# Coalition for Derivatives End-Users

## Statement for the Senate Committee on Agriculture Hearing, "Reforming U.S. Financial Market Regulation"

## November 18, 2009

### INTRODUCTION

The Coalition for Derivatives End-Users and its member trade associations represent American businesses that use over-the-counter (OTC) derivatives to manage business risks, including fluctuating currency rates, interest rates and commodity prices. The Coalition thanks Chairman Lincoln, Ranking Member Chambliss, and the members of the committee for the opportunity to provide this statement for the record of the hearing held on November 18, 2009.

The Coalition supports current efforts by policymakers to improve transparency, accountability and stability in the nation's financial markets and we appreciate the hard work that has been done to ensure these efforts are focused on minimizing risk, while limiting the negative impact on business end-users. However, we remain concerned that certain proposals for reform of the OTC derivatives market would place an extraordinary burden on end-users in diverse sectors of the economy – including manufacturers, energy companies, healthcare companies and commercial real estate owners and developers.

OTC derivatives provide companies with access to lower cost capital and protect against risk – enabling businesses to grow, make new investments and retain and create jobs. In promoting market stability, transparency and oversight, it is critical that policymakers preserve the ability of companies to manage their individual risk exposures by ensuring access to reasonably priced OTC derivative products.

Proposals that would require OTC derivatives used by business end-users to be executed on exchanges, centrally cleared, or subject to daily mark-to-market collateral or onerous capital charges, could prevent companies from using these important risk management tools in the course of their everyday business operations.

### PRINCIPLES FOR REFORM

The Coalition offers the following principles for reform of OTC derivatives:

#### *Central Clearing and Cash Margin Requirements Should Not Apply to End-Users*

The Coalition believes that business end-users who are able to access debt markets on an uncollateralized basis, whether by virtue of their credit strength or alternative security arrangement, should also be able to access derivatives on similar terms. At a time when the Administration is urging lenders to provide credit to stimulate the economy, it would be counterproductive to restrict access to credit used for legitimate risk management.

Therefore, we oppose mandated central clearing or bilateral margining for OTC derivatives transactions that involve end-users, which, according to the Bank for International Settlements, currently comprise less than 15% of the entire OTC derivatives market. Requirements for significant amounts of cash or liquid securities to serve as collateral for mark-to-market margin calls would result in an extraordinary drain on working capital for American companies. By adding to the cost of prudent risk management, this would impede growth and undermine companies seeking to effectively manage their risk.

Furthermore, the companies we represent need their most liquid assets for their working capital and investment purposes – activities that are necessary for American businesses to grow the US economy and protect jobs. To the extent that the counterparties to customized OTC derivatives determine that margin is needed, they should continue to allow end-users to use a broader range of eligible assets, such as physical assets, to secure their swap obligations.

***Central Clearing is Appropriate for Transactions between Major Swap Participants, and Additional Reporting is Appropriate for All Transactions***

The Coalition believes that any reform proposal should promote clearing for derivatives transactions between swap dealers and major swap participants. Since derivatives transactions that occur between swap dealers and major swap participants comprise over 85% of the market, requiring these trades to be cleared through regulated central counterparties would reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk.

In addition, we believe that policymakers should promote transparency for all OTC derivatives through enhanced reporting requirements for financial intermediaries, which are in a better position than end-users to report relevant information. These reporting requirements should not be duplicative. Any transparency rules, including a central repository requirement, should recognize the difference between information provided to the government for regulatory purposes and information provided to the public for investment purposes. Government agencies should handle information provided real-time on a confidential basis and any information available to the public should be in aggregate format and reported with a lag period to protect proprietary information.

***Customization is Critical***

A key benefit of OTC derivatives for end-users is the ability to customize these products to manage a specific business risk. A requirement that end-users execute derivatives on an exchange would force standardization of derivative contracts and preclude companies from accessing customized derivatives to offset or reduce unique business risks, whether arising from exposure to fluctuating commodity prices, foreign exchange rates or interest rates. Standardized derivatives may not serve as a perfect hedge, thereby increasing a company's earnings volatility from the mismatch in the standard hedge versus the custom risk. Such mismatch would prevent businesses from hedging, increase capital costs and would negatively impact the ability of end-users to compete in the global marketplace. Consequently, it is imperative that any enacted reforms not mandate exchange trading for derivatives used by end-users.

***Capital Requirements Should be Risk-Based***

Current risk-based capital guidelines require banks, as counterparties, to set aside capital to protect against potential losses. The objective of any new rules should be to promote the safety and soundness of the financial system by protecting against actual risk of loss, not to push derivatives trading activity toward exchanges by penalizing OTC trades. While the relevant regulators may determine that these capital charges should be increased in order to adequately protect the financial system, policymakers should use caution before making these valuable risk management tools more expensive by imposing increases in capital charges for these products, which dealer banks will simply pass on to end-users. Increasing costs for standard commercial risk management would diminish the value of US investments by increasing risk within individual companies.

### *New Regulations Should Be Implemented on a Prospective Basis*

The Coalition believes that new regulations should apply to end-users only on a prospective basis. End-users entered into their current OTC derivative contracts based on bilateral negotiations with their counterparties and an understanding of their future obligations at the time of agreement. If new rules apply retroactively to pre-existing swaps, the change in credit terms and costs could potentially cause grounds for the termination of these arrangements. The terminations would result in mark-to-market settlements of these trades, which could cause significant liquidity problems for end users. Additionally, these firms would be exposed to the precise price risk they intended to mitigate.

## COMMENTS ON PROPOSED LEGISLATION

The Coalition appreciates that Senate Banking Committee Chairman Dodd has circulated a draft of his comprehensive regulatory reform proposal. While the Coalition has concerns that this proposal would impose onerous requirements on derivatives end-users, we appreciate that Senate debate on this important issue will now begin in earnest. We hope the Senate Agriculture Committee will play a significant role in this reform effort, and we look forward to working with members of both Senate Committees to find a responsible balance that allows the government to manage systemic risk and corporate end-users to manage their business risk. The following are specific comments on the draft legislation proposed by Chairman Dodd.

### *Definition of Major Swap Participant*

The Senate Banking Committee proposal defines a "major swap participant" as any person whose swaps could cause "significant credit losses," regardless of whether the swaps are hedges or if potential losses are too small to harm financial stability. The Coalition is concerned that this language would allow regulators to label end-users that are hedging and do not pose a threat to the financial system as major swap participants. Such a classification would subject end-users to heavy regulatory requirements appropriate for the largest, systemically significant firms. We support a definition of "major swap participant" that would exempt companies that are hedging for legitimate commercial risks, including hedging risks within corporate pension plans.

### *Central Clearing Requirement*

The Coalition supports a specific exemption for end-users who are not major swap participants from requirements that derivatives transactions be executed on an exchange or cleared through a central counterparty. Under the Senate Banking proposal, the CFTC would have the authority to impose central clearing requirements on end-users even if they are not classified as major swap participants. The CFTC would be allowed, but not required, to grant exemptions to the central clearing requirement in limited cases. The proposal also gives private clearinghouses the authority to determine which non-major swap participants qualify for such an exemption. We would prefer a clear exception from clearing for end-users that do not pose a risk to the broader financial system, and we continue to have concerns about outsourcing important regulatory decisions to for-profit non-government entities like clearinghouses.

***Margin Requirements***

The Coalition is concerned by proposals that would allow regulators to impose initial or mark-to-market margin requirements on bilateral OTC contracts in which one party is an end-user. The Senate Banking proposal would give regulators the authority to impose margin requirements on end-users that are not major swap participants and limits the ability for an end-user to earn an exemption by reverting to the Administration's language and requiring the swap to be an "effective hedge" under GAAP. This poses a problem for the thousands of private companies that do not report under GAAP and for public end users that may not elect to designate their hedges under FAS 133. Additionally, this language effectively outsources a significant component of the regulation of OTC derivatives to the Financial Accounting Standards Board (FASB). This is particularly troubling now, when the rule that governs effective hedging, FAS 133, is being reviewed for modification – creating significant uncertainty for derivatives end-users.

While the Senate Banking proposal makes it clear that any margin requirement imposed on end-users must allow non-cash assets to serve as collateral, we believe that providing regulators the authority to impose margin requirements on end-users would be detrimental to their ability to manage commercial business risks. Instead, the Coalition believes that margin requirements should be focused on the more than 85% of trades that are executed between major swap participants who are not end-users and that these requirements should not apply to those end-users who are currently able to secure derivatives products based on the strength of their credit.

***Capital Charges***

The Coalition remains concerned that the Senate Banking proposal would impose higher capital charges on derivatives transactions involving business end-users simply because they are not cleared. We continue to believe that risk-based capital requirements are extremely important to contain systemic risk, however we believe they should continue to be based on an evaluation of risk – not as a punitive charge for non-cleared trades. To that end, we support specifically directing regulators to consider the actual risk of loss when setting capital requirements for non-cleared derivatives transactions.

**CONCLUSION**

The Coalition thanks Chairman Lincoln, Ranking Member Chambliss and the members of the committee for your thoughtful consideration of our concerns. We look forward to working with you to contain systemic risk while promoting stability and transparency as part of the ongoing economic recovery.

Attachment: October 2, 2009, Coalition Letter to Senate Majority Leader Reid

## Appendix

### Coalition for Derivatives End-Users Steering Committee

**Business Roundtable**: Business Roundtable is an association of chief executive officers of leading U.S. companies with more than $5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and pay nearly half of all corporate income taxes paid to the federal government. Annually, they return $133 billion in dividends to shareholders and the economy. Business Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with more than $70 billion in annual research and development spending – more than a third of the total private R&D spending in the United States. **Contact**: Larry Burton, lburton@businessroundtable.org, 202 496-3264.

**Financial Executives International (FEI)**: FEI is a professional association, representing the interests of more than 15,000 CFOs, treasurers, controllers, tax directors, and other senior financial executives from over 8,000 major corporations of all sizes. FEI represents both the providers and users of financial information. **Contact**: Cady North, cnorth@financialexecutives.org, 202 626-7803.

**National Association of Manufacturers (NAM)**: The NAM – the nation's largest industrial trade association – represents large, mid-size and small manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. **Contact**: Dorothy Coleman, dcoleman@nam.org, 202 637-3077.

**National Association of Real Estate Investment Trusts (NAREIT)**: NAREIT is the representative voice for U.S. REITs and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. **Contact**: Kirk Freeman, kfreeman@nareit.com, 202 739-9400.

**The Real Estate Roundtable**: The Real Estate Roundtable (Roundtable) provides a forum for top U.S. real estate and political leaders to discuss major policy issues and their implications for real estate and the economy. Collectively, Roundtable members' portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. **Contact**: Chip Rodgers, crodgers@rer.org, 202 639-8400.

**U.S. Chamber of Commerce**: The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. **Contact**: Ryan McKee, RMcKee@USChamber.com, 202 463-5887.

# Coalition for Derivatives End-Users

Identical Letter Sent To Each Member Of The Senate

October 2, 2009

The Honorable Harry M. Reid
United States Senate
522 Hart Senate Office Building
Washington, DC 20510

Dear Senator Reid:

The undersigned companies and trade associations—representing diverse segments of American industry and serving virtually all U.S. consumers—support efforts by Congress to improve transparency, accountability and stability in the nation's financial markets. As you develop a regulatory framework, we strongly urge policymakers to preserve the ability of companies to manage their individual risk exposures by ensuring access to reasonably priced and customized over-the-counter (OTC) derivative products.

Business end-users rely on OTC derivatives to manage risks including fluctuating currency exchange, interest rates, and commodity prices. By insulating companies from risk, customized OTC derivatives provide businesses with access to lower cost capital—enabling them to grow, make new investments and retain and create new jobs.

In contrast, some reform proposals would place an extraordinary burden on end-users of derivatives in every sector of the economy—including manufacturers, energy companies, utilities, healthcare companies and commercial real estate owners and developers. Specifically, proposals that would require all OTC derivatives used by business end-users to be centrally cleared, executed on exchanges or cash collateralized or subject end-users to capital charges, would inhibit companies from using these important risk management tools in the course of everyday business operations. These proposals, which would increase business risk and raise costs, are at cross purposes with the goals of lowering systemic risk and promoting economic recovery.

In order to promote U.S. competitiveness and economic growth, policymakers must ensure that any financial services reform effort allows U.S. business to manage the risks inherent to their businesses. In today's challenging economy, access to customized derivatives helps businesses maintain operations, invest in new technologies, build new plants and retain and expand workforces.

Thank you for your thoughtful consideration of our request. We look forward to working with you to promote stability and transparency as part of the ongoing economic recovery.

Sincerely,

3M
Acadia Realty Trust
Air Products and Chemicals, Inc.
Allegheny Technologies Incorporated
Alpha Natural Resources
AMB Property Corporation
AMC Entertainment Inc.

Ameren Services
American Chemistry Council
American Electric Power
American Forest & Paper Association
American Gas Association
American Residential Communities LLC
Anadarko Petroleum Corporation

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API - American Petroleum Institute
Apple Inc.
ARAMARK Corporation
Associated Estates Realty Corporation
Association for Financial Professionals
Bayer Corporation
Behringer Harvard
Boston Scientific Corporation
BP America
Brady Corporation
Brookdale Senior Living Inc.
Bunge
Business Roundtable
Cabot Corporation
Cargill, Incorporated
Caterpillar Inc.
CDW Corporation
Chesapeake Energy Corporation
CNL Financial Group
Coca-Cola Bottling Company United, Inc.
Cohen Brothers Realty Corporation
Commercial Developments International, Inc.
Commodity Markets Council
Community Health Systems
Compass Minerals
Constellation Energy
Cooper Tire & Rubber Company
Corning Incorporated
Corporate Properties of the Americas, LLC
Covidien
Cummins Inc.
Deere & Company
Devon Energy
Digital Realty Trust
Direct Energy
Dominion
Donaldson Company, Inc.
DTE Energy
Duke Energy Corporation
Dynegy
Eastman Chemical Company
Eaton Corporation
Ecolab
Edens & Avant
Edison Electric Institute
EFCO Corp.
El Paso Corporation
Electric Power Supply Association (EPSA)
Eli Lilly and Company
Emdeon Inc.
Enbridge Energy Partners and Subsidiaries
EnCana Oil & Gas (USA) Inc.
Energy Future Holdings
Entergy Corporation
Exelon Corporation
Financial Executives International
First Energy
FMC Corporation
Ford Motor Company
Forest City Enterprises, Inc.
FPL Group
GDF SUEZ Energy North America
General Electric Company
GID Investment Advisers LLC
Goodrich Corporation
Grove Property Fund LLC
Harley-Davidson, Inc.
HCA Inc.
HCR ManorCare
Health Care REIT, Inc.
Helix Funds
Hersha Hospitality Trust
Hobbico, Inc.
Host Hotels & Resorts, Inc.
IBM
Independent Petroleum Association of America
Industrial Energy Consumers of America
Information Technology Industry Council
Intel Corporation
International Housewares Association
Invenergy LLC
Johnson & Johnson
KBS Capital Advisors
KBS Real Estate Investment Trust
KBS Real Estate Investment Trust II
Kinder Morgan
Lefrak Organization Inc
Legacy Reserves LP
Lexmark
Loews Corporation
MarkWest Energy Partners, L.P.
MeadWestvaco

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Medtronic, Inc.
Meredith Corporation
Mid-America Apartment Communities, Inc.
MillerCoors
Millipore Corporation
Mississippi Manufacturers Association
Monday Properties
National Association of Manufacturers
National Association of Real Estate
 Investment Trusts
Natural Gas Supply Association
National Grid
National Gypsum Company
Newfield Exploration
Northwestern Energy
Novation Capital
Novelis Inc.
NRG Energy
Owens-Illinois, Inc.
PPL Corporation
Praxair, Inc.
Procter & Gamble
Progress Energy
PSEG
Questar Energy
Regency Centers Corporation
Retail Energy Supply Association
Ryder System, Inc.
ScanSource Inc.
Sempra Energy
Shell Oil Company
Simon Property Group, Inc.
Simons Petroleum, Inc.
Southern Company
Stellar Industries, Inc.
Strategic Hotels & Resorts, Inc.
Superior Graphite Co.
Superior Woodcraft, Inc.
Tenaska Marketing Ventures
Tenaska Power Services
Targa Resources
Tennant Company
Teradata Corporation
The Boeing Company
The Commonwealth Group, LLC
The Durst Organization
The JBG Companies
The John Buck Company
The Pinnacle Companies
The Process Gas Consumers Group
The Real Estate Roundtable
The Williams Companies
Thomas Properties Group, Inc.
TRW Automotive
United Launch Alliance
U.S. Chamber of Commerce
Vanguard Natural Resources, LLC
Vermeer Corporation
Volvo Group North America
Washington Gas
Weather Risk Management Association
Weingarten Realty Investors
Weyerhaeuser Company
Whirlpool Corporation
Xcel Energy
Yocum Oil Company
Zimmer, Inc.