



**LEADING TREASURY  
PROFESSIONALS**

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**DAT consultation response:**

**Incentives to centrally clear over-the-counter (OTC) derivatives  
A post-implementation evaluation of the effects of the G20 financial regulatory reforms  
Response by The Association of Corporate Treasurers**

**Respondent**

The Association of Corporate Treasurers ("The ACT") is a United Kingdom based association which represents corporate treasurers worldwide a proportion of which whom are employed in non-financial counterparties (NFC), including multi nationals, which we understand to be the "price takers" and mostly "smaller and less active" clients in your analysis. We also represent corporate treasurers employed in larger NFCs which we understand you class as large clients, are defined as having "sufficiently large amounts of activity in the OTC derivatives markets".

**Essential Differences Between Financial Counterparties (FC) and Non-Financial Counterparties (NFC)**

You note in the evaluation paper that some regulatory authorities have provided exemptions from central clearing, and more generally margining of Over-the-counter (OTC) derivatives. These exemptions recognise that NFC use OTC derivatives to manage price and liquidity risk and are not position takers. We note that entity stress in the OTC derivatives markets during and immediately after the 2008 Global Financial Crisis (the "GFC") was a problem for the financial services industry. Many Financial Counterparties (FC) required either direct funding by government, or access to abnormal central bank liquidity facilities to manage the consequences of the GFC.

**Non-financial entities, large or small:**

- neither sought, nor required, nor were offered direct governmental financial support as a result of the 2008 GFC;
- do not use OTC derivatives for speculative purposes but to hedge, for example by fixing a price: typically interest rates or forex rates;

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- in many cases prefer to suffer Credit Valuation Adjustment (CVA) rather than enter into margin-based arrangements whether payable by central clearing or Credit Support Agreements (CSA);
- have limited access to interbank markets and no access to central bank funds;
- apply substantial resource to their business purpose and not to financial regulation compliance in the manner of financial services entities;
- depending on their financial resources may not hold cash reserves beyond those forecast to be required for their business purpose;
- do not generally hold stocks of High Quality Liquid Assets (HQLA), other than the cash reserves referred to above.

We wish to stress these last two points. Reading of the published financial accounts of NFCs may suggest that they hold liquid reserves but these will be: to reflect their pension liabilities which are legally ringfenced from the business purpose of the business and so are unavailable for liquidity management. For example: to hold reserves against a forecast transaction; or to hold liquid reserves to support a credit rating.

Some NFCs may be engaged in exchange traded derivatives markets, typically to manage commodities' price exposure, and they then pay the initial and variation margin as required by the relevant exchanges. These markets have evolved a process of margining. Exchanges sit between parties and use IM and VM to neutralise their risk to all parties.

Otherwise transactions used are over-the-counter (the "OTC") derivatives, typically used to manage interest rate and foreign exchange risk. OTC are used to manage volatility in these markets, and usually in order to manage economic risks, but management of cash flow is also important. Any margining requirement will undermine the ability to manage cash. NFCs in the main enter OTC derivative transactions with FCs with which they have diverse relationships which usually creates a mutual credit risk which each party can evaluate. For example, a derivative transaction is usually with a bank which has extended multi-year credit facilities to the NFC. The credit margin used in those facilities will be the FC credit valuation of the NFC.

The scale and nature of an NFC's activities in an OTC market is a factor of the business' size and complexity and not as a result of a chosen trading position. Our members' businesses are largely excluded from the clearing obligation (for example, under EMIR) because their OTC transactions fall within the hedging exemption or are within exemption thresholds.

### **The ACT Position**

Your paper quotes the following:

"Given their exemption from mandatory clearing requirements in many jurisdictions, the choice between cleared and uncleared trades for such clients may depend on factors such as their ease of access to central clearing, fixed costs, ease of accessing acceptable collateral, and the relative costs of cleared versus uncleared trades."<sup>1</sup>

We dispute this statement in relation to NFCs. The NFC objective of transacting OTC derivatives is to achieve certainty by transacting uncollateralised trades, usually for interest or forex rates. The cost of the additional liquidity for margin calls in clearing is not the most important argument to clear or not. The alternate CVA charge which results from choosing not to clear derivatives is regarded as an increase of the fixed price which has the benefit of removing the risk of not being able to source liquidity for margin calls.

There are a small number of members who are larger businesses and exposed to central clearing of OTC derivatives because part of their business trades in commodities (e.g. oil) and their exchange traded derivatives are of such a scale as to remove the hedging and threshold exemptions (although this remains under review within the EU regulation). There are also a very small number of larger businesses who choose to centrally clear their OTC

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<sup>1</sup> Part C1, page 16

interest rate derivatives because they do not want to face the credit risk of their financial counterparties, however this does not represent the typical NFC.

Below are our detailed responses to the questions posed in the paper.

Yours sincerely



Stephen Baseby  
Associate Policy & Technical Director

## Questions for public consultation

### Incentives

- 1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?**

We do not agree that incentives are appropriate for larger non-financial counterparties (NFC) to centrally clear OTC derivatives because the process of paying initial and variation margins creates liquidity risk which the use of uncollateralised OTC derivatives does not.

**Example:** a large NFC (for example, an NFC+ under EMIR) in the commodities industry enters a floating to fixed interest swap with a relationship bank to fix its interest cost by the use of a swap on one transaction in a portfolio of debt. It qualifies for neither the hedging or threshold exemption under EU due to the scale and nature of its commodities trading.

The NFC is "incentivised" to centrally clear OTC derivatives only because it is not exempted from doing so. The margin payments remove certainty, in effect converting interest rate risk to liquidity risk. Margin volatility requires reserving capital otherwise available for investment: the "higher capital requirements" in Part D1. It is otherwise satisfied with its counterparty exposure management which is that usually of its lending relationship banks and therefore derives no benefit from the use of a CCP.

Should it be able to elect for an alternative Credit Valuation Adjustment (CVA) charge for non-clearing, it would increase the fixed cost but remove the margin volatility and remove the need to reserve capital.

Smaller NFCs have the same rationale for non-central clearing.

- 2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?**

The reforms have either obliged large "clients" to centrally clear, whether or not appropriate to their business purpose, or is burdening both larger and smaller clients with higher costs through CVAs passed onto them by their banks in the form of higher derivative prices. For most corporates, this charge is preferable to the liquidity risk comes from central clearing.

Central clearing is regarded by regulators as a means of reducing counterparty exposure. Counterparty exposure is monitored and managed by NFCs but is a generally manageable problem with derivatives often transacted with bank lenders with which the NFC has a strong relationship

we are concerned that central clearing shifts liquidity and settlement risk onto the NFC sector which in the event of a crisis of a nature similar to the GFC will only cycle back to the financial services sector to fund the liquidity, and hence back to governments. We understand the arguments for CCPs to be able to better manage credit exposure on FCs, because it can net their assets and liabilities in the event of crisis, but central clearing has also concentrated liquidity and settlement risk into a few CCPs, in itself a systemic risk as you note<sup>2</sup>: "the amount of cleared client trading activity which passes through the top five clearing members exceeds 80% for IRS". Corporates will be at greater risk in a future financial crisis if they have a liquidity shortfall due to a collateralised derivative.

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<sup>2</sup> Part C4, page 20

3. **Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?**

NFCs prefer where possible to avoid margin-based derivatives by paying the CVA as part of their derivative price. If margin was a consideration for NFC in choosing to centrally clear, the decision is dependent on the cost of centrally clearing which is discussed in the second last paragraph of page 31 of your paper. Most NFCs will have few derivatives transactions and are therefore unattractive customers to CCPs and costs are weighed against them.

We are not aware of particular instruments for which incentives could be offered. The principal objective of an NFC transacting in a derivative is generally to reduce risk, not to generate a liquidity risk.

4. **The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.**

We can agree the analysis in Parts D3 to D5 and the conclusion that central clearing may be more expensive relative to non-central clearing for clients that trade less frequently.

To this we add:

- that NFCs are not typically required in our experience to have CSAs, see D8 and D9 for the probable explanation, and therefore are able to hedge without creating a liquidity risk;
- that NFCs would require material additional resources to re-negotiate ISDA agreements to change to CSA and/or cleared transactions.

## **Markets**

5. **Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?**

The paragraph below Table D10 can be considered with regard to the EU EMIR rules. A commodities business with substantial trading may have all its derivatives brought into central clearing by the current threshold rules and so the move to central clearing is obligatory and not the result of financial analysis. This is likely to be a major part of the move to central clearing.

6. **There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?**

NFCs, classed as amongst large and small clients in the paper, use OTC derivatives to manage their business costs: for example, fixing interest rates on their funding to assist price certainty for their goods and services. This approach makes them relatively unconcerned about changes in clearing costs, administrative or margin as they do not typically have cleared trades.

## Reforms

**7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?**

- a. central clearing mandates (both in terms of product scope and entity scope);
- b. minimum standards for margin requirements for uncleared derivatives;
- c. capital requirements for credit valuation adjustment (CVA) risk;
- d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
- e. G-SIB requirements; and
- f. The leverage ratio.

As discussed elsewhere in this response, NFC are concerned about liquidity risk from central clearing and in general transact uncollateralised OTC derivatives.

**8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?**

As discussed elsewhere in this response, NFC do not benefit from centrally clearing.

**9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?**

No response.

## Access

**10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:**

- a. accessing clearing arrangements; and
- b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

We agree that NFCs have difficulty accessing clearing arrangements. Most non-financial entities will not have relationships with clearing entities as part of their business operations and will have a small number of derivative transactions. The latter makes them unattractive clients for clearing arrangements.

As a general observation, NFCs have found access to financial services has generally become more difficult since the GFC. This has been due to the retreat of many financial services businesses from the provision of broad based services for clients, and the FC businesses focus on a narrower range of business activities in tighter geographic regions and are less able to provide liquidity solutions to clients.

**11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?**

We agree that clearing services have become concentrated in fewer banks and CCPs. We regard this as unattractive concentration of counterparty and settlement risk.

We are not surprised and expect this trend to continue. The system development costs of clearing will drive the market to a few specialist entities.

**12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:**

- a. using clearing services?
- b. providing client clearing services?

No comment

**13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.**

The ACT does not agree that economic factors generally incentivise central clearing for NFCs. Central clearing would create a liquidity risk for the NFC which they will wish to avoid.

Generally, we do not agree that central clearing has economic benefit because substantial movements in hedged factors, such as interest rates, may create a liquidity crisis for some parties as they would be required to provide margin in cash or HQLAs under that crisis, and this would accelerate the crisis.

The concept of central clearing for OTC derivatives was taken from exchange traded (equity) transactions which has used margining to resolve the counterparty exposure issues of a freely traded market. OTC derivatives are discreet transactions between counterparties which have the opportunity to analyse one another's credit risk, and often have other, and related transaction relationships.

**14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.**

Central clearing should not become mandatory for NFCs as they have limited access to liquidity and therefore uncollateralised OTC derivatives are more appropriate than centrally cleared trades in most instances. Therefore, it would be beneficial if financial counterparties are not disincentivised from dealing with NFCs on an OTC basis.

It is important to NFCs that they understand the counterparty risk they adopt when dealing with a financial services counterparty. It would be preferable for consistent application of regulation to all those financial counterparties.