TREASURY, RISK
AND FINANCE
PROFESSIONALS

The Association of Corporate Treasurers

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Comments in response to

Joint ESMA/EBA/EIOPA Discussion Paper On Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories. (JC/DP/2012/1),

March 2012

2nd April 2012

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 seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

The ACT welcomes the opportunity to comment on this matter. Many of our members work in non financial companies so we have a particular interest in how the EMIR regulation and the alternative risk mitigation measures might affect these companies

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General

There is still some uncertainty as to whether FX spot and forwards will be within scope of the mandatory clearing requirements of EMIR. If it is decided to follow the US pattern and exclude them, then the drafting of technical standards needs to be very clear that although such deals will not be going through a CCP, they are also outside any requirement for alternative risk mitigation techniques.

We note that the discussion paper concentrates on margining as a risk mitigation technique. However there exist a range of risk mitigation tools in the real world. In the OTC arena one being that parties refrain from doing business with one another unless they are comfortable with the credit risk and are adequately remunerated for taking that risk, another being the holding of capital as a buffer against loss, or having alternative liquidity sources should the settlement be delayed or frustrated.

Specific questions

We comment only on those questions with particular relevance to NFCs

Initial margin:

Q2. What are your views regarding option 1 (general initial margin requirement)?

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

Option 1 proposes 2 way initial margin in all cases. The concept of initial and variation margin is one that may fit with the business model of financial counterparties that are trading derivative or are otherwise in the business of selling derivatives and laying off the risk. Non financial entities are, in contrast, generally using derivative to hedge a future cashflow risk so until that future date arrives they do not want the derivative to generate any cash flow such as that would be created by having to margin. We are pleased that EMIR exempts transactions by NFCs that are "objectively measureable as reducing risk…" but if for some reason an NFC goes above the threshold then all its deals whether hedging or not would become subject to mandatory clearing.

Many NFCs are quite simply not in a position to have access to liquidity sufficient to pay an initial margin, and even for those companies that do have funding available, margining would deflect funding from what might have been more productive investment benefiting economic activity generally.

One role of banking is to take credit risk on customers and, particularly, to carry liquidity risks that banks are far better able to manage than an NFC with no access to central bank liquidity.

Requiring initial margin would in effect be banning a bank from taking a limited credit risk on its customer through derivatives, while there is no such ban on banks, if they have adequate capital, taking credit risk through lending to the same customer. A requirement for initial margin could thus create the bizarre outcome that banks would have to lend to companies cash which would then be placed back with the bank as margin!

End users are generally particularly opposed to the idea of mandatory exchanging of initial margin.

Q5. What are your views regarding option 2?

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

Option 2 proposes one way margin in favour of the financial counterparty.

This suggestion is totally inequitable, and would enshrine in law a commercial advantage to the bank side, and make it very difficult for an NFC to negotiate receipt of initial margin. This is all the more strange since in many cases the customer will be of a better stand-alone credit standing/rating than the financial counterparty.

And for the reasons given above we regard any requirement for initial margin as unnecessary.

Q7. What is the current practice in this respect, e.g.
- If a threshold is currently in place, for which contracts and counterparties, is it used?
- Which criteria are currently the bases for the calculation of the threshold?
Q8. For which types of counterparties should a threshold be applicable?

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

Q10. How – in your opinion - would a threshold change transactions and business models?

Option 3 proposes one way margin in favour of the financial party but with thresholds such that initial margin is only posted above those thresholds. As already mentioned we regard one way margins as unacceptable. However the concept of thresholds is an attractive one in that it recognises that it would not be systemically risky for banks to take some exposure on their NFC customers and vice versa.

As an aside, most investment grade companies will mark a smaller credit limit for the bank than the bank will mark for the customer, in view of the smaller credit portfolio of the NFC and that extending credit is not part of its basic business. This does mean that, above some threshold, such companies will require a credit support agreement with the bank including two-way variation margin but no initial margin for the reasons set out above.

Q11. Are there any further options that the ESAs should consider?

The ACT is proposing that initial margin should not be required on transactions with NFCs. However a variation on this concept would be to have 2 way exchange of initial margin but only once a threshold is exceeded, with the threshold set by the bank as being an amount for which it can prudently take the risk and hold appropriate capital against that risk.

Note that for catastrophe-risks, such as CDS, NFCs do not generally *sell* them so they would never provide margin, initial or variation, anyway. For rate transactions, where variation margin is agreed as one-margin period's rate movement, variation risk is relatively speaking, small and so initial margin is not required.

Variation margin:

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

Q15. What would be the cost implications of a daily exchange of collateral?

Again thinking of the practicalities for a NFC the daily exchange of variation margin could be burdensome and represent an operational administration cost. Since it would probably only be very large or active companies that are subject to this, if thresholds are reasonable, it is probably manageable, but we do question if it is strictly necessary to impose this overhead cost. In order to handle the need for quick access to liquidity and the admin of making or receiving payments companies may well set up credit lines with their banks and appoint the bank to deal with the payments in and out. In other words by removing the credit risk on the derivative it is simply switched to a credit risk on lending. Far simpler would be to allow thresholds below which exchange of variation margin would not be required or not to require them at all. Instead the bank would take that credit risk and hold appropriate capital. Thresholds or weekly or monthly exchange of variation margin would all reduce admin costs and should be allowed as an option in any case.

Initial margin calculation:

Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?

Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

Q20. Do you think that the "Internal Model Method" as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?

Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?

Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?

Q23. To what extent would the "mark-to-market method" or the "standardised method" change market practices?

We make no particular comment on the calculation of initial margin other than to mention that, where required, it should allow for the riskiness of the particular instrument and the credit standing of the particular parties.

Segregation and re-use:

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

Q29. What are the practical problems with Tri-Party transactions?

Q30. What are current practices regarding the re-use of received collateral?

Q31. What will be the impact if re-use of collateral was no longer possible?

As you say in paragraph 43 "For IM to be effective, it should be held on a segregated basis, away from the receiving party's own assets and should not be reused. Without segregation, IM posted two-ways is off-setting and the protection is nullified." We agree that segregation and no re-use is essential. As an aside we see mandatory transferability of contracts as important and segregation and non-reuse are an important parts of this. For similar reasons, initial margin should be protected from other creditors in bankruptcy with no "mixing" allowed.

Eligible collateral:

Q32. What are, in your view, the advantages and disadvantages of the two options?

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

Q34. What consequences would changing the range of eligible collateral have for market practices?

Q35. What other criteria and factors could be used to determine eligible collateral?

An OTC transaction is very different from one passed through CCP. There is a relationship between the parties and as previously discussed we do think it appropriate that banks should be able to take some credit exposure on their customers. Eligible collateral can therefore be defined to be a great deal wider and less liquid than is required by a CCP.

NFCs are not natural holders of top quality liquid financial collateral hence the need for wide definitions.

Furthermore there is a global shortage of top quality collateral so we do not want to end up with collateral requirements that are impossible to achieve or that are too expensive.

Collateral valuation and haircuts:

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

We have proposed that a wider definition of eligible collateral is appropriate and accordingly we accept that it may be necessary to impose haircuts to reflect any lack of liquidity and credit risk.

Intra-group exemptions:
Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?

Q46. What is the current practice regarding the collateralisation of intra-group derivative transactions?

Impediments to prompt transfer of funds should reflect the actual regulatory regime. For example where there are existing exchange controls that prevent the free flow of funds within an international group. By contrast where a group operates a cash pooling arrangement for example, then that should support the view that collateralisation of intra-group derivatives is not a requirement for entities that are part of that pooling arrangement.

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The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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