Coalition for Derivatives End-Users

**Statement for the House Committee on Financial Services Hearing,
"Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness"**

October 7, 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 exchange and interest rates and commodity prices. The Coalition thanks Chairman Frank, Ranking Member Bachus, and the members of the committee for the opportunity to provide this statement for the record of the hearing held on October 7, 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. We remain concerned that some derivative reform proposals under consideration 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.

Customized, 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 and customized 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:

Customization is Critical

A key benefit of OTC derivatives for end-users is the customization of these products to manage a specific risk. A requirement that derivatives be traded 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 in turn 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.

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 rating or alternative security arrangement, should also be able to access derivatives on similar terms. Derivatives are simply an alternative method for a bank to extend credit and should be recognized as such. At a time when the Administration is urging banks to restore liquidity to the economy, it may be counterproductive to close down this form of lending.

Therefore, we oppose mandated central clearing or bilateral margining for OTC derivatives transactions that involve end-users, which currently comprise less than 15% of all such transactions. 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, non-financial companies need their most liquid assets for their working capital and investment purposes. 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 two major swap participants that are not end-users. Since derivatives transactions that occur between two major swap participants that are not end-users comprise over 85% of the market, requiring these trades to be cleared through regulated central counterparties would reduce systemic and counterparty 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.

Capital Requirements Should be Focused on the Transactions that Pose Systemic Risk

OTC derivatives are contracts between two parties to exchange financial risk. 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, not to push derivatives trading activity toward exchanges by penalizing OTC trades. While bank 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.

Implementation of new Regulations should Promote Market Stability, Oversight and Transparency

The Coalition believes that the successful implementation of any new regulation depends on harmonization and a clear delineation of regulatory authorities and functions among the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and other agencies. This is necessary to provide certainty to the market and to ensure similar products are governed by similar standards. Duplication that would result in excessive or ill-fitting restrictions that would hinder market access must be avoided.

Furthermore, the Coalition believes that any new rules should apply only on a prospective basis. If new rules apply retroactively to pre-existing risk management tools, the change in credit terms and costs could potentially cause grounds for the termination of these arrangements, suddenly exposing the firms to the precise price risk they intended to mitigate.

COMMENTS ON THE CHAIRMAN'S DRAFT LEGISLATION

The Coalition applauds Chairman Frank for his efforts to address the concerns of business end-users in his draft legislation. His draft satisfies many of the principles we have enumerated above, and of the proposals under review over the past several months, it provides the clearest exemptions for end-users.

For example, the Coalition supports the clarification of the definition of "major swap participant" to exclude end-users that hold positions, "primarily for hedging (including balance sheet hedging) or risk management positions." This is an improvement over the Administration proposal, which relied on the definition of an effective hedge under Generally Accepted Accounting Principles (GAAP). This language is important because many end-users who are managing risk do not elect to use these accounting standards. Additionally, we believe that the regulation of OTC derivatives should not be outsourced to the Financial Accounting Standards Board (FASB). This is particularly true now, when the rule that governs effective hedging, FAS 133, is being reviewed for modification – creating significant uncertainty for derivatives end-users.

Furthermore, the Coalition is pleased that Chairman's draft clearly exempts end-users who are not major swap participants from requirements that derivatives transactions be executed through a clearinghouse or exchange. Additionally, the draft is an improvement over the

Treasury proposal, which would have given clearinghouses the authority to determine which contracts should be cleared.

However, the Coalition has some remaining concerns. Our primary concerns with the discussion draft are included below. We continue to analyze the Chairman's draft and its potential impact on end-users, and we look forward to continued conversations with the Chairman, the Ranking Member, Members of the Committee and staff.

While we are pleased that the Chairman's bill is clear that any margin requirement imposed on end-users must allow non-cash assets to serve as collateral, we are concerned that the Chairman's draft authorizes regulatory agencies to impose margin requirements on end-users that enter into derivatives transactions that are not centrally cleared.

We believe 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. We believe that the legislative text should explicitly allow financially sound end-users that do not pose systemic risk to continue to access derivative products without margin requirements.

Similarly, we remain concerned that the Chairman's bill 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.

CONCLUSION

The Coalition thanks Chairman Frank, Ranking Member Bachus 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: Sign-on Letter from the Coalition Members and Individual Companies

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.