TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

House Financial Services Committee
Chair, The Honorable Barney Frank

By Committee website submission

July 2, 2009

Dear Sir,

Reform of OTC derivatives

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

The Association of Corporate Treasurers (ACT) is aware of the May 13th announcement from the US Department of the Treasury for Regulatory Reform of Over-The-Counter (OTC) Derivatives. In general we accept that the trading of all standardized derivatives through an exchange with clearing through regulated central counterparties (CCP) could have merit in helping to minimise some of the credit risk involved and in contributing to the overall monitoring and supervision of trades and positions.

We have noted that there have been calls to require all OTC derivatives to be standardised and moved to exchange trading and clearing. Were this to happen it could have negative consequences for companies who at present use OTC derivatives to help manage and hedge some of their financial risks, such as to foreign exchange rates, interest rates and commodity prices - corporate use of credit derivatives is very limited.

Ordinary non-financial companies use tailored derivatives provided by their banks to hedge the sorts of risks that arise from normal business activity, and not for speculative purposes. Exactly matched hedging can be done for specific risks, amounts and timings, using OTC derivatives to eliminate or manage the risk. If standardised contracts traded on exchange were the only hedging derivatives available, transacting could become too complicated for some companies

In most cases, bank counterparties do not require margining of derivative contracts with their corporate clients – the bank adding a credit spread to the pricing. The need to put up margining collateral in every case would be an administrative burden, could be costly, and could introduce a material volatility into a company's cash flows that would not match the timing of the underlying risk/cashflow being hedged. In other words in attempting to remove the credit risk between company and bank a liquidity risk is introduced instead.

Furthermore, with a standardised contract the match with the underlying risk would usually be imperfect so that companies would end up retaining some of the risk that currently can be transferred.

Prohibiting OTC derivatives might help in minimising risk in the financial sector but could result in additional risk being carried in the non financial sector with potentially devastating effect. Even were some risks to be partly hedged "on exchange" it is likely that the hedges would not be “effective” for accounting purposes thus creating a further complication and confusion in understanding accounts.

That said it may be that by introducing certain standard contracts eg a five year interest rate swap, some activity would naturally migrate to an exchange, but OTC contracts should still be permitted. A new use would potentially be in hedging the basis risk between the underlying risk and the available OTC contracts.

There is a lot of evidence that companies make insufficient use of derivatives in hedging the financial price risks to which they are exposed. It is important that any regulatory changes do not impair the ability of ordinary companies, large and small, to make use of suitable OTC derivatives for perfectly legitimate and beneficial purposes.

Yours faithfully,

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Cc:
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The Association of Corporate Treasurers

The ACT is the UK based 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 international examining body for treasury, providing benchmark qualifications. We support continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members and 1,700 students work widely in companies of all sizes through industry, commerce and professional service firms, in the UK and 66 other countries.

Further information is available on our website www.treasurers.org

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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