EACT Response to the European Banking Authority's Consultation on the Treatment of CVA under SREP

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The European Association of Corporate Treasurers (EACT)

The EACT is a grouping of national associations representing treasury and finance professionals in 18 countries of the European Union. We bring together about 13,000 members representing 6,500 groups/companies located in the EU. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe.

We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

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Introduction

We welcome the opportunity to respond to this consultation on this important topic.

The European Association of Corporate Treasurers has for several years demonstrated the legitimate use of OTC derivatives by non-financial companies to mitigate financial risk arising from their business. The economic importance of this gained an important political recognition in the form of the exemption from central clearing under Article 10 (3) of the European Market Infrastructure Regulation (EMIR) and a read-across exemption from CVA risk capital charges under Article 382(4) of CRR.

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These exemptions are instrumental in allowing EU non-financial companies to use OTC derivatives to hedge the impact of movements in currencies, interest rates and commodities. This benefits the wider economy by allowing companies to focus on their core purpose of building strong businesses, which through their growth create employment and investment. If non-financial companies which are below the clearing threshold as defined in EMIR could not benefit from such exemptions, they would face severe negative consequences e.g. in the form of increased pricing of OTC derivatives and a potential consequential reduction in risk mitigation. EU NFCs are for structural reasons more dependent on risk mitigation tools than for instance their US counterparts, and putting at risk the continued availability of such tools would put EU companies at a competitive disadvantage.

Non-financial companies' use of OTC derivatives does not present systemic risk and therefore such an outcome would be completely disproportionate. Furthermore, the use of derivatives for hedging does not only reduce operational risks for non-financial companies themselves; it also reduces risks for the banks which lend to these companies and hence contributes to the global stability of the financial system.

Furthermore – as pointed out in our response to the European Commission's call for evidence on EU framework for financial services [1] – **the post-crisis financial regulation has already materially affected the offering of OTC derivative products by banks to their corporate customers**:

- Pricing of OTC derivatives has increased, sometimes substantially, and is generally less transparent, probably due to the complexity of the different price components.

- Hedging long-term exposures has become very difficult if not impossible. However, some industries need to hedge for long maturities due to the nature of their business.

- Some products, such as cross-currency swaps, are difficult to obtain altogether.

- There is increased pressure by banks to demand collateralisation, even when this is no legal requirement to do so.

[1] http://www.eact.eu/docs/EACT-Response-EC-Consultation-Cumulative-Impact-Financial-Reform-31Jan16.pdf

- Lastly, the number of banking counterparties has reduced, which in turn increases counterparty risk. The reduction in the number of counterparties is due to different factors such as problems in delegated reporting done by banks, ceasing to deal with US banking counterparties due to regulatory uncertainty (Dodd-Franck) or because it is easier to manage the reporting obligation with fewer banking counterparties.

As a result, a number of companies have reduced or are planning to reduce hedging of their business and commercial activities, despite economic needs. Some respondents even point out that their hedging behaviour is more driven by the need to fulfil regulatory obligations than the need to reduce business risk, which we consider to be a perverse consequence of a regulation that first and foremost targets banks. Adding the (partial) elimination of the CVA exemption to the above negative consequences would only further deteriorate the situation.

In summary, **we strongly oppose the adoption of the suggested guidelines for the following reasons:**

- In our view the **EBA does not hold a mandate** to impose supervisory measures that will overrule the level 1 text that has been democratically agreed upon by the EU legislator. Such action by an ESA would be a **dangerous precedent that poses serious questions about legal certainty and visibility in the EU** – policy decisions such as the CVA exemption are solely the competence of the legislator, not the competence of an ESA.

- Implementing the guidelines will **result in materially altering the CVA exemptions and essentially eliminating their beneficial impact on non-financial corporate end-users**. Banks will inevitably pass on the cost of additional regulatory capital requirements to their corporate clients – this will increase the cost of risk mitigation and could lead to companies electing not to hedge altogether, leaving risk in the real economy.

- **The analysis on which the EBA bases itself** for these draft guidelines, made in the *Report on Credit Valuation Adjustment (CVA) under Article 456(2) of Regulation (EU) No 575/2013 (Capital Requirements Regulation — CRR)*[2] – hereinafter the 'CVA report' – concerning the exemption on non-financial counterparties, **is contestable and leaves many aspects unconsidered.**

[2] https://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf

We have elected not to respond to the specific questions posed by the consultation document, but rather to make some general comments.

Legal basis of EBA's action

We consider that the **EBA does not hold a legal mandate** to impose additional capital requirements through SREP considering the following elements:

CRR Article 382(4) exemption for non-financial counterparties

CRR introduced in its Article Art. 382 (3) an exemption for CVA charges for OTC derivatives transactions that have been exempted from central clearing under EMIR Article 10. This exemption was adopted by the EU legislator in order to preserve the economic value of the EMIR central clearing exemption, as applying CVA charges on these transactions would have substantially increased the cost of hedging, as well as probably reduced the amount of risk-mitigating hedging.

We believe that it is totally inappropriate for an ESA to interfere on the level 1 text and propose supervisory measures that will in effect go against what has been democratically decided at level 1. The EU legislator willingly – and based on solid arguments – decided to exempt from CVA charges the transactions of non-financial counterparties that are subject to the central clearing exemption on EMIR. This was the result of a democratic process and resulted from the legislator's willingness not to remove the economic effect of the EMIR central clearing exemption by imposing CVA charges under CRR.

We would also point out that the European Parliament has in its recent report entitled *Stocktaking and challenges of the EU Financial Services Regulation* [3] expressed *"concern that valid exemptions in the European Market Infrastructure Regulation (EMIR) for non-financial companies have been partly undone in the Capital Requirements Directive and Regulation with regard to the application of the Credit Valuation Adjustment (CVA) charge; calls on the Commission to better perform its role in ensuring consistency in policy approach and outcome across different legislative proposals".* We would urge the EBA to take these valid concerns of the European Parliament into consideration.

[3] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0006+0+DOC+PDF+V0//EN

CRR Article 456(2)

The draft guidelines are issued following the CVA report based on CRR Article 456(2). Indeed, Article 456(2) mandates the EBA to monitor the own fund requirements for credit valuation adjustment risk and to submit a report to the Commission. Importantly, however, this report can only be used for amending Article 382 points (1) to (3), which therefore **excludes any amendment of the exemptions granted under Article 382(4). This clearly demonstrates the legislator's intention *not* to subject the exemptions to any review or supplementary measure by the EBA.** Therefore, the EBA was not acting under the mandate given in Article 456(2) when it included an assessment of the exemptions in the CVA report.

CRD IV Article 104

The EBA further considers that based on CRD IV Article 104, competent authorities have the power the impose additional own funds on institutions where these competent authorities consider that minimum own funds requirements are insufficient to cover CVA risk, if a risk is not sufficiently covered by the prudential requirements of CRR. We acknowledge that this provision gives rather extensive powers to supervisors, however we contest its use for the purposes of circumventing clear policy decisions adopted by the legislator.

Regulation 1093/2010 establishing the EBA

Article 16 of the EBA's founding Regulation states that "*The Authority shall, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law, issue guidelines and recommendations addressed to competent authorities or financial institutions."* Therefore the use of guidelines is clearly limited to purposes of harmonisation of the implementation of already existing legal provisions, not re-writing level 1 provisions.

Furthermore, the European Parliament has reminded the ESAs of the limitations set to guidelines and recommendations on its report on *Stocktaking and challenges of the EU Financial Services Regulation,* where it *"reminds the ESAs that technical standards, guidelines and recommendations are bound by the principle of proportionality; calls on the ESAs to adopt a careful approach to the extent and number of guidelines, particularly where they are not explicitly empowered in the basic act".*

Expected consequences

1. <u>Substantial increase in prices of uncollateralised OTC derivative instruments</u>

Regulatory CVA drives banks' pricing of uncollateralised OTC derivatives. EU banks will pass on the costs of increase in CVA risk charge to their non-financial clients, and this will lead to material increase of hedging cost for those clients.

Our members observe a clear difference in pricing between US banks that do not benefit from the CVA capital exemption, and European banks that do. US banks are clearly, consistently and materially more expensive, as demonstrated in the below example.

Uncollateralised derivative costs example:

- A recent live trade was conducted via an competitive auction with more than 20 banks (see below)
- The trade was an uncollateralised 10 year cross-currency swap (USD vs a G5 currency)
- The counterparty was a strong investment grade corporate
- Below are the additional charges over 'mid-market' price shown below in basis points

	US Banks (7)	**European Banks (17)**	**Difference**
Max	25bp	19bp	6bp (+32%)
Average	**19bp**	**13bp**	**6bp (+46%)**
Min	14bp	7bp	7bp (+100%)

In the above example the CVA charge increases by almost 50% on average for banks that do not benefit from an exemption for hedging transactions.
This additional CVA charge represented 6 bp which is material in a low rate environment. For a USD 1 bio transaction, the additional CVA charge is equivalent to the costs of several Treasury headcounts.

2. <u>Deterioration of companies' financial position</u>

Further to the impact on risk mitigation, the proposed measures by the EBA are also likely to negatively impact non-financial companies' financial position, either by

a. forcing NFCs to enter into credit support enhancements agreements that the banks' own credit department did not initially deem necessary. This will ultimately divert funds from productive investments. Should banks be required to obtain collateral, the corporations may end up borrowing from financial institutions to finance the margining. Then the risk will only have been shifted within banks, from the derivatives book to the lending book.

   or

b. increasing the companies' credit spreads in the market because banks will be forced to mitigate counterparty risk by buying single-name corporate credit default swaps, thereby increasing the cost of funding for non-financial companies, without any connection to a real degradation in the company's creditworthiness. Such a development would be in fundamental contradiction with the current policy objectives of facilitating companies' access to funding. Furthermore, only large multinational corporations have a deep and liquid CDS market so it will not be possible for banks to hedge their credit exposure with CDSs. It would be a concern for medium and small companies,

3. <u>Reduction in the offer of OTC derivatives and the number of counterparties</u>

These proposed additional capital requirements, if implemented, would likely reduce the number of banks entering into uncollateralised OTC derivative transactions. Firstly, banks might wish to reduce their OTC derivative portfolios in order to remain below the relevant thresholds defined in the guidelines, and therefore remain outside the scope of the additional capital requirements. Secondly, for many non-financial counterparties banks will not be able to use CDSs in order to limit the volatility of their capital base due a lack of non-financial CDS market. This is also likely to lead to some banks to limit, overprice or stop transacting with non-financial counterparties.

Shortcomings in the EBA report on CVA

As the draft guidelines are based on the analysis made in the EBA CVA report, we would like to highlight some shortcomings of the analysis, and therefore the very need to foresee additional capital for exempted transactions.

Generally, the EBA CVA report shows a complete lack of understanding of NFCs' usage or needs of OTC derivatives and of the policy goals behind the CVA exemption.

In our view the Report takes a very limited approach in the analysis on CVA risks – we would in particular criticise the following aspects of the report:

- The EBA report first highlights the importance of exempted NFCs by counting the number of counterparties (Figure 16 on page 53). We see no value in this argument, as this is perfectly natural since NFCs represent the entire non-financial economy, with a far larger number of legal entities than financial counterparties.

- Then the EBA report highlights that the total CVA charge of exempted counterparties represents a material amount (Figure 17 on page 54 and subsequent paragraphs). We point out that assessing the systemic risk by using that number is flawed. Firstly, derivatives cannot be taken standalone when talking of default risk of a corporate. Secondly, there is a fundamental difference in the CVA risks posed by NFCs compared to financial counterparties: NFCs' business and default risks are much less correlated and therefore less systemically important than those of financial institutions; therefore the CVA risk due to non-financial counterparties cannot be treated in the same way as that of financial counterparties. The sector diversification of NFCs means that correlation is low and in consequence, the CVA risk of the diversified portfolio is far smaller than the arithmetic sum of the CVAs as presented in Figure 7. In addition, due to the high number of counterparties, the individual NFC risk is not a threat to the system. Also, hedging transactions are generally matched in the NFCs by equal and opposite business flows, which further reduces the riskiness of their transactions.

- The EBA ignores what is yet evident from its own figures: the fact that historically the CVA losses due to NFCs have been negligible, as pointed out in figure 7 (on page 25). Most CVA losses have occurred in CDOs linked to ABSs and mono-line Insurers - instruments and sectors totally unrelated to NFCs.

- The EBA ignores the underlying reasons and justification of the CVA exemption and the reasons for NFCs engaging on OTC derivative transactions. Therefore we do not accept the EBA statement (pages 58-59) that the exemption both from central clearing and CVA charges may be justified only for SMEs. The size of the company is irrelevant as to the ability to support liquidity risk or higher hedging costs. Large companies have larger derivatives portfolios due the scale of their business operations, and would suffer significantly from an amendment of the exemptions.

- The report does not take into account the fact that the reduction in risk mitigation by NFCs as a consequence of any deletion or amendment of the

CVA exemption will make NFCs more risky as counterparties to financial institutions. Hedging improves the overall risk profile and credit worthiness of companies.

- Also pushing for cleared derivatives transactions (which the EBA seems to imply) where collateral is posted would not make the system overall safer, as risk would simply be moved from financial institutions –where this risk can be dealt with – to non-financial companies that are less equipped to deal with the liquidity risks involved. Furthermore, NFCs would have to have credit lines at banks in order to hope to face margin calls, which would add another layer of counterparty risk for banks also. In a worst case, it could create stress on the liquidity of companies and force them to stop hedging. This in turn would create volatility and business risk.

- As regard to the EBA suggestion to align the EU capital requirements framework with the Basel framework in the future, i.e. deleting the current CVA exemption for corporate end-users, it should be noted that it is in our view justified that the EU legislator adapts the Basel framework to better reflect the fundamental differences with companies in other jurisdictions. Indeed, EU companies have a greater need for hedging for structural reasons. For instance, compared to their US counterparts, EU companies have much higher FX exposures due to the importance of exports and the fact that the US dollar is a dominant currency in many markets; and EU companies have different funding patterns compared to US companies, which calls the need for hedging interest rate risk.

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