EACT Response to Basel Committee on Banking Supervision consultative document on Review of the Credit Valuation Adjustment Risk Framework

30 September 2015

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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1. Introduction

We welcome the opportunity to respond to this consultation.

Due to the fact that many aspects of the consultation are relevant mainly to the banking industry, we have chosen to comment only on one aspect of the CVA framework, namely the scope of application. We strongly urge the BCBS to exclude non-financial counterparties from the application of the CVA risk capital charge; exclusion of NFCs would align the BCBS proposals with existing EU legislation.

Non-financial companies (NFCs) require fairly market-priced, tailor-made and widely offered OTC derivative products to protect their core business activities from
financial risks. The use of OTC derivatives by NFCs is part of prudent company risk management which contributes to financial stability by making these NFCs less risky to their financial counterparties, suppliers, customers, employees and to economic stability in general. This was recognised by the EU legislator in the exemption granted from central clearing in the European Market Infrastructure Regulation (EMIR) and the read-across exemption for CVA risk capital charge in the Capital Requirements Regulation (CRR). Without these exemptions EU non-financial corporates would have faced materially higher hedging costs, leading to a reduction in financial risk mitigation by companies – an outcome highly undesirable from an economic but also from a financial stability perspective. We would therefore recommend that the BCBS adopt a similar position by exempting all risk mitigating OTC derivative transactions by non-financial counterparties from the scope of application of the CVA framework.

2. Scope of application - need for exemption for non-financial counterparties

Non-financial companies, as end-users, enter into OTC derivatives transactions to hedge the impact of movements in currencies, interest rates, commodity and other market prices. This allows them to focus on their core purpose of building strong businesses, which through their growth create employment and further investment.

The access of non-financial companies to OTC derivative products must be maintained as it is beneficial to the economy and reduces systemic risk instead of increasing it. Non-financial companies use derivatives for reducing risks of underlying commercial and industrial operations, not for speculative purposes. They represent only a small proportion of the whole OTC derivatives markets and do not pose systemic risks by their derivative transactions. Furthermore, the use of derivatives for hedging does not simply 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.

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 would have led some corporations to discontinue hedging, therefore increasing the overall economic risk.
These two exemptions recognise the important role that non-cleared OTC derivatives play in companies’ risk management.

The exclusion of non-financial counterparties’ risk mitigating transactions from the CVA risk charge is justified by the following fundamental differences compared to financial counterparties:

- There is a fundamental difference in the CVA risks posed by NFCs compared to financial counterparties: NFCs operate in very diverse industrial sectors and do not transact financial derivatives with one another, therefore 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 NFC portfolio is smaller than a portfolio of financial counterparties of the same size would be. In addition, due to the high number of counterparties, the individual NFC risk is not a threat to the system. In addition, hedging transactions are generally matched in the NFCs by equal and opposite business flows, which further reduces the riskiness of their transactions.

- Historically the CVA losses due to NFCs have been negligible and most CVA losses have occurred in CDOs linked to ABSs and mono-line Insurers - instruments and sectors totally unrelated to NFCs.

- The reduction in risk mitigation by NFCs as a consequence of applying CVA risk capital charges will make NFCs more risky as counterparties to financial institutions. Hedging improves the overall risk profile and credit worthiness of companies.
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