Hearing to Review the Impact of G-20 Clearing and Trade Execution Requirements

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Good afternoon Chairman Scott, Ranking Member Scott, and members of the subcommittee. I thank you for the opportunity to testify today regarding aspects of the Dodd-Frank Act that emanated from the G-20 agenda for OTC derivatives. My name is Luke Zubrod and I am a Director at Chatham Financial ("Chatham"). Chatham is an independent advisory and technology firm providing services to businesses that use derivatives to reduce their interest rate, foreign currency and commodity price risks ("end users"). A global firm based in Pennsylvania, Chatham serves as a trusted advisor to over 1,800 end-user clients annually ranging from Fortune 100 companies to small businesses, including clients headquartered or doing business in every state represented by members of this subcommittee. Since our founding in 1991, we have advised clients on nearly $4 trillion in hedging transactions.

Chatham's clients rely on derivatives to reduce business risks, not for trading or speculative purposes. This risk reduction activity benefits the global economy, by allowing a range of businesses – from manufacturing to agriculture to real estate to financial services – to improve planning and forecasting, and offer more stable prices to consumers and a more stable contribution to economic growth.

Chatham supports the Dodd-Frank Act's aims of reducing systemic risk and increasing transparency in the derivatives market. We also appreciate the bipartisan efforts of this body to ensure that regulatory burdens are proportionately applied, taking into account an entity's potential ability to jeopardize financial stability. In particular, we appreciate efforts to address key concerns of nonfinancial end users following the passage of Dodd-Frank, including efforts to clarify that margin and clearing requirements should not apply to such end users and their centralized treasury units. These efforts were instrumental in eliminating key barriers to efficient access of the derivatives market.

Today, I will identify two similar barriers affecting a range of financial end users that use low volumes of derivatives to reduce risk. In particular, clearing and margin requirements, when applied to those transacting low volumes of OTC derivatives, deter such end users from managing their risks, cause them to manage their risks poorly or dictate that they manage such risks at significant expense. Indeed, per transaction costs for low-volume users are especially high when compared to the costs applicable to larger users – a fact that is at odds with their relative contributions to systemic risk.

Chatham’s clients facing unwarranted burdens due to clearing and/or margin requirements touch a wide variety of industries, including the following:

- **Corporates** deemed to be financial in nature under Title VII (e.g., technology companies that process certain types of payments);
- **Real estate and infrastructure funds** that make cross-border investments in buildings, railroads, ports and other such physical assets;
- **Regional banks** that use limited quantities of derivatives products or are contemplating using such products to serve their customers, reduce risk or compete with larger banks in their footprints, and that do not otherwise qualify for the small bank exemption;
- **Microfinance funds** whose capital is directed toward enabling the world’s poor to lift themselves and their families from poverty in developing countries.

While the businesses in which these firms engage vary widely, such firms share at least two characteristics: they (1) use derivatives to manage and reduce risk and (2) do not use quantities of derivatives that are sufficient to jeopardize financial market stability.

Let's consider the burdens such firms face, assess whether such burdens are necessary for the mitigation of systemic risk and consider what actions might alleviate unnecessary burdens.

The first burden relates to the **cost of clearing for low-volume users**. Clearing members typically charge minimum monthly fees to establish a relationship that would enable a customer to comply with the clearing mandate. These fees vary by firm and customer but typical fees amount to **one hundred thousand dollars per year or more**. Consider a firm that does not qualify for the end-user exception and needs to hedge a single interest rate risk over a five year period, as might be the case for a firm entering into a variable rate bank loan. That firm will obligate itself to a **half million dollars** in fees over that period just to have the privilege of hedging in the OTC derivatives market.

The second burden relates to **risk imposed by the margin requirements** applicable to cleared swaps and soon to be applicable to swaps that are not centrally cleared. Margin requirements expose a company to new risks that many firms are unwilling to take on – especially liquidity risk. Liquidity risk is the risk that a sudden sharp movement in market conditions could cause a company, via a margin call, to come up with sums of cash that are significant to the company on short notice. In an extreme case, such a margin call could cause a firm to default on an obligation. At a minimum, a firm will need to hold back funds that it might otherwise invest in its business to ensure it has enough cash on hand to meet margin calls.

Consider the aforementioned firm with a five year interest rate risk. Such a firm might be concerned that in today's historically low interest rate environment, increasing rates could adversely affect their ability to make payroll. In the OTC derivatives market, such a firm could fully eliminate such risk by entering into a five year interest rate swap to lock in a fixed interest rate. Prior to the clearing mandate, such a firm might have been able to negotiate a credit arrangement that did not require it to post cash margin. Rather, banks were able to manage credit risk to such borrowers through a variety of other means. The borrower was able to enter into the swap without any upfront fees – all costs associated with the swap were included in the fixed interest rate paid to the bank. On a $100 million swap, a firm would need to post approximately $2 million at inception, which could grow to as much as **$25 million** in a stressed market such as was seen during the financial crisis (or approximately $12 million in normalized market conditions). These amounts are illustrative of liquidity risks and would not need to be diverted from productive use if a firm were exempt from the clearing and margin requirements.

These costs and risks create unintended consequences by negatively impacting the risk management decisions many firms make. In particular, a firm's risk management behavior may change in three ways: the firm may (1) stop hedging, (2) hedge poorly or (3) hedge expensively.

1. **Stop Hedging**: Some firms respond to the high cost of clearing and margining by choosing not to hedge, retaining risk in their businesses that could unnecessarily jeopardize business performance or, in extreme cases, even a firm's viability.
2. **Hedge Poorly**: Some firms enter into risk management products that force them to retain some risks. For example, some firms avoid the liquidity risk associated with cleared and margined swaps by managing their risks with products like options that do not create uncertain demands on a company's cash. While this may satisfy a firm's risk management objective in the short term, option products generally become very expensive when hedging for longer periods, and so companies often buy less protection,

increasing their exposure to financial market gyrations over the long term.

3. **Hedge Expensively**: Some firms may proceed with entering into cleared swaps, but incur the substantial costs to do so. This in turn increases the cost of their services and/or dampens their ability to deliver returns to investors like pension funds.

While the benefits of clearing were widely understood when Congress enacted the clearing mandate, the costs were not. We now understand central clearing to be a system that simply does not accommodate small and low-volume users. The consequence is that entities whose derivatives use has no ability to undermine financial stability are cut off from properly or effectively managing their risks. **Small financial end users are essentially thrown into a raging see of market volatility without a dependable life preserver**.

These concerns could easily be addressed if Congress exempted low-volume users from clearing and margin requirements via a financial entities de minimis exception. Such an exception could be narrowly tailored to ensure that firms that meaningfully contribute to systemic risk would not be eligible. Congress has already recognized the principle underlying such an exception in Title VII of Dodd-Frank. However, that principle was narrowly applied to small banks and credit unions (i.e., those with less than $10 billion in assets) and does not include the various types of market participants identified in this testimony.

Numerous foreign governments, including Australia, Canada, Japan and Singapore, have exempted or proposed to exempt a range of financial entities whose transaction volumes are relatively small from their clearing and/or margining rules, effectively acknowledging the burdens such requirements create for smaller entities and the limited public policy benefits of encompassing such entities within the requirements' scope.

On the basis of the evidence now available on the cost of clearing and margin, the extent to which such costs adversely affect low-volume users, the recognition that such entities have limited ability to undermine financial stability, and the extent to which foreign governments have similarly exempted low-volume users, we urge policymakers to enact a financial entities de minimis exception from clearing and margin requirements. We believe such a policy would provide needed relief without increasing systemic risk.

We appreciate your attention to these concerns and look forward to supporting the subcommittee’s efforts to ensure that derivatives regulations, while fully reflecting the policy objectives of Dodd-Frank, do not unnecessarily burden American businesses, jeopardize economic growth, or harm job creation by creating barriers to tools used to reduce the risk of investing in the economy.

Thank you for the opportunity to testify today and I am happy to address any questions you may have.