Coalition for Derivatives End-Users

Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House Committee on Financial Services

"Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act"

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Mr. Chairman, Ranking Member Waters, other members of the Subcommittee, I want to thank you for inviting the Coalition for Derivatives End-Users to be represented at this important hearing. The Coalition includes more than 300 end-user companies and trade associations and, collectively, we represent thousands of end-users from across the economy. Our members are united in one respect; they use derivatives to manage risk, not create it.

The breadth and diversity of the Coalition demonstrates the widespread use of derivatives by Main Street businesses and helps drive home the real economic consequences of getting derivatives regulation wrong. Many U.S. companies are able to maintain more stable and successful operations through the use of a variety of risk management tools, including derivatives.

Yet, derivatives use by end-users must be put in perspective. End-user trades account for less than 10% of the notional value of the overall derivatives market.

The Coalition has been very engaged throughout the regulatory process, meeting with regulators dozens of times and submitting nearly 20 comment letters. We very much appreciate the receptivity of regulators to hearing our concerns and for taking the time to meet and speak with us on numerous occasions. Our goal is to remind policymakers that end-users rely on derivatives to reduce risk; bring certainty and stability to their businesses; and, ultimately, to benefit their customers.

We also work with Congress—and in particular with your committee—on legislative means to prevent unnecessary regulatory burdens from being imposed on Main Street businesses. On behalf of the Coalition, I would like to take a moment to thank the Financial Services Committee for its hard work in helping to move legislation through the House to address some of the unintended consequences of the Dodd-Frank Act. H.R. 2682, introduced by Cong. Grimm and Peters, was approved

unanimously by this Committee and by a 370-24 margin in the full House. The bill creates a narrow exemption from margin requirements for non-financial businesses that use derivatives in their commercial operations. This Committee also gave unanimous approval to H.R. 2779, introduced by Cong. Stivers and Fudge. The bill, which passed the full House 357-36, prevents internal, inter-affiliate trades from being subject to regulatory burdens that were designed to be applied only to market-facing swaps and, when amended, will ensure that companies are not forced to abandon hedging through central risk-mitigation centers. The overwhelmingly bi-partisan and collegial process that led to passage of H.R. 2682 and H.R. 2779 in the House demonstrates that there are changes to the Dodd-Frank Act that make sense and can achieve a consensus, and that can help grow business and improve the economy.

With regulatory compliance deadlines for end-users looming in the next few months, however, the Coalition is concerned with the direction in which certain rules appear to be heading. We are primarily concerned about regulations relating to margin and capital requirements, inter-affiliate trades, treasury hedging centers, and the application of rules across borders. I will touch upon each concern briefly.

The proposed margin requirements—and particularly those proposed by the prudential banking regulators—are especially troubling and would harm Main Street businesses. Congress was clear both throughout the legislative process and in the text of the Dodd-Frank Act that end-users should not be subject to margin requirements because they do not meaningfully contribute to systemic risk. Congress also made clear that imposing margin requirements would unnecessarily impede end-users' ability to efficiently and effectively manage risks. As proposed, however, the rules contradict congressional intent and would impose unnecessary margin requirements on end-users, diverting working capital away from productive business use. A survey conducted by our Coalition found that a 3% initial margin requirement could reduce capital spending by as much as $5.1 to $6.7 billion among S&P 500 companies alone and cost 100,000 to 120,000 jobs.

Capital requirements, too, could make managing risk prohibitively expensive for end-users. Even if margin is not imposed on end-users, overly-aggressive capital requirements could make the exemption pointless. Therefore, the Coalition believes that exposures subject to Basel capital requirements should not be subject to margin requirements or should be subject to substantively less onerous margin requirements than have been proposed by the CFTC.

We are also concerned that inter-affiliate derivatives trades, which take place between affiliated entities within a corporate group, may face the same regulatory burdens as market-facing swaps. There are two serious problems that need

addressing. First, under the CFTC's proposed rule, financial end-users would have to clear purely internal trades between affiliates unless end-users posted variation margin between the affiliates or met specific requirements for an exception. If end-users have to post variation margin, there is little point to exempting inter-affiliate trades from clearing requirements, as the costs could be similar. And let's not forget the larger point—internal end-user trades do not create systemic risk and, hence, should not be regulated the same as those trades that do.

Second, many end-users—approximately one-quarter of those we surveyed—execute swaps through an affiliate. This of course makes sense, as many companies find it more efficient to manage their risk centrally, and to have one affiliate trading in the open market, instead of dozens or hundreds of affiliates making trades in uncoordinated fashion. But it appears from the regulators' interpretation of the Dodd-Frank Act that purely non-financial end-users will face a choice; either dismantle their central hedging centers and find a new way to manage risk or clear all of their trades. Stated another way, this problem threatens to deny the end-user clearing exception to end-users because they have chosen to hedge their risk in an efficient, highly-effective and risk-reducing way. It is difficult to believe that this is the result Congress hoped to achieve.

Finally, the proposed cross-border guidance is also a cause for concern for the Coalition. The guidance would impose additional costs on end-users and would diminish their available choices of counterparties. We are also concerned by the CFTC's creation of a new regulated entity found nowhere in the four corners of the Dodd-Frank Act. The term "conduit," as used in the proposed guidance, could be applied to central hedging centers and, again, could force end-users to abandon these efficient structures for executing trades.

Throughout the congressional development of the Dodd-Frank Act and the regulatory process that has followed its passage, the Coalition has advocated for a more transparent derivatives market through the imposition of thoughtful, new regulatory standards that enhance financial stability while avoiding needless costs on end-users. We believe that imposing unnecessary regulation on derivatives end-users, which did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy. In short, end-users should not face the same regulatory burden as those who speculate and create systemic risk.

Thank you, and I am happy to address any questions that you may have.