BUSINESSEUROPE

POSITION PAPER

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Derivatives and Market Infrastructures

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Introduction

BUSINESSEUROPE is in favour of smart regulation for financial services in response to the regulatory failures that led to the financial crisis and to address the risk of similar events occurring in the future. In this context, we support in principle enhancing the resilience of 'over-the-counter' derivatives markets and moves towards central clearing and increased standardisation in order to increase the quality of risk management for these derivatives. However, we believe that total standardisation and central clearing could have unintended consequences for the corporate end-user community.

Standardisation

The advantage of 'over-the-counter' derivatives is that they are bilaterally negotiated contracts and that the terms of these contracts can vary considerably according to the needs of each party. The principal benefit of these contracts is that they can be customised to match particular risk exposures and provide specific risk mitigation. Standardisation would reduce the opportunity for end users to obtain the risk management protection which they seek. This would reduce the ability of corporations to manage and hedge some of their financial risks and ultimately reduce the effectiveness of their risk management procedures. Less tailored derivatives would also lead to disqualification of IAS39 hedge accounting pre-requisites and would cause increased Profit&Loss volatility.

Centralised clearing

Whilst the move to centralised clearing may reduce the collateral burden on financial firms, burdens on non-financial companies would increase if corporate counterparties will be required to post collateral for trades subject to central clearing. A requirement to providing collateral would mean the necessity to raise such liquidity which might be difficult and expensive, or even impossible in the currently prevailing market conditions. The liquidity posted as collateral will also not be available for much needed investments in the operative business of corporations which could slow down the recovery of the EU economy. Moreover, non-financial companies will have to deal with the administrative and cost-intensive burden of managing their collateral positions. Uncertain movements in mark-to-market values of assets would lead to possible increases in the collateral to be posted that would be difficult or even impossible to raise and expensive to manage.

The suggestion that margins will have to be calculated by using a margin-at-risk approach with a 99% confidence level, to be provided intra-day whilst requiring only the use of cash or liquid instruments, implies that margin requirements will exceed the mark-to-market value of derivatives by far, leading to serious liquidity constraints.

Providing intra-day cash collateral is not feasible for market participants that have no access to Central Bank liquidity. Consequently, to avoid the risk of illiquidity under extreme circumstances, non-financial companies would need substantial additional credit lines to cover tail-risks which would be hard and costly to obtain. This would lead to corporations stop hedging risks increasing not only the risk for the single corporation concerned but also for the economy as a whole. Reduced hedging will also lead to a different risk assessment of the non-financial companies concerned by capital markets which will negatively affect the cost of equity and financing. Collateralisation would not resolve this and might even increase the default probability in times of financial distress as non-financial companies have an incentive to significantly reduce their hedging activity to stay within the intervention threshold.

Exemption

If derivatives are executed in conjunction with risk mitigation of underlying real economic risks, there is no systemic risk relevance and therefore differentiation of regulatory measures between the financial and non-financial sector is appropriate. BUSINESSEUROPE consequently believes that a full exemption for non-financial companies which are not predominantly engaged in financial activities would be the best solution. Consequently, BUSINESSEUROPE would not support a threshold approach, as quantitative thresholds do not adequately take account of the variety of different companies and their hedging strategies.

Although it is true that many corporations have financial services operations in order to support sales activities and that some of these financial services operations have a banking license, they are an integral part of the businesses concerned and have no link to speculative activities of some investment banks.

Thresholds

If it is deemed necessary (e.g. for transparency reasons) to introduce some kind of threshold, an <u>information threshold</u> for corporations should be rather large and geared to systemic risk (= risk to the system as a whole, not just for single market participants) to enable corporations to pursue their normal hedging business untouched. The introduction of a <u>clearing threshold</u> for corporations bears heavy risks for the corporations and for the capital markets as a whole and therefore should be unconditionally avoided. The regulators - in good faith – may create a new systemic liquidity risk while trying to mitigate i.a. counterparty risks. In any case, a clearing threshold should exclude all kind of corporate hedges and the clearing requirement shall just apply to the non hedge related derivatives exceeding the clearing threshold.

BUSINESSEUROPE would like to stress the point, that any additional financial burden on non-financial hedging parties must in any case be avoided – a solution to carve out corporations from the central clearing requirement but require them to post collateral for not-centrally cleared transactions would lead to the same negative results on the economy as pointed out above.

Level playing field

Any unilateral approach in this area needs to be avoided. The G20 called for greater international co-operation and consistency and it is thus important that a level playing field is maintained.