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

34. We comment on the third and fourth bullets only.

35. Most derivative dealing is between financial sector parties. We understand that the reduction in risks in this sector is important for systemic stability. However, as discussed above, we do not think that non-financial companies represent systemic risks in the total market network. We see any mandatory requirement for margin as extremely detrimental to the operations of non-financial companies, as explained above.

Trade Repository Directive

Central data repositories provide aggregate information of firms' positions and improve operational efficiency of Over The Counter (OTC) derivatives markets and market transparency. The communications suggest that legislation should provide a common legal framework for the operation of trade repositories. The Commission believe the European Securities and Markets Authority (ESMA) should be responsible for authorising and supervising trade repositories.

What benefits the use of trade repositories bring both in terms of transparency and improved risk management?

Should the EU regulate the legal framework for the operation of trade repositories?

What provisions and rules should such regulation impose to improve regulation of trade repositories?

Should trade repositories be supervised by ESMA or by national supervisory authorities?

36. We understand the advantages transparency can bring. On practical grounds we would expect reporting to central repositories should be by the regulated counterparty (where there is one) who would report that the counterparty is a non-reporting entity so that statistical comparability can be maintained. A simple reporting mechanism should be provided for those trades which are material and where both parties are non-regulated (if any).

37. We think it important for market confidence that the aggregate information created from the various repositories is made publicly available promptly.

Further issues

The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?

38. We see no disadvantages in subjecting derivatives generally to MAD provisions, suitably adapted.

The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?

39. As discussed above, it is necessary to separate intra-financial services trades from those with non-financial customers. As non-financial-company customers are not systemically significant, the absence of collateral in most of their OTC trades is not a concern and to require it would be to introduce great financial instability into those companies – which would not be in the interests of the wider economy.

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

40. It is important that the EU make sensible plans. It is preferable that the arrangements are comparable to those adopted in the US in material respects but there is no argument whatsoever for adopting changes introduced by the US which are not soundly based or are unnecessarily damaging to the real economy.

Are there further areas for regulation that the communications do not cover?

41. No comment

42. 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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