
Coalition for Derivatives End-Users



Statement of the U.S. Chamber of Commerce and The Coalition for Derivatives End-Users

**ON: To Review the Impact of Capital and Margin
Requirements on End-Users**

**TO: Subcommittee on Commodity Exchanges, Energy,
and Credit, U.S. House Committee on Agriculture**

**BY: Thomas C. Deas, Jr., on behalf of the U.S. Chamber
of Commerce and the Coalition for Derivatives End-Users**

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The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

The Coalition for Derivatives End-Users represents the views of end-user companies that employ derivatives to manage risks. Hundreds of companies and business associations have been active in the Coalition on both legislative and regulatory matters and our message is straightforward: financial regulatory measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users, who are the engines of the economy. Imposing unnecessary regulation on derivatives end-users, parties that did not contribute to the financial crisis, would fuel economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy.

**Testimony before the Subcommittee on Commodity Exchanges, Energy, and
Credit, U.S. House Committee on Agriculture
“To Review the Impact of Capital and Margin Requirements on End-Users”
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Competitiveness and Coalition for Derivatives End-Users
April 28, 2016**

Mr. Chairman, Ranking Member Scott, other members of the Subcommittee, thank you for inviting me to testify at this important hearing, which focuses on matters of significant concern to the end-user community. I am Thomas C. Deas, Jr., Chairman of the National Association of Corporate Treasurers, an organization of treasury professionals from several hundred of the largest public and private companies in the country. I am testifying today on behalf of both the U.S. Chamber of Commerce (“Chamber”) and the Coalition for Derivatives End-Users (“Coalition”). The Chamber is the world’s largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions. The Coalition includes more than 300 end-user companies and trade associations, including the National Association of Corporate Treasurers. Collectively, the Chamber and the Coalition represent a wide and diverse population of domestic and international commercial businesses and trade associations.

As detailed below, we strongly believe that there are many capital and liquidity requirements impacting our counterparties that will directly impede the ability of end-users to effectively manage risks and result in higher costs for the end-user community, and ultimately consumers. Specifically, these include:

- The Net Stable Funding Ratio;
- The Supplemental Leverage Ratio;
- Restrictions on Models for Non-Bank Swap Dealers;
- Competitive Issues Surrounding the Credit Valuation Adjustment;
- The Swap Dealer *De Minimis* Threshold; and
- The Cumulative Impact of Capital Rulemakings on End-Users

Background

The Chamber's mission is to ensure America's global leadership in capital formation by supporting robust capital markets that are the most fair, transparent, efficient, and innovative in the world. As part of that mission, the Chamber recognizes the acute need for commercial end-users to effectively manage risk. Similarly, the Coalition, representing the engines of our domestic and global economy, has consistently supported financial regulatory measures that promote economic stability and transparency without imposing undue burdens on derivatives end-users.

At the outset, let me thank the members of this subcommittee and the full committee for their bipartisan efforts and focus on ensuring that Main Street businesses have the tools and access to capital necessary to operate and grow. Last year, you led the charge in enacting key legislation to protect end-users, including the end-user margin bill, which clarified that end-users are not subject to margin requirements for their uncleared swaps, and the centralized treasury unit bill, which helped ensure that end-users can continue to use a risk-reducing best practice. Similarly, the Commodity End-User Relief Act includes several provisions that will provide immediate relief to end-users who rely on risk management tools to keep their operations and businesses running during times of uncertain volatility.

Despite these laudable efforts, however, end-users still face the distinct possibility that their hedging activities will become too costly because of new and higher capital, margin and liquidity requirements imposed on their bank and non-bank counterparties. In essence, this means that the significant progress Congress has made to ensure that end-users do not bear the brunt of costs associated with derivatives risk management, including exemptions from clearing and margin requirements, are pyrrhic victories. In particular, I wish to highlight the impact of the following capital and liquidity requirements, which have resulted either in higher costs for end-users (or will do so once fully implemented) or will incentivize end-user counterparties to leave the market altogether.

Net Stable Funding Ratio

The Chamber and the Coalition believe that the Basel Committee of Banking Supervision's net stable funding ratio ("NSFR") which would lead to billions in additional funding requirements for derivatives activities, does not take into account the impacts on end-users. This is especially concerning given that many of the provisions of the NSFR would further restrict end-users' ability to hedge by increasing the cost of risk management and could lead to decreased liquidity in the derivatives

markets. We understand that the Prudential Banking Regulators released their proposed rules on the NSFR earlier this week and we will be carefully reviewing their proposals and evaluating the impact on end-users.

In particular, the concern is two-fold: (1) long-term funding costs required under the NSFR limit and discourage dealer involvement in derivatives and derivatives-related transactions, effectively reducing liquidity in the market that end-users rely on to hedge risk; and (2) costs associated with capital-raising in a less liquid market would inevitably be borne by derivatives end-users and consumers. The immediate impact of the NSFR can already be seen as fewer bank counterparties are willing to extend longer-term credit, including in the form of swaps used to hedge long-term exposures. Additionally, the costs to hedge are likely to be passed on to end-user companies in the form of increased fees or transaction costs, less favorable terms, and collateral requirements.¹

These concerns are particularly reflected in the add-on costs associated with counterparty payables; the treatment of uncollateralized receivables; the lack of collateral offsetting provisions; and the liquidity squeeze related to the treatment of corporate debt. For example, requiring dealer counterparties to provide required stable funding for 20% of the negative replacement cost of derivative liabilities (before deducting variation margin posted) is a clear example of the direct burdens that would affect end-users' ability to efficiently mitigate risk.

Another concern under the NSFR is the treatment of dealers with respect to uncollateralized net receivables, which could require 100% long-term funding. As we are now seeing, end-users are being required to collateralize transactions with cash margin to meet the stringent Basel III leverage ratio requirements. Or, if a dealer counterparty did not demand collateral, the costs of long-term funding could simply be passed on to end-users through embedded derivatives fees.

Moreover, we believe that disproportionate discounting of collateral posted forces dealers to mitigate costs elsewhere. As a result, in implementing the NSFR, the Prudential Banking Regulators should align collateral posted by commercial end-users with long-term funding obligations under NSFR. This is particularly true because, while most end-users are exempted from posting margin for their derivatives with bank counterparties, the "back to back" hedges entered into by banks to offset end-user transactions are still subject to mandatory clearing and margin requirements.

¹ A January 2015 study of the OTC derivatives market by Oliver Wyman concluded that the NSFR's treatment of OTC derivatives would require an additional \$500 billion in long-term funding, generating \$5-8 billion in incremental costs to the industry, with a cost increase of 10-15% for derivatives transactions.

Consequently, the costs borne by banks to offset end-user transactions are passed on to the very end-users that were meant to be exempt from the costs of mandatory clearing and margin requirements—and ultimately to consumers.

Further, the NSFR's treatment of corporate debt could hinder end-user capital raising efforts. The NSFR does not take into account the maturity of end-user-issued debt when determining a dealer's required stable funding and would restrict liquidity in the corporate debt markets by requiring dealers to raise 50-85% long-term funding to support their inventory, which would discourage market making. End-users rely on market-based funding and the importance of liquid markets for corporate bonds and commercial paper ("CP"). To cite a real-world example of the costs and diminished liquidity from these rules, many corporate treasuries issue CP daily to balance their funding requirements. If they are faced with a same-day payment that they identify too late in the day to complete a placement in the market of the required CP, their bank CP dealer frequently will take the paper overnight for its own account and fund-out the requirement the next day. The NSFR rules require the bank to hold 85% of that overnight funding as long-term funding – at a cost over ten times the overnight amount. Ultimately this liquidity will no longer be available to end-user treasury departments. Accordingly, the Prudential Banking Regulators should carefully consider the impact of the NSFR's 50-85% long-term funding requirements on end-users.

Supplemental Leverage Ratio

The supplemental leverage ratio ("SLR") penalizes high quality assets and acts as a disincentive to market participants to provide clearing services. The SLR does not permit the clearing member to take "credit" for the segregated initial margin posted by its customer that is expressly for the purpose of limiting the clearing member's exposure to derivatives. Further, segregated initial margin in the form of cash may be required to be added to a clearing member's balance sheet exposure, requiring additional capital. The overall result of the SLR seems to ignore the fact that for derivatives cleared on behalf of a customer, the customer's segregated initial margin must be held to margin the customer's positions and cannot be used as leverage by the clearing firm.

Ultimately, the failure of the SLR to recognize the risk-reducing effect of segregated client collateral will likely lead to fewer banks willing to provide clearing services for customers, thus constraining the ability of end-users that clear derivatives to access central clearing. Further, even end-users that do not clear their derivatives will likely see the impact of the SLR in the form of increased costs for hedging, as their bank counterparties will see their clearing costs increase on their back to back

hedges and will pass those costs along to end-users. We are hopeful that regulators can work together to get this right in the United States and abroad.

Restrictions on Models for Non-Bank Swap Dealers

Another significant issue directly impacts non-bank swap dealers, many of which routinely do business with end-users. As proposed in 2011, the CFTC's capital rules for non-bank swap dealers do not permit the use of internal models for computing market risk and counterparty credit risk charges for capital purposes. Instead, they must use the "standardized approach," which measures market risk according to standards established by the Basel Committee on Banking Supervision, generally requiring capital for both "general" and "specific" risks.

These two approaches differ significantly, particularly with respect to dealing in commodity derivatives. For many asset classes, non-bank swap dealers using the standardized approach would be required to hold regulatory capital potentially hundreds of times more than swap dealers using the internal models approach. This regulatory disparity will ultimately force those dealers to exit the business, leaving end-users with fewer choices for access to risk mitigation tools. Moreover, the disparity creates an unlevel playing field between bank and non-bank dealers participating in the same markets, ultimately resulting in higher costs for end-users.

In this respect, Section 311 of the Commodity End-Users Relief Act would permit the use of comparable financial models by non-bank swap dealers and major swap participants. This provision would help ensure comparability in capital requirements across all swap dealers (whether bank or non-bank) and eliminate a commercial disparity that only raises costs on end-users that decide to do business with non-bank swap dealers.

Competitive Issues Surrounding the Credit Valuation Adjustment

European policymakers have implemented capital charges on derivatives positions significantly more favorable to end-users than the U.S. Prudential Banking Regulators. The European approach recognizes that end-users' hedging activities are in fact reducing risks, and accordingly, exempts end-user derivatives transactions from the credit valuation adjustment ("CVA") risk capital charge, which would otherwise require the calculation and subsequent holding of capital to mitigate counterparty credit risk in a derivatives transaction. The absence of a U.S. exemption puts American companies at a meaningful competitive disadvantage compared to our European competitors.

In particular, we note that lack of a CVA exemption forces end-users to enter into credit support enhancement agreements that a bank would normally not deem necessary in the absence of regulation. If banks require collateral, end-users may be put in the position of borrowing from financial institutions to finance the margining associated with those transactions, resulting merely in a shift of risk between financial institutions. This result contradicts the objective of facilitating end-user access to capital, drives costs directly to end-users, and does nothing to mitigate risk within the financial system, as the risk is simply being transferred from one bank to another.

Swap Dealer De-Minimis Threshold

Finally, we believe that the CFTC should follow clear Congressional intent and promptly draft an interim final rule that makes clear that the swap dealer *de minimis* exception threshold shall remain at the \$8 billion gross notional level or be raised. The Chamber and Coalition are concerned that any decrease below the current \$8 billion level could reduce liquidity and the availability of counterparties for end-users to trade with, thereby concentrating risk in fewer counterparties and negatively impacting end-users' ability to hedge.

Indeed, we believe that the swap dealer *de minimis* exception should remain broad enough to exclude swap dealing activities that do not rise to the level of systemic significance, either because the level of activity or the type of transaction. Lowering the threshold from the \$8 billion gross notional amount would needlessly and unnecessarily capture a significant number of additional market participants and require them to register as swap dealers or, more likely, reduce their available products and services to derivatives end-users to ensure they remain below the thresholds.

Any decrease from the current threshold would likely cause a further consolidation of swap dealing activities, reducing competitiveness and potentially increasing risk. Such changes to the market would reduce liquidity to end-users, reduce counterparty selection and increase interconnectedness of counterparties—results that run contrary to the goals of the Dodd-Frank Act.

In this respect, we fully support Section 310 of the Commodity End-Users Relief Act, which would set the *de minimis* threshold of swap dealing at \$8 billion. This section would ensure that the *de minimis* threshold could only be amended or changed through a new affirmative rulemaking by the CFTC.

Cumulative Impact of Capital Rulemakings on End-Users

In summary, we believe the legislative intent of the Dodd-Frank Act was to exempt end-users from having to use their own capital for mandatory margining of derivatives transactions, diverting these funds from investment in business expansion and ultimately costing jobs. The imposition of additional capital requirements by U.S. Prudential Banking Regulators would undermine this intent by forcing our bank counterparties to hold much more of their own capital in reserve against end-users' derivatives positions, passing on the increased costs to these end-users.

The larger point, which I know this Subcommittee appreciates, is that the cumulative effect of new derivatives regulation threatens to impose undue burdens on end-users. The indirect but potentially even more onerous regulation of end-users through bank capital and liquidity requirements serves to discourage end-user risk management through hedging and would effectively negate the benefits of Congress's clear intent to exempt end-users from margin requirements. The importance of smart prudential regulation that promotes Main Street business has been echoed by Members of Congress, including by Chairman Conaway, who has noted that bipartisan efforts must "protect end-users from being roped into reporting, registration, or regulatory requirements that are inappropriate for the level of risk they can impose on financial markets. It is clear that end-users did not cause the financial crisis, they do not pose a systemic risk to the U.S. financial markets, and they should not be treated like financial entities."²

We need a regulatory system that allows Main Street to effectively use derivatives to hedge commercial risk, resulting in key economic benefits; one that allows businesses—from manufacturing to healthcare to agriculture to energy to technology—to improve their planning and forecasting, manage unforeseen and uncontrollable events, offer more stable prices to consumers and contribute to economic growth. End-users are entering into derivatives to mitigate the business risks they face in their day-to-day business activities. In this respect they are fundamentally different from swap dealers who maintain an open book of exposures against which posting of cash margin is not unwarranted. However, when rules intended to apply to swap dealers directly or indirectly burden end-users, it is the end-user segment of our economy that bears the higher costs. The imposition of unnecessary burdens on end-user businesses restricts job growth, decreases

² Press Release, *Congressman Conaway Praises Approval of the Customer Protection and End User Relief Act*, U.S. Representative Mike Conaway (Apr. 9, 2014), available at <http://agriculture.house.gov/news/documentsingle.aspx?DocumentID=1110>.

investment and undermines our competitiveness in Europe and elsewhere across the globe—leading to material cumulative impacts on corporate end-users and our economy.

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