Corporate concerns about OTC derivative regulation

Summary: **page 1**
Regulation of OTC derivatives: **page 2**
Explanatory Notes: **page 4**
BIS data on OTC derivatives: **page 6**
Contacts page 7

Summary

The EACT's main concerns and recommendation for change are:

- It looks as though non-financial companies may be called on to put up margin monies in respect of derivative positions even though their use of those derivatives poses no systemic risk.
- Companies may be required to be able to pay margin to their contracted counterparty for negative positions during the life of a derivative although the offsetting, hedged, underlying cashflows will not take place until maturity.
- Margin calls could be large in relation to the size of companies. Capital and undrawn lines of credit must be held against potential margin for major price changes in the derivative's underlying reference.
- While margin would be received for derivatives showing a gain, it cannot be used in the business prior to maturity as it is "hot money" that could flow out again just as quickly as underlying prices change.
- All this would be likely to cause a reduction in corporate activity, with obvious consequences for the real economy, employment, taxes, etc.
- **Derivative contracts between non-financial companies and the financial sector should be exempt from any requirements for mandatory margining or for use of central counterparties with margin requirements as non-financial companies pose no systemic risks in their use of derivatives.**

Regulation of OTC derivatives

Concerns of private non-financial companies (PNFCs)

- PNFCs' major concern is that, seeking to reduce systemic risk in the financial sector, regulations will impose material cashflow risks on them. This is an unintended consequence and not an objective of the proposals. PNFCs account for a small proportion of derivative transactions and are not likely to be a systemic risk.
- Companies also see increased inconvenience and operating costs (both in the transaction prices and in administration) arising from the regulations.

How does PNFCs' cashflow risk arise from the proposed regulations?

- At present, most corporate derivative purchases are of Over The Counter (OTC) derivatives, privately negotiated with the counterparty. With no margin, cashflows normally take place on maturity, potentially matching with underlying exposures.
- If non-margined OTC derivatives are prohibited (either directly or by requiring use of central counterparties) or made expensive (by punitive capital requirements), margin cashflows can take place throughout the life of a derivative contract.
- Some companies use exchange traded or centrally cleared derivatives for some of their business, but the great majority of investment grade companies do not.

Margin (where agreed or required):

- Variation margin is, at agreed intervals, put up against any loss or received for any gain arising from the derivative contract. Initial margin (often 2% or 3% of the nominal value of the derivative) is provided as surety against daily margin payments. Variation margin can add up to much more. Exchange rate and commodity price movements of 20% or more are not uncommon – which is why companies need to hedge. Margin received can flow out again as the underlying reference price moves and can't used in the business: it is "hot money".

Why is margin needed?

- Central counterparties for on-exchange derivatives and clearing houses have to be bankruptcy remote entities and take initial and daily margin from holders of loss making derivatives to help ensure the eventual obligations are met at maturity.
- The overwhelming majority of investment grade companies' OTC derivatives are without margin.
  However, parties unhappy with an OTC counterparty's credit standing may ask for collateral or margin ("credit support") when the counterparty is "out of the money". Mutual credit support is an option in standard ISDA derivative agreements.
  In recent years, for example, some companies have asked certain banks to give credit support for some contracts. There is no initial margin – who would pay whom? Variation margins are often only paid if above a small threshold (e.g. £20m or £50m) and recalculated weekly or fortnightly or longer to reduce administration.
- For financial companies which may be position takers with speculative portfolios which are constrained only by credit considerations, we understand that margining, including initial margin may be a useful protection of the system.

Why is margin generally not needed for non-financial companies?

- Non-financial companies use derivatives to hedge business risks. Volume is, accordingly, limited and non-financial companies account for only a small proportion of derivative outstandings[i]. Individually or collectively, they do not represent a systemic risk. Taking corporate credit risk is usually part of a bank's business.

What would be the consequence of requiring non-financial corporate margining?

- Increased cashflow risk from margining or alternatively not hedging identified risks would require companies to hold more risk capital and available lines of credit. Corporate activity would be reduced with obvious consequences for the real economy, employment etc.

Explanatory Notes

Hedging

- Hedging is the mitigation or elimination of a risk. It is like insurance, but insurance is used for unknowable binary risks – will your house catch fire or a ship sink, or not. Hedging is for graduated and repetitive things – frequently traded things like currencies and commodities.

Derivatives

- So called because the value of the contract is derived from some underlying price and varies with it.
- Said to be "in the money" for a party if the underlying price has moved so it could now make a gain on closing out the derivative. If closing out would be at a loss, the derivative is "out of the money" for that party.

Why do non-financial companies use derivatives

- Non-financial companies use financial derivatives for hedging risks such as interest rates, exchange rates, commodity prices, inflation and a number of others such as longevity.
- The volume of hedging is related to a firm's business – unlike financial companies' speculation.
- Companies usually hedge economic risks, especially cashflow risks. Some companies hedge accounting risks, but if the economic, cashflow risk not covered, or even introduced by such accounting hedging is large, this can be significantly sub-optimal.
- To the extent that companies retain exposures (i.e. do not hedge), they need to hold extra capital against those exposures or reduce risks elsewhere in the business, increasing cost of capital and reducing activity levels.

"Mark to market"

During the life of a derivative contract, as the market price of the underlying reference (currency, commodity, etc.) varies, the gain ("in the money") or loss ("out of the money") for a party to the contract from immediately terminating the contract can be estimated "marking to market".

- "In the money" good, "out of the money" bad?
  For a company, if a derivative help is "in the money", there will have been a corresponding move in the value of the corresponding hedged item. If it represents business which will probably be repeated, while the company has the consolation of the gain on the hedged amount, it would probably have preferred that the fundamental price relationships moved in its favour rather than against it. Perhaps "out of the money" good, "in the money" bad – the opposite situation from that of a speculator.

How large are private non-financial companies in derivatives?

- Statistics from the BIS show all non-financial customers in which PNFCs are included are only a small proportion of derivative outstandings (see end note, below).

Over The Counter (OTC) Derivatives

- Agreed between the two parties, OTC derivatives can be tailor-made to suit a company's needs. Often the legal basis is standardised (e.g. using standard ISDA agreements) but specifics such as amount, maturity and the underlying reference price are set out case by case.
- Are usually not margined – cashflows taking place on maturity.

Exchange traded derivatives

- Are standardised as to amounts, maturities and underlying reference prices.
- May leave some mismatch of risk for a corporate hedger ("basis risk").
- Use central counterparties and so are margined, with initial and daily variation margins, cash flowing through the life of the derivative.

Central counterparties (CCPs)

- While on an Exchange buying and selling contracts is agreed between exchange members, the agreement is notified to the exchange's CCP and when both sides have confirmed, the actual contracts are between the parties and the CCP. It is similarly possible for an OTC derivative for the parties to notify a CCP of their agreement and then novate the contract to the CCP, so the CCP becomes the counterparty of each.
- CCPs are used to substitute their credit standing for that of the counterparties. Accordingly they are supposed to be bankruptcy remote (unlikely to default) and have strict rules accordingly. Central counterparties have been known to default however. If there are several counterparties, they can actually increase risk by reducing the opportunities for bilateral netting.

Margin

- Because central counterparties have to be bankruptcy-remote entities and do not take credit risks, they demand "margin" monies from counterparties.
- "Initial margin", commonly 2-3% of the nominal value of the derivative, is held as surety.
- A daily "variation margin" is required or paid by the central counterparty as the value of the derivative contract falls or rises – moves "out of" or "into the money".
  The variation margin can be very large – a 20% exchange rate movement is not unusual and commodity price variations can be larger. A company's profit margin, which the derivative is protecting, may be only a few percent.
- Variation margin received cannot be used in the business as it could flow out again just a quickly – it is "hot money".

Why are non-financial companies not concerned at requirements for financial companies to put up margin within the financial sector?

- Most banks have a wide variety of long and short positions they acquire from customers. They lay off most of the net residual risk with other banks, so margining overall for any institution is quite small unless it is using derivatives to take a position – speculating. So costs to customers from margining within the financial sector can be expected to be small.

Financial sector

- Used here to mean the whole financial sector, whether regulated or not.

Non-financial companies

- Companies or non-financial companies are used here to mean private non-financial companies.

BIS data on OTC derivatives

BIS statistics are available at http://www.bis.org/statistics/derstats.htm and extracts are shown below.

Private non-financial companies (PNFCs) are included in the category of 'all non-financial customers' used by the BIS.

PNFCs are clearly only a small part of derivative outstandings. There are many PNFCs. Both common sense and the statistics available indicate that derivative positions of PNFCs individually or collectively do not represent a systemic threat.

All data is US Dollars (billions) – at the end of 2008

Amounts outstanding of Over the Counter (OTC) derivatives

	Outstanding	Gross market value
Total	591,963	33,889

of which:

Amounts outstanding of OTC foreign exchange derivatives

	Outstanding	Gross market value
Total	49,753	3,917
Non-financial customers	9,158	737

Amounts outstanding of OTC single-currency interest rate derivatives

	Outstanding	Gross market value
Total	418,678	18,420
Non-financial customers	41,601	1,061

Amounts outstanding of commodity derivatives

	Outstanding	Gross market value
Total	4,427	955
Non-financial customers	Not provided	

Amounts outstanding of OTC equity-linked derivatives

	Outstanding	Gross market value
Total	6,494	1,113
Non-financial customers	793	142

Credit default swaps

	Outstanding	Gross market value
Total	41,868	5,652
Non-financial customers	494	98

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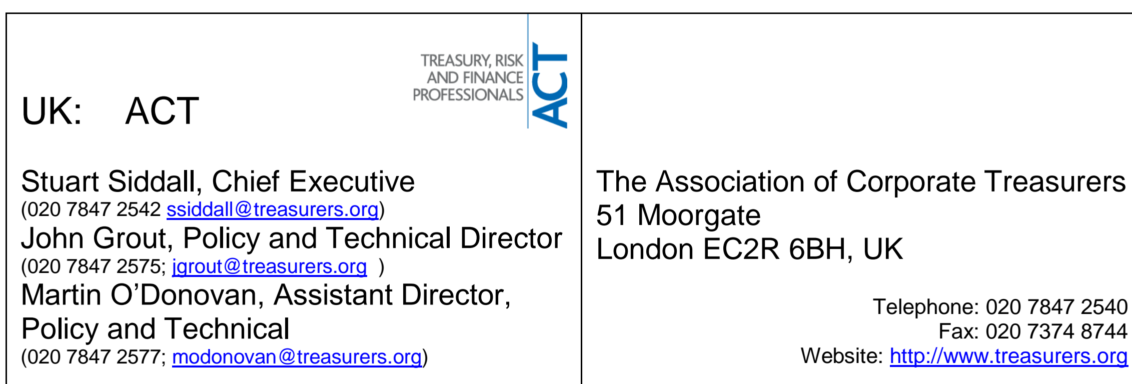

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